

[4830-01-u]

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG-116050-99]

RIN 1545-AX65

Stock Transfer Rules: Carryover of Earnings and Taxes

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice of proposed rulemaking and notice of public hearing.

SUMMARY: This document contains proposed regulations addressing transactions described in section 367(b) of the Internal Revenue Code (section 367(b) transactions). A section 367(b) transaction includes a corporate reorganization, liquidation, or division involving one or more foreign corporations. The proposed regulations address the carryover of certain tax attributes, such as earnings and profits and foreign income tax accounts, when two corporations combine in a section 367(b) transaction. The proposed regulations also address the allocation of certain tax attributes when a corporation distributes stock of another corporation in a section 367(b) transaction. This document also provides notice of a public hearing on the proposed regulations.

DATES: Written or electronic comments and requests to speak (with outlines of oral comments) at a public hearing scheduled for March 13, 2001 must be received by February 20, 2001.

ADDRESSES: Send submissions to: CC:M&SP:RU (REG-116050-99), room 5226, Internal Revenue Service, POB 7604, Ben Franklin

Station, Washington, DC 20044. Submissions may be hand delivered Monday through Friday between the hours of 8 a.m. and 5 p.m. to: CC:M&SP:RU (REG-116050-99), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC.

Alternatively, taxpayers may submit comments electronically via the Internet by selecting the "Tax Regs" option on the IRS Home Page, or by submitting comments directly to the IRS Internet site at http://www.irs.gov/tax_regs/regslst.html. The public hearing will be held in room 7218, Internal Revenue Building, 1111 Constitution Avenue, NW., Washington DC.

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, Anne O'Connell Devereaux, at (202) 622-3850; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Guy Traynor, at (202) 622-7180 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, W:CAR:MP:FP:S:O,

Washington, DC 20224. Comments on the collection of information should be received by January 16, 2001. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information (see below);

How the quality, utility, and clarity of the information to be collected may be enhanced;

How the burden of complying with the proposed collection of information may be minimized, including through the application of automated collection techniques or other forms of information technology; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in this proposed regulation is in §1.367(b)-1. This collection of information is required by the IRS to verify compliance with the regulations under section 367(b) relating to exchanges described therein. The likely respondents are corporations that are affected by such exchanges.

Estimated total annual reporting burden: 1,800 hours.

The estimated annual burden per respondent is 3 hours.

Estimated number of respondents: 600.

Estimated annual frequency of responses: One.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

On December 27, 1977, the IRS and Treasury issued proposed and temporary regulations under section 367(b) of the Code. Subsequent guidance updated and amended the 1977 temporary regulations several times over the next 14 years. On August 26, 1991, the IRS and Treasury issued proposed regulations §§1.367(b)-1 through 1.367(b)-6 (the 1991 proposed regulations). Final regulations under section 367(b) of the Internal Revenue Code (Code) were issued in June 1998 and January 2000 and the 1977 temporary regulations and the 1991 proposed regulations were generally removed. The preamble to the January 2000 final regulations refers to proposed regulations that would be issued at a later date to address the carryover of certain corporate tax attributes in transactions involving one or more foreign corporations. Those proposed regulations are set forth in this document.

Overview

A. General Policies of Section 367(b)

In general, section 367 governs corporate restructurings under sections 332, 351, 354, 355, 356, and 361 (Subchapter C nonrecognition transactions) in which the status of a foreign corporation as a "corporation" is necessary for the application of the relevant nonrecognition provisions. Other provisions in Subchapter C (Subchapter C carryover provisions) apply to such transactions in conjunction with the enumerated provisions and detail additional consequences that occur in connection with the transactions. For example, sections 362 and 381 govern the carryover of basis and earnings and profits from the transferor corporation to the transferee corporation in applicable transactions and section 312 governs the allocation of earnings and profits from a distributing corporation in a transaction described in section 355.

The Subchapter C carryover provisions generally have been drafted to apply to domestic corporations and U.S. shareholders, and thus do not fully take into account the cross-border aspects of U.S. taxation. For example, sections 381 and 312 do not take into account source and foreign tax credit issues that arise when earnings and profits move from one corporation to another.

Congress enacted section 367(b) to ensure that international tax considerations in the Code are adequately addressed when the Subchapter C provisions apply to an exchange involving a foreign corporation in order to prevent the avoidance of U.S. taxation. Because determining the proper interaction of the Code's

international and Subchapter C provisions is “necessarily highly technical,” Congress granted the Secretary broad regulatory authority to provide the “necessary or appropriate” rules rather than enacting a complex statutory regime. H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975). Thus, section 367(b)(2) provides in part that the regulations “shall include (but shall not be limited to) regulations . . . providing . . . the extent to which adjustments shall be made to earnings and profits, basis of stock or securities, and basis of assets.”

The proposed regulations provide rules regarding the movement of certain corporate tax attributes between corporations in a Subchapter C nonrecognition transaction involving one or more foreign corporations. Generally, the regulations continue to apply the principles of the Subchapter C carryover provisions with modifications as necessary or appropriate to preserve international tax policies of the Code and to prevent material distortions of income.

The remainder of this Overview section is divided by specific categories of section 367(b) transactions and describes the relevant Subchapter C and international policies and provisions. The “Details of Provisions” portion of this preamble describes the proposed regulations’ principal operative rules that implement the policies and reconcile the provisions described in the Overview portion of this preamble. The IRS and Treasury welcome comments regarding both the general approach and the specific provisions of the proposed regulations.

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

Proposed §1.367(b)-3 addresses acquisitions by a domestic corporation (domestic acquiring corporation) of the assets of a foreign corporation (foreign acquired corporation) in a section 332 liquidation or an asset acquisition described in section 368(a)(1), such as a C, D, or F reorganization (inbound nonrecognition transaction).

The preamble to the January 2000 final regulations generally describes international policy issues that can arise in an inbound nonrecognition transaction. The preamble states that the “principal policy consideration of section 367(b) with respect to inbound nonrecognition transactions is the appropriate carryover of attributes from foreign to domestic corporations. This consideration has interrelated shareholder-level and corporate-level components.” The final regulations address the carryover of certain attributes, such as the carryover of foreign taxes, earnings and profits, and basis. However, the carryover of earnings and profits and basis are addressed only to the extent attributable to earnings and profits accumulated during a U.S. shareholder’s holding period, i.e., “the all earnings and profits amount,” as defined in §1.367(b)-2(d).

The preamble to the final regulations also notes that it would be consistent with the policy considerations of section 367(b) for future regulations to provide further rules with respect to the extent to which attributes carry over from a foreign corporation to a U.S. corporation. The proposed

regulations do not comprehensively address this issue. Compare Modify Treatment of Built-In Losses and Other Attribute Trafficking, General Explanations of the Administration's Fiscal Year 2001 Revenue Proposals at 205. However, the proposed regulations do provide additional rules concerning several attributes, specifically net operating loss and capital loss carryovers, and earnings and profits that are not included in income as an all earnings and profits amount (or a deficit in earnings and profits). The proposed regulations generally provide that these tax attributes carry over from a foreign acquired corporation to a domestic acquiring corporation only to the extent that they are effectively connected to a U.S. trade or business (or attributable to a permanent establishment, in the case of an applicable U.S. income tax treaty).

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

Proposed regulation §1.367(b)-7 applies to an acquisition by a foreign corporation (foreign acquiring corporation) of the assets of another foreign corporation (foreign target corporation) in a transaction described in section 381 (foreign 381 transaction) and addresses the manner in which earnings and profits and foreign income taxes of the foreign acquiring corporation and foreign target corporation carry over to the surviving foreign corporation (foreign surviving corporation). This would include, for example, a C, D, or F reorganization or a section 332 liquidation between two foreign corporations.

The international provisions of the Code distinguish between

categories of foreign corporations. A foreign acquiring, target, or surviving corporation can be a controlled foreign corporation as defined in section 953 or 957 (CFC), a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) after 2003, the effective date of section 1105(b) of Public Law 105-34 (111 Stat. 788) (the 1997 Act) (look-through 10/50 corporation and, together with CFCs, look-through corporations), a noncontrolled section 902 corporation before 2003 (non-look-through 10/50 corporation and, together with look-through 10/50 corporations, 10/50 corporations), or a foreign corporation that is neither a CFC nor a 10/50 corporation (less-than-10%-U.S.-owned foreign corporation).

The principal Code sections implicated by the carryover of earnings and profits and foreign income taxes in a foreign 381 transaction are sections 381, 902, 904, and 959. Section 381 generally permits earnings and profits (or deficit in earnings and profits) to carry over to a surviving corporation, thus enabling "the successor corporation to step into the 'tax shoes' of its predecessor. . . . [and] represents the economic integration of two or more separate businesses into a unified business enterprise." H. Rep. No. 1337, 83rd Cong., 2nd Sess. 41 (1954). However, a deficit in earnings and profits of either the transferee or transferor corporation can only be used to offset earnings and profits accumulated after the date of transfer (hovering deficit rule). Section 381(c)(2)(B). The hovering deficit rule is a legislative mechanism designed to deter the

trafficking in favorable tax attributes that the IRS and courts had repeatedly encountered. See, e.g., Commissioner v. Phipps, 336 U.S. 410 (1949). The proposed regulations adopt the principles of section 381 but adapt its operation in consideration of the international provisions that address foreign corporations' earnings and profits and their related foreign income taxes, such as sections 902, 904, and 959.

Section 902 generally provides that a deemed paid foreign tax credit is available to a domestic corporation that receives a dividend from a foreign corporation in which it owns 10 percent or more of the voting stock (i.e., a look-through corporation or non-look-through 10/50 corporation). The Code modifies the general last-in, first-out (LIFO) rule of section 316 and provides that look-through corporations and non-look-through 10/50 corporations pay dividends out of multi-year pools of earnings and profits and foreign income taxes for earnings and profits accumulated (and related foreign income taxes paid or deemed paid) in taxable years beginning after December 31, 1986, or the first day after which a domestic corporation owns 10 percent or more of the voting stock of a foreign corporation, whichever is later. Section 902(c). (The Code and regulations refer to pooled earnings and profits and foreign income taxes as post-1986 undistributed earnings and post-1986 foreign income taxes even though a particular corporation may begin to pool after 1986. Sections 902(c)(1) and (2), §1.902-1(a)(8) and (9).)

Congress enacted the pooling rules because it believed that

averaging of foreign income taxes was fairer than distributions out of annual layers. Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986 (Public Law 99-514) (1986 Bluebook) at 870. Averaging prevents taxpayers from inflating their foreign income tax rate for a particular year in order to obtain artificially enhanced foreign tax credits. *Id.* Averaging also prevents the trapping of foreign income taxes in years in which a taxpayer may have no earnings and profits. *Id.*

However, Congress enacted pooling on a limited basis. Earnings and profits accumulated (and related foreign income taxes paid or deemed paid) while a foreign corporation is a less-than-10%-U.S.-owned foreign corporation and pre-1987 earnings and profits accumulated (and related foreign income taxes paid or deemed paid) by a look-through corporation or non-look-through 10/50 corporation are not pooled. Rather, such earnings and profits (and related foreign income taxes) are maintained in separate annual layers. Section 902(c)(6). (The Code and regulations refer to earnings and profits and foreign income taxes in annual layers as pre-1987 accumulated profits and pre-1987 foreign income taxes even though a particular corporation may have annual layers for years after 1986. Section 902(c)(6); §1.902-1(a)(10).)

A distribution of earnings and profits is first out of pooled earnings and profits and then, only after all pooled earnings and profits have been distributed, out of annual layers of earnings and profits on a LIFO basis. Section 902(a) and (c).

The retention of annual layers beneath pooled earnings and profits limits the need to recreate tax histories, an administrative burden that is more significant for periods during which a corporation had limited nexus to the U.S. taxing jurisdiction and for pre-1987 earnings and profits when pooling was not required.

The section 904 foreign tax credit limitation ensures that taxpayers can use foreign tax credits only to offset U.S. tax on foreign source income. The limitation is computed separately with respect to different categories of income (baskets). The purpose of the baskets is to limit taxpayers' ability to cross-credit taxes from different categories of foreign source income. Congress was concerned that, without separate limitations, cross-crediting opportunities would distort economic incentives to invest in the United States versus abroad. 1986 Bluebook at 862.

A dividend received by a U.S. shareholder that owns less than 10 percent of the stock of a foreign corporation is categorized as passive income because such a dividend is in the nature of a portfolio investment. 1986 Bluebook at 866.

A dividend received by a U.S. shareholder that owns 10 percent or more of a foreign corporation is subject to other limitations. Dividends paid by a non-look-through 10/50 corporation to a 10 percent or greater U.S. corporate shareholder are currently subject to a separate basket limitation on a corporation-by-corporation basis. Congress initially separately basketed dividends from each 10/50 corporation because it

believed a minority investment in a foreign corporation did not create sufficient identity of interest to justify look-through treatment and that cross-crediting of taxes among investments in 10/50 corporations was inappropriate because the foreign companies were not parts of a single economic unit. 1986 Bluebook at 868. In addition, Congress was concerned about the administrability of applying the look-through rules to 10/50 corporations. 1986 Bluebook at 868.

In 1997, Congress amended the Code's treatment of dividends from 10/50 corporations to provide that dividends paid after taxable years beginning after December 31, 2002 by a look-through 10/50 corporation out of earnings and profits accumulated before 2003 are subject to a single separate basket limitation for all 10/50 corporations, while dividends paid out of earnings and profits accumulated after 2003 are treated as income in a basket based on the ratio of the earnings and profits attributable to income in such basket to the foreign corporation's total earnings and profits (the so-called "look-through" approach). Earnings and profits accumulated after 2003 by a look-through 10/50 corporation are distributed before earnings and profits accumulated by that same foreign corporation before 2003. Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in 1997 (1997 Bluebook) at 303.

The legislative history indicates that Congress changed its view with respect to 10/50 corporations because the separate basket limitation for dividends from each 10/50 corporation

imposed a substantial recordkeeping burden and discouraged minority investments in foreign joint ventures. 1997 Bluebook at 302. However, as described above, the 1997 Act enacted look-through treatment for 10/50 corporation dividends only on a limited basis. Furthermore, Congress provided regulatory authority regarding the treatment of distributions out of earnings and profits for periods prior to a taxpayer's acquisition of stock in a look-through 10/50 corporation because of concerns that look-through treatment could provide inappropriate opportunities to traffic in foreign taxes.

Dividends paid by a CFC out of earnings and profits accumulated while the corporation was not a CFC are treated as a distribution from a 10/50 corporation while dividends paid out of earnings and profits accumulated while the corporation was a CFC are eligible for look-through treatment. Section 904(d)(2)(E)(i) and (d)(3). As in the case of a look-through 10/50 corporation, pooled earnings and profits of a CFC that are eligible for look-through treatment are distributed before other pooled earnings and profits. Prop. Reg. §1.904-4(g)(3)(iii). Congress provided look-through treatment for dividends paid by CFCs in order to provide greater parity between the treatment of income earned through a branch and a subsidiary. 1986 Bluebook at 866.

Before 1997, except as otherwise provided in regulations, dividend distributions to a 10 percent U.S. shareholder of a CFC did not obtain look-through treatment unless the distributed earnings and profits accrued while the shareholder was a 10

percent U.S. shareholder and the corporation was a CFC. Section 904(d)(2)(E)(i), as in effect before the 1997 Act. This rule was intended to prevent trafficking in foreign income taxes related to preacquisition earnings and profits. However, because of the administrative issues presented by maintaining shareholder-level earnings and profits accounts, Congress modified the rule in 1997 to provide that look-through treatment applies with respect to CFC earnings and profits without regard to whether a 10 percent U.S. shareholder was a shareholder at the time accumulated. However, pre-CFC earnings and profits continue to be treated as earnings and profits of a 10/50 corporation because of foreign tax credit trafficking concerns.

The section 904 basketing rules reflect Congress' concern with respect to cross-crediting opportunities and its intent to limit the benefit of look-through treatment to appropriate circumstances. Where Congress determined that look-through is inappropriate, a dividend is treated as passive income or is subject to a separate limitation for 10/50 corporations (whether separately or collectively). Regulations have not yet been issued with respect to preacquisition earnings and profits of a look-through 10/50 corporation and the effect, if any, on the treatment of pre-CFC earnings and profits described in section 904(d)(2)(E)(i). The IRS and Treasury solicit comments as to the appropriate treatment of such earnings and profits after 2003 in light of Congress' anti-trafficking concerns, as well as the impact that such rules should have on the section 367(b)

regulations.

Another international provision implicated by the movement of earnings and profits in foreign 381 transactions is section 959. Section 959 governs the distribution of earnings and profits that have been previously taxed to U.S. shareholders under section 951(a) (PTI). After studying the interaction of section 367(b) and the PTI rules, the IRS and Treasury determined that more guidance under section 959 would be useful before issuing regulations to address PTI issues that arise under section 367(b). Accordingly, the IRS and Treasury have opened a separate regulations project under section 959 and expect to issue regulations that address PTI issues under section 959 as well as section 367(b) in the future. The fundamental issue under consideration in that project is whether earnings and profits that are treated as PTI should be distributable to another shareholder, as well as the various implications that result from that determination. The IRS and Treasury invite comments with respect to these issues. Accordingly, the proposed regulations reserve on section 367(b) issues related to PTI.

Other sections may have also applied to characterize pre-transaction earnings of a foreign acquiring corporation or a foreign target corporation for certain purposes of the Code. For example, certain earnings may have been subject to characterization as U.S. source earnings under section 904(g), effectively connected earnings and profits under section 884, or post-1986 undistributed U.S. earnings under section 245. The

characterization of such earnings carry over to the foreign surviving corporation for purposes of applying the relevant Code sections. See Georday Enterprises v. Commissioner, 126 F.2d 384 (4th Cir. 1942).

D. Specific Policies Related to Foreign Divisive Transactions (Prop. Reg. §1.367(b)-8)

Proposed regulation §1.367(b)-8 addresses the allocation of earnings and profits and foreign income taxes in a transaction described in section 312(h) (that is, a section 355 distribution whether or not in connection with a section 368(a)(1)(D) reorganization) in which either or both the distributing or the controlled corporation is a foreign corporation (foreign divisive transaction). The scope of proposed §1.367(b)-8 thus encompasses three situations: a domestic distributing corporation that distributes stock of a foreign controlled corporation, a foreign distributing corporation that distributes stock of a domestic controlled corporation, and a foreign distributing corporation that distributes stock of a foreign controlled corporation. The proposed regulations generally adopt the principles embodied in the regulations under section 312(h) but modify their application in consideration of the international provisions such as the source and foreign tax credit rules.

Regulations under section 312(h) reflect the principle that a pro rata portion of a distributing corporation's earnings and profits should be reduced to account for the distribution of a portion of its assets. §1.312-10. Furthermore, the earnings and profits of a controlled corporation should include the portion of

the distributing corporation's earnings and profits allocable to any assets transferred to the controlled corporation in connection with a section 368(a)(1)(D) reorganization (D reorganization) that immediately precedes the section 355 distribution (together with a D reorganization, a D/355 distribution). §1.312-10(a). If a section 355 distribution is not preceded by a D reorganization, the earnings and profits of the controlled corporation are at least equal to the amount of the reduction in the distributing corporation's earnings and profits. §1.312-10(b). It is likely that this rule was included to prevent taxpayers from using a section 355 distribution as a device to facilitate a bailout of earnings and profits through the controlled corporation. (The §1.312-10 rules are derived from the Senate's directions to the IRS and Treasury in implementing the regulatory authority in section 312(h); the Senate Report does not, however, explain its reasons for these rules. Senate Finance Committee, Report on H.R. 8300 (1954), at 249.)

The application of the §1.312-10 rules to foreign divisive transactions implicates the Code's international provisions because earnings and profits are moving in the cross-border context and because the earnings and profits of controlled foreign corporations are being adjusted. In transactions involving a domestic distributing corporation and a foreign controlled corporation, the foreign controlled corporation may succeed to earnings and profits of the domestic distributing

corporation. A post-transaction distribution by the foreign controlled corporation out of earnings and profits it receives from the domestic distributing corporation is generally eligible for the dividends received deduction and treated as U.S. source income under sections 243(e) and 861(a)(2)(C). This treatment is appropriate because the earnings and profits have already been subject to U.S. corporate taxation and should not be subject to a second level of U.S. corporate tax upon repatriation if the earnings and profits would have qualified for the dividends received deduction if distributed before the section 355 distribution. H.R. Rep. No. 2101, at 3 (1960). In addition, such earnings and profits should not increase a domestic distributee's foreign tax credit limitation under section 904.

In circumstances where the foreign controlled corporation makes a post-transaction distribution to foreign shareholders, the foreign divisive transaction should not alter the character of earnings and profits allocated from the domestic distributing corporation. Otherwise, the section 355 distribution may serve as a vehicle to avoid U.S. tax, including U.S. withholding tax. Accordingly, the proposed regulations provide that a post-transaction distribution out of earnings and profits of a distributing corporation that carry over to a foreign controlled corporation is generally treated as a U.S. source dividend for purposes of Chapter 3 of subtitle A of the Code. See Georday Enterprises v. Commissioner, 126 F.2d 384 (4th Cir. 1942).

Foreign divisive transactions involving a foreign

distributing corporation and a domestic controlled corporation are similar to inbound nonrecognition transactions to the extent the domestic controlled corporation receives assets of a foreign corporation. Current regulations under §1.367(b)-3 require direct and indirect U.S. shareholders in an inbound asset reorganization to include an all earnings and profits amount in income in order to ensure, in part, that the bases of assets repatriated to the United States reflect an after-tax amount. Section 1.367(b)-3(d) and proposed §1.367(b)-3(f) provide further rules regarding the carryover of earnings and profits and foreign income taxes from a foreign corporation to a domestic corporation. Those rules should also apply to a section 355 distribution involving a foreign distributing corporation and a domestic controlled corporation. These transactions also implicate the current rules under §1.367(b)-5, because a reduction in a foreign distributing corporation's earnings and profits can directly affect the post-transaction application of section 1248 with respect to U.S. shareholders of the distributing corporation.

Foreign divisive transactions involving a foreign distributing corporation and a foreign controlled corporation raise issues similar to those raised in the context of a foreign 381 transaction described in §1.367(b)-7, to the extent the controlled corporation succeeds to earnings and profits (and related foreign income taxes) of the distributing corporation. Accordingly, the proposed regulations adopt the principles of

§1.367(b)-7 to determine the manner in which the foreign controlled corporation succeeds to the earnings and profits (and related foreign income taxes) of a foreign distributing corporation. These transactions also implicate the §1.367(b)-5 rules concerning diminutions in U.S. shareholders' section 1248 amounts.

