The Treasury Department and the IRS decline to withdraw the temporary regulations and the proposed regulations relating to the recognition period but agree with the comment relating to the length of the recognition period. Accordingly, these final regulations provide that the term *recognition period* means the recognition period described in section 1374(d)(7), beginning, in the case of a conversion transaction that is a qualification of a C corporation as a RIC or a REIT, on the first day of the RIC's or the REIT's first taxable year, and, in the case of other conversion transactions, on the day the RIC or the REIT acquires the property. The final regulations will apply prospectively from February 17, 2017, but taxpayers may choose to apply the definition of recognition period in the final regulations, instead of the 10-year recognition period in the temporary regulations, for conversion transactions occurring on or after August 8, 2016, and on or before February 17, 2017.

The Treasury Department and the IRS continue to study the other issues addressed in the temporary regulations and the proposed regulations, including other issues raised by the comment, and welcome further comment on those issues.

Special Analyses

Certain IRS regulations, including this one, are exempt from the requirements of Executive Order 12866, as supplemented by Executive Order 13653. Therefore, a regulatory assessment is not required. Pursuant to the Regulatory Flexibility Act (5 U.S.C. chapter 6), it is hereby certified that this regulation will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that this regulation will primarily affect large corporations with a substantial number of shareholders. Accordingly, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking preceding this regulation was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Drafting Information

The principal author of these regulations is Austin M. Diamond-Jones, Office of Associate Chief Counsel (Corporate). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

■ **Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

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

* * * * *

■ **Par. 2.** Section 1.337(d)–7 is amended by revising paragraphs (b)(2)(iii) and (g)(2)(iii) to read as follows:

§ 1.337(d)–7 Tax on property owned by a C corporation that becomes property of a RIC or REIT.

* * * * *

(b) * * *

(2) * * *

(iii) *Recognition period.* For purposes of applying the rules of section 1374 and the regulations thereunder, as modified by paragraph (b) of this section, the term *recognition period* means the recognition period described in section 1374(d)(7), beginning—

(A) In the case of a conversion transaction that is a qualification of a C corporation as a RIC or a REIT, on the first day of the RIC's or the REIT's first taxable year; and

(B) In the case of other conversion transactions, on the day the RIC or the REIT acquires the property.

* * * * *

(g) * * *

(2) * * *

(iii) *Recognition period.* Paragraphs (b)(1)(ii) and (d)(2)(iii) of this section apply to conversion transactions that occur on or after August 8, 2016. Paragraph (b)(2)(iii) of this section applies to conversion transactions that occur after February 17, 2017. For conversion transactions that occurred on or after August 8, 2016 and on or before February 17, 2017, see § 1.337(d)–7T(b)(2)(iii) in effect on August 8, 2016. However, taxpayers may apply paragraph (b)(2)(iii) of this section to conversion transactions that occurred on or after August 8, 2016 and on or before February 17, 2017. For conversion transactions that occurred on or after January 2, 2002 and before August 8, 2016, see § 1.337(d)–7 as contained in 26 CFR part 1 in effect on April 1, 2016.

■ **Par. 3.** Section 1.337(d)–7T is amended by revising paragraphs (b)(1) through (3) and (g)(2)(iii) to read as follows:

§ 1.337(d)–7T Tax on property owned by a C corporation that becomes property of a RIC or REIT.

* * * * *

(b)(1) through (3) [Reserved]. For further guidance, see § 1.337(d)–7(b)(1) through (3).

* * * * *

(g) * * *

(2) * * *

(iii) [Reserved]. For further guidance, see § 1.337(d)–7(g)(2)(iii).

* * * * *

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: December 30, 2016.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2017–00479 Filed 1–17–17; 8:45 am]

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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[TD 9812]

RIN 1545–BL00; 1545–BM45

Guidance for Determining Stock Ownership; Rules Regarding Inversions and Related Transactions

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations, temporary regulations, and removal of temporary regulations.