The proposed regulations under §1.367(b)-8 balance the §1.312-10 rules and policies with the interests and concerns of the relevant international provisions of the Code. However, the IRS and Treasury recognize that the mechanics of §1.312-10 as applied in the international context can be cumbersome and complex. The IRS and Treasury solicit comments as to whether the mechanical difficulties of applying the section 312 rules in the cross-border context outweigh the benefits and, if so, whether there are simpler alternative regimes that would address the international policy concerns without compromising the Subchapter C policies embodied in §1.312-10.

Details of Provisions

A. Prop. Reg. §1.367(b)-1

The proposed regulations supplement the current §1.367(b)-1 notice requirements in consideration of the transactions addressed by proposed §§1.367(b)-7 and 1.367(b)-8. Accordingly, foreign surviving corporations described in proposed §1.367(b)-7 and distributing and controlled corporations involved in transactions described in proposed §1.367(b)-8 are included within the scope of the §1.367(b)-1 notice requirement.

B. Prop. Reg. §1.367(b)-3

The proposed regulations address the carryover of net operating loss and capital loss carryovers, and earnings and profits that are not included in income as an all earnings and profits amount (or a deficit in earnings and profits). The proposed regulations generally provide that these tax attributes do not carry over from a foreign acquired corporation to a domestic acquiring corporation unless they are effectively connected to a U.S. trade or business (or attributable to a permanent establishment, in the context of a relevant U.S. income tax treaty).

The limitations on the carryover of these attributes prevent inappropriate or anomalous results. For example, net operating loss and capital loss carryovers are eligible to carry over from a foreign acquired corporation to a domestic acquiring corporation only to the extent the underlying deductions or losses were allowable under Chapter 1 of subtitle A of the Code. Thus, only a net operating loss or capital loss carryover that is effectively connected to a U.S. trade or business (or attributable to a permanent establishment) may carry over. Inappropriate or anomalous results are thus avoided because losses incurred by a foreign acquired corporation outside the U.S. taxing jurisdiction should not be available to offset the future U.S. tax liability of a domestic acquiring corporation. Otherwise, a taxpayer would have an incentive to import losses into the United States in order to shelter future income from

U.S. tax.

The carryover of earnings and profits (or a deficit in earnings and profits) of the foreign acquired corporation can create similarly inappropriate results. For example, the policies underlying the section 243(a) dividends received deduction are not present with respect to a subsequent distribution by the domestic acquiring corporation out of earnings and profits accumulated by the foreign acquired corporation because those earnings and profits are not generally subject to a U.S. corporate level of tax. On the other hand, if the foreign acquired corporation has PTI, those earnings should not be taxed again when distributed to U.S. shareholders to whom the PTI is attributable regardless of whether or not the U.S. shareholder is eligible for the dividends received deduction. A deficit in earnings and profits can also be used to avoid tax, such as in the case of a foreign shareholder of a domestic acquiring corporation that imports a deficit and therefore is not subject to U.S. withholding tax on subsequent corporate distributions.

As a result of the issues raised by a carryover of earnings and profits and given that §1.367(b)-3 already requires U.S. shareholders to include in income as a deemed dividend the all earnings and profits amount, the proposed regulations provide that earnings and profits (or deficit in earnings and profits) of the foreign acquired corporation do not carry over to the domestic acquiring corporation except to the extent effectively

connected to a U.S. trade or business (or attributable to a permanent establishment, in the context of a relevant U.S. income tax treaty).

C. Prop. Reg. §1.367(b)-7

Proposed §1.367(b)-7 provides the manner in which a foreign surviving corporation succeeds to and takes into account the earnings and profits and foreign income taxes of a foreign acquiring corporation and a foreign target corporation. The proposed regulation attempts to preserve the character of earnings and profits and foreign income taxes to the extent possible in light of the applicable statutory limitations, as well as the relevant policy and administrative concerns. Compare §1.381(c)(2)-1(a)(3) (ensuring that earnings and profits accumulated before March 1, 1913 retain their character as pre-1913 earnings and profits after a section 381 transaction). Accordingly, the proposed rules provide that, to the extent possible, pooled earnings and profits (and foreign income taxes) remain pooled, earnings and profits (and foreign income taxes) in annual layers remain in annual layers, foreign income taxes trapped before the transaction remain trapped after the transaction, and earnings and profits (and foreign income taxes) remain in the same basket before and after the transaction.

The proposed regulation also respects the section 902 preference for distributing pooled earnings and profits before earnings and profits in annual layers. Accordingly, proposed §1.367(b)-7 provides that a foreign surviving corporation's

pooled earnings and profits are distributed first (even though earnings and profits in the annual layers may have been accumulated after earnings and profits in the pool) and annual layers are distributed on a LIFO basis. Similarly, the proposed regulation also incorporates the section 904 preference for distributing pooled earnings and profits eligible for look-through before other pooled earnings and profits.

However, in certain cases, an overriding statutory policy requires that the proposed regulation modify the character of earnings and profits (and related foreign income taxes). For example, if a CFC combines with a non-look-through 10/50 corporation in a foreign 381 transaction and the foreign surviving corporation is a non-look-through 10/50 corporation, dividends paid by the surviving non-look-through 10/50 corporation are required to be separately basketed and do not obtain the benefit of look-through. Thus, earnings and profits of a CFC that would have obtained the benefit of look-through if distributed before the foreign 381 transaction are not eligible for look-through after the transaction. (The loss of look-through in connection with this type of foreign 381 transaction is somewhat ameliorated by a U.S. shareholder's section 1248 amount inclusion under §1.367(b)-4 with respect to earnings and profits that accrued during its holding period.)

Proposed regulation §1.367(b)-7 also provides rules regarding the carryover of deficits in earnings and profits from one foreign corporation to another. The purpose of the hovering

deficit rule in the domestic context is to prevent the trafficking of deficits in earnings and profits. Otherwise, a corporation with positive earnings and profits may acquire or be acquired by another corporation with a deficit in earnings and profits and make distributions out of capital rather than earnings and profits.

In transactions involving foreign corporations, similar concerns exist regarding the trafficking of deficits in earnings and profits. The ability to benefit from combining positive and deficit earnings and profits among foreign corporations is different than in the domestic context, however, because of the nature of the foreign tax credit rules. In a reorganization involving two domestic corporations, the hovering deficit rule applies to a corporation with a net accumulated deficit in earnings and profits because the relevant statutory rules do not distinguish among classes of earnings and profits. In contrast, the foreign tax credit rules require further subcategorization of earnings and profits according to the pooling and basketing rules. Because of these distinctions, taxpayers may inappropriately benefit by trafficking in an earnings and profits deficit in a basket, pool, or particular annual layer, even though a corporation may have net positive earnings and profits. Accordingly, the proposed regulations apply the hovering deficit principle to the relevant subcategories of earnings and profits and provide that foreign income taxes related to the deficit are not added to the foreign surviving corporation's foreign income

tax accounts until all of the deficit has been offset with post-transaction earnings. (Under proposed §1.367(b)-9 (which is described below), these hovering deficit rules do not apply to F reorganizations and foreign 381 transactions in which either the foreign target corporation or the foreign acquiring corporation is newly created.)

Because the treatment of distributions by a foreign surviving corporation depends on whether it is a look-through corporation, a non-look-through 10/50 corporation, or a less-than-10%-U.S.-owned foreign corporation, proposed §1.367(b)-7 is divided according to these categories. The proposed regulation uses the term surviving corporation in order to prevent confusion between the acquiring corporation and the foreign surviving entity. In addition, the term highlights the proposed regulation's general approach that provides the same results regardless of whether a corporation is the ostensible acquiring or target corporation.

1. Look-through surviving corporation

Where the foreign surviving corporation is a look-through corporation, the proposed regulation generally preserves the character of earnings and profits and foreign income taxes. For example, if a CFC (CFC1) acquires the assets of another CFC (CFC2) in a foreign 381 transaction and the surviving corporation is a CFC, then the corporations' positive amounts of earnings and profits and foreign income taxes would carry over in a manner that combines the look-through earnings and profits pools (and

related foreign income taxes) of each corporation on a basket-by-basket basis. Thus, for example, CFC1's passive basket would be combined with CFC2's passive basket, CFC1's general basket would be combined with CFC2's general basket, and so forth.

If CFC1 or CFC2 has pooled earnings and profits or foreign income taxes that do not qualify for look-through treatment (non-look-through pool) (for example, earnings and profits accumulated during a period when the corporation was not a CFC and that are subject to a separate 10/50 limitation), such earnings and profits and foreign income taxes would be distributed only after all of the look-through earnings and profits pool has been distributed. This rule is consistent with the ordering rule in Prop. Reg. §1.904-4(g)(3)(iii), which provides that when a 10/50 corporation becomes a CFC, pooled earnings and profits accumulated and foreign income taxes paid or accrued while the corporation is a CFC are distributed before pooled earnings and profits accumulated and foreign income taxes paid or accrued while the corporation was a 10/50 corporation. (If the foreign surviving corporation is instead a look-through 10/50 corporation, this rule is also consistent with the earnings and profits in the look-through pool being distributed before earnings and profits in the non-look-through pool.)

When earnings and profits from the non-look-through pool are distributed, the earnings and profits will be distributed pro rata out of the non-look-through pools of CFC1 and CFC2 (if any) and placed in two separate baskets under section 904(d)(1)(E).

This preserves the character of the earnings and profits and related foreign income taxes and is consistent with the policy of section 904(d)(1)(E) to maintain separate baskets for each 10/50 corporation. After 2003, these earnings and profits will continue to be distributed pro rata from separate non-look-through pools but will be combined into a single 10/50 basket in the hands of the distributee. Maintaining separate pools prevents the refreshing of foreign income taxes that would have been trapped had the foreign 381 transaction not occurred. (The same rules apply in the case of a foreign surviving corporation that is a look-through 10/50 corporation.)

If CFC1 or CFC2 has pre-1987 accumulated profits (i.e., annual layers of earnings and profits) or foreign income taxes, then those earnings and profits are distributed only after the distribution of all pooled earnings and profits and taxes, regardless of whether those earnings and profits may have been accumulated after the pooled earnings and profits of the other corporation. Such earnings and profits are distributed on a LIFO basis and pro rata out of the respective corporation's annual layers if both companies have earnings and profits in the same year that are treated as pre-1987 accumulated profits and foreign income taxes. This rule respects two international policies. First, pooled earnings and profits are distributed before earnings and profits in annual layers. Second, earnings and profits in annual layers should not be pooled unless they are distributed to an upper-tier entity. Compare §1.902-1(a)(8)(ii)

(providing that distributions out of pre-1987 earnings and profits by a lower-tier corporation are included in the post-1986 earnings and profits of an upper-tier corporation). This rule is also consistent with the section 902 rule that traps foreign income taxes in annual layers in which there are no earnings and profits.

These results preserve the character of earnings and profits and taxes because pooled earnings and profits and taxes remain pooled, earnings and profits and taxes retain the same character under the look-through provisions, and foreign income taxes that were trapped before the foreign 381 transaction remain trapped. The rules are also consistent with concerns about limiting the administrative burden of requiring taxpayers to recreate tax histories.

Because of the foreign tax credit considerations presented by foreign 381 transactions, §1.367(b)-7 applies the hovering deficit rule to subcategories of earnings and profits. Thus, deficits in the look-through pool, non-look-through pool, and net deficits in annual layers can offset only future earnings and profits of the foreign surviving corporation. In addition, a hovering deficit cannot be used to reduce current earnings and profits of the foreign surviving corporation and, as a result, does not reduce subpart F income. Foreign income taxes related to a hovering deficit do not enter the foreign income tax accounts of the surviving corporation until the entire hovering deficit offsets post-transaction earnings and profits. However,

foreign income taxes related to the post-transaction earnings that are offset by the hovering deficit immediately enter the foreign income tax accounts of the foreign surviving corporation.

2. Non-look-through 10/50 surviving corporation

The proposed regulation's rules with respect to a non-look-through 10/50 corporation apply if the foreign surviving corporation is a 10/50 corporation before 2003. The principal statutory limitation of a non-look-through 10/50 corporation is that a dividend distribution is not eligible for look-through treatment and is instead separately basketed for each 10/50 corporation. As a result, earnings and profits of an acquiring or target corporation that would have been eligible for look-through (assuming the corporation qualified under the look-through rule) if distributed before the foreign 381 transaction lose their look-through character after the transaction.

For example, suppose a CFC combines with a non-look-through 10/50 corporation in a foreign 381 transaction in 2001 and the surviving entity is a non-look-through 10/50 corporation. Prior to the transaction, the CFC maintained earnings and profits and foreign income tax accounts expecting that the look-through rules would apply on a distribution of earnings and profits to U.S. shareholders. However, after the foreign 381 transaction, section 904(d)(1)(E) requires that a distribution from the surviving 10/50 corporation will be deemed to be paid out of a single pool of earnings and profits that will be separately basketed. In order to address the carryover of attributes to a

non-look-through 10/50 corporation in a manner consistent with section 904(d)(1)(E), the proposed regulations combine the net positive earnings and profits and foreign income taxes in the respective pools of the acquiring and target corporations.

(Thus, the separate baskets of pooled earnings and profits and foreign income taxes of the CFC would be netted into a single pool along with the non-look-through 10/50 corporation's pooled earnings and profits and foreign income taxes.)

Annual layers of the acquiring and target corporations are carried over to the foreign surviving corporation under the same rules as described above with respect to look-through corporations. Hovering deficit rules similar to those described with respect to a look-through corporation's non-look-through pool and annual layers also apply to surviving non-look-through 10/50 corporations.

Look-through treatment of earnings and profits and foreign income taxes does not re-emerge if the corporation later becomes a look-through corporation. For example, if the surviving non-look-through 10/50 corporation becomes a CFC, all of the earnings and profits and foreign income taxes of the surviving non-look-through 10/50 corporation remain as earnings and profits to which the look-through rules do not apply. Look-through only applies to earnings and profits accumulated after the corporation becomes a CFC. The IRS and Treasury believe that this rule is appropriate because of the administrative difficulties posed by recreating tax histories. In addition, earnings and profits and

foreign income taxes of a CFC accumulated during a U.S. shareholder's holding period are generally deemed distributed (and the look-through rules apply) if a U.S. shareholder includes a section 1248 amount in income under §1.367(b)-4 in connection with the foreign 381 transaction.

3. Less-than-10%-U.S.-owned foreign surviving corporation

Proposed §1.367(b)-7 also determines the manner in which earnings and profits and foreign income taxes of the acquiring and target corporation are combined if the foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation. Generally, rules similar to the rules provided for annual layers of look-through corporations and non-look-through 10/50 corporations apply with respect to the annual layers of the acquiring and target corporations, but the rules take into account the possibility that one of the corporations may have been a CFC or 10/50 corporation immediately prior to the foreign 381 transaction.

If either the acquiring or target corporation is a CFC or a 10/50 corporation, its pooled earnings and profits and foreign income taxes are treated as earnings and profits and foreign income taxes accumulated in the annual layer of the applicable corporation immediately before the foreign 381 transaction. For example, suppose a less-than-10%-U.S.-owned foreign corporation combines with a 10/50 corporation and the foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation. The foreign surviving corporation is an entity that has never

been required to pool earnings and profits and foreign income taxes under section 902(c)(3). Accordingly, distributions from the foreign surviving corporation are out of annual layers on a LIFO basis. Rather than recreating the tax history of the acquired 10/50 corporation for each year, the proposed regulation places all pooled earnings and profits and foreign income taxes of the 10/50 corporation into a single annual layer that closes immediately before the foreign 381 transaction. This rule is intended to ameliorate administrative burdens while respecting the policy that earnings and profits and foreign income taxes are distributed from annual layers for a less-than-10%-U.S.-owned foreign corporation. Because of concerns about neutrality, the same result applies regardless of whether the 10/50 corporation is the ostensible acquiring or target corporation.

If the surviving less-than-10%-U.S.-owned foreign corporation later becomes a non-look-through 10/50 corporation or a look-through corporation, earnings and profits and foreign income taxes that were pooled or obtained the benefit of look-through prior to the foreign 381 transaction are not recreated. Instead, those earnings and profits and foreign income taxes remain as earnings and profits accumulated and foreign income taxes paid or deemed paid while the corporation was a less-than-10%-U.S.-owned foreign corporation. As in the case of a surviving non-look-through 10/50 corporation that later becomes a look-through corporation, this rule is provided because of administrative issues associated with recreating tax histories.

In addition, earnings and profits and foreign income taxes of a CFC accumulated during a shareholder's holding period generally would have been deemed distributed (and the look-through rules would have applied) if the shareholder was required to include a section 1248 amount in income under §1.367(b)-4 in connection with the foreign 381 transaction.

D. Prop. Reg. §1.367(b)-8

Section 1.367(b)-8 provides rules applicable to foreign divisive transactions. The regulation is divided into four sections. Section 1.367(b)-8(b) provides rules that are generally applicable to foreign divisive transactions. The other three sections describe the application of the general rules to specific situations. Section 1.367(b)-8(c) applies to a distribution by a domestic distributing corporation of the stock of a foreign controlled corporation, §1.367(b)-8(d) applies to a distribution by a foreign distributing corporation of the stock of a domestic controlled corporation, and §1.367(b)-8(e) applies to a distribution by a foreign distributing corporation of the stock of a foreign controlled corporation.

1. General rules applicable to foreign divisive transactions

Section 1.367(b)-8(b) provides that the rules of §1.312-10 generally apply to determine the allocation of earnings and profits between a distributing and a controlled corporation, as well as to determine the reduction in the earnings and profits of a distributing corporation. The rules of §1.312-10 are, however, subject to certain modifications.

In a D/355 distribution involving a controlled corporation that is newly created as part of the transaction, §1.312-10(a) allocates the pre-transaction earnings and profits of the distributing corporation between the distributing and controlled corporations based upon a comparison of the fair market values of the assets received by the controlled corporation and the assets retained by the distributing corporation after the D reorganization. Section 1.312-10(a) provides that, "in a proper case," this allocation should be based on the relative net bases of the assets transferred and retained by the distributing corporation, or based on another "appropriate" method.

The proposed regulations generally adopt the rule of §1.312-10(a), except that the allocation is based upon relative net adjusted bases of assets transferred and retained in all cases. This rule reflects the view that net basis is the most accurate measure of the appropriate amount of earnings and profits that should be allocated to the assets transferred by a distributing corporation in the D reorganization. For example, in cases where the controlled corporation recognizes gain on a later sale or distribution of appreciated property that it receives from the distributing corporation an allocation based upon relative bases prevents a misallocation of earnings and profits to the controlled corporation.

In a section 355 distribution that is not preceded by a D reorganization, §1.312-10(b) provides that the earnings and profits of the distributing corporation are decreased by an

amount equal to the lesser of (i) the amount by which the earnings and profits of the distributing corporation would have been decreased if it had transferred the stock of the controlled corporation to a new corporation in a D/355 distribution, and (ii) the net worth of the controlled corporation. For this purpose, net worth is defined as "the sum of the bases of all of the properties plus cash minus all liabilities." If "the earnings and profits of the controlled corporation immediately before the transaction are less than the amount of the decrease in earnings and profits of the distributing corporation . . . the earnings and profits of the controlled corporation, immediately after the transaction, shall be equal to the amount of such decrease. If the earnings and profits of the controlled corporation immediately before the transaction are more than the amount of the decrease in the earnings and profits of the distributing corporation, they shall remain the same."

Section 1.312-10(b) reflects the principle that a pro rata portion of a distributing corporation's earnings and profits should be reduced to account for the distribution of the controlled corporation. In addition, the requirement that the earnings and profits of the controlled corporation at least equal the reduction in the distributing corporation's earnings and profits appears intended to prevent a bailout of earnings and profits through the controlled corporation, while preventing the potential double counting of earnings and profits in situations where the distributing corporation did not organize the

controlled corporation.

In consideration of the complexities raised by the cross-border application of the §1.312-10(b) adjustment to the controlled corporation's earnings and profits, taken together with the current rules that prevent the potential bailout of earnings and profits in the international context (such as the §1.367(b)-5 requirement that a shareholder include in income a reduction in its section 1248 amount), the IRS and Treasury have concluded that the §1.312-10(b) rules should be modified when applied to section 367(b) transactions. Accordingly, the proposed regulations provide that the earnings and profits of the distributing corporation are decreased in an amount equal to the amount by which the earnings and profits of the distributing corporation would have been decreased if it had transferred the stock of the controlled corporation to a new corporation in a D/355 distribution. However, the earnings and profits of the controlled corporation are not increased or replaced. The reduction in earnings and profits (and related foreign income taxes) of the distributing corporation disappears unless otherwise included in income, such as under §1.367(b)-5.

Section 1.312-10 does not specifically address the allocation and reduction of earnings and profits in connection with a D/355 distribution that involves a preexisting controlled corporation. The proposed regulations provide that, in such a case, the distributing corporation's earnings and profits are reduced in a manner that incorporates both the rules applicable

to a D/355 distribution with a newly created controlled corporation and a section 355 distribution that is not preceded by a D reorganization. The rule thus accounts for a decrease in earnings and profits attributable to assets transferred to the controlled corporation as part of the D reorganization as well as a decrease in earnings and profits attributable to the distribution of stock of a preexisting controlled corporation (without regard to the D reorganization). The controlled corporation succeeds only to those earnings and profits allocable to the property it receives in the D reorganization.

In consideration of the international provisions' distinctions among classes and categories of earnings and profits, proposed §1.367(b)-8(b) specifically addresses the determination of which earnings and profits of the distributing corporation are affected by a foreign divisive transaction. The proposed regulation provides that an allocation or reduction in earnings and profits shall generally be pro rata out of a cross-section of the distributing corporation's tax history (except to the extent it is included in income as a deemed dividend such as under §1.367(b)-3 or §1.367(b)-5). This rule determines the earnings and profits (and related foreign income taxes, where applicable) that remain in the distributing corporation after the transaction as well as any earnings and profits (and related foreign income taxes, where applicable) to which the controlled corporation succeeds in a D reorganization.

The proposed §1.367(b)-8(b) cross-section rule decreases the

earnings and profits of a distributing corporation without regard to the type of income generated by the assets of the controlled corporation. This is consistent with the general assumption in §1.312-10 and the proposed regulations that the earnings and profits of the distributing corporation should be decreased proportionately to reflect the transfer or distribution of assets, rather than by some other measure, such as by determining the earnings and profits attributable to the income generated by assets transferred or distributed (a tracing model) or by decreasing most recently accumulated earnings and profits to the extent of assets transferred or distributed (a dividend model).

2. Branch profits tax considerations

Notwithstanding the above-described rules, the proposed regulations provide that an allocation or reduction in a distributing corporation's earnings and profits shall not reduce the distributing corporation's effectively connected earnings and profits or non-previously taxed accumulated effectively connected earnings and profits, as defined in the branch profits rule in section 884 (branch earnings). Both a domestic or foreign distributing corporation can potentially have branch earnings that are subject to the branch profits tax.