SUMMARY: This document contains final regulations that identify certain stock of a foreign corporation that is disregarded in calculating ownership of the foreign corporation for purposes of determining whether it is a surrogate foreign corporation. These regulations also provide guidance on the effect of transfers of stock of a foreign corporation after the foreign corporation has acquired substantially all of the properties of a domestic corporation or of a trade or business of a domestic partnership. These regulations affect certain domestic corporations and partnerships (and certain parties related thereto) and foreign corporations that acquire substantially all of the properties of such domestic corporations or of the trades or businesses of such domestic partnerships. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on Rules

Regarding Inversions and Related Transactions in the Proposed Rules section of this issue of the **Federal Register**.

DATES: *Effective Date:* These regulations are effective on January 18, 2017.

Applicability Dates: For dates of applicability, see §§ 1.7874–4(k), 1.7874–5(e), 1.7874–7T(h), and 1.7874–10T(i).

FOR FURTHER INFORMATION CONTACT: Joshua G. Rabon at (202) 317–6937 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains regulations under section 7874 of the Internal Revenue Code (Code). On September 17, 2009, the Department of the Treasury (Treasury Department) and the IRS issued Notice 2009–78 (2009–40 IRB 452), which announced that regulations would be issued under section 7874 identifying certain stock of a foreign corporation that would not be taken into account for purposes of determining the ownership percentage described in section 7874(a)(2)(B)(ii) (the 2009 notice). On January 17, 2014, temporary regulations (TD 9654) were published in the **Federal Register** (79 FR 3094) that implemented and obsoleted the 2009 notice and provided guidance with respect to subsequent transfers of stock of a foreign corporation described in section 7874(a)(2)(B)(ii) (the 2014 temporary regulations). A notice of proposed rulemaking (REG–121534–12) cross-referencing the 2014 temporary regulations was published in the same issue of the **Federal Register** (79 FR 3145) (the 2014 proposed regulations). On November 19, 2015, the Treasury Department and the IRS issued Notice 2015–79 (2015–49 IRB 775), which announced, in part, that regulations would be issued to clarify certain aspects of the 2014 temporary regulations (the 2015 notice). On April 8, 2016, the Treasury Department and the IRS published temporary regulations (TD 9761) in the **Federal Register** (81 FR 20858) that, in part, implemented the clarifications announced in the 2015 notice and provided common definitions for purposes of certain regulations under sections 367(b), 956, 7701(l), and 7874 (the 2016 temporary regulations). A notice of proposed rulemaking (REG–135734–14) cross-referencing the 2016 temporary regulations was published in the same issue of the **Federal Register** (81 FR 20588) (the 2016 proposed regulations). The 2014 temporary regulations as modified by the 2016 temporary regulations are referred to in this preamble as the ''temporary regulations.'' No public hearing was requested or held on the 2014 proposed regulations or the 2016 proposed regulations; however, comments were received. All comments are available at *www.regulations.gov* or upon request. After consideration of the comments, the 2014 proposed regulations, as modified by the 2016 proposed regulations and as updated to reflect the common definitions in those regulations, are adopted as amended by this Treasury decision, and the corresponding temporary regulations are removed.

Summary of Comments and Explanation of Revisions

I. The Disqualified Stock Rule—General Approach

A foreign corporation (foreign acquiring corporation) generally is treated as a surrogate foreign corporation under section 7874(a)(2)(B) if, pursuant to a plan (or a series of related transactions), three conditions are satisfied. First, the foreign acquiring corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (domestic entity acquisition). Second, after the domestic entity acquisition, at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the domestic corporation (former domestic entity shareholders) by reason of holding stock in the domestic corporation (such percentage, the ownership percentage, and the fraction used to calculate the ownership percentage, the ownership fraction). And third, after the domestic entity acquisition, the expanded affiliated group (as defined in section 7874(c)(1)) that includes the foreign acquiring corporation (EAG) does not have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized when compared to the total business activities of the EAG. Similar provisions apply if a foreign acquiring corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership. The domestic corporation or the domestic partnership described in this paragraph is referred to at times in this preamble as the ''domestic entity.'' For other definitions used throughout this preamble but not defined in this preamble, see § 1.7874–12T (providing common definitions for purposes of certain regulations under sections 367(b), 956, 7701(l), and 7874).