In the case of a foreign divisive transaction that does not include a D reorganization, a U.S. branch of a foreign distributing corporation would be retained by the foreign distributing corporation. Accordingly, §1.367(b)-8 should not reduce the foreign distributing corporation's branch earnings

because such a reduction would improperly decrease the earnings subject to the branch profits tax upon the section 355 distribution (which would trigger the branch profits tax under section 884). The same issues arise in the case of a D/355 distribution in which a foreign distributing corporation transfers the assets that are not part of a U.S. branch to a controlled corporation. The IRS and Treasury do not believe that it is appropriate to reduce the earnings that could give rise to a subsequent branch profits tax under these circumstances.

Different issues arise in a foreign divisive transaction in which a foreign distributing corporation transfers the assets of a U.S. branch to a controlled corporation as part of a D/355 distribution. While the branch profits rules permit a deferral of the branch profits tax in certain instances (by allowing branch earnings to be allocated to the domestic transferee in proportion to the assets transferred when a branch is incorporated in a section 351 exchange in a domestic corporation (see §1.884-2T(d)(1)), the branch profits tax is triggered in any event if stock of the incorporated branch is later distributed to its shareholders. See §1.884-2T(d)(5). Accordingly, because foreign divisive transactions include a section 355 distribution immediately following the D reorganization, it would be unnecessary and inappropriate to attribute branch earnings to a domestic controlled corporation under proposed §1.367(b)-8.

Similar branch profits issues can arise with respect to a domestic distributing corporation. While branch earnings are

accumulated by a foreign corporation, such earnings may have been carried over to a domestic corporation in a prior section 351 or 381 transaction. See §1.884-2T(c)(4). Accordingly, the proposed regulations treat domestic distributing corporations in the same manner as foreign distributing corporations with respect to branch earnings.

3. Domestic corporation distributes stock of a foreign corporation

In foreign divisive transactions involving a domestic distributing corporation and a foreign controlled corporation, the foreign controlled corporation may succeed to earnings and profits of the domestic distributing corporation. The regulations provide that sections 243(e) and 861(a)(2)(C) apply to earnings and profits allocated to the foreign controlled corporation that were accumulated by a domestic corporation. In addition, a post-transaction distribution out of earnings and profits allocated to the foreign controlled corporation is generally treated as a U.S. source dividend under section 904(g) and for purposes of Chapter 3 of subtitle A of the Code. See Georday Enterprises v. Commissioner, 126 F.2d 384 (4th Cir. 1942).

4. Foreign corporation distributes stock of a domestic corporation

In foreign divisive transactions involving a foreign distributing corporation and a domestic controlled corporation, two issues arise in determining the appropriate reduction in the foreign distributing corporation's earnings and profits and its

effects on the earnings and profits of the domestic controlled corporation. First, it should be determined whether it is appropriate to reduce PTI of the foreign distributing corporation and, if so, in what manner (e.g., if the foreign distributing corporation has earnings and profits that are PTI and not PTI, should the reduction in earnings and profits be out of PTI first, last, pro rata, or depending on the identity of the controlled corporation's shareholders). As in the case of §1.367(b)-7, §1.367(b)-8 reserves on PTI issues, and the IRS and Treasury solicit comments with respect to the appropriate treatment of these amounts.

Second, a domestic corporation succeeds to the earnings and profits of a foreign corporation if the section 355 distribution is preceded by a D reorganization. Because earnings and profits are allocable from foreign corporate solution to U.S. corporate solution, U.S. shareholders are required to include in income the all earnings and profits amount attributable to earnings and profits that carry over to the controlled corporation. The proposed regulations provide rules that coordinate the proposed §1.367(b)-8 and the current §1.367(b)-3 regimes. The regulations, however, reserve with respect to the treatment of U.S. persons that own foreign distributing corporation stock after a non pro rata distribution. The IRS and Treasury invite comments as to whether U.S. shareholders should have an all earnings and profits amount inclusion in connection with a non pro rata foreign divisive transaction in which they do not

receive stock of the domestic controlled corporation.

5. Foreign corporation distributes stock of a foreign corporation

In foreign divisive transactions involving a foreign distributing corporation and a foreign controlled corporation, the foreign controlled corporation may succeed to earnings and profits of the foreign distributing corporation. Because such earnings and profits are allocated from one foreign corporation to another foreign corporation, the transaction raises issues similar to those in a foreign 381 transaction. Accordingly, the proposed regulations adopt and apply the principles in proposed regulation §1.367(b)-7 to these transactions.

E. Prop. Reg. §1.367(b)-9

Proposed §1.367(b)-9 provides special rules applicable to foreign-to-foreign F reorganizations and foreign 381 transactions in which either the foreign target corporation or the foreign acquiring corporation is newly created. Proposed §1.367(b)-9 also applies to foreign divisive transactions that involve a foreign distributing and a foreign controlled corporation, either of which is newly created.

Under proposed §1.367(b)-9, a foreign surviving corporation succeeds to earnings and profits, deficits in earnings and profits, and foreign income taxes without regard to the proposed §1.367(b)-7 hovering deficit rules. See section 1.381(b)-1(a)(2) (providing an analogous rule with respect to domestic F reorganizations).

This rule prevents inappropriate tax consequences. For

example, under the generally applicable hovering deficit rules, a foreign corporation with significant deficits in earnings and profits could combine with a newly created foreign corporation and thereafter distribute dividends (along with deemed paid foreign income taxes under section 902), despite the presence of a significant deficit that would have precluded a dividend distribution before the transaction. Proposed §1.367(b)-7 provides the Commissioner discretion to apply the principles of proposed §1.367(b)-9 to circumstances where a principal purpose of the foreign 381 transaction is to affirmatively use the hovering deficit rule in order to gain a tax benefit.

Proposed Effective Dates

These regulations are proposed to apply to section 367(b) exchanges that occur on or after 30 days after these regulations are published as final regulations in the **Federal Register**.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations, and because the regulation does not impose a collection of information on small entities, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply.

Comments and Public Hearing

Before these proposed regulations are adopted as final

regulations, consideration will be given to any electronic or written comments (a signed original and eight (8) copies) that are submitted timely to the IRS. The IRS and Treasury Department request comments on the clarity of the proposed rules and how they can be made easier to understand. All comments will be available for public inspection and copying.

A public hearing has been scheduled for March 13, 2001, beginning at 10 a.m., in room 7218 of the Internal Revenue Building, 1111 Constitution Avenue, NW., Washington, DC. Due to building security procedures, visitors must enter at the 10th Street entrance, located between Constitution and Pennsylvania Avenues, NW. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 15 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the "FOR FURTHER INFORMATION CONTACT" section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments and an outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by February 20, 2001. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed.

Copies of the agenda will be available free of charge at the hearing.

Drafting Information

The principal author of these regulations is Anne O'Connell Devereaux, Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Proposed Amendments to the Regulations

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

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by revising the entries for sections 1.367(b)-7, 1.367(b)-8, and 1.367(b)-9 to read in part as follows:

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

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

Section 1.367(b)-8 also issued under 26 U.S.C. 367(a) and (b), 26 U.S.C. 902, and 26 U.S.C. 904.

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

Par. 2. Section 1.312-10 is amended by adding paragraph (d) to read as follows:

§1.312-10 Allocation of earnings in certain corporate separations.

* * * * *

(d) For additional rules involving foreign corporations, see

§1.367(b)-8.

Par. 3. Section 1.367(b)-0 is amended by:

1. Revising the introductory text.
2. Revising the entry for §1.367(b)-2(j)(3) and adding entries for §1.367(b)-2(j)(4), (j)(5), and (l).
3. Adding entries for §1.367(b)-3(e) and (f).
4. Adding entries for §1.367(b)-5(c)(2)(i), (c)(2)(ii), and (e)(3).
5. Adding entries for §§1.367(b)-7 through 1.367(b)-9.

The revisions and additions read as follows:

§1.367(b)-0 Table of contents.

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

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

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(j) * * *

- (3) Dividend described in section 243(e).
- (4) Coordination with §1.367(b)-8(c)(2).
- (5) Other rules.

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- (1) Additional definitions.
- (1) Foreign income taxes.
- (2) Post-1986 undistributed earnings.
- (3) Post-1986 foreign income taxes.
- (4) Pre-1987 accumulated profits.
- (5) Pre-1987 foreign income taxes.
- (6) Pre-1987 section 960 earnings and profits.
- (7) Pre-1987 section 960 foreign income taxes.
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- (11) Less-than-10%-U.S.-owned foreign corporation.
- (12) Separate category.
- (13) Statutory grouping of earnings and profits.

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

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- (e) Net operating loss and capital loss carryovers.
- (f) Carryover of earnings and profits.

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

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

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- (4) Divisive D reorganization with a preexisting controlled corporation.
 - (i) Calculation of earnings and profits of distributing corporation.
 - (ii) Calculation of earnings and profits of controlled corporation.
 - (c) Foreign divisive transactions involving a domestic distributing corporation and a foreign controlled corporation.
 - (1) Scope.
 - (2) Earnings and profits allocated to a foreign controlled corporation.
 - (3) Examples.
 - (d) Foreign divisive transactions involving a foreign distributing corporation and a domestic controlled corporation.
 - (1) Scope.
 - (2) Coordination with §1.367(b)-3.
 - (i) In general.
 - (ii) Determination of all earnings and profits amount.
 - (iii) Interaction with section 358 and §1.367(b)-2(e)(3)(ii).
 - (iv) Coordination with §1.367(b)-3(c).
 - (v) Special rule for U.S. persons that own foreign distributing corporation stock after a non pro rata distribution. [Reserved]
 - (3) Foreign income taxes.
 - (4) Previously taxed earnings and profits. [Reserved]
 - (5) Coordination with §1.367(b)-5.
 - (6) Examples.
 - (e) Foreign divisive transactions involving a foreign distributing corporation and a foreign controlled corporation.
 - (1) Scope.
 - (2) Earnings and profits of foreign controlled corporation.
 - (i) In general.
 - (ii) Special rule for pre-transaction earnings allocated to a newly created controlled corporation.
 - (3) Foreign income taxes.
 - (4) Previously taxed earnings and profits. [Reserved]
 - (5) Coordination with §1.367(b)-5.
 - (6) Examples.
 - (f) Effective date.

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

- (a) Scope.
- (b) Hovering deficit rules inapplicable.
- (c) Example.
- (d) Effective date.

Par. 4. Section 1.367(b)-1 is amended by:

1. Removing the language "and" at the end of paragraph (c)(2)(iii).
2. Removing the period at the end of paragraph (c)(2)(iv)(B) and adding ";" in its place.
3. Adding paragraphs (c)(2)(v), (c)(2)(vi), and (c)(2)(vii).
4. Revising paragraphs (c)(3)(ii)(A), (c)(4)(iv), and (c)(4)(v).

The additions and revisions read as follows:

§1.367(b)-1 Other transfers.

* * * * *

(c) * * *

(2) * * *

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

(vi) A distributing corporation that is subject to the rules of §1.367(b)-8; and

(vii) A controlled corporation that is subject to the rules of §1.367(b)-8.

(3) * * *

(ii) * * *

(A) United States shareholders (as defined in §1.367(b)-3(b)(2)) of foreign corporations described in paragraph

(c)(2)(i), (v), (vi), or (vii) of this section; and

* * * * *

(4) * * *

(iv) A statement that describes any amount (or amounts) required, under the section 367(b) regulations, to be taken into account as income or loss or as an adjustment (including an adjustment under §1.367(b)-7, 1.367(b)-8, or 1.367(b)-9) to basis, earnings and profits, or other tax attributes as a result of the exchange;

(v) Any information that is or would be required to be furnished with a Federal income tax return pursuant to regulations under section 332, 351, 354, 355, 356, 361, 368, or 381 (whether or not a Federal income tax return is required to be filed), if such information has not otherwise been provided by the person filing the section 367(b) notice;

* * * * *

Par. 5. Section 1.367(b)-2 is amended by:

1. Revising paragraph (j)(1)(i).
2. Redesignating paragraph (j)(3) as paragraph (j)(5).
3. Adding new paragraphs (j)(3) and (j)(4).
4. Adding paragraph (l).

The revision and addition read as follows:

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

* * * * *

(j) Sections 985 through 989--(1) Change in functional currency of a qualified business unit--(i) Rule. If, as a result

of a section 367(b) exchange described in section 381(a) or 312(h), a qualified business unit (as defined in section 989(a)) (QBU) has a different functional currency determined under the rules of section 985(b) than it used prior to the transaction, then the QBU shall be deemed to have automatically changed its functional currency immediately prior to the transaction. A QBU that is deemed to change its functional currency pursuant to this paragraph (j) must make the adjustments described in §1.985-5.

* * * * *

(3) Dividend described in section 243(e). Dividend distributions by a foreign corporation out of earnings and profits accumulated by a domestic corporation that are eligible for the dividends received deduction under section 243(e) shall not exceed an amount equal to the U.S. dollar value of the earnings and profits at the time the earnings and profits were accumulated by such domestic corporation. See §1.367(b)-8(c)(3), Example 1 and Example 3.

(4) Coordination with §1.367(b)-8(c)(2). Solely for purposes of Chapter 3 of subtitle A of the Internal Revenue Code, dividend distributions by a foreign corporation that are treated under §1.367(b)-8(c)(2) as U.S. source shall not exceed an amount equal to the U.S. dollar value of the earnings and profits at the time allocated to the foreign corporation. See §1.367(b)-8(c)(3), Example 1.

* * * * *

(1) Additional definitions--(1) Foreign income taxes. The

term foreign income taxes has the meaning set forth in §1.902-1(a)(7).

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

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

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

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

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

959.

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

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

(9) Look-through corporation. The term look-through corporation means a foreign corporation that is subject to the look-through rules of section 904(d)(3) or section 904(d)(4) (as in effect for taxable years beginning after December 31, 2002 (the day before the effective date of section 1105(b) of Public Law 105-34 (111 Stat. 788))) and regulations thereunder.

(10) Non-look-through 10/50 corporation. The term non-look-through 10/50 corporation means a noncontrolled section 902 corporation as defined in section 904(d)(2)(E) that is not a look-through corporation.

(11) Less-than-10%-U.S.-owned foreign corporation. The term less-than-10%-U.S.-owned foreign corporation means a foreign corporation that is neither a look-through corporation nor a non-look-through 10/50 corporation.

(12) Separate category. The term separate category has the

meaning set forth in section 904(d)(1), and shall also include any other category of income to which section 904(a), (b), and (c) are applied separately under any other provision of the Internal Revenue Code (e.g., sections 56(g)(4)(C)(iii)(IV), 245(a)(10), 865(h), 901(j), and 904(g)(10)).

(13) Statutory grouping of earnings and profits. The term statutory grouping of earnings and profits means the earnings and profits from a specific source or activity that must be determined for purposes of applying a provision of the Internal Revenue Code. Compare §1.861-8(a)(4) (providing an analogous definition for statutory grouping of gross income).

Par. 6. Section 1.367(b)-3 is amended by adding paragraphs (e) and (f) to read as follows:

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

* * * * *

(e) Net operating loss and capital loss carryovers. A net operating loss or capital loss carryover of the foreign acquired corporation is described in section 381(c)(1) and (c)(3) and thus is eligible to carry over from the foreign acquired corporation to the domestic acquiring corporation only to the extent the underlying deductions or losses were allowable under chapter 1 of subtitle A of the Internal Revenue Code. Thus, only a net operating loss or capital loss carryover that is effectively connected with the conduct of a trade or business within the United States (or that is attributable to a permanent

establishment, in the context of an applicable United States income tax treaty) is eligible to be carried over under section 381. For further guidance, see Rev. Rul. 72-421 (1972-2 C.B. 166) (see also §601.601(d)(2) of this chapter).

(f) Carryover of earnings and profits. Except to the extent otherwise specifically provided (see, e.g., Notice 89-79 (1989-2 C.B. 392) (see also §601.601(d)(2) of this chapter)), earnings and profits of the foreign acquired corporation that are not included in income as a deemed dividend under the section 367(b) regulations (or deficit in earnings and profits) are eligible to carry over from the foreign acquired corporation to the domestic acquiring corporation under section 381(c)(2) or §1.367(b)-8(b)(1)(i) only to the extent such earnings and profits (or deficit in earnings and profits) are effectively connected with the conduct of a trade or business within the United States (or are attributable to a permanent establishment, in the context of an applicable United States income tax treaty). All other earnings and profits (or deficit in earnings and profits) of the foreign acquired corporation shall not carry over to the domestic acquiring corporation and, as a result, shall be eliminated.

Par. 7. Section 1.367(b)-5 is amended by:

1. Revising paragraphs (b)(1)(ii) and (c)(2).
2. Adding paragraph (e)(3).

The revisions and addition read as follows:

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

* * * * *

(b) * * *

(1) * * *

(ii) If the distributee is an individual or a tax-exempt entity as described in §1.337(d)-4(c)(2) 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.

* * * * *

(c) * * *

(2) Adjustment to basis in stock and income inclusion--(i) In general. 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. See, e.g., paragraph (g) Example 1 of this section.

(ii) Exception. The basis reduction rule of paragraph (c)(2)(i) of this section shall apply only to the extent such

reduction increases the distributee's section 1248 amount (as defined in §1.367(b)-2(c)(1)) with respect to the distributing or controlled corporation; otherwise such basis reduction shall be replaced by the income inclusion rule of paragraph (c)(2)(i) of this section. See, e.g., §1.367(b)-8(d)(6) Example 2.

* * * * *

(e) * * *

(3) Divisive D reorganization with a preexisting controlled corporation. In the case of a transaction described in §1.367(b)-8(b)(4), the predistribution amount with respect to a distributing or controlled corporation shall be computed after the allocation of the distributing corporation's earnings and profits described in §1.367(b)-8(b)(4)(i)(A) and (b)(4)(ii)(A) (without regard to the parenthetical phrase in §1.367(b)-8(b)(4)(ii)(A)), but before the reduction in the distributing corporation's earnings and profits described in §1.367(b)-8(b)(4)(i)(B). See, e.g., §1.367(b)-8(d)(6) Example 3 and §1.367(b)-8(e)(7) Example 3.

* * * * *

Par. 8. In §1.367(b)-6, paragraph (a)(1) is revised to read as follows:

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

(a) Effective date--(1) In general. Sections 1.367(b)-1 through 1.367(b)-5, and this section, apply to section 367(b) exchanges that occur on or after the date that is 30 days after

the date these regulations are published as final regulations in the **Federal Register**. For guidance with respect to section 367(b) exchanges that occur prior to the date 30 days after these regulations are published as final regulations in the **Federal Register**, see §§1.367(b)-1 through 1.367(b)-6 in effect prior to the date 30 days after these regulations are published in the **Federal Register** (see 26 CFR part 1 revised as of April 1, 2000).

Par. 9. Section 1.367(b)-7 is added to read as follows:

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

(a) Scope. This section applies to an acquisition by a foreign corporation (foreign acquiring corporation) of the assets of another foreign corporation (foreign target corporation) in a transaction described in section 381 (foreign 381 transaction). This section describes the manner and extent to which earnings and profits and foreign income taxes of the foreign acquiring corporation and the foreign target corporation carry over to the surviving foreign corporation (foreign surviving corporation). See §1.367(b)-9 for special rules governing reorganizations described in section 368(a)(1)(F) and foreign 381 transactions in which either the foreign target corporation or the foreign acquiring corporation is newly created.

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

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

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

(c) Ordering rule for post-transaction distributions.

Dividend distributions out of a foreign surviving corporation's earnings and profits shall be ordered in accordance with the rules of paragraph (c)(1), (2), or (3) of this section, depending on whether the foreign surviving corporation is a look-through corporation, a non-look-through 10/50 corporation, or a less-than-10%-U.S.-owned foreign corporation.

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

(2) If foreign surviving corporation is a non-look-through 10/50 corporation. In the case of a foreign surviving

corporation that is a non-look-through 10/50 corporation, post-transaction distributions shall be first out of the non-look-through pool (as described in paragraph (e)(2) of this section), and second out of the pre-pooling annual layers (as described in paragraph (f)(1) of this section) under the LIFO method.

(3) If foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation. In the case of a foreign surviving corporation that is a less-than-10%-U.S.-owned corporation, post-transaction distributions shall be out of the pre-pooling annual layers (as described in paragraph (f)(2) of this section) under the LIFO method.

(d) Look-through pool. If the foreign surviving corporation is a look-through corporation, then the look-through pool shall be determined under the rules of this paragraph (d).

(1) In general--(i) Qualifying earnings and taxes. The look-through pool shall consist of the post-1986 undistributed earnings and related post-1986 foreign income taxes of the foreign acquiring corporation and the foreign target corporation that were subject to the look-through provisions of section 904(d)(3) or section 904(d)(4) (as in effect for taxable years beginning after December 31, 2002 (the day before the effective date of section 1105(b) of Public Law 105-34 (111 Stat. 788))) and regulations thereunder.

(ii) Carryover rule. Subject to paragraph (d)(2) of this section, the amounts described in paragraph (d)(1)(i) of this section attributable to the foreign acquiring corporation and the

foreign target corporation shall carry over to the foreign surviving corporation and shall be combined on a separate category-by-separate category basis.

(2) Hovering deficit. The rules of this paragraph (d)(2) apply when the foreign acquiring corporation or the foreign target corporation has a deficit in one or more separate categories of post-1986 undistributed earnings described in paragraph (d)(1)(i) of this section immediately prior to the foreign 381 transaction. In the event both the foreign acquiring corporation and the foreign target corporation have a deficit in the same separate category of earnings and profits, such deficits and their related foreign income taxes shall be combined for purposes of applying this paragraph (d)(2). See also paragraphs (g)(1) and (4) of this section (describing other rules applicable to a deficit described in this paragraph (d)(2)).

(i) Offset rule. A deficit in a separate category of earnings and profits described in this paragraph (d)(2) shall offset only earnings and profits accumulated by the foreign surviving corporation after the foreign 381 transaction (post-transaction earnings) in the same separate category of earnings and profits.

(ii) Related taxes. Foreign income taxes that are related to a deficit in a separate category of earnings and profits described in this paragraph (d)(2) shall be added to the foreign surviving corporation's post-1986 foreign income taxes related to that separate category of earnings and profits only after post-

transaction earnings in the same separate category have been offset by and exceed the entire amount of the deficit.