The temporary regulations provide a rule (the disqualified stock rule) that, subject to a de minimis exception, excludes disqualified stock from the denominator of the ownership fraction. In general, disqualified stock is stock of the foreign acquiring corporation that, in a transaction related to the domestic entity acquisition, is transferred in one of two types of exchanges. See Parts II.A and B of this Summary of Comments and Explanation of Revisions for the discussion of these exchanges. However, stock is disqualified stock only to the extent that the transfer of the stock in the exchange increases the fair market value of the assets of the foreign acquiring corporation or decreases the amount of its liabilities (the net asset requirement). The disqualified stock rule thus generally prevents stock of the foreign acquiring corporation that is transferred in certain transactions that increase the net assets of the foreign acquiring corporation from inappropriately increasing the denominator of the ownership fraction and thereby diluting the ownership percentage.

Under the temporary regulations, stock may be disqualified stock regardless of whether it is, has been, or will be publicly traded. In addition, stock may be disqualified stock regardless of whether it is transferred by reason of an issuance, sale, distribution, exchange, or any other type of disposition, or whether it is transferred by the foreign acquiring corporation or another person.

One comment suggested that disqualified stock should generally include only stock transferred by reason of an issuance by the foreign acquiring corporation. According to the comment, this would generally simplify the disqualified stock rule by obviating the need for the net asset requirement, though it noted that special rules regarding hook stock would likely be needed. The final regulations do not adopt this comment. The Treasury Department and the IRS have determined that transfers other than solely by reason of an issuance can inappropriately dilute the ownership percentage. For example, see § 1.7874–4(j) *Example 6* (iii) (issuance of stock by the foreign acquiring corporation in exchange for qualified property followed by a transfer of that stock by the transferee in satisfaction of an obligation of the transferee) and § 1.7874–4(j) *Example 10* (issuance of stock followed by use of the stock to satisfy an obligation). The Treasury Department and the IRS have concluded

that addressing these transactions and other transactions (such as transactions involving hook stock) via special rules would largely negate the simplicity benefits of the approach recommended by the comment.

II. Exchanges That Give Rise to Disqualified Stock

A. Exchanges for Nonqualified Property

1. In General

Disqualified stock includes stock of the foreign acquiring corporation that, in a transaction related to the domestic entity acquisition, is transferred to a person other than the domestic entity in exchange for ''nonqualified property.'' Nonqualified property means (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations (as discussed in Part II.A.3 of this Summary of Comments and Explanation of Revisions), and (iv) any other property acquired with a principal purpose of avoiding the purposes of section 7874, regardless of whether the transaction involves an indirect transfer of property described in clause (i), (ii), or (iii). This preamble refers at times to the property described in clauses (i), (ii), and (iii) of the preceding sentence collectively as ''specified nonqualified property'' and to the property described in clause (iv) as ''avoidance property.'' For this purpose, marketable securities has the meaning set forth in section 453(f)(2), except that the term does not include stock of a corporation or an interest in a partnership that becomes a member of the EAG in a transaction (or series of transactions) related to the domestic entity acquisition.

2. Different Treatment for Stock and Asset Acquisitions

Under the temporary regulations, the extent to which stock of a foreign acquiring corporation is considered transferred in exchange for nonqualified property can differ depending on the structure of a transaction. For example, if, in a transaction related to a domestic entity acquisition, the foreign acquiring corporation acquires all the stock of another foreign corporation (foreign target corporation) in exchange for stock of the foreign acquiring corporation, then such stock of the foreign acquiring corporation would normally not be considered transferred in exchange for nonqualified property, regardless of the extent to which the properties of the foreign target corporation constitute nonqualified property, unless the stock of the foreign target corporation constitutes avoidance property. However, if the transaction were instead structured so that the foreign acquiring corporation acquires all of the properties of the foreign target corporation in exchange for stock of the foreign acquiring corporation, then such stock of the foreign acquiring corporation would be considered transferred in exchange for nonqualified property, to the extent that the properties of the foreign target corporation constitute nonqualified property. The preamble to the 2014 temporary regulations acknowledged this disparity and the decision not to harmonize the treatment of stock and asset acquisitions by, for example, applying a look-through approach to stock acquisitions. See Part C of the Explanation of Provisions section of the preamble to the 2014 temporary regulations. Nevertheless, comments requested more consistent treatment between stock and asset acquisitions, noting in particular that, when the foreign target corporation is publicly-traded, corporate and other legal considerations may dictate the structure of the transaction.

One comment suggested that this result could be achieved when a foreign acquiring corporation acquires substantially all of the properties of a foreign target corporation by viewing the two corporations as a single combined unit for purposes of the disqualified stock rule. Under this view, properties historically held by the foreign target corporation (including nonqualified property) would not represent an infusion of value into the combined group. The comment thus asserted that, regardless of the structure of the transaction, the disqualified stock rule generally should not apply to stock attributable to such properties. The comment noted, though, that if asset acquisitions were to be treated similar to stock acquisitions, there might be a heightened need for rules, in addition to the anti-abuse rule of section 7874(c)(4), to address certain related transactions in which stock of the foreign target corporation is transferred in exchange for nonqualified property.

After considering the comments, the Treasury Department and the IRS decline to adopt a rule treating certain asset acquisitions as stock acquisitions or to otherwise coordinate their treatment. The Treasury Department and the IRS have determined that stock of a foreign acquiring corporation attributable to any nonqualified property—whether acquired in a transaction related to the domestic entity acquisition or historically held—generally presents opportunities to inappropriately dilute the ownership percentage. For example, see, the passive assets rule of § 1.7874–7T. Thus, the Treasury Department and the IRS have concluded that a look-through approach, pursuant to which stock acquisitions would be treated similar to asset acquisitions, would be the preferable approach for harmonizing the treatment, in contrast to the comments' recommendation to treat certain assets acquisitions similar to stock acquisitions. The final regulations, however, do not implement a look-through approach out of concerns of undue complexity and administrative burden.

Another comment recommended that, if the final regulations retain different treatment for stock and asset acquisitions, working capital of a foreign target corporation should be excluded from the definition of nonqualified property. After considering this comment, the Treasury Department and the IRS have determined that providing special rules that exclude working capital from the definition of nonqualified property would result in undue complexity and administrative burden. Notably, such special rules would have limited applicability when the foreign target corporation is a parent corporation of an affiliated group—which is often the case—because, in such a structure, working capital generally would be held by subsidiaries. Accordingly, the final regulations do not adopt the comment.

3. Obligations Constituting Nonqualified Property

Under the temporary regulations, nonqualified property includes an obligation owed by (i) a member of the EAG; (ii) a former domestic entity shareholder or former domestic entity partner; or (iii) a person that owns, before or after the domestic entity acquisition, stock of (or a partnership interest in) a person described in clause (i) or (ii) or that is related (within the meaning of section 267 or 707(b)) to such a person. Comments requested several modifications to this rule.

First, a comment recommended that, if the final regulations retain different treatment for stock and asset acquisitions, they exclude certain obligations owed by a member of the EAG from the definition of nonqualified property. In particular, the comment suggested excluding intercompany obligations held by the foreign target corporation (that is, obligations owed by an affiliate of the foreign target corporation to the foreign target corporation), at least to the extent that the obligations arose in the ordinary course of the foreign target group's cash management program. The comment noted that, in these cases, had the

foreign target corporation instead funded its affiliate through equity (rather than debt), stock of the foreign acquiring corporation transferred in exchange for the equity generally would not be disqualified stock. The comment questioned this disparate treatment.

After considering the comment, the Treasury Department and the IRS have determined that transfers of stock of a foreign acquiring corporation in exchange for intercompany obligations generally do not present opportunities to inappropriately reduce the ownership fraction. Accordingly, the final regulations exclude from the definition of nonqualified property an obligation owed by a member of the EAG if the holder of the obligation immediately before the domestic entity acquisition and any related transaction (or its successor), is a member of the EAG after the domestic entity acquisition and all related transactions. § 1.7874–4(i)(2)(iii)(A).

Another comment recommended that nonqualified property generally not include an obligation owed by a person that is only a de minimis former domestic entity shareholder or former domestic entity partner. The comment made a similar recommendation for an obligation owed by a person that, before and after the domestic entity acquisition, owns no more than a de minimis interest in any member of the EAG. The Treasury Department and the IRS agree with this comment, and the final regulations are modified accordingly. See § 1.7874–4(i)(2)(iii)(B) and (C) (providing a de minimis rule for a less than five percent ownership interest). Nevertheless, the anti-abuse rule in section 7874(c)(4) may still apply to disregard transfers of stock in exchange for such obligations.