(3) Examples. The following examples illustrate the rules of this paragraph (d). The examples presume the following facts: Foreign corporations A and B were both incorporated after December 31, 1986, always have been controlled foreign corporations, and always have had calendar taxable years. None of the shareholders of foreign corporations A and B are required to include any amount in income under §1.367(b)-4 as a result of the foreign 381 transaction. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. Finally, unless otherwise stated, any earnings and profits described in section 904(d)(1)(D) and 904(d)(1)(E) (shipping income and 10/50 dividends, respectively) qualified for the high tax exception from subpart F income under section 954(b)(4), and all United States shareholders elected to exclude such earnings and profits from subpart F income under section 954(b)(4) and §1.954-1(d)(5). The examples are as follows:

Example 1--(i) Facts. (A) On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Separate Category</u>		
10/50 dividends from FC1, a noncontrolled section 902 corporation	100u	\$40
General	<u>300u</u>	<u>\$60</u>
	400u	\$100

<u>Foreign Corporation B</u>		
<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Shipping	200u	\$40
10/50 dividends from FC2, a noncontrolled section 902 corporation	50u	\$20
General	<u>300u</u>	<u>\$70</u>
	550u	\$130

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a controlled foreign corporation (CFC).

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

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Shipping	200u	\$40
General	600u	\$130
10/50 dividends from FC1	100u	\$40
10/50 dividends from FC2	<u>50u</u>	<u>\$20</u>
	950u	\$230

(iii) Post-transaction distribution. (A) During 2002, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2002, foreign surviving corporation distributes 475u to its shareholders. Under the rules described in §1.902-1(d)(1) and paragraph (c)(1) of this section, the distribution is out of separate categories and reduces foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Shipping	100u	\$20
General	300u	\$65
10/50 dividends from FC1	50u	\$20
10/50 dividends from FC2	<u>25u</u>	<u>\$10</u>
	475u	\$115

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

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

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Shipping	100u	\$20
General	300u	\$65
10/50 dividends from FC1	50u	\$20
10/50 dividends from FC2	<u>25u</u>	<u>\$10</u>
	475u	\$115

Example 2--(i) Facts. (A) On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>		
<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Shipping	(100u)	\$ 5
10/50 dividends	400u	\$160
General	<u>200u</u>	<u>\$ 25</u>
	100u	\$190

<u>Foreign Corporation B</u>		
<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Shipping	100u	\$20
General	<u>300u</u>	<u>\$60</u>
	400u	\$80

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a CFC.

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

<u>Separate Category</u>	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&P</u>	Hovering <u>Deficit</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
Shipping	100u	(100u)	\$ 20	\$ 5
10/50 dividends	400u	0u	\$160	\$ 0
General	<u>300u</u>	<u>(200u)</u>	<u>\$ 60</u>	<u>\$25</u>
	800u	(300u)	\$240	\$30

(iii) Post-transaction distribution--(A) During 2002, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2002, foreign surviving corporation distributes 400u to its shareholders. Under the rules described in section 904(d)(3) and paragraph (c)(1) of this section, the distribution is out of separate categories and reduces foreign income taxes as

follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Shipping	50u	\$ 10
10/50 dividends	200u	\$ 80
General	<u>150u</u>	<u>\$ 30</u>
	400u	\$120

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

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

<u>Separate Category</u>	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&P</u>	Hovering <u>Deficit</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
Shipping	50u	(100u)	\$ 10	\$ 5
10/50 dividends	200u	0u	\$ 80	\$ 0
General	<u>150u</u>	<u>(200u)</u>	<u>\$ 30</u>	<u>\$25</u>
	400u	(300u)	\$120	\$30

(iv) Post-transaction earnings. (A) In its taxable year ending on December 31, 2003, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Shipping	105u	\$20
General	<u>100u</u>	<u>\$20</u>
	205u	\$40

(B) None of foreign surviving corporation's earnings and profits for its 2003 taxable year qualify as subpart F income as defined in section 952(a). Under the rules described in paragraphs (d)(2)(i) and (ii) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes accounts on December 31, 2003:

<u>Separate Category</u>	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&P</u>	<u>Hovering Deficit</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
Shipping	55u	0u	\$ 35	\$ 0
10/50 dividends	200u	0u	\$ 80	\$ 0
General	<u>150u</u>	<u>(100u)</u>	<u>\$ 50</u>	<u>\$25</u>
	405u	(100u)	\$165	\$25

Example 3--(i) Facts. The facts are the same as Example 2 (i), (ii), (iii), and (iv)(A), except that the 105u in the section 904(d)(1)(D) shipping separate category accumulated by foreign surviving corporation during 2003 qualify as subpart F income, all of which is included in income under section 951(a) by United States shareholders (as defined in section 951(b)).

(ii) Result. (A) Under the rule described in paragraph (g)(1) of this section, the 100u hovering deficit in the shipping separate category does not reduce foreign surviving corporation's current earnings and profits for purposes of determining subpart F income. Thus, foreign surviving corporation's United States shareholders include their pro rata shares of the 105u in taxable income for the year and are eligible for a deemed paid foreign tax credit under section 960, computed by reference to their pro rata shares of \$20.32 (105u subpart F inclusion ÷ (105u + 50u accumulated earnings and profits in the shipping category = 155u) = 0.68%, x \$30 foreign income taxes in the shipping category = \$20.32).

(B) Immediately after the subpart F inclusion and section 960 deemed paid taxes (and taking into account the taxable year 2003 earnings and profits and related taxes in the general category), foreign surviving corporation has the following earnings and profits and foreign income taxes accounts:

<u>Separate Category</u>	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	Positive <u>E&P</u>	<u>Hovering Deficit</u>	Foreign Taxes <u>Available</u>	Foreign Taxes Associated with Hovering <u>Deficit</u>
Shipping	50u	(100u)	\$ 9.68	\$ 5
10/50 dividends	200u	0u	\$ 80.00	\$ 0
General	<u>150u</u>	<u>(100u)</u>	<u>\$ 50.00</u>	<u>\$25</u>
	400u	(200u)	\$139.68	\$30

(C) The 105u included as subpart F income constitutes previously taxed earnings and profits under section 959.

(e) Non-look-through pool--(1) If foreign surviving corporation is a look-through corporation. If the foreign surviving corporation is a look-through corporation, then the non-look-through pool shall be determined under the rules of this paragraph (e)(1).

(i) Qualifying earnings and taxes. The non-look-through pool shall consist of the post-1986 undistributed earnings and related post-1986 foreign income taxes that were accumulated (or treated as accumulated) by the foreign target corporation or the foreign acquiring corporation while it was a non-look-through 10/50 corporation.

(ii) Carryover rule. Subject to paragraph (e)(1)(iii) of this section, the amounts described in paragraph (e)(1)(i) of this section attributable to the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation but shall not be combined. Thus, post-transaction distributions by the foreign surviving corporation out of the non-look-through pool shall be made from the separate amounts attributable to the foreign acquiring corporation and the foreign target corporation on a pro rata basis, and shall reduce a pro rata portion of any related foreign income taxes.

(iii) Hovering deficit. The rules of this paragraph (e)(1)(iii) apply when the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in the post-1986 undistributed earnings described in paragraph (e)(1)(i) of this section immediately prior to the foreign 381 transaction.

In the event that this paragraph (e)(1)(iii) applies to a deficit of both the foreign acquiring corporation and the foreign target corporation, the deficits shall not be combined and the rules of this paragraph (e)(1)(iii) shall be applied separately to each of such deficits on a pro rata basis. See also paragraphs (g)(1) and (g)(4) of this section (describing other rules applicable to a deficit described in this paragraph (e)(1)(iii)).

(A) Offset rule. A deficit described in this paragraph (e)(i)(iii) shall offset only post-transaction earnings. The deficit shall offset a pro rata portion of post-transaction earnings accumulated in each separate category of earnings and profits by the foreign surviving corporation.

(B) Related taxes. Foreign income taxes that are related to a deficit described in this paragraph (e)(1)(iii) shall be added to the foreign surviving corporation's post-1986 foreign income taxes (in the applicable segregated portion of the non-look-through pool) only after post-transaction earnings have been offset by and exceed the entire amount of the deficit.

(iv) Examples. The following examples illustrate the rules of this paragraph (e)(1). The examples presume the following facts: Foreign corporation A was a non-look-through 10/50 corporation from its incorporation on January 1, 1995 until December 31, 1997; foreign corporation A became a CFC on January 1, 1998 and has been a CFC since that time. Foreign corporation B has been a non-look-through 10/50 corporation since its incorporation on January 1, 1993. Both foreign corporation A and

foreign corporation B always have had calendar taxable years. None of the shareholders of foreign corporation A are required to include any amount in income under §1.367(b)-4 as a result of the foreign 381 transaction. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. Finally, any earnings and profits described in section 904(d)(1)(E) (10/50 dividends) qualified for the high tax exception from subpart F income under section 954(b)(4), and all United States shareholders elected to exclude such earnings and profits from subpart F income under section 954(b)(4) and §1.954-1(d)(5). The examples are as follows:

Example 1--(i) Facts. (A) On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Separate Category:</u>		
10/50 dividends	100u	\$ 40
General	300u	\$ 60
<u>E&P Accumulated as Non-Look- Through 10/50 Corporation:</u>	<u>400u</u>	<u>\$100</u>
	800u	\$200
<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>E&P Accumulated as Non-Look- Through 10/50 Corporation:</u>	200u	\$ 40

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a CFC.

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

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Look-Through Pool Separate Category:</u>		
10/50 dividends	100u	\$ 40
General	300u	\$ 60
<u>Two Side-by-Side Non-Look-Through Pool Amounts:</u>		
Non-look-through pool amount #1 (from Corp A)	400u	\$100
Non-look-through pool amount #2 (from Corp B)	<u>200u</u>	<u>\$ 40</u>
	1,000u	\$240

(iii) Post-transaction distribution. (A) During 2002, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2002, foreign surviving corporation distributes 700u to its shareholders. Under the rules described in paragraphs (c)(1) and (e)(1)(ii) of this section, the distribution is first out of the look-through pool, then out of the non-look-through pool, as follows:

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Look-Through Pool Separate Category:</u>		
10/50 dividends	100u	\$ 40
General	300u	\$ 60
<u>Non-Look-Through Pool Amounts:</u>		
Non-look-through pool amount #1	200u	\$ 50
Non-look-through pool amount #2	<u>100u</u>	<u>\$ 20</u>
	700u	\$170

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

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

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Two Side-by-Side Non-Look-Through Pool Amounts:</u>		
Non-look-through pool amount #1	200u	\$50
Non-look-through pool amount #2	<u>100u</u>	<u>\$20</u>
	300u	\$70

Example 2--(i) Facts--(A) On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Look-through Pool Separate Category:</u>		
10/50 dividends	100u	\$ 40
General	300u	\$ 60
<u>E&P Accumulated as Non-Look-Through 10/50 Corporation:</u>	<u>400u</u>	<u>\$100</u>
	800u	\$200
<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>E&P Accumulated as Non-Look-Through 10/50 Corporation:</u>	(200u)	\$ 5

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a CFC.

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

	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	Positive	Hovering Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
	<u>E&P</u>	<u>Hovering Deficit</u>	<u>Available</u>	<u>Deficit</u>
<u>Look-through Pool Separate Category:</u>				
10/50 dividends	100u		\$ 40	
General	300u		\$ 60	
<u>Two Side-by-Side Non-Look-Through Pool Amounts:</u>				
Non-look-through pool amount #1	400u		\$100	
Non-look-through pool amount #2		(200u)		\$5
	<u>800u</u>	<u>(200u)</u>	<u>\$200</u>	<u>\$5</u>

(iii) Post-transaction distribution. (A) During 2002, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2002, foreign surviving corporation distributes 600u to its shareholders. Under the rules described in paragraphs (c)(1) and (e)(1)(ii) of this section, the distribution is first out of the look-through pool, then out of the non-look-through pool, as follows:

<u>Look-Through Pool Separate Category:</u>	<u>E&P</u>	<u>Foreign Taxes</u>
10/50 dividends	100u	\$ 40
General	300u	\$ 60
<u>Non-Look-Through Pool Amount:</u>		
Non-look-through pool amount #1	<u>200u</u>	<u>\$ 50</u>
	600u	\$150

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

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

	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	Positive	Deficit	Foreign Taxes Available	Foreign Taxes Associated with Hovering Deficit
	<u>E&P</u>	<u>Hovering</u>	<u>Available</u>	<u>Deficit</u>
<u>Two Side-by-Side Non-Look-Through Pool Amounts:</u>				
Non-look-through pool amount #1	200u		\$50	
Non-look-through pool amount #2		(200u)		\$5
	<u>200u</u>	<u>(200u)</u>	<u>\$50</u>	<u>\$5</u>

(iv) Post-transaction earnings. (A) In the taxable year ending on December 31, 2003, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

<u>Separate Category:</u>	<u>E&P</u>	<u>Foreign Taxes</u>
10/50 dividends	150u	\$ 60
General	<u>300u</u>	<u>\$ 60</u>
	450u	\$120

(B) None of the earnings and profits qualify as subpart F income as defined in section 952(a). Under the rules described in paragraph (e)(1)(iii)(A) of this section, the 200u deficit in non-look-through pool amount #2 offsets a pro rata portion of the foreign surviving corporation's post-transaction earnings in each separate category. Thus, the 200u deficit offsets 66.66u of section 904(d)(1)(E) 10/50 dividends separate category earnings (33.33% of 200u) and offsets 133.34u of section 904(d)(1)(I) general separate category earnings (66.67% of 200u).

Accordingly, foreign surviving corporation has the following earnings and profits and foreign income taxes accounts as of December 31, 2002:

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Look-Through Pool Separate Category:</u>		
10/50 dividends	83.34u	\$ 60
General	166.66u	\$ 60
<u>Two Side-by-Side Non-Look-Through Pool Amounts:</u>		
Non-look-through pool amount #1	200u	\$ 50
Non-look-through pool amount #2	<u> </u>	<u>\$ 5</u>
	450u	\$175

(C) Under paragraph (e)(1)(iii)(B) of this section, the \$5 of foreign income taxes associated with the non-look-through pool amount #2 hovering deficit are added to foreign surviving corporation's available foreign income taxes because post-transaction earnings have been offset by and exceed the deficit in the non-look-through pool. However, the \$5 of foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped.

(2) If foreign surviving corporation is a non-look-through 10/50 corporation. If the foreign surviving corporation is a non-look-through 10/50 corporation, then the non-look-through pool shall be determined under the rules of this paragraph (e)(2).

(i) Qualifying earnings and taxes. The non-look-through pool shall consist of the post-1986 undistributed earnings and related post-1986 foreign income taxes of the foreign acquiring corporation and the foreign target corporation.

(ii) Carryover rule. Subject to paragraph (e)(2)(iii) of this section, the amounts described in paragraph (e)(2)(i) of this section attributable to the foreign acquiring corporation and the foreign target corporation shall carry over to the foreign surviving corporation and shall be combined as a single

separate category of earnings and profits under section 904(d)(1)(E).

(iii) Hovering deficit. The rules of this paragraph (e)(2)(iii) apply when the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate deficit in its post-1986 undistributed earnings described in paragraph (e)(2)(i) of this section immediately prior to the foreign 381 transaction. In the event that both the foreign acquiring corporation and the foreign target corporation have an aggregate deficit in post-1986 undistributed earnings, such deficits and their related foreign income taxes shall be combined for purposes of applying this paragraph (e)(2)(iii). See also paragraphs (g)(1) and (4) of this section (describing other rules applicable to a deficit described in this paragraph (e)(2)(iii)).

(A) Offset rule. A deficit described in this paragraph (e)(2)(iii) shall offset only post-transaction earnings accumulated by the foreign surviving corporation.

(B) Related taxes. Foreign income taxes that are related to a deficit described in this paragraph (e)(2)(iii) shall be added to the foreign surviving corporation's post-1986 foreign income taxes only after post-transaction earnings have been offset by and exceed the entire amount of the deficit.

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

and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. Finally, any earnings and profits described in section 904(d)(1)(E) (10/50 dividends) qualified for the high tax exception from subpart F income under section 954(b)(4), and all United States shareholders elected to exclude such earnings and profits from subpart F income under section 954(b)(4) and §1.954-1(d)(5). The examples are as follows:

Example 1--(i) Facts. (A) Foreign corporations A and B are and always have been non-look-through 10/50 corporations since they were incorporated in 1995. On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
E&P accumulated as non-look-through 10/50 corporation	400u	\$100
<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
E&P accumulated as non-look-through 10/50 corporation	200u	\$ 40

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a non-look-through 10/50 corporation.

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

<u>Non-Look-Through Pool:</u>	<u>E&P</u>	<u>Foreign Taxes</u>
	600u	\$140

Example 2--(i) Facts--(A) Foreign corporation A is and always has been a CFC since it was incorporated in 1995. Foreign corporation B is and always has been a non-look-through 10/50 corporation since it was incorporated in 1995. Immediately before the foreign 381 transaction (but after application of the rules of §1.367(b)-4 to foreign corporation A and its shareholders), foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Separate Category:</u>		
Passive	(200u)	\$ 10
10/50 dividends	100u	\$ 40
General	<u>300u</u>	<u>\$ 60</u>
	200u	\$110

<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
E&P accumulated as non- look-through 10/50 corporation:	200u	\$ 30

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a non-look-through 10/50 corporation.

(ii) Result. Because neither foreign corporation A nor foreign corporation B has an aggregate deficit in post-1986 undistributed earnings, the rules described in paragraphs (e)(2)(i) and (ii) of this section apply, but the rules described in paragraph (e)(2)(iii) do not. Accordingly, foreign corporation A's net positive earnings and profits of 200u (300u + 100u + (200u)) and its aggregate foreign income taxes of \$110 (\$10 + \$40 + \$60) are combined with the earnings and profits and foreign income taxes of foreign corporation B, so that foreign surviving corporation has the following earnings and profits and foreign income taxes accounts:

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Non-Look-Through Pool:</u>	400u	\$140

Example 3--(i) Facts. (A) Foreign corporation A is and always has been a CFC since it was incorporated in 1995. Foreign corporation B is and always has been a non-look-through 10/50 corporation since it was incorporated in 1995. On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Separate Category:</u>		
Passive	(200u)	\$ 10
10/50 dividends	100u	\$ 40
General	<u>(300u)</u>	<u>\$ 60</u>
	(400u)	\$110

<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
E&P accumulated as non- look-through 10/50 corporation:	200u	\$ 30

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in

section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a non-look-through 10/50 corporation. (Assume that none of the shareholders of foreign corporation A are required to include an amount in income under §1.367(b)-4 with regard to this transaction.)

(ii) Result. Because foreign corporation A has an aggregate deficit in post-1986 undistributed earnings, the rules of paragraph (e)(2)(iii) of this section apply. Accordingly, foreign corporation A's 400u aggregate deficit in earnings and profits ((200u) + 100u + (300u)) carries over as a hovering deficit to foreign surviving corporation, so that foreign surviving corporation has the following earnings and profits and foreign income taxes accounts:

	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
<u>Non-Look-Through Pool:</u>	200u	(400u)	\$30	\$110

(iii) Post-transaction earnings. (A) In the taxable year ending on December 31, 2002, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>E&P accumulated as non-look-through 10/50 corporation:</u>	500u	\$100

(B) Under the rule described in paragraph (e)(2)(iii)(A) of this section, the hovering deficit of 400u in the non-look-through pool offsets 400u of post-transaction earnings. Under the rules of paragraph (e)(2)(iii)(B) of this section, the foreign income taxes related to the hovering deficit are added to foreign surviving corporation's available foreign income taxes because post-transaction earnings have been offset by and exceed the deficit in the non-look-through pool. Accordingly, foreign surviving corporation has the following earnings and profits and foreign income taxes accounts as of December 31, 2002:

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Non-Look-Through Pool:</u>	300u	\$240

(f) Pre-pooling annual layers--(1) If foreign surviving corporation is a look-through corporation or a non-look-through

10/50 corporation. If the foreign surviving corporation is a look-through corporation or a non-look-through 10/50 corporation, the pre-pooling annual layers shall be determined under the rules of this paragraph (f)(1).

(i) Qualifying earnings and taxes. The pre-pooling annual layers shall consist of the pre-1987 accumulated profits and the pre-1987 foreign income taxes of the foreign acquiring corporation and the foreign target corporation.

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

(iii) Deficits. The rules of this paragraph (f)(1)(iii) apply when the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in one or more years

that comprise its pre-1987 accumulated profits immediately prior to the foreign 381 transaction (see also paragraphs (g)(1) and (g)(4) of this section, describing other rules applicable to a deficit described in this paragraph (f)(1)(iii)).

(A) Aggregate positive earnings and profits. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more individual years, then the rules otherwise applicable to such deficits shall apply separately to the pre-1987 accumulated profits and related foreign income taxes of such corporation. For further guidance, see Rev. Rul. 74-550 (1974-2 C.B. 209) (see also §601.601(d)(2) of this chapter); Champion Int'l Corp. v. Commissioner, 81 T.C. 424 (1983), acq. in result, 1987-2 C.B. 1; Rev. Rul. 87-72 (1987-2 C.B. 170) (see also §601.601(d)(2) of this chapter). As a result, no amount in excess of the aggregate positive amount of pre-1987 accumulated profits shall be distributed from the pre-transaction earnings of the foreign acquiring corporation or the foreign target corporation.

(B) Aggregate deficit in earnings and profits. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate deficit in pre-1987 accumulated profits, then the rules under §1.902-2(b) shall apply to such deficit (and related foreign income taxes) immediately prior to the transaction, except that the aggregate deficit that is carried forward into the look-through pool (in the case of a

foreign surviving corporation that is a look-through corporation) or non-look-through pool (in the case of a foreign surviving corporation that is a non-look-through 10/50 corporation) shall be available to offset only post-transaction earnings accumulated by the foreign surviving corporation.

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

(v) Examples. The following examples illustrate the rules of this paragraph (f)(1). The examples presume the following facts: foreign corporation A was incorporated in 1998 and was a less-than-10%-U.S.-owned foreign corporation through December 31, 1999. Foreign corporation A became a non-look-through 10/50 corporation on January 1, 2000 and, as a result, began to maintain a pool of post-1986 undistributed earnings on that date. Foreign corporation B was incorporated in 1998 and always has been owned by foreign shareholders (and thus never has met the requirements of section 902(c)(3)(B)). Both foreign corporation

A and foreign corporation B always have had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. The examples are as follows:

Example 1--(i) Facts. (A) On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
E&P accumulated as non-look-through 10/50 corporation:	1,000u	\$350
1999	400u	160u
1998	<u>100u</u>	5u
	1,500u	

<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
2001	100u	20u
2000	150u	30u
1999	0u	50u
1998	<u>50u</u>	<u>5u</u>
	300u	105u

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a non-look-through 10/50 corporation.

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

	<u>E&P</u>	<u>Foreign Taxes</u>
Non-look-through pool	1,000u	\$350
2001	100u	20u
2000	150u	30u
<u>Two Side-by-Side Layers of 1999 E&P:</u>		
1999 layer #1 (from Corp A)	400u	160u
1999 layer #2 (from Corp B)	0u	50u
<u>Two Side-by-Side Layers of 1998 E&P:</u>		
1998 layer #1 (from Corp A)	100u	5u
1998 layer #2 (from Corp B)	<u>50u</u>	5u
	1,800u	

(iii) Post-transaction distribution. (A) During 2002, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On

December 31, 2002, foreign surviving corporation distributes 1,700u to its shareholders. Under the rules of paragraph (c)(2) of this section, the distribution is first out of the non-look-through pool, and then out of the pre-pooling annual layers under the LIFO method, as follows:

<u>Distribution</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Non-look-through pool	1,000u	\$350
2001	100u	20u
2000	150u	30u
<u>Two Side-by-Side</u>		
<u>Layers of 1999 E&P:</u>		
1999 layer #1	400u	160u
1999 layer #2	0u	0u
<u>Two Side-by-Side</u>		
<u>Layers of 1998 E&P:</u>		
1998 layer #1	33.33u	1.67u
	(100u in layer ÷ 150u aggregate 1997 earnings = 66.67% x 50u distribution)	
1998 layer #2	16.67u	1.67u
	(50u in layer ÷ 150u aggregate 1997 earnings = 33.33% x 50u distribution)	
	<u>1,700u</u>	

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

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

	<u>E&P</u>	<u>Foreign Taxes</u>
1999 layer #2	0.00u	50.00u
<u>Two Side-by-Side Layers of 1998 E&P:</u>		
1998 layer #1	66.67u	3.33u
1998 layer #2	<u>33.33u</u>	<u>3.33u</u>
	100.00u	56.66u

(iv) Post-transaction earnings. For the taxable year ending on December 31, 2003, foreign surviving corporation accumulates 500u of current earnings and profits and pays \$70 in foreign income taxes. As of the close of the 2003 taxable year, foreign surviving corporation has the following earnings and profits and foreign income taxes accounts:

	<u>E&P</u>	<u>Foreign Taxes</u>
E&P accumulated as non- look-through 10/50 corporation	500.00u	\$70.00
1999	0.00u	50.00u
<u>Two Side-by-Side Layers of 1998 E&P:</u>		
1998 layer #1	66.67u	3.33u
1998 layer #2	<u>33.33u</u>	3.33u
	600u	

Example 2--(i) Facts. (A) On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
E&P accumulated as non- look-through 10/50 corporation	1,000u	\$350
1999	100u	20u
1998	<u>(50u)</u>	5u
	1,050u	

<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
2001	100u	20u
2000	(50u)	5u
1999	0u	50u
1998	<u>100u</u>	<u>10u</u>
	150u	85u

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a non-look-through 10/50 corporation.

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

	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&P</u>	<u>Deficit E&P</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Deficit E&P</u>
<u>Non-Look-Through</u>				
10/50 Pool	1,000u		\$350	
2001	100u		20u	
2000		(50u)		5u
<u>Two Side-by-Side Layers of 1999 E&P:</u>				
1999 layer #1 (from foreign corporation A)	100u		20u	
1999 layer #2 (from foreign corporation B)	0u		50u	
<u>Two Side-by-Side Layers of 1998 E&P:</u>				
1998 layer #1 (from foreign corporation A)		(50u)		5u
1998 layer #2 (from foreign corporation B)	<u>100u</u>		10u	
	1,300u	<u>(100u)</u>		<u>10u</u>

(iii) Post-transaction distribution--(A) During 2002, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2002, foreign surviving corporation distributes 1,175u to its shareholders. Under the rules described in paragraphs (c)(2) and (f)(1)(iii)(A) of this section, the distribution is first out of the non-look-through pool, and then out of the pre-pooling annual layers, as follows:

<u>Distribution</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Non-Look-Through 10/50 Amount	1,000u	\$350
2001	100u	20u
2000	0u	0u
<u>Two Side-by-Side Layers of 1999 E&P:</u>		
1999 layer #1	50u	20u
1999 layer #2	0u	0u
<u>Two Side-by-Side Layers of 1998 E&P:</u>		
1998 layer #1	0u	0u
1998 layer #2	<u>25u</u>	5u
	1,175u	

(B) Under the rules described in paragraph (f)(1)(iii)(A)

of this section, the rules otherwise applicable when a foreign corporation has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more individual years, apply separately to the pre-1987 accumulated profits and related foreign income taxes of foreign corporation A and foreign corporation B. As a result, distributions out of the pre-pooling annual layers of foreign corporation A and foreign corporation B can not exceed the aggregate positive amount of pre-1987 accumulated profits of each corporation. Accordingly, only 50u can be distributed from foreign corporation A's pre-pooling annual layers and is out of its 1999 layer #1. Under Champion Int'l Corp. v. Commissioner, 81 T.C. 424 (1983), the full 20u of taxes related to 1999 layer #1 is reduced or deemed paid ($\$20 \times (50 \div 50)$). Under Rev. Rul. 74-550 (1974-2 C.B. 209) (see also §601.601(d)(2) of this chapter), 100u is distributed from foreign corporation B's 2001 annual layer. Foreign corporation B's deficit in 2000 is then rolled back to offset its 1998 annual layer to reduce earnings in that layer to 50u, 25u of which is distributed (and reduces one-half of that year's foreign income taxes).

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

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

	<u>E&P</u>	<u>Foreign Taxes</u>
2000	0u	5u
1999 layer #2	0u	50u
<u>Two Side-by-Side Layers</u> <u>of 1998 E&P:</u>		
1998 layer #1	0u	5u
1998 layer #2	<u>25u</u>	<u>5u</u>
	25u	65u

(E) Under the rules described in paragraph (f)(1)(iii)(A) of this section, the 5u, 50u, and 5u of foreign income taxes related to foreign surviving corporation's 2000 layer, 1999 layer #2, and 1998 layer #1, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped.

Example 3--(i) Facts. (A) On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
E&P accumulated as non- look-through 10/50 corporation:	1,000u	\$350
1999	150u	20u
1998	<u>100u</u>	5u
	1,250u	

<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
2001	100u	20u
2000	(250u)	5u
1999	0u	50u
1998	<u>100u</u>	<u>10u</u>
	(50u)	85u

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a non-look-through 10/50 corporation.

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

	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
Non-Look-Through 10/50 Pool	1,000u	(50u)	\$350	\$0
2001	0u		20u	
2000	0u		5u	
<u>Two Side-by-Side Layers of 1999 E&P:</u>				
1999 layer #1 (from Corp A)	150u		20u	
1999 layer #2 (from Corp B)	0u		50u	
<u>Two Side-by-Side Layers of 1998 E&P:</u>				
1998 layer #1 (from Corp A)	100u		5u	
1998 layer #2 (from Corp B)	0u		10u	
	<u>1,250u</u>	(50u)		<u>\$0</u>

(B) Under paragraph (f)(1)(iii)(B) of this section, the 20u, 5u, 50u, and 10u of foreign income taxes associated with foreign corporation B's earnings and profits for 2001, 2000, 1999 layer #2, and 1998 layer #2, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped.

(2) If foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation. If the foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation, then the pre-pooling annual layers shall be determined under the rules of this paragraph (f)(2).

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

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

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

(iii) Deficits. The rules of this paragraph (f)(2)(iii) apply when the foreign acquiring corporation or the foreign target corporation (or both) has a deficit in one or more years that comprise its pre-1987 accumulated profits immediately prior

to the foreign 381 transaction (and after application of the last sentence of paragraph (f)(2)(i) of this section). See also paragraphs (g)(1) and (4) of this section (describing other rules applicable to a deficit described in this paragraph (f)(2)(iii)).

(A) Aggregate positive earnings and profits. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more individual years, then the rules otherwise applicable to such deficits shall apply separately to the pre-1987 accumulated profits and related foreign income taxes of such corporation. For further guidance, see Rev. Rul. 74-550 (1974-2 C.B. 209) (see also §601.601(d)(2) of this chapter); Champion Int'l Corp. v. Commissioner, 81 T.C. 424 (1983), acq. in result, 1987-2 C.B. 1; Rev. Rul. 87-72 (1987-2 C.B. 170) (see also §601.601(d)(2) of this chapter). As a result, no amount in excess of the aggregate positive amount of pre-1987 accumulated profits shall be distributed from the pre-transaction earnings of the foreign acquiring corporation or the foreign target corporation.

(B) Aggregate deficit in earnings and profits. If the foreign acquiring corporation or the foreign target corporation (or both) has an aggregate deficit in pre-1987 accumulated profits, then the rules otherwise applicable to such deficits shall apply separately to the pre-transaction earnings and profits and related taxes of the applicable corporation. See, e.g., sections 316(a) and 381(c)(2)(B). Thus, any aggregate net

deficit shall be available to offset only post-transaction earnings accumulated by the foreign surviving corporation.

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

(v) Examples. The following examples illustrate the rules of this paragraph (f)(2). The examples presume the following facts: Both foreign corporation A and foreign corporation B always have had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. The examples are as follows:

Example 1--(i) Facts. (A) Foreign corporations A and B both were incorporated in 1998. Nine percent of the voting stock of foreign corporation A is owned by domestic corporate shareholder C. Nine percent of the voting stock of foreign corporation B is owned by domestic corporate shareholder D. Shareholders C and D are unrelated. The remaining 91% of the voting stock of each foreign corporation is owned by unrelated foreign shareholders. Thus, neither corporation meets the requirements of section 902(c)(3)(B). On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
2001	500u	350u
2000	400u	300u
1999	400u	160u
1998	<u>100u</u>	<u>5u</u>
	1,400u	815u

<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
2001	100u	20u
2000	300u	60u
1999	0u	50u
1998	<u>50u</u>	<u>5u</u>
	450u	135u

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation that does not meet the requirements of section 902(c)(3)(B).

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

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Two Side-by-Side Layers of 2001 E&P:</u>		
2001 layer #1 (from Corp A)	500u	350u
2001 layer #2 (from Corp B)	100u	20u
<u>Two Side-by-Side Layers of 2000 E&P:</u>		
2000 layer #1 (from Corp A)	400u	300u
2000 layer #2 (from Corp B)	300u	60u
<u>Two Side-by-Side Layers of 1999 E&P:</u>		
1999 layer #1 (from Corp A)	400u	160u
1999 layer #2 (from Corp B)	0u	50u
<u>Two Side-by-Side Layers of 1998 E&P:</u>		
1998 layer #1 (from Corp A)	100u	5u
1998 layer #2 (from Corp B)	<u>50u</u>	<u>5u</u>
	1,850u	950u

(iii) Post-transaction distribution. (A) During 2002, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2002, foreign surviving corporation distributes 600u to its shareholders. Under the rules of paragraph (c)(3) of this section, the distribution is out of pre-pooling annual layers under the LIFO method as follows:

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Two Side-by-Side Layers of 2001 E&P:</u>		
2001 layer #1 (from Corp A)	500u	350u
2001 layer #2 (from Corp B)	<u>100u</u>	<u>20u</u>
	600u	370u

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

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

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Two Side-by-Side Layers of 2000 E&P:</u>		
2000 layer #1 (from Corp A)	400u	300u
2000 layer #2 (from Corp B)	300u	60u
<u>Two Side-by-Side Layers of 1999 E&P:</u>		
1999 layer #1 (from Corp A)	400u	160u
1999 layer #2 (from Corp B)	0u	50u
<u>Two Side-by-Side Layers of 1998 E&P:</u>		
1998 layer #1 (from Corp A)	100u	5u
1998 layer #2 (from Corp B)	<u>50u</u>	<u>5u</u>
	1,250u	580u

Example 2--(i) Facts. (A) The facts are the same as in Example 1 (i)(A), except that foreign corporation A met the requirements of section 902(c)(3)(B) on January 1, 2000, when U.S. corporate shareholder C acquired an additional 1% of voting stock for a total ownership interest of 10%; foreign corporation A thereby became a non-look-through 10/50 corporation. On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>E&P Accumulated as Non-Look-Through 10/50 Corporation:</u>		
1999	900u	\$650
1998	400u	160u
	<u>100u</u>	5u
	1,400u	
<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
2001	100u	20u
2000	300u	60u
1999	0u	50u
1998	<u>50u</u>	<u>5u</u>
	450u	135u

(B) On January 1, 2002, foreign corporation B acquires the

assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation that does not meet the requirements of section 902(c)(3)(B).

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

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Two Side-by-Side Layers of 2001 E&P:</u>		
2001 layer #1 (from Corp A's pool)	900u	\$650
2001 layer #2 (from Corp B's layer)	100u	20u
2000 (from Corp B):	300u	60u
<u>Two Side-by-Side Layers of 1999 E&P:</u>		
1999 layer #1 (from Corp A)	400u	160u
1999 layer #2 (from Corp B)	0u	50u
<u>Two Side-by-Side Layers of 1998 E&P:</u>		
1998 layer #1 (from Corp A)	100u	5u
1998 layer #2 (from Corp B)	<u>50u</u>	5u
	1,850u	

(iii) Subsequent ownership change. On January 1, 2007, USS (a domestic corporation) acquires 100% of the stock of foreign surviving corporation. Under the rules of paragraph (g)(3) of this section, foreign surviving corporation begins to pool its earnings and profits under section 902(c)(3) as of January 1, 2007. Foreign surviving corporation's earnings and profits and foreign income taxes accrued before January 1, 2007 retain their character as pre-1987 accumulated profits and pre-1987 foreign income taxes.

Example 3--(i) Facts. (A) The facts are the same as in Example 2 (i)(A), except that on December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>E&P Accumulated as Non-Look-Through 10/50 Corporation:</u>		
	1,000u	\$500
1999	(200u)	10u
1998	<u>400u</u>	5u
	1,200u	
<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
2001	300u	20u
2000	(100u)	60u
1999	0u	50u
1998	<u>50u</u>	<u>5u</u>
	250u	135u

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation that does not meet the requirements of section 902(c)(3)(B).

(ii) Result. Because foreign corporations A and B have aggregate positive amounts of pre-1987 earnings and profits with a deficit in one or more individual years, the rules of paragraph (f)(2)(iii)(A) of this section apply. Accordingly, after the foreign 381 transaction, foreign surviving corporation has the following earnings and profits and foreign income taxes accounts:

	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&P</u>	<u>Deficit E&P</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Deficit E&P</u>
<u>Two Side-by-Side Layers of 2001 E&P:</u>				
2001 layer #1 (from Corp A's non-look-through 10/50 pool)	1,000u		\$500	
2001 layer #2 (from Corp B's layer)	300u		20u	
2000 (from Corp B)		(100u)		60u
<u>Two Side-by-Side Layers of 1999 E&P:</u>				
1999 layer #1 (from Corp A)		(200u)		10u
1999 layer #2 (from Corp B)	0u		50u	
<u>Two Side-by-Side Layers of 1998 E&P:</u>				
1998 layer #1 (from Corp A)	400u		5u	
1998 layer #2 (from Corp B)	50u		5u	
	<u>1,750u</u>	<u>(300u)</u>		<u>70u</u>

(iii) Post-transaction distribution. (A) During 2002, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On

December 31, 2002, foreign surviving corporation distributes 1,300u to its shareholders. Under the rules described in paragraphs (c)(3) and (f)(2)(iii)(A) of this section, the distribution is out of the pre-pooling annual layers, as follows:

	<u>E&P</u>	<u>Foreign Taxes Paid</u>
<u>Two Side-by-Side Layers</u>		
<u>of 2001 E&P:</u>		
2001 layer #1	1,000u	\$500
2001 layer #2	250u	20u
<u>1998 E&P:</u>		
1998 layer #1	50u	1.25u (25% of 5u taxes)
	1,300u	

(B) Under the rules described in paragraph (f)(2)(iii)(A) of this section, the rules otherwise applicable when a foreign corporation has an aggregate positive (or zero) amount of pre-1987 accumulated profits, but a deficit in one or more individual years, apply separately to the pre-1987 accumulated profits and related foreign income taxes of foreign corporation A and foreign corporation B. As a result, distributions out of the pre-pooling annual layers of foreign corporation A and foreign corporation B cannot exceed the aggregate positive amount of pre-1987 accumulated profits of each corporation. Accordingly, only 1,200u and 250u can be distributed out of foreign corporation A's and foreign corporation B's pre-pooling annual layers, respectively. Thus, 1,250u of the distribution is out of 1,000u of foreign corporation A's 2001 layer #1 and 250u of foreign corporation B's 2001 layer #2. Under the principles of §1.902-1(b)(3) and Champion Int'l Corp. v. Commissioner, 81 T.C. 424 (1983), all of the taxes in each of those respective layers are reduced. Applying Rev. Rul. 74-550 (1974-2 C.B. 209) (see also §601.601(d)(2) of this chapter), the remaining 50u is distributed from foreign corporation A's 1998 layer #1 (after rolling back the 200u deficit in 1999 layer #1 to reduce earnings in 1998 layer #1 to 200u (400u - 200u)). Thus, after the distribution, 150u remains in the 1998 layer #1 along with 3.75u of foreign income taxes (5u x (150u ÷ 200u)).

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

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

	<u>E&P</u>	<u>Foreign Taxes</u>
2000	0u	60u
<u>Two Side-by-Side Layers</u> <u>of 1999 E&P:</u>		
1999 layer #1	0u	10u
1999 layer #2	0u	50u
<u>Two Side-by-Side Layers</u> <u>of 1998 E&P:</u>		
1998 layer #1	150u	3.75u
1998 layer #2	<u>0u</u>	<u>5u</u>
	150u	128.75u

(E) Under the rules described in paragraph (f)(2)(iii)(A) of this section, the 60u, 10u, 50u, and 5u of foreign income taxes related to foreign surviving corporation's 2000 layer, 1999 layer #1, 1999 layer #2, and 1998 layer #2, respectively, remain in those layers. These foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped.

Example 4--(i) Facts. (A) The facts are the same as in Example 2 (i)(A), except that on December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u> <u>E&P Accumulated as Non-Look-</u> <u>Through 10/50 Corporation:</u>	<u>E&P</u>	<u>Foreign Taxes</u>
	(1,000u)	\$20
1999	(200u)	10u
1998	<u>400u</u>	5u
	(800u)	
 <u>Foreign Corporation B</u>	 <u>E&P</u>	 <u>Foreign Taxes</u>
2001	100u	20u
2000	300u	60u
1999	0u	50u
1998	<u>50u</u>	<u>5u</u>
	450u	135u

(B) On January 1, 2002, foreign corporation A acquires the assets of foreign corporation B in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a less-than-10%-U.S.-owned foreign corporation.

(ii) Result. Because foreign corporation A has an aggregate deficit in pre-1987 earnings and profits, the rules of paragraph (f)(2)(iii)(B) of this section apply and the rules otherwise applicable apply separately to the pre-1987 accumulated profits that carry over to foreign surviving corporation from foreign corporation A. Accordingly, after the foreign 381 transaction,

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

	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&P</u>	<u>Deficit E&P</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Deficit E&P</u>
<u>Two Side-by-Side Layers of 2001 E&P:</u>				
2001 layer #1 (from Corp A)		(1,000u)		\$20
2001 layer #2 (from Corp B)	100u		20u	
2000	300u		60u	
<u>Two Side-by-Side Layers of 1999 E&P:</u>				
1999 layer #1 (from Corp A)		(200u)		10u
1999 layer #2 (from Corp B)	0u		50u	
<u>Two Side-by-Side Layers of 1998 E&P:</u>				
1998 layer #1 (from Corp A)	400u		5u	
1998 layer #2 (from Corp B)	<u>50u</u>		<u>5u</u>	
	850u	(1,200u)	140u	

(iii) Post-transaction distribution. (A) During 2002, foreign surviving corporation does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2002, foreign surviving corporation distributes 200u to its shareholders. Under the rules described in paragraph (f)(2)(iii)(B) of this section, no distribution can be made out of the pre-1987 accumulated profits of foreign corporation A (and the 800u aggregate deficit is available to offset only post-transaction earnings accumulated by foreign surviving corporation). Thus, the distribution is out of pre-pooling annual layers as follows:

	<u>E&P</u>	<u>Foreign Taxes Paid</u>
2001 layer #2	100u	20u
2000	<u>100u</u>	<u>20u</u>
	200u	40u

(B) Foreign surviving corporation's foreign income tax accounts are reduced to reflect the distribution of earnings and profits, see §1.902-1(a)(10)(iii), notwithstanding that no

shareholders are eligible to claim deemed paid foreign income taxes under section 902.

(g) Special rules--(1) Treatment of deficit. Any deficit described in paragraph (d)(2), (e)(1)(iii), (e)(2)(iii), (f)(1)(iii), or (f)(2)(iii) of this section shall not be taken into account in determining current or accumulated earnings and profits of a foreign surviving corporation, including for purposes of calculating--

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

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

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

(3) Post-transaction change of status. If a foreign surviving corporation that is subject to the rules of paragraph (c)(2) of this section subsequently becomes a look-through corporation, or if a foreign surviving corporation that is subject to the rules of paragraph (c)(3) of this section subsequently becomes a non-look-through 10/50 corporation or a look-through corporation, by reason, for example, of a reorganization, liquidation, or change of ownership, then post-1986 undistributed earnings and post-1986 foreign income taxes

that have lost their look-through or pooling character by reason of this section shall not have such look-through or pooling character restored. See, e.g., paragraph (f)(2)(v) Example 2 of this section.

(4) Ordering rule for offsetting multiple hovering deficits

--(i) Rule. A foreign surviving corporation shall apply the deficit rules of paragraphs (d)(2), (e)(1)(iii), (e)(2)(iii), (f)(1)(iii), and (f)(2)(iii) of this section in that order (in the event that more than one of such rules applies to the foreign surviving corporation).

(ii) Example. The following example illustrates the rules of this paragraph (g)(4). The examples presume the following facts: Foreign corporation A was a non-look-through 10/50 corporation from its incorporation on January 1, 1995 until December 31, 1997; foreign corporation A became a CFC on January 1, 1998 and has been a CFC since that time. Foreign corporation B has been a non-look-through 10/50 corporation since its incorporation on January 1, 1993. Foreign corporations A and B always have had calendar taxable years. Foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency. Finally, any earnings and profits described in section 904(d)(1)(E) (10/50 dividends) qualified for the high tax exception from subpart F income under section 954(b)(4), and all shareholders elected to exclude such earnings and profits from subpart F income under section 954(b)(4) and §1.954-1(d)(5). The

example is as follows:

Example--(i) Facts. (A) On December 31, 2001, foreign corporations A and B have the following earnings and profits and foreign income taxes accounts:

<u>Foreign Corporation A</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Separate Category:</u>		
10/50 dividends from FC1, a noncontrolled section 902 corporation	100u	\$60
General	(300u)	\$25
<u>E&P Accumulated as Non-Look- Through 10/50 Corporation:</u>	<u>300u</u>	<u>\$100</u>
	100u	\$185
<u>Foreign Corporation B</u>	<u>E&P</u>	<u>Foreign Taxes</u>
<u>E&P Accumulated as Non-Look- Through 10/50 Corporation:</u>	(200u)	\$50

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). Immediately following the foreign 381 transaction, foreign surviving corporation is a CFC.