4. Definition of Obligation

The temporary regulations define an obligation by reference to § 1.752–1(a)(4)(ii), which includes ''any fixed or contingent obligation to make payment. . . . Obligations include, but are not limited to, debt obligations, environmental obligations, tort obligations, contract obligations, pension obligations, obligations under a short sale, and obligations under derivative financial instruments such as options, forward contracts, futures contracts, and swaps.''

The Treasury Department and the IRS are concerned that the reference in the temporary regulations to § 1.752–1(a)(4)(ii) may cause confusion when applied outside of a partnership setting. The final regulations thus remove the reference to § 1.752–1(a)(4)(ii) and provide that an obligation for purposes of the disqualified stock rule includes any fixed or contingent obligation to make payment or provide value (such as through providing goods or services). § 1.7874–4(i)(3). No inference is intended regarding the treatment, under § 1.752–1(a)(4)(ii) or the temporary regulations, of a contractual agreement by a person to provide goods or services.

5. Definition of Avoidance Property

Avoidance property means any property (other than specified nonqualified property) acquired with a principal purpose of avoiding the purposes of section 7874. The 2015 notice and the 2016 temporary regulations clarified that this definition applies regardless of whether the transaction involves an indirect transfer of specified nonqualified property. One comment was received regarding this clarification.

The comment agreed with the clarification but asserted that avoidance property should not include property that meets two conditions. First, the property (or, in cases in which the property is stock or a partnership interest, the property indirectly transferred) either (i) constitutes a trade or business within the meaning of § 1.367(a)–2(d)(2), or (ii) is related to an existing business of the foreign acquiring corporation. And, second, the property is transferred without an intention to dispose of it at a later time. After considering the comment, the Treasury Department and the IRS have determined that whether property constitutes avoidance property should in all cases depend on the principal purpose for the acquisition of the property, which cannot be determined based on an exclusive set of objective factors, such as the nature of the property or holding period. In certain circumstances, property that meets the conditions described by the comment could be acquired with a principal purpose of avoiding the purposes of section 7874. Thus, the Treasury Department and the IRS have concluded that it would be inappropriate to exclude such property from the definition of avoidance property. Consequently, the final regulations do not adopt the comment.

B. Subsequent Transfers of Stock in Exchange for the Satisfaction or Assumption of an Obligation Associated With the Property Exchanged

1. In General

Disqualified stock also generally includes stock of the foreign acquiring corporation that is transferred by a person (the transferor) to another person (the transferee) in exchange for property (the exchanged property) if, pursuant to the same plan (or series of related transactions), the transferee subsequently transfers the stock in exchange for the satisfaction or assumption of one or more obligations associated with the exchanged property (the associated obligation rule). The purpose of the rule is to ensure that the same amount of stock of the foreign acquiring corporation is included in the denominator of the ownership fraction in economically similar situations.

For example, consider a situation in which a foreign acquiring corporation (FA) intends to acquire the property of a domestic entity (DT), which holds property with a fair market value of $100x and has a $25x obligation that is associated with the property. The parties could structure the domestic entity acquisition using the following steps: (i) DT transfers all of its property to FA in exchange for $75x of FA stock and FA's assumption of the $25x associated obligation, (ii) DT distributes the $75x of FA stock to its shareholders, and (iii) in a related transaction, FA issues $25x of its stock to the public for cash and uses that cash to satisfy the associated obligation. Alternatively, FA could not assume the associated obligation and could thus acquire all of DT's properties in exchange for $100x of FA stock, followed by DT using $25x of FA stock to satisfy the $25x associated obligation and distributing the remaining $75x of FA stock to its shareholders in liquidation. Under the first alternative, the $25x of FA stock issued to the public in exchange for cash (which is nonqualified property) would be excluded from the denominator of the ownership fraction. Under the second alternative, however, no FA stock would be excluded absent the associated obligation rule. Allowing a different result under the second alternative would be inappropriate because the first and second alternatives are economically similar. That is, under both alternatives, FA's value reflects the gross value of the acquired property (under the first alternative, because the amount of the associated obligation is satisfied with the cash and, under the second alternative, because FA did not assume the associated obligation), and DT's obligations have been reduced by the amount of the associated obligation. The associated obligation rule thus ensures that, as under the first alternative, $25x of FA stock is excluded from the denominator of the ownership fraction under the second alternative. The rule serves the same

purpose when the transferee is a person other than the domestic entity.