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

	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive</u>	<u>Hovering</u>	<u>Foreign</u>	<u>Foreign</u>
	<u>E&P</u>	<u>Deficit</u>	<u>Taxes</u>	<u>Taxes</u>
			<u>Available</u>	<u>Associated</u>
				<u>with</u>
				<u>Hovering</u>
				<u>Deficit</u>
<u>Look-Through Pool:</u>				
10/50 dividends	100u		\$60	
General		(300u)		\$25
<u>Two Side-by-</u>				
<u>Side Non-Look-</u>				
<u>Through Pool</u>				
<u>Amounts:</u>				
Non-look-				
through pool				
amount #1 (from				
Corp A)	300u		\$100	
Non-look-				
through pool				
amount #2 (from				
Corp B)		(200u)		\$50
	<u>400u</u>	<u>(500u)</u>	<u>\$160</u>	<u>\$75</u>

(iii) Post-transaction earnings. (A) In the taxable year ending on December 31, 2002, foreign surviving corporation accumulates earnings and profits and pays related foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
10/50 dividends from FC1	150u	\$ 40
General	<u>400u</u>	<u>\$ 60</u>
	550u	\$100

(B) None of the earnings and profits qualify as subpart F income as defined in section 952(a). Under the rules of paragraph (g)(4)(i) of this section, the rules of paragraph (d)(2) of this section apply before the rules of paragraph (e)(1)(iii) of this section. Accordingly, post-transaction earnings in a separate category are first offset by a hovering deficit in the same separate category in the look-through pool. Thus, foreign surviving corporation's 300u deficit in the section 904(d)(1)(I) general separate category offsets 300u of post-transaction general separate category earnings. After application of paragraph (d)(2) of this section, foreign surviving corporation has the following post-transaction earnings available for further offset by a hovering deficit: 150u in the section 904(d)(1)(E) 10/50 dividends separate category and 100u in the general separate category. Under paragraph (e)(1)(iii) of this section, a deficit in the non-look-through pool offsets a pro rata portion of post-transaction earnings in each separate category. Thus, foreign surviving corporation's 200u deficit in

non-look-through pool amount #2 offsets the remaining post-transaction earnings on a pro rata basis ($200u \times (150u \div 250u) = 120u$ against 10/50 dividends separate category earnings and $200u \times (100u \div 250u) = 80u$ against general separate category earnings). Accordingly, foreign surviving corporation has the following earnings and profits and foreign income taxes accounts at the end of 2002:

	<u>E&P</u>	<u>Foreign Taxes</u>
<u>Look-Through Pool Separate Category:</u>		
10/50 dividends	130u	\$100
General	20u	\$85
<u>Two Side-by-Side Non-Look-Through Pool Amounts:</u>		
Non-look-through pool amount #1	300u	\$100
Non-look-through pool amount #2	<u>0u</u>	<u>\$ 50</u>
	450u	\$335

(C) Under paragraph (d)(2)(ii) of this section, the \$25 of foreign income taxes related to the 300u hovering deficit in the section 904(d)(1)(I) general separate category is added to foreign surviving corporation's post-1986 foreign income taxes in that separate category (because post-transaction earnings in the general separate category have been offset by and exceed the deficit in that category). Under paragraph (e)(1)(iii)(B) of this section, the \$50 of foreign income taxes related to the 200u hovering deficit in non-look-through pool amount #2 is added to foreign surviving corporation's post-1986 foreign income taxes for non-look-through pool amount #2 (because post-transaction earnings have been offset by and exceed the deficit in the non-look-through pool). However, the \$50 of foreign income taxes generally will not be reduced or deemed paid unless a foreign tax refund restores a positive balance to the associated earnings pursuant to section 905(c), and thus will be trapped.

(5) Pro rata rule for earnings during transaction year. For purposes of offsetting post-transaction earnings of a foreign surviving corporation under the rules described in paragraphs (d)(2), (e)(1)(iii), (e)(2)(iii), (f)(1)(iii), and (f)(2)(iii), the earnings and profits for the taxable year of the foreign surviving corporation in which the transaction occurs shall be deemed to have been accumulated after such transaction in an amount which bears the same ratio to the undistributed earnings and profits of the foreign surviving corporation for such taxable

year (computed without regard to any earnings and profits carried over) as the number of days in the taxable year after the date of transaction bears to the total number of days in the taxable year. See, e.g., §1.381(c)(2)-1(a)(7) Example 2 (illustrating application of this rule with respect to domestic corporations).

(6) Nonapplicability of hovering deficit rules to certain transactions--(i) Rule. If a principal purpose of a foreign 381 transaction is to gain a tax benefit from affirmative use of the hovering deficit rule described in paragraph (d)(2), (e)(1)(iii), (e)(2)(iii), (f)(1)(iii), or (f)(2)(iii) of this section, then the Commissioner may exercise discretion to apply the principles of §1.367(b)-9 to such transaction.

(ii) Example. The following example illustrates the rules of this paragraph (h)(6). The example is as follows:

Example--(i) Facts. (A) Foreign corporations A and B are and always have been wholly owned subsidiaries of USP, a domestic corporation. Both foreign corporations A and B were incorporated in 1990, and both always have been CFCs using a calendar taxable year. Both foreign corporations A and B (and all of their respective qualified business units as defined in section 989) maintain a "u" functional currency and 1u = US\$1 at all times. Any earnings and profits described in section 904(d)(1)(E) (10/50 dividends) qualified for the high tax exception from subpart F income under section 954(b)(4), and USP elected to exclude such earnings and profits from subpart F income under section 954(b)(4) and §1.954-1(d)(5). On December 31, 2001, foreign corporation A and foreign corporation B have the following earnings and profits and foreign income taxes accounts:

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

Foreign Corporation B

Separate Category

10/50 dividends

E&P

5u

Foreign Taxes

\$ 3

(B) On January 1, 2002, foreign corporation B acquires the assets of foreign corporation A in a reorganization described in section 368(a)(1)(C). A principal purpose of the foreign 381 transaction is to gain a tax benefit from affirmative use of the hovering deficit rule described in paragraph (d)(2) of this section. Immediately following the foreign 381 transaction, foreign surviving corporation is a CFC.

(ii) Result under general rules. (A) If the rules of paragraphs (d)(1) and (2) of this section were to apply, foreign surviving corporation would have the following earnings and profits and foreign income taxes accounts immediately after the foreign 381 transaction:

	<u>Earnings & Profits:</u>		<u>Foreign Taxes:</u>	
	<u>Positive E&P</u>	<u>Hovering Deficit</u>	<u>Foreign Taxes Available</u>	<u>Foreign Taxes Associated with Hovering Deficit</u>
Passive		(1,000u)		\$5
10/50 dividends	5u		\$ 3	
General	<u>200u</u>		<u>\$200</u>	
	205u	<u>(1,000u)</u>	\$203	\$5

(B) Accordingly, if the hovering deficit rules of paragraph (d)(2) of this section were to apply, foreign surviving corporation would be able to pay to USP a dividend of \$205 that would carry deemed paid foreign income taxes of \$203 under section 902.

(iii) Result under this paragraph (g)(6). Because a principal purpose of the foreign 381 transaction was to gain a tax benefit from affirmative use of the hovering deficit rule described in paragraph (d)(2) of this section, the Commissioner may exercise discretion to apply the principles of §1.367(b)-9 to the transaction. Under the principles of §1.367(b)-9, the earnings and profits and foreign income taxes accounts of foreign corporation A and foreign corporation B are combined under paragraph (d)(1) of this section without reference to the hovering deficit rule of paragraph (d)(2) of this section. Accordingly, foreign surviving corporation would have the following earnings and profits and foreign income taxes accounts immediately after the transaction:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
Passive	(1,000u)	\$ 5
10/50 dividends	5u	\$ 3
General	<u>200u</u>	<u>\$200</u>
	(795u)	\$208

(h) Effective date. This section shall apply to section 367(b) exchanges that occur on or after the date 30 days after these regulations are published as final regulations in the **Federal Register**.

Par. 10. Section 1.367(b)-8 is added to read as follows:

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

(a) Scope. This section applies to distributions to which section 355 (or so much of section 356 as relates to section 355) applies, whether or not in connection with a section 368(a)(1)(D) reorganization (D reorganization), in which the distributing corporation or the controlled corporation (or both) is a foreign corporation (foreign divisive transaction). For purposes of this section, the terms distributing corporation and controlled corporation have the same meaning as used in section 355 and the regulations thereunder. Paragraph (b) of this section provides general rules governing the allocation and reduction of a distributing corporation's earnings and profits and foreign income taxes (pre-transaction earnings and pre-transaction taxes, respectively) in foreign divisive transactions. Paragraphs (c), (d), and (e) of this section describe special rules for the application of paragraph (b) of this section to specific situations, depending upon whether the distributing corporation

or the controlled corporation (or both the distributing and the controlled corporation) is a foreign corporation.

(b) General rules--(1) Application of §1.312-10--(i) In general. Pre-transaction earnings of a distributing corporation shall be allocated between the distributing corporation and the controlled corporation in accordance with the rules of §1.312-10(a) and shall be reduced in accordance with the rules of §1.312-10(b), except to the extent otherwise provided in this section.

(ii) Special rules for application of §1.312-10(b)--(A) Distributing corporation. The pre-transaction earnings of a distributing corporation shall be reduced without taking into account §1.312-10(b)(2).

(B) Controlled corporation. Section 1.312-10(b) shall not apply to increase or replace the earnings and profits of a controlled corporation by the amount of any decrease in the pre-transaction earnings of a distributing corporation.

(iii) Net deficit in pre-transaction earnings. Nothing in this section shall permit any portion of the pre-transaction earnings of a distributing corporation that has a net deficit in pre-transaction earnings to be allocated or reduced under paragraph (b)(1)(i) of this section. See §1.312-10(c). Compare paragraph (b)(2) of this section (requiring an allocation or reduction of a pro rata portion of deficits in statutory groupings of earnings and profits when a distributing corporation has a net positive amount of pre-transaction earnings).

(iv) Use of net bases. All allocations and reductions described in paragraph (b)(1)(i) of this section shall be determined in accordance with the net bases in assets. Net basis shall have the same meaning as under §1.312-10(a).

(v) Gain recognized by distributing corporation. The pre-transaction earnings that are subject to allocation or reduction under paragraph (b)(1)(i) of this section shall include any increase in earnings and profits from gain recognized or income included by the distributing corporation as a result of the foreign divisive transaction. See, for example, section 367(a) and (e), section 1248(f), and §1.367(b)-5(b).

(vi) Coordination with branch profits tax. An allocation or reduction in a distributing corporation's pre-transaction earnings under paragraph (b)(1)(i) of this section shall not be out of or reduce effectively connected earnings and profits or non-previously taxed accumulated effectively connected earnings and profits, as defined in section 884. See also §1.884-2T(d)(5)(iii) (providing that such earnings and profits are not subject to reduction under §1.312-10(b)).

(2) Cross-section of earnings and profits. Except to the extent provided in paragraphs (b)(1)(iii), (b)(1)(vi), (d)(2)(ii), (d)(4), and (e)(4) of this section and other than any portion attributable to an inclusion under §1.367(b)-5 or paragraph (d)(2)(i) of this section, an allocation or reduction of pre-transaction earnings described in paragraph (b)(1)(i) of this section shall decrease, on a pro rata basis, the statutory

groupings of earnings and profits (or deficits in statutory groupings of earnings and profits) of the distributing corporation. Thus, for example, a pro rata portion of a foreign distributing corporation's separate categories, post-1986 undistributed earnings, and annual layers of pre-1987 accumulated profits and pre-1987 section 960 earnings and profits shall be allocated or reduced.

(3) Foreign income taxes. Pre-transaction taxes of a distributing corporation shall be ratably allocated or reduced only to the extent described in paragraphs (d)(3) and (e)(3) of this section. Thus, a distributing corporation's excess foreign taxes described in section 904(c) shall not be allocated or reduced under this section.

(4) Divisive D reorganization with a preexisting controlled corporation. In the case of a foreign divisive transaction that includes a D reorganization with a controlled corporation that is not newly created (a preexisting controlled corporation), paragraph (b)(1)(i) of this section shall apply in the following manner:

(i) Calculation of earnings and profits of distributing corporation. The pre-transaction earnings of a distributing corporation shall be reduced by the sum of--

(A) The amount of the reduction in the pre-transaction earnings of the distributing corporation as described in §1.312-10(a) (as determined under this section); and

(B) The amount of the reduction in the pre-transaction

earnings of the distributing corporation as described in §1.312-10(b) (as determined under this section).

(ii) Calculation of earnings and profits of controlled corporation. The amount of earnings and profits of the controlled corporation immediately after the foreign divisive transaction shall equal the sum of--

(A) The amount described in paragraph (b)(4)(i)(A) of this section (except to the extent such amounts are included in income as a deemed dividend pursuant to the foreign divisive transaction or are subject to the rule of §1.367(b)-3(f)); and

(B) The amount of earnings and profits of the controlled corporation immediately before the foreign divisive transaction.

(c) Foreign divisive transactions involving a domestic distributing corporation and a foreign controlled corporation--

(1) Scope. The rules of this paragraph (c) apply to a foreign divisive transaction involving a domestic distributing corporation and a foreign controlled corporation.

(2) Earnings and profits allocated to a foreign controlled corporation. Pre-transaction earnings of a domestic distributing corporation that are allocated to a foreign controlled corporation under the rules described in paragraph (b)(1)(i) of this section shall not be included in the foreign controlled corporation's post-1986 undistributed earnings, pre-1987 accumulated profits, or pre-1987 section 960 earnings and profits. In addition, if a distribution by the domestic distributing corporation out of pre-transaction earnings

immediately before the foreign divisive transaction would have been treated as a U.S. source dividend under section 861(a)(2)(A) that would not be exempt from tax under section 871(i)(2)(B) or 881(d), a distribution out of such earnings and profits by the foreign controlled corporation shall be treated as a U.S. source dividend under section 904(g) and for purposes of Chapter 3 of subtitle A of the Internal Revenue Code. See Georday Enterprises v. Commissioner, 126 F.2d 384 (4th Cir. 1942). See also sections 243(e) and 861(a)(2)(C) and §1.367(b)-2(j) for other rules that may apply.

(3) Examples. The following examples illustrate the application of the rules of this section to transactions described in paragraph (c)(1) of this section. The examples presume the following facts: USD is a domestic corporation engaged in manufacturing and shipping activities through Business A and Business B, respectively. FC is a foreign corporation that is wholly owned by USD. USD and FC use calendar taxable years. FC (and all of its qualified business units as defined in section 989) maintains a "u" functional currency and, except as otherwise specified, 1u = US\$1 at all times. The examples are as follows:

Example 1--(i) Facts. The stock of USD is owned in equal parts by three shareholders, USP (a domestic corporation), USI (a United States citizen), and FP (a foreign corporation). USD owns assets with total net bases of \$260 (including \$100 attributable to the Business B shipping assets, which have a \$160 fair market value). USD has \$500 of earnings and profits (that it accumulated). The entire \$500 would have been treated as a U.S. source dividend under section 861(a)(2)(A) that would not be exempt from tax under sections 871(i)(2)(B) or 881(d) if distributed by USD immediately before the foreign divisive transaction. On January 1, 2002, USD incorporates FC and transfers to FC the Business B shipping assets. USD then

distributes the FC stock pro rata to USP, USI, and FP. The transaction meets the requirements of sections 368(a)(1)(D) and 355.

(ii) Result--(A) Gain Recognition. Under section 367(a)(5), USD recognizes gain equal to the difference between the fair market value and USD's adjusted basis in the Business B shipping assets ($\$160 - \$100 = \$60$).

(B) Calculation of USD's earnings and profits. Under paragraph (b)(1)(v) of this section, USD's pre-transaction earnings include any gain recognized or income included as a result of the foreign divisive transaction. As described in this Example 1 (ii)(A), USD recognizes \$60 of gain as a result of the foreign divisive transaction. Accordingly, USD has \$560 of pre-transaction earnings ($\$500 + \60). Under paragraph (b)(1)(i) of this section, USD's pre-transaction earnings are reduced by an amount equal to its pre-transaction earnings times the net bases of the assets transferred to FC divided by the net bases of the assets held by USD immediately before the foreign divisive transaction ($\$560 \times (\$160 \div \$320) = \280). Following this reduction, USD has \$280 of earnings and profits ($\$560 - \280).

(C) Calculation of FC's earnings and profits. Under paragraph (b)(1)(i) of this section, the \$280 reduction in USD's pre-transaction earnings is allocated to FC. Under §1.367(b)-2(j)(1), the \$280 is translated into "u" at the spot rate on January 1, 2002, to 280u. Under paragraph (c)(2) of this section, the 280u is not included as part of FC's post-1986 undistributed earnings, pre-1987 accumulated profits, or section 960 earnings and profits.

(iii) Post-transaction distribution. During 2002, FC does not accumulate any earnings and profits or pay or accrue any foreign income taxes. On December 31, 2002, at a time when US\$1 = 0.5u, FC distributes 180u (or \$360) to its shareholders. Thus, FP, USP, and USI each receive a \$120 dividend. See section 989(b)(1). Under paragraph (c)(2) of this section and §1.367(b)-2(j)(4), \$93.33 of the distribution to FP is subject to withholding under Chapter 3 of subtitle A of the Internal Revenue Code ($\$280 \div 3 = \93.33). Under section 243(e) and §1.367(b)-2(j)(3), \$93.33 of the distribution to USP is eligible for the dividends received deduction. See also section 861(a)(2)(C). Under paragraph (c)(2) of this section, the remaining \$26.67 distribution to USP is treated as U.S. source under section 904(g) (and is not eligible for the dividends received deduction under section 243(e)). Under paragraph (c)(2) of this section, the \$120 dividend distribution to USI is treated as U.S. source under section 904(g).

Example 2--(i) Facts. The stock of USD is owned by the following unrelated persons: 20 percent by USP (a domestic

corporation), 20 percent by USI (a United States citizen), and 60 percent by FP (a foreign corporation). FC is a preexisting controlled corporation that was incorporated in 1995 and USD always has owned all of the FC stock. USD owns assets with total net bases of \$320 (including \$160 attributable to the FC stock), and USD has \$500 of earnings and profits. FC has 150u of earnings and profits in the section 904(d)(1)(D) shipping separate category and has \$60 of related foreign income taxes. FC's earnings and profits qualified for the high tax exception from subpart F income under section 954(b)(4), and USD elected to exclude the earnings and profits from subpart F income under section 954(b)(4) and §1.954-1(d)(5). On January 1, 2002, USD distributes the stock of FC to its shareholders in a transaction that meets the requirements of section 355. FC is not a controlled foreign corporation after the foreign divisive transaction. On the date of the foreign divisive transaction, the FC stock has a \$460 fair market value.

(ii) Result--(A) Gain Recognition. Under §1.367(b)-5(b)(1)(ii), USD recognizes gain equal to the difference between the fair market value and USD's adjusted basis in the FC stock distributed to USI. Under §1.367(e)-1(b)(1), USD recognizes gain equal to the difference between the fair market value and USD's adjusted basis in the FC stock distributed to FP. As a result of the transfers to USI and FP, USD recognizes gain of \$240 ($4/5 \times (\$460 - \$160)$), \$120 of which is included in USD's income as a dividend under section 1248(a) and (f)(1) ($4/5 \times 150u$, translated at the spot rate under section 989(b)(2)). Under section 1248(a) and (f)(1), USD includes as a dividend the difference between the fair market value and its adjusted basis in the FC stock distributed to USP to the extent of FC's earnings and profits attributable to the distributed stock. For further guidance, see also Notice 87-64 (1987-2 C.B. 375) (see also §601.601(d)(2) of this chapter). As a result of this transfer, USD includes a \$30 dividend under section 1248(a) and (f)(1) ($1/5 \times 150u$). USD qualifies for a section 902 deemed paid foreign tax credit with respect to its \$150 of section 1248 dividends.

(B) Calculation of USD's earnings and profits. Under paragraph (b)(1)(v) of this section, USD's pre-transaction earnings include any gain recognized or income included as a result of the foreign divisive transaction. As described in this Example 2 (ii)(A), USD recognizes and includes a total of \$270 of gain and dividend income as a result of the foreign divisive transaction. Accordingly, USD has \$770 of pre-transaction earnings ($\$500 + \270). Under paragraphs (b)(1)(i) and (b)(1)(ii)(A) of this section, USD's pre-transaction earnings are reduced by the amount of the reduction that would have been required if USD had transferred the stock of FC to a new corporation in a D reorganization. Thus, USD's pre-transaction earnings are reduced by an amount equal to its pre-transaction earnings times its net basis in the FC stock divided by the net

bases of the assets held by USD immediately before the foreign divisive transaction ($\$770 \times (\$430 \div \$590) = \561.19). Following this reduction, USD has \$208.81 of earnings and profits ($\$770 - \561.19).

(C) Calculation of FC's earnings and profits. Under paragraph (b)(1)(ii)(B) of this section, FC's earnings and profits are not increased (or replaced) as a result of the foreign divisive transaction.

Example 3--(i) Facts. USP, a domestic corporation, owns all of the stock of USD. FC is a preexisting controlled corporation and USD has owned all of the FC stock since FC was incorporated in 1995. USD owns assets with total net bases of \$320 (including \$100 attributable to the FC stock and \$160 attributable to the Business B shipping assets). USD has \$500 of pre-transaction earnings. FC has 150u of earnings and profits in the section 904(d)(1)(D) shipping separate category and has \$60 of related foreign income taxes. FC's earnings and profits qualified for the high tax exception from subpart F income under section 954(b)(4), and USD elected to exclude the earnings and profits from subpart F income under section 954(b)(4) and §1.954-1(d)(5). On January 1, 2002, USD transfers to FC the Business B shipping assets. USD then distributes the FC stock to USP. The transaction meets the requirements of sections 368(a)(1)(D) and 355. USD's transfer of the Business B shipping assets to FC falls within the active trade or business exception to section 367(a)(1) described in §1.367(a)-2T. Immediately after the foreign divisive transaction, the FC stock has a \$460 fair market value. USP and USD meet and comply with the requirements of section 367(a)(5) and 1248(f)(2) (and any regulations thereunder). (Sections 1.367(b)-5(b)(1)(ii) and 1.367(e)-1(b)(1) do not apply with respect to the foreign divisive transaction because the distributee, USP, is a domestic corporation.)