Several comments were received regarding the purpose and effect of the associated obligation rule. First, a comment noted that the rule serves an important purpose and suggested that the final regulations retain the rule. Another comment questioned the practical significance of the rule under the temporary regulations and suggested that the final regulations remove it. In particular, the comment asserted that creditors typically require obligations to be satisfied in cash, rather than stock. Moreover, the comment stated that, under the temporary regulations, the rule might not apply if, instead of using stock of the foreign acquiring corporation to satisfy an associated obligation, the transferee sold the stock for cash and then used the cash to satisfy the obligation. One comment acknowledged, however, that a plan (or series of related transactions) to satisfy obligations of the transferee using the proceeds of the sale of stock of the foreign acquiring corporation could be subject to the anti-abuse rule under section 7874(c)(4).

After considering the comments, the Treasury Department and the IRS have determined that the associated obligation rule promotes an important policy and thus the final regulations retain the rule. The Treasury Department and the IRS also have determined that when a foreign acquiring corporation issues its stock in lieu of assuming an obligation associated with the exchanged property, the rule should not be limited to situations in which, pursuant to the same plan (or series of related transactions), the transferee uses the stock to directly satisfy the associated obligation. Rather, the Treasury Department and the IRS have concluded that the rule should generally apply if, pursuant to the same plan (or series of related transactions), the transferee uses the stock to directly or indirectly satisfy any obligation of the transferee (regardless of whether it is an associated obligation). For example, the rule should apply if the transferee sells the stock and then uses the proceeds to satisfy an amount of an obligation of the transferee equal to the amount of the associated obligation. In these cases, the transferee and the foreign acquiring corporation are in an economic position similar to the one in which they would have been had the foreign acquiring corporation assumed the associated obligation, issued stock in exchange for cash, and then used that cash to satisfy the obligation. The final regulations accordingly modify the associated obligation rule. See § 1.7874–4(c)(1)(ii)(A). In addition, the final regulations generally limit the amount of disqualified stock arising under the associated obligation rule to the proportionate share of obligations associated with the exchanged property that, pursuant to the same plan (or series of related transactions), is not assumed by the foreign acquiring corporation. See § 1.7874–4(c)(1)(ii)(B).

2. Acquisitions of Less than Substantially All of the Property of Transferee

A comment requested a modification of the associated obligation rule so that it applies only if the transferor acquires substantially all of the property of the transferee. The comment asserted that, when the transferor acquires only a portion (rather than substantially all) of the transferee's property, it may be difficult or burdensome to determine which obligations are associated with the exchanged property.

The associated obligation rule addresses a concern that, absent the rule, a different amount of stock of a foreign acquiring corporation might be included in the denominator of the ownership fraction in economically similar scenarios. The Treasury Department and the IRS have determined that this concern may exist regardless of the portion of the transferee's property that is acquired. In addition, determinations concerning the association between obligations and property may be required under the Code for purposes other than applying the associated obligation rule. For example, see section 358(h)(2). Accordingly, the final regulations decline to adopt the comment.

3. Application of Rule When Domestic Entity Is Transferee

One comment suggested broadening the associated obligation rule to address certain cases in which the domestic entity is the transferee and the foreign acquiring corporation issues its stock in lieu of assuming any obligation of the transferee (regardless of whether it is associated with the exchanged property). For example, consider a situation in which a domestic entity (DT) has two lines of business: (i) Business A, which comprises property that, in the aggregate, has a fair market value of $90x and no obligations associated with it, and (ii) Business B, which comprises property that, in the aggregate, has a fair market value of $20x and $10x of obligations associated with it. If a foreign acquiring corporation (FA) acquires only the Business A property in exchange for $90x of FA stock, DT might use $10x of FA stock to satisfy the Business B associated obligations and distribute the remaining $80x of FA stock and the $20x of Business B property to its shareholders in liquidation. In such a case, the $10x of FA stock would not be disqualified stock under the associated obligation rule because the transferee did not retain any obligations associated with the exchanged property (the Business A property); thus, absent special rules, the stock might inappropriately dilute the ownership percentage. The comment noted that the associated obligation rule could be modified to address such cases.

The Treasury Department and the IRS acknowledge the concern raised by the comment but decline to broaden the associated obligation rule to address it at this time. However, the Treasury Department and the IRS will monitor transactions in which the foreign acquiring corporation transfers its stock in lieu of assuming an obligation of the domestic entity and continue to study whether future guidance should broaden the rule. In addition, section 7874(c)(4) (which would disregard the transfer of the $10x of FA stock in satisfaction of the obligation if the transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874) and § 1.7874–10T (which could cause DT's distribution of the $20x of Business B assets to give rise to a non-ordinary course distribution, which, in turn, would cause the former domestic entity shareholders of DT to be deemed to receive additional FA stock for purpose of computing the ownership fraction) may apply to address the concern raised by the comment.

III. The De Minimis Exception

The disqualified stock rule contains a de minimis exception, which generally applies when two requirements are satisfied. First, the ownership percentage—determined without regard to the application of the disqualified stock rule, the passive assets rule of § 1.7874–7T (the passive assets rule), and the non-ordinary course distribution rule of § 1.7874–10T (the non-ordinary course distribution rule)—must be less than five (by vote and value). Second, after the domestic entity acquisition and all related transactions, former domestic entity shareholders or former domestic entity partners, in the aggregate, must own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) any member of

the EAG. When the de minimis exception applies, the disqualified stock rule does not apply and, as a result, no stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction pursuant to the rule.

The passive assets rule and the non-ordinary course distribution rule contain similar de minimis exceptions (the three exceptions collectively, the de minimis exceptions). See §§ 1.7874–7T(c) and 1.7874–10T(d). Together, the de minimis exceptions generally prevent one or more of the disqualified stock rule, the passive assets rule, and the non-ordinary course rule from causing section 7874 to apply to a domestic entity acquisition that, given minimal actual ownership continuity, largely resembles a cash purchase by the foreign acquiring corporation of the stock of (or interests in) the domestic entity.

Comments requested expanding the de minimis exceptions in several respects. First, comments requested increasing the ownership thresholds in the de minimis exceptions. One comment recommended a 20-percent threshold, noting that such a threshold would be generally consistent with the threshold in the internal group restructuring exception under § 1.7874–1(c)(2) (permitting up to 20 percent ownership by non-EAG members). The internal group restructuring exception, however, addresses different policies than the de minimis exceptions. In particular, the internal group restructuring exception addresses transactions in which there is no, or only a small, shift in ownership of a domestic entity to persons outside of a corporate group, whereas the de minimis exceptions address transactions in which there is almost a complete shift in ultimate ownership of a domestic entity. Moreover, the Treasury Department and the IRS have concluded that a five-percent threshold appropriately differentiates between domestic entity acquisitions that largely resemble a cash purchase and those that do not. Accordingly, the final regulations do not adopt the comment.

Other comments requested removing the second requirement of the de minimis exceptions or, alternatively, modifying the requirement so that it looks only to stock held by reason of holding stock (or interests) of the domestic entity. The comments noted that, particularly in cases involving a publicly-traded domestic entity or a complex ownership structure, it could be difficult or burdensome to identify each former domestic entity shareholder or former domestic entity partner (including a de minimis former domestic entity shareholder or former domestic entity partner), as applicable, and then determine (taking into account the applicable attribution rules) the former domestic entity shareholders' or former domestic entity partners' collective ownership of the foreign acquiring corporation and each member of the EAG. Accordingly, the comment asserted that, at least in certain cases, uncertainty surrounding whether the second requirement is satisfied could result in taxpayers having to apply—and thus conduct the potentially complicated analyses required by—the disqualified stock rule, passive assets rule, and non-ordinary course distribution rule, notwithstanding that the domestic entity acquisition may largely resemble a purchase.