(ii) Result--(A) Calculation of USD's earnings and profits. Under paragraph (b)(4)(i) of this section, USD's pre-transaction earnings are reduced by the sum of the amounts described in paragraphs (b)(4)(i)(A) and (b)(4)(i)(B) of this section. Under paragraph (b)(4)(i)(A) of this section, USD's pre-transaction earnings are reduced by an amount equal to USD's pre-transaction earnings times the net bases of the assets transferred to FC divided by the total net bases of the assets held by USD immediately before the foreign divisive transaction ($\$500 \times (\$160 \div \$320) = \250). Under paragraph (b)(4)(i)(B) of this section, USD's pre-transaction earnings are reduced by an amount equal to USD's pre-transaction earnings times USD's net basis in the stock of FC (immediately before USD's transfer of the shipping assets) divided by the total net bases of the assets held by USD immediately before the foreign divisive transaction ($\$500 \times (\$100 \div \$320) = \156.25). The sum of the amounts described in paragraphs (b)(4)(i)(A) and (B) of this section is

\$406.25 (\$250 + \$156.25). Following the reduction described in paragraph (b)(4)(i) of this section, USD has \$93.75 of earnings and profits (\$500 - \$406.25).

(B) Calculation of FC's earnings and profits. Under paragraphs (b)(4)(ii) of this section, the earnings and profits of FC immediately after the foreign divisive transaction are increased by the amount of the reduction in USD's pre-transaction earnings described in paragraph (b)(4)(i)(A) of this section (\$250). Under §1.367(b)-2(j)(1), this \$250 is translated into "u" at the spot rate on January 1, 2002, to 250u. Under paragraph (c)(2) of this section, the 250u is not included as part of FC's post-1986 undistributed earnings. FC has 400u in earnings and profits (250u + 150u) immediately after the foreign divisive transaction.

(iii) Post-transaction distribution. FC does not accumulate any earnings and profits or pay or accrue any foreign income taxes during 2002. On December 31, 2002, FC distributes 100u as a dividend to USP, which has remained its sole shareholder. Under section 989(b)(1), the 100u distribution is translated into US\$ at the spot rate on December 31, 2002, to \$100. Proportionate parts of the \$100 dividend are attributable to the pre-transaction earnings of FC (\$37.50 = \$100 x (150 ÷ 400)) and USD (\$62.50 = \$100 x (250 ÷ 400)). See sections 243(e) and 245. Thus, under sections 243(e) and §1.367(b)-2(j)(3), \$62.50 of the distribution is eligible for the dividends received deduction. See also section 861(a)(2)(C). The remaining \$37.50 of the distribution (and \$15 of related foreign income taxes) is subject to the generally applicable rules concerning dividends paid by foreign corporations.

(d) Foreign divisive transactions involving a foreign distributing corporation and a domestic controlled corporation--

(1) Scope. The rules of this paragraph (d) apply to a foreign divisive transaction involving a foreign distributing corporation and a domestic controlled corporation.

(2) Coordination with §1.367(b)-3--(i) In general. In the case of a foreign divisive transaction that includes a D reorganization, the rules of §1.367(b)-3 are applicable with respect to the pre-transaction earnings of a foreign distributing corporation that are allocable to a domestic controlled corporation under paragraph (b)(1)(i) of this section.

(ii) Determination of all earnings and profits amount. An all earnings and profits amount inclusion under paragraph (d)(2)(i) of this section shall be computed with respect to the pre-transaction earnings that are allocable to the domestic controlled corporation, without regard to the parenthetical phrase in paragraph (b)(4)(ii)(A) of this section.

(iii) Interaction with section 358 and §1.367(b)-2(e)(3)(ii). The basis increase provided in §1.367(b)-2(e)(3)(ii) shall apply to an all earnings and profits amount inclusion under paragraph (d)(2)(i) of this section, subject to the following rules--

(A) Section 358 shall apply to determine the distributee's basis in the foreign distributing and domestic controlled corporation without regard to the all earnings and profits amount inclusion;

(B) After application of the rule in paragraph (d)(2)(iii)(A) of this section, the basis increase provided in §1.367(b)-2(e)(3)(ii) shall be applied in a manner that attributes such basis increase solely to the exchanging shareholder's stock in the domestic controlled corporation; and

(C) the rule of paragraph (d)(2)(iii)(B) of this section shall apply prior to §1.367(b)-5(c)(4) and (d)(4).

(iv) Coordination with §1.367(b)-3(c). In applying the rule of §1.367(b)-3(c)(2), an exchanging shareholder described in §1.367(b)-3(c)(1) shall recognize gain with respect to the stock of the domestic controlled corporation after the foreign divisive transaction.

(v) Special rule for U.S. persons that own foreign distributing corporation stock after a non pro rata distribution.
[Reserved]

(3) Foreign income taxes. Pre-transaction taxes related to a foreign distributing corporation's pre-transaction earnings that are allocable or are reduced under the rules described in paragraph (b)(1)(i) of this section shall be ratably reduced. Pre-transaction taxes related to a foreign distributing corporation's pre-transaction earnings that are allocable to a domestic controlled corporation under the rules described in paragraph (b)(1)(i) of this section shall not carry over to the domestic controlled corporation. Nothing in this paragraph (d)(3) shall affect the deemed paid taxes that otherwise would accompany an inclusion under §1.367(b)-5 or paragraph (d)(2)(i) of this section.

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

(5) Coordination with §1.367(b)-5. See also §1.367(b)-5(c) and (d) for other rules that may apply to a foreign divisive transaction described in paragraph (d)(1) of this section.

(6) Examples. The following examples illustrate the application of the rules of this section to transactions described in paragraph (d)(1) of this section. The examples presume the following facts: FD is a foreign corporation engaged in manufacturing and shipping activities through Business A and Business B, respectively. Any earnings and profits of FD described in section 904(d)(1)(D) (shipping income) qualified for the high tax exception from subpart F income under section

954(b)(4), and FD's United States shareholders elected to exclude the earnings and profits from subpart F income under section 954(b)(4) and §1.954-1(d)(5). USC is a domestic corporation that is wholly owned by FD. FD and USC use calendar taxable years. FD (and all of its qualified business units as defined in section 989) maintains a "u" functional currency, and 1u = US\$1 at all times. The examples are as follows:

Example 1--(i) Facts. (A) USP, a domestic corporation, has owned all of the stock of FD since FD's incorporation in 1995. USP's adjusted basis in the FD stock is \$100, and the FD stock has a fair market value of \$800. FD owns assets with total net bases of 320u (including 160u attributable to the Business B shipping assets), and has the following pre-transaction earnings and pre-transaction taxes accounts:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	300u	\$60
Shipping	<u>200u</u>	<u>\$80</u>
	500u	\$140

(B) On January 1, 2002, FD incorporates USC and transfers to USC the Business B shipping assets. FD then distributes the USC stock to USP. The transaction meets the requirements of sections 368(a)(1)(D) and 355. Immediately after the foreign divisive transaction, the FD stock and the USC stock each have a fair market value of \$400.

(ii) Results--(A) Calculation of FD's earnings and profits. Under paragraph (b)(1)(i) of this section, FD's pre-transaction earnings are reduced by an amount equal to its pre-transaction earnings times the net bases of the assets transferred to USC divided by the net bases of the assets held by FD immediately before the foreign divisive transaction (500u x (160u ÷ 320u) = 250u). Following this reduction, FD has 250u of earnings and profits (500u - 250u).

(B) All earnings and profits amount inclusion. Under §1.367(b)-3 and paragraph (d)(2)(i) of this section, USP includes in income as an all earnings and profits amount the pre-transaction earnings of FD that are allocable to USC under paragraph (b)(1)(i) of this section. Thus, USP's all earnings and profits amount inclusion is \$250. See also section 989(b)(1) and paragraph (d)(2)(ii) of this section. Under §1.367(b)-3(b)(3)(i) and §1.367(b)-2(e), USP includes the all earnings and profits amount as a deemed dividend received from FD immediately before the foreign divisive transaction. Because the requirements of section 902 are met, USP qualifies for a deemed

paid foreign tax credit with respect to the deemed dividend that it receives from FD. Under §1.902-1(d)(1), the \$250 deemed dividend is out of FD's separate categories and reduces foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	150u	\$30
Shipping	100u	\$40
	250u	\$70

(C) Calculation of USP's basis in USC and USC's earnings and profits. Under paragraph (d)(2)(iii) of this section, the §1.367(b)-2(e)(3)(ii) basis increase applies with respect to USP's all earnings and profits amount inclusion from FD and is attributed solely to USP's basis in USC (after application of section 358). Accordingly, USP has a \$300 basis in the USC stock (\$50 section 358 basis, determined by reference to the relative values of USP's FD and USC stock: $\$100 \text{ pre-transaction basis} \times (\$400 \div \$800) + \$250 \text{ §1.367(b)-2(e)(3)(ii) basis increase} = \300). Because USP included in income as a deemed dividend under §1.367(b)-3 and paragraph (d)(2) of this section the pre-transaction earnings of FD that are allocable to USC under paragraph (b)(1)(i) of this section, such earnings and profits are not available to increase USC's earnings and profits. As a result, USC has zero earnings and profits immediately after the foreign divisive transaction.

(D) Application of §1.367(b)-5(c). The basis adjustment and income inclusion rules of §1.367(b)-5(c)(2) apply if USP's postdistribution amount with respect to FD stock is less than its predistribution amount with respect to FD stock. Under §1.367(b)-5(e)(1), USP's predistribution amount with respect to FD stock is USP's section 1248 amount attributable to such stock computed immediately before the distribution but after taking into account the allocation of earnings and profits as a result of the D reorganization. Thus, USP's predistribution amount with respect to FD stock is \$250 (500u - 250u). See also section 989(b)(2). Under section 358, USP allocates its \$100 basis in FD stock between FD stock and USC stock according to the stock blocks' relative values, yielding a \$50 ($\$100 \times (\$400 \div \$800)$) basis in FD stock. See also paragraph (d)(2)(iii) of this section. Under §1.367(b)-5(e)(2), USP's postdistribution amount with respect to FD stock is USP's section 1248 amount with respect to such stock, computed immediately after the distribution. Accordingly, USP's postdistribution amount with respect to FD stock is \$250. Because USP's postdistribution amount with respect to FD stock is not less than its predistribution amount, USP is not required to make any basis adjustment or include any income under §1.367(b)-5(c).

(E) FD's earnings and profits after the foreign divisive transaction. Following the reduction described in this Example 1 (ii)(A) and (B), FD has the following earnings and profits and foreign income taxes accounts:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	150u	\$30
Shipping	<u>100u</u>	<u>\$40</u>
	250u	\$70

Example 2--(i) Facts. (A) USP, a domestic corporation, has owned all of the stock of FD since FD's incorporation in 1995. USP's adjusted basis in the FD stock is \$400 and the FD stock has a fair market value of \$800. USC is a preexisting controlled corporation. FD owns assets with net total bases of 320u (including 160u attributable to the USC stock), and has the following pre-transaction earnings and pre-transaction taxes accounts:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	300u	\$60
Shipping	<u>200u</u>	<u>\$80</u>
	500u	\$140

(B) On January 1, 2002, FD distributes the USC stock to USP in a transaction that meets the requirements of section 355. Immediately after the foreign divisive transaction, the FD stock and the USC stock each have a \$400 fair market value.

(ii) Results--(A) Calculation of FD's earnings and profits. Under paragraphs (b)(1)(i) and (b)(1)(ii)(A) of this section, FD's pre-transaction earnings are reduced by the amount of the reduction that would have been required if FD had transferred the stock of USC to a new corporation in a D reorganization. Thus, FD's pre-transaction earnings are reduced by an amount equal to its pre-transaction earnings times its net basis in the USC stock divided by the net bases of the assets held by FD immediately before the foreign divisive transaction ($500u \times (160u \div 320u) = 250u$). Following this reduction, FD has 250u of earnings and profits ($500u - 250u$).

(B) Calculation of USC's earnings and profits. Under paragraph (b)(1)(ii)(B) of this section, USC's earnings and profits are not increased (or replaced) as a result of the foreign divisive transaction. As a result, USP is not required to include an amount in income under paragraph (d)(2)(i) of this section.

(C) Application of §1.367(b)-5(c). The basis adjustment and income inclusion rules of §1.367(b)-5(c)(2) apply if USP's postdistribution amount with respect to FD stock is less than its predistribution amount with respect to FD stock. Under §1.367(b)-5(e)(1), USP's predistribution amount with respect to FD stock is USP's section 1248 amount attributable to such stock computed immediately before the distribution. Thus, USP's predistribution amount with respect to FD stock is \$400 (the predistribution amount is limited to USP's built-in gain in FD stock immediately before the distribution ($\$800 - \400)). See also section 989(b)(2). Under section 358, USP allocates its

\$400 basis in FD stock between FD stock and USC stock according to the stock blocks' relative values, yielding a \$200 ($\$400 \times (\$400 \div \$800)$) basis in each block. Under §1.367(b)-5(e)(2), USP's postdistribution amount with respect to FD stock is USP's section 1248 amount with respect to such stock, computed immediately after the distribution. Accordingly, USP's postdistribution amount with respect to FD stock is \$200 (the postdistribution amount is limited to USP's built-in gain in FD stock immediately after the distribution ($\$400 - \200)). Because USP's postdistribution amount with respect to FD stock is \$200 less than its predistribution amount with respect to such stock ($\$400 - \200), §1.367(b)-5(c)(2)(i) and (ii) require USP to reduce its basis in FD stock by the \$200 difference, but only to the extent such reduction increases USP's section 1248 amount with respect to the FD stock. As a result, USP reduces its basis in the FD stock from \$200 to \$150 and includes \$150 in income as a deemed dividend from FD. Because the requirements of section 902 are met, USP qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FD. Under §1.902-1(d)(1), the \$150 deemed dividend is out of FD's separate categories and reduces foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	90u	\$18
Shipping	<u>60u</u>	<u>\$24</u>
	150u	\$42

(D) Basis adjustment. Under §1.367(b)-5(c)(3), USP does not increase its basis in FD stock as a result of USP's \$150 deemed dividend from FD. Under §1.367(b)-5(c)(4), USP increases its basis in the USC stock by the amount by which it decreased its basis in the FD stock, as well as by the amount of its deemed dividend inclusion. The §1.367(b)-5(c)(4) basis increase applies in full because USP's basis in the USC stock is not increased above the fair market value of such stock. Thus, USP increases its basis in USC stock to \$400 ($\$200 + \$50 + \150).

(E) Reduction in FD's statutory groupings of earnings and profits. Under paragraph (b)(2) of this section, the reduction in FD's pre-transaction earnings that is not attributable to USP's inclusion under §1.367(b)-5 decreases FD's statutory groupings of earnings and profits on a pro rata basis. Under paragraph (d)(3) of this section, FD's pre-transaction taxes also are ratably reduced. As described in this Example 2 (ii)(A), the reduction in FD's pre-transaction earnings is 250u. As described in this Example 2 (ii)(C), 150u of the 250u reduction is attributable to an inclusion under §1.367(b)-5. As a result, under paragraphs (b)(2) and (d)(3) of this section the remaining 100u reduction in FD's pre-transaction earnings is out of the following separate categories of earnings and profits and foreign income taxes:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	60u	\$12

Shipping	<u>40u</u>	<u>\$16</u>
	100u	\$28

(F) FD's earnings and profits after the foreign divisive transaction. After the reductions described in this Example 2 (ii)(C) and (E), FD has the following earnings and profits and foreign income taxes accounts:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	150u	\$30
Shipping	<u>100u</u>	<u>\$40</u>
	250u	\$70

Example 3--(i) Facts. (A) USP, a domestic corporation, has owned all of the stock of FD since FD's incorporation in 1995. USP's adjusted basis in the FD stock is \$400 and the FD stock has a fair market value of \$800. USC is a preexisting controlled corporation. FD owns assets with total net bases of 320u (including 160u attributable to the USC stock and 80u attributable to the Business B shipping assets), and has the following pre-transaction earnings and pre-transaction taxes accounts:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	300u	\$ 60
Shipping	<u>200u</u>	<u>\$ 80</u>
	500u	\$140

(B) On January 1, 2002, FD transfers to USC the Business B shipping assets. FD then distributes the USC stock to USP. The transaction meets the requirements of sections 368(a)(1)(D) and 355. Immediately after the foreign divisive transaction, the FD stock has a \$200 fair market value and the USC stock has a \$600 fair market value.

(ii) Results--(A) Calculation of FD's earnings and profits. Under paragraph (b)(4)(i) of this section, FD's pre-transaction earnings are reduced by the sum of the amounts described in paragraphs (b)(4)(i)(A) and (B) of this section. Under paragraph (b)(4)(i)(A) of this section, FD's pre-transaction earnings are reduced by an amount equal to FD's pre-transaction earnings times the net bases of the Business B shipping assets transferred to USC divided by the total net bases of the assets held by FD immediately before the foreign divisive transaction ($500u \times (80u \div 320u) = 125u$). Under paragraph (b)(4)(i)(B) of this section, FD's pre-transaction earnings are reduced by an amount equal to FD's pre-transaction earnings times FD's net basis in the stock of USC divided by the total net bases of the assets held by FD immediately before the foreign divisive transaction ($500u \times (160u \div 320u) = 250u$). The sum of the amounts described in paragraphs (b)(4)(i)(A) and (B) of this section is 375u ($125u + 250u$).

(B) All earnings and profits amount inclusion. Under §1.367(b)-3 and paragraph (d)(2)(i) of this section, USP is

required to include in income as an all earnings and profits amount the pre-transaction earnings of FD that are allocable to USC under paragraph (b)(1)(i) of this section. Under paragraph (b)(4)(ii)(A) of this section, the 125u of pre-transaction earnings described in paragraph (b)(4)(i)(A) are allocable to USC. Thus, the all earnings and profits amount is \$125. See also section 989(b)(1) and paragraph (d)(2)(ii) of this section. Under §§1.367(b)-3(b)(3)(i) and 1.367(b)-2(e), USP includes the all earnings and profits amount as a deemed dividend received from FD immediately before the foreign divisive transaction. Because the requirements of section 902 are met, USP qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FD. Under §1.902-1(d)(1), the \$125 deemed dividend is out of FD's separate categories and reduces foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	75u	\$15
Shipping	<u>50u</u>	<u>\$20</u>
	125u	\$35

(C) Calculation of USP's basis in USC and USC's earnings and profits. Under paragraph (d)(2)(iii) of this section, the §1.367(b)-2(e)(3)(ii) basis increase applies with respect to USP's all earnings and profits amount inclusion and is attributed solely to USP's basis in USC (after application of section 358). Accordingly, USP has a \$425 basis in the USC stock (\$300 section 358 basis, determined by reference to the relative values of USP's FD and USC stock: $\$400 \text{ pre-transaction basis} \times (\$600 \div \$800) + \$125 \text{ §1.367(b)-2(e)(3)(ii) basis increase} = \425). Because USP included in income as a deemed dividend under §1.367(b)-3 and paragraph (d)(2) of this section the pre-transaction earnings of FD that are allocable to USC under paragraph (b)(1)(i) of this section, such earnings and profits are not available to increase USC's earnings and profits. As a result, USC's earnings and profits are not increased as a result of the foreign divisive transaction.

(D) Application of §1.367(b)-5(c). The basis adjustment and income inclusion rules of §1.367(b)-5(c)(2) apply if USP's postdistribution amount with respect to FD stock is less than its predistribution amount with respect to FD stock. Under §1.367(b)-5(e)(1) and (3), USP's predistribution amount with respect to FD stock is USP's section 1248 amount attributable to such stock computed immediately before the distribution, after the allocation of FD's pre-transaction earnings described in paragraphs (b)(4)(i)(A) and (ii)(A) of this section, but without regard to the reduction in FD's pre-transaction earnings described in paragraph (b)(4)(i)(B) of this section. Thus, USP's predistribution amount with respect to FD stock is \$375 ($\$500 - \125). See also section 989(b)(2). Under section 358, USP allocates its \$400 basis in FD stock between FD stock and USC stock according to the stock blocks' relative values, yielding a \$100 ($\$400 \times (\$200 \div \$800)$) basis in FD stock. See also

paragraph (d)(2)(iii) of this section. Under §1.367(b)-5(e)(2), USP's postdistribution amount with respect to FD stock is USP's section 1248 amount with respect to such stock, computed immediately after the distribution. Accordingly, USP's postdistribution amount with respect to FD stock is \$100. (While FD has earnings and profits of 125u immediately after the foreign divisive transaction, USP's postdistribution amount is limited to its built-in gain in FD stock immediately after the distribution (\$200 - \$100).) Because USP's postdistribution amount with respect to FD stock is \$275 less than its predistribution amount with respect to such stock (\$375 - \$100), §1.367(b)-5(c)(2)(i) and (ii) require USP to reduce its basis in FD stock, but only to the extent such reduction increases USP's section 1248 amount with respect to the FD stock. As a result, USP reduces its basis in the FD stock from \$100 to \$75 and includes \$250 in income as a deemed dividend from FD. Because the requirements of section 902 are met, USP qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FD. Under §1.902-1(d)(1), the \$250 deemed dividend is out of FD's separate categories and reduces foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	150u	\$30
Shipping	<u>100u</u>	<u>\$40</u>
	250u	\$70

(E) Basis adjustment. Under §1.367(b)-5(c)(3), USP does not increase its basis in FD stock as a result of USP's \$250 deemed dividend from FD. Under §1.367(b)-5(c)(4), USP increases its basis in the USC stock by the amount by which it decreased its basis in the FD stock, as well as by the amount of its deemed dividend inclusion, but only up to the fair market value of USP's USC stock. As described in this Example 3 (ii)(C), USP has already increased its basis in the USC stock to \$425. Because the fair market value of FD's USC stock is \$600, USP's basis increase under §1.367(b)-5(c)(4) is limited to \$175. See also paragraph (d)(2)(iii)(C) of this section. Thus, USP has a \$600 basis in the USC stock immediately after the foreign divisive transaction.

(F) Reduction in FD's statutory groupings of earnings and profits. Under paragraph (b)(2) of this section, the reduction in FD's pre-transaction earnings that is not attributable to USP's inclusion under paragraph (d)(2)(i) of this section or §1.367(b)-5 decrease FD's statutory groupings of earnings and profits on a pro rata basis. Under paragraph (d)(3) of this section, FD's pre-transaction taxes are also ratably reduced. As described in this Example 3 (ii)(A), the reduction in FD's pre-transaction earnings is 375u. As described in this Example 3 (ii)(B) and (D), the entire 375u reduction was subject to inclusion as a deemed dividend by USP under paragraph (d)(2)(i) of this section or §1.367(b)-5. Thus, none of FD's pre-transaction earnings remain to be reduced under paragraph (b)(2) of this section.

(G) FD's earnings and profits after the foreign divisive transaction. After the reductions described in this Example 3 (ii)(B) and (D), FD has the following earnings and profits and foreign income taxes accounts:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	75u	\$15
Shipping	<u>50u</u>	<u>\$20</u>
	125u	\$35

(e) Foreign divisive transactions involving a foreign distributing corporation and a foreign controlled corporation--

(1) Scope. The rules of this paragraph (e) apply to a foreign divisive transaction involving a foreign distributing corporation and a foreign controlled corporation.

(2) Earnings and profits of foreign controlled corporation
--(i) In general. Except to the extent specified in paragraph (e)(2)(ii) of this section, pre-transaction earnings of a foreign distributing corporation that are allocated to a foreign controlled corporation under the rules described in paragraphs (b)(1)(i) and (4) of this section shall carry over to the foreign controlled corporation in accordance with the rules described in §1.367(b)-7.

(ii) Special rule for pre-transaction earnings allocated to a newly created controlled corporation. Section 1.367(b)-9 shall apply to pre-transaction earnings that are allocated from a foreign distributing corporation to a newly created foreign controlled corporation under the rules described in paragraph (b)(1)(i) of this section.

(3) Foreign income taxes. Pre-transaction taxes related to a foreign distributing corporation's pre-transaction earnings that are allocated or reduced under the rules described in

paragraph (b)(1)(i) of this section shall be ratably reduced. Pre-transaction taxes related to a foreign distributing corporation's pre-transaction earnings that are allocated to a foreign controlled corporation under the rules described in paragraph (b)(1)(i) of this section shall carry over to the foreign controlled corporation in accordance with the rules of §1.367(b)-7. Section 1.367(b)-9 shall apply to pre-transaction taxes that are allocated from a foreign distributing corporation to a newly created foreign controlled corporation under the rules described in paragraph (b)(1)(i) of this section.

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

(5) Coordination with §1.367(b)-5. See also §1.367(b)-5(c) and (d) for other rules that may apply to a foreign divisive transaction described in paragraph (e)(1) of this section.

(6) Examples. The following examples illustrate the application of the rules of this section to transactions described in paragraph (e)(1) of this section. The examples presume the following facts: FD is a foreign corporation engaged in manufacturing and shipping activities through Business A and Business B, respectively. FC is a foreign corporation that is wholly owned by FD. Any earnings and profits of FD or FC described in section 904(d)(1)(D) (shipping income) qualified for the high tax exception from subpart F income under section 954(b)(4), and FD's and FC's United States shareholders elected to exclude the earnings and profits from subpart F income under section 954(b)(4) and §1.954-1(d)(1). FD and FC have calendar taxable years. FD and FC (and all of their respective qualified

business units as defined in section 989) maintain a "u" functional currency, and 1u = US\$1 at all times. The examples are as follows:

Example 1--(i) Facts. (A) USP, a domestic corporation, has owned all of the stock of FD since FD's incorporation in 1995. USP's adjusted basis in the FD stock is \$400 and the FD stock has a fair market value of \$800. FD owns assets with total net bases of 320u (including 160u attributable to the Business B shipping assets), and has the following pre-transaction earnings and pre-transaction taxes accounts:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	300u	\$60
Shipping	<u>200u</u>	<u>\$80</u>
	500u	\$140

(B) On January 1, 2002, FD incorporates FC and transfers to FC the Business B shipping assets. FD then distributes the FC stock to USP. The transaction meets the requirements of sections 368(a)(1)(D) and 355. Immediately after the foreign divisive transaction, the FD stock and the FC stock each have a \$400 fair market value.

(ii) Result. (A) Calculation of FD's earnings and profits. Under paragraph (b)(1)(i) of this section, FD's pre-transaction earnings are reduced by an amount equal to its pre-transaction earnings times the net bases of the assets transferred to FC divided by the net bases of the assets held by FD immediately before the foreign divisive transaction ($500u \times (160u \div 320u) = 250u$). Following this reduction, FD has 250u of earnings and profits ($500u - 250u$).

(B) Application of §1.367(b)-5(c). The basis adjustment and income inclusion rules of §1.367(b)-5(c)(2) apply if USP's postdistribution amount with respect to FD or FC stock is less than its predistribution amount with respect to such stock. Under §1.367(b)-5(e)(1), USP's predistribution amount with respect to FD or FC stock is USP's section 1248 amount attributable to such stock computed immediately before the distribution but after taking into account the allocation of earnings and profits as a result of the D reorganization. Thus, USP's predistribution amounts with respect to FD and FC stock are both \$200. See also section 989(b)(2) and §1.1248-1(d)(3). Under section 358, USP allocates its \$400 basis in FD stock between FD stock and FC stock according to the stock blocks' relative values, yielding a \$200 ($\$400 \times (\$400 \div \$800)$) basis in each block. Under §1.367(b)-5(e)(2), USP's postdistribution amount with respect to FD or FC stock is USP's section 1248 amount with respect to such stock, computed immediately after the distribution. Accordingly, USP's postdistribution amounts with respect to FD and FC stock are both \$200. Because USP's

postdistribution amounts with respect to FD and FC stock are not less than USP's respective predistribution amounts, USP is not required to make any basis adjustment or include any income under §1.367(b)-5(c).

(C) Reduction in FD's statutory groupings of earnings and profits. Under paragraph (b)(2) of this section, the 250u reduction in FD's pre-transaction earnings decreases FD's statutory groupings of earnings and profits on a pro rata basis. Under paragraph (e)(3) of this section, FD's pre-transaction taxes also are ratably reduced. Accordingly, FD's pre-transaction earnings and pre-transaction taxes are reduced by the following amounts:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	150u	\$30
Shipping	<u>100u</u>	<u>\$40</u>
	250u	\$70

(D) Calculation of FC's earnings and profits. Under paragraph (e)(2) of this section, the pre-transaction earnings of FD that are allocated to FC under paragraph (b)(1)(i) of this section carry over to FC in accordance with the rules of §1.367(b)-7, subject to the rule of §1.367(b)-9. Under paragraph (e)(3) of this section, FD's pre-transaction taxes related to the pre-transaction earnings that are allocated to FC similarly carry over to FC in accordance with the rules of §1.367(b)-7, subject to the rule of §1.367(b)-9. As a result, under §1.367(b)-7(d), FC has the following earnings and profits and foreign income taxes accounts immediately after the foreign divisive transaction:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	150u	\$30
Shipping	<u>100u</u>	<u>\$40</u>
	250u	\$70

Example 2--(i) Facts. (A) USP, a domestic corporation, has owned all of the stock of FD since FD's incorporation in 1995. USP's adjusted basis in the FD stock is \$300 and the FD stock has a fair market value of \$1,500. FC is a preexisting controlled corporation and FD has always owned all of the FC stock. FD owns assets with total net bases of 320u (including 160u attributable to the FC stock). FD and FC have the following earnings and profits and foreign income taxes accounts:

FD:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	400u	\$ 50
Passive	(100u)	\$ 6
Shipping	<u>200u</u>	<u>\$ 80</u>
	500u	\$136

FC:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	600u	\$100
Passive	(50u)	\$ 6
Shipping	<u>100u</u>	<u>\$ 40</u>
	650u	\$146

(B) On January 1, 2002, FD distributes the FC stock to USP in a transaction that meets the requirements of section 355. Immediately after the foreign divisive transaction, the FD stock and the FC stock each have a \$750 fair market value.

(ii) Result--(A) Calculation of FD's earnings and profits. Under paragraph (b)(1)(i) and (ii)(A) of this section, FD's pre-transaction earnings are reduced by the amount of the reduction that would have been required if FD had transferred the stock of FC to a new corporation in a D reorganization. Thus, FD's pre-transaction earnings are reduced by an amount equal to its pre-transaction earnings times its net basis in the FC stock divided by the net bases of the assets held by FD immediately before the foreign divisive transaction ($500u \times (160u \div 320u) = 250u$). Following this reduction, FD has 250u of earnings and profits ($500u - 250u$).

(B) Application of §1.367(b)-5(c). The basis adjustment and income inclusion rules of §1.367(b)-5(c) apply if USP's postdistribution amount with respect to FD or FC stock is less than its predistribution amount with respect to such stock. Under §1.367(b)-5(e)(1), USP's predistribution amount with respect to FD or FC stock is USP's section 1248 amount attributable to such stock computed immediately before the distribution. Thus, USP's predistribution amounts with respect to FD and FC stock are \$500 and \$650, respectively. See also section 989(b)(2). Under section 358, USP allocates its \$300 basis in FD stock between FD stock and FC stock according to the stock blocks' relative values, yielding a \$150 ($\$300 \times (\$750 \div \$1,500)$) basis in each block. Under §1.367(b)-5(e)(2), USP's postdistribution amount with respect to FD or FC stock is USP's section 1248 amount with respect to such stock, computed immediately after the distribution. Accordingly, USP's postdistribution amount with respect to FD stock is \$250 ($500u - 250u$), and its postdistribution amount with respect to FC stock is \$600 (while FC has 650u of earnings and profits immediately after the foreign divisive transaction, USP's postdistribution amount is limited to its built-in gain in FC stock immediately after the distribution ($\$750 - \150)). USP's postdistribution amount with respect to both the FD and FC stock is less than its predistribution amount with respect to such stock. This difference is \$50 with respect to FC ($\$650 - \600), and \$250 with respect to FD ($\$500 - \250). Under §1.367(b)-5(c)(2)(i) and (ii), USP is required to reduce its basis in the FD and FC stock, but only to the extent such reductions increase USP's section 1248 amount with respect to the stock. Accordingly, USP reduces its basis in the FC stock by \$50, and thereafter USP has a \$100

basis in such stock (\$150 - \$100). Because a reduction in USP's basis in FD stock would not increase any of USP's section 1248 amount with respect to such stock, USP includes the entire \$250 difference between its predistribution and postdistribution amounts with respect to the FD stock as a deemed dividend from FD. Because the requirements of section 902 are met, USP qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FD. Under §1.960-1(i)(4), the 100u deficit in the section 904(d)(1)(A) passive separate category is allocated proportionately against the other separate categories for purposes of computing the deemed paid credit on the distribution. Thus, there are 333.33u (400u - (100u x (400u ÷ 600u))) of available earnings in the section 904(d)(1)(I) general separate category (along with \$50 of foreign income taxes) and 166.67u (200u - (100u x (200u ÷ 600u))) of available earnings in the section 904(d)(1)(D) shipping separate category (along with \$80 of foreign income taxes). Under §1.902-1(d)(1), the \$250 deemed dividend is out of FD's separate categories and reduces foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	166.67u	\$25
Passive	0u	\$ 0
Shipping	<u>83.33u</u>	<u>\$40</u>
	250u	\$65

(C) Basis adjustments. Under §1.367(b)-5(c)(3), USP does not increase its basis in FD stock as a result of USP's \$250 deemed dividend from FD. Under §1.367(b)-5(c)(4), USP increases its basis in the FD and FC stock by the amount of its basis decrease or deemed dividend inclusion with respect to the other corporation, but only to the extent such basis increase does not diminish USP's postdistribution amount with respect to that other corporation and only to the extent of the other corporation's fair market value. Under these rules, USP increases its basis in the FD stock by the full amount by which it decreased its basis in FC (\$150 + \$50 = \$200). USP does not increase its basis in the FC stock as a result of its deemed dividend from FD because any increase in the FC stock basis would diminish USP's postdistribution amount with respect to such stock.

(D) FD's earnings and profits after the foreign divisive transaction. Because the entire \$250 reduction in FD's pre-transaction earnings was subject to inclusion under §1.367(b)-5 (as described in this Example 2 (ii)(B)), paragraph (b)(2) of this section does not apply. FD has the following earnings and profits and foreign income taxes accounts immediately after the foreign divisive transaction (see §1.960-1(i)(4)):

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	233.33u	\$25
Passive	(100u)	\$ 6
Shipping	<u>116.67u</u>	<u>\$40</u>
	250u	\$71

(E) Calculation of FC's earnings and profits. Under paragraph (b)(1)(ii)(B) of this section, FC's earnings and profits are not increased (or replaced) as a result of the foreign divisive transaction. FC's earnings and profits also are not reduced because USP was not required to include a deemed dividend out of FC under §1.367(b)-5.

Example 3--(i) Facts. (A) USP, a domestic corporation, has owned all of the stock of FD since FD's incorporation in 1995. USP's adjusted basis in the FD stock is \$100 and the FD stock has a fair market value of \$2,000. FC is a preexisting controlled corporation and FD has always owned all of the FC stock. FD owns assets with total net bases of 320u (including 100u attributable to the FC stock and 160u attributable to the Business B shipping assets). FD and FC have the following earnings and profits and foreign income taxes accounts:

FD:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	300u	\$ 50
10/50 dividends from FC1, a noncontrolled section 902 corporation	100u	\$ 6
Shipping	<u>200u</u>	<u>\$ 80</u>
	600u	\$136

FC:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	100u	\$10
Passive	(50u)	\$ 6
Shipping	<u>100u</u>	<u>\$40</u>
	150u	\$56

(B) On January 1, 2002, FD transfers to FC the Business B shipping assets. FD then distributes the FC stock to USP. The transaction meets the requirements of sections 368(a)(1)(D) and 355. Immediately after the foreign divisive transaction, the FD stock and the FC stock each have a \$1,000 fair market value.

(ii) Result--(A) Calculation of FD's earnings and profits. Under paragraph (b)(4)(i) of this section, FD's pre-transaction earnings are reduced by the sum of the amounts described in paragraphs (b)(4)(i)(A) and (B) of this section. Under paragraph (b)(4)(i)(A) of this section, FD's pre-transaction earnings are reduced by an amount equal to FD's pre-transaction earnings times the net bases of the Business B shipping assets transferred to FC divided by the total net bases in the assets held by FD immediately before the foreign divisive transaction (600u x (160u

÷ 320u) = 300u). Under paragraph (b)(4)(i)(B) of this section, FD's pre-transaction earnings are reduced by an amount equal to FD's pre-transaction earnings times FD's net bases in the stock of FC divided by the total net bases of the assets held by FD immediately before the foreign divisive transaction (600u x (100u ÷ 320u) = 187.50u). The sum of the amounts described in paragraphs (b)(4)(i)(A) and (B) of this section is 487.50u.

(B) Application of §1.367(b)-5(c). The basis adjustment and income inclusion rules of §1.367(b)-5(c)(2) apply if USP's postdistribution amount with respect to FD or FC stock is less than its predistribution amount with respect to such stock. Under §1.367(b)-5(e)(1) and (3), USP's predistribution amount with respect to FD or FC stock is USP's section 1248 amount attributable to such stock computed immediately before the distribution, after the allocation of FD's pre-transaction earnings described in paragraphs (b)(4)(i)(A) and (ii)(A) of this section, but before the reduction in FD's pre-transaction earnings described in paragraph (b)(4)(i)(B) of this section. Thus, USP's predistribution amounts with respect to FD and FC stock are \$300 (600u - 300u) and \$450 (150u + 300u), respectively. See also section 989(b)(2). Under section 358, USP allocates its \$100 basis in FD stock between FD stock and FC stock according to the stock blocks' relative values, yielding a \$50 ($\$100 \times (\$1,000 \div \$2,000)$) basis in each block. Under §1.367(b)-5(e)(2), USP's postdistribution amount with respect to FD or FC stock is USP's section 1248 amount with respect to such stock, computed immediately after the distribution. Accordingly, USP's postdistribution amount with respect to FD stock is \$112.50 (600u - 300u - 187.50u), and its postdistribution amount with respect to FC stock is \$450 (150u + 300u). Because USP's postdistribution amount with respect to FC stock is not less than its predistribution amount with respect to such stock, the §1.367(b)-5(c)(2) basis adjustment and income inclusion rules do not apply with respect to the FC stock. Because USP's postdistribution amount with respect to FD stock is \$187.50 less than its predistribution amount with respect to such stock (\$300 - \$112.50), §1.367(b)-5(c)(2)(i) and (ii) require USP to reduce its basis in FD stock, but only to the extent such reduction increases USP's section 1248 amount with respect to the FD stock. Because a reduction in USP's basis in the FD stock would not increase any of USP's section 1248 amount with respect to such stock, USP includes the entire \$187.50 difference between its predistribution and postdistribution amounts with respect to the FD stock as a deemed dividend from FD. Because the requirements of section 902 are met, USP qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from FD. Under §1.902-1(d)(1), the \$187.50 deemed dividend is out of FD's separate categories and reduces foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	93.75u	\$15.63
10/50 dividends from FC1	31.25u	\$ 1.88
Shipping	<u>62.50u</u>	<u>\$25</u>
	187.50u	\$42.51

(C) Basis adjustment. Under §1.367(b)-5(c)(3), the basis increase provided in §1.367(b)-2(e)(3)(ii) does not apply with respect to USP's \$187.50 deemed dividend from FD. Under §1.367(b)-5(c)(4), USP increases its basis in the FC stock by the amount of its deemed dividend inclusion from FD, but only to the extent such basis increase does not diminish USP's postdistribution amount with respect to FC stock and only up to the fair market value of the FC stock. Under these rules, USP increases its basis in the FC stock by the full amount of its deemed dividend from FD (\$50 + \$187.50 = \$237.50).

(D) Reduction in FD's statutory groupings of earnings and profits. Under paragraph (b)(2) of this section, the reduction in FD's pre-transaction earnings that is not attributable to USP's inclusion under §1.367(b)-5 decreases FD's statutory groupings of earnings and profits on a pro rata basis. Under paragraph (e)(3) of this section, FD's pre-transaction taxes are also ratably reduced. As described in this Example 3 (ii)(A), the reduction in FD's pre-transaction earnings is 487.50u. As described in this Example 3 (ii)(B), 187.50u of the 487.50u reduction is attributable to a deemed dividend inclusion by USP under §1.367(b)-5. Thus, under paragraphs (b)(2) and (e)(3) of this section, the remaining 300u reduction in FD's pre-transaction earnings and related pre-transaction taxes is out of FD's separate categories and reduces foreign income taxes as follows:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	150u	\$25
10/50 dividends from FC1	50u	\$ 3
Shipping	<u>100u</u>	<u>\$40</u>
	300u	\$68

(E) Calculation of FC's earnings and profits. Under paragraph (b)(4)(ii) of this section, FC's earnings and profits immediately after the foreign divisive transaction equal the sum of FC's earnings and profits immediately before the foreign divisive transaction, plus the amount of the reduction in FD's earnings and profits described in paragraph (b)(4)(i)(A) of this section, except to the extent such amount was included in income as a deemed dividend pursuant to the foreign divisive transaction. The reduction in FD's earnings and profits described in paragraph (b)(4)(i)(A) of this section is 300u, none of which was included in income by USP as a deemed dividend pursuant to the foreign divisive transaction. Under paragraphs (e)(2) and (3) of this section, the 300u of pre-transaction earnings and related pre-transaction taxes carry over to FC and combine with FC's earnings and profits and foreign income taxes

accounts in accordance with the rules described in §1.367(b)-7. Under §1.367(b)-7(d), FC has the following earnings and profits and foreign income taxes accounts immediately after the foreign divisive transaction:

<u>Separate Category</u>	<u>E&P</u>	<u>Hovering Deficit</u>	<u>Taxes</u>	<u>Taxes Associated w/ Hovering Deficit</u>
General	250u		\$35	
10/50 dividends from FC1	50u		\$ 3	
Passive Shipping	<u>200u</u>	(50u)	<u>\$80</u>	\$6
	500u	<u>(50u)</u>	\$118	<u>\$6</u>

(F) FD's earnings and profits after the foreign divisive transaction. Following the reductions described in this Example 3 (ii)(B) and (D), FD has the following earnings and profits and foreign income taxes accounts:

<u>Separate Category</u>	<u>E&P</u>	<u>Foreign Taxes</u>
General	56.25u	\$ 9.37
10/50 dividends from FC1	18.75u	\$ 1.12
Shipping	<u>37.50u</u>	<u>\$15</u>
	112.50u	\$25.49

(f) Effective date. This section shall apply to section 367(b) exchanges that occur on or after the date 30 days after these regulations are published as final regulations in the **Federal Register.**

Par. 11. Section 1.367(b)-9 is added to read as follows:

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

(a) Scope. This section applies to any foreign 381 transaction (as described in §1.367(b)-7(a)) described in section 368(a)(1)(F) or in which either the foreign target corporation or the foreign acquiring corporation is newly created. This section also applies to any foreign divisive transaction (as described in §1.367(b)-8(a)) that is described in §1.367(b)-8(e)(1) and that involves a newly created foreign distributing or foreign

controlled corporation.

(b) Hovering deficit rules inapplicable. If a transaction is described in paragraph (a) of this section, a foreign surviving corporation or a newly created controlled corporation shall succeed to earnings and profits, deficits in earnings and profits, and foreign income taxes without regard to the hovering deficit rules of §1.367(b)-7(d)(2), (e)(1)(iii), (e)(2)(iii), (f)(1)(iii), and (f)(2)(iii). In the case of a foreign divisive transaction, nothing in this section shall affect the application of §1.367(b)-8(b)(iii).

(c) Example. The following example illustrates the rules of this section:

Example--(i) Facts. (A) Foreign corporation A is and always has been a wholly owned subsidiary of USP, a domestic corporation. Foreign corporation A was incorporated in 1990, and always has been a controlled foreign corporation using a calendar taxable year. Foreign corporation A (and all of its respective qualified business units as defined in section 989) maintains a "u" functional currency, and 1u = US\$1 at all times. On December 31, 2001, foreign corporation A has the following earnings and profits and foreign income taxes accounts:

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

(B) On January 1, 2002, foreign corporation A moves its place of incorporation from Country 1 to Country 2 in a reorganization described in section 368(a)(1)(F).

(ii) Result. Under §1.367(b)-7(d), as modified by paragraph (b) of this section, foreign surviving corporation has the following earnings and profits and foreign income taxes accounts immediately after the foreign 381 transaction:

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

(d) Effective date. This section shall apply to section

367(b) exchanges that occur on or after the date 30 days after these regulations are published as final regulations in the **Federal Register**.

Par. 12. In §1.367(e)-1, paragraph (a) is amended by adding a sentence at the end of the paragraph to read as follows:

§1.367(e)-1 Distributions described in section 367(e)(1).

(a) * * * See §1.367(b)-8(c)(3) for an example illustrating the interaction of §1.367(e)-1 with other sections of the Internal Revenue Code (such as sections 367(b) and 1248).

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Par. 13. In §1.381(a)-1, paragraph (c) is revised to read as follows:

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

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

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Robert E. Wenzel

Deputy Commissioner of Internal Revenue