After considering the comment, the final regulations modify each of the de minimis exceptions to provide that the second requirement is satisfied if, after the domestic entity acquisition and all related transactions, each former domestic entity shareholder or former domestic entity partner, as applicable, owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the EAG. § 1.7874–4(d)(1)(ii); § 1.7874–7T(c)(2); § 1.7874–10T(d)(2). The Treasury Department and the IRS have determined that limiting the second requirement to consider only the ownership of former domestic entity shareholders or former domestic entity partners (with applicable attribution rules), individually, rather than the ownership of all former domestic entity shareholders or former domestic entity partners, collectively, strikes the appropriate balance between preventing the de minimis exceptions from applying in inappropriate circumstances and addressing the practical difficulties noted in the comment.

IV. Certain Public Offerings

The preamble to the 2014 temporary regulations noted that the de minimis exception with respect to the disqualified stock rule may facilitate certain transactions that have the effect of converting a publicly traded domestic corporation into a publicly traded foreign corporation over time. For example, a buyer may contribute cash to a newly formed foreign acquiring corporation that uses such cash, along with the proceeds from borrowings and a small amount of its stock (often issued to the management of the domestic corporation), to acquire all of the stock of a publicly traded domestic corporation in a domestic entity acquisition. After a period of time, the buyer may sell its stock of the foreign acquiring corporation pursuant to a public offering, which may have been contemplated at the time of the domestic entity acquisition. The preamble to the 2014 regulations explained that the Treasury Department and the IRS would study these transactions and requested comments on the application of section 7874 to such transactions.

A comment asserted that, given the number of non-tax contingencies between the domestic entity acquisition and the public offering, it would be inappropriate to apply the step-transaction doctrine or related principles to the transactions. Comments also suggested that these transactions do not violate the policies of section 7874 because the domestic entity acquisition is essentially a purchase by the foreign acquiring corporation of the stock of the publicly traded domestic corporation. Accordingly, comments recommended against new rules to address the transactions.

After further study and consideration of the comments, the Treasury Department and the IRS decline at this time to provide special rules to address these transactions. However, section 7874(c)(4), § 1.7874–4(d)(2) (providing that the de minimis exception does not apply to disqualified stock that is transferred with a principal purpose of avoiding the purposes of section 7874), and judicial doctrines each may apply to address the concerns raised by these transactions.

V. Additional Clarifications Requested

A. Stock Included in Numerator Also Included in Denominator

A comment requested that the Treasury Department and the IRS clarify that stock of a foreign acquiring corporation included in the numerator of the ownership fraction is also included in the denominator of the fraction, regardless of whether the stock is disqualified stock. The preamble to the temporary regulations indicated that stock described in section 7874(a)(2)(B)(ii) (by reason of stock) is never treated as disqualified stock and thus cannot be excluded from the denominator of the ownership fraction under the disqualified stock rule. See Part A of the Explanation of Provisions section of the preamble to the 2014 temporary regulations. Nevertheless, in response to the comment and for the avoidance of doubt, the final regulations clarify that by reason of stock may never

be treated as disqualified stock. See § 1.7874–4(c)(1). Accordingly, the final regulations clarify that stock of the foreign acquiring corporation included in the numerator of the ownership fraction is in all cases also included in the denominator of the fraction.

B. Treatment of partnerships

Comments requested clarification about whether an acquisition of a partnership interest is treated similarly to an acquisition of stock for purposes of the disqualified stock rule. That is, the comment asked whether stock of a foreign acquiring corporation transferred in exchange for a partnership interest is treated as stock transferred in exchange for a proportionate share of partnership assets represented by the partnership interest (a look-through approach). The Treasury Department and the IRS confirm that a partnership interest does not constitute nonqualified property unless it is a marketable security (for example, an interest in a publicly traded partnership described in § 1.7704–1(a)(1)(i)) or is avoidance property. The definition of marketable securities in the temporary regulations excludes an interest in a partnership that becomes a member of the EAG in a transaction (or series of transactions) related to the domestic entity acquisition, an exclusion that would be unnecessary if partnership interests were subject to a look-through approach. Nevertheless, in response to the comment and for the avoidance of doubt, the definition of nonqualified property is clarified to provide that an interest in a partnership is nonqualified property only to the extent it is a marketable security or avoidance property.

VI. The Subsequent Transfer Rule

The temporary regulations provide a rule (the subsequent transfer rule) pursuant to which stock of a foreign corporation that is described in section 7874(a)(2)(B)(ii) (that is, by reason of stock) does not cease to be so described as a result of any subsequent transfer of the stock by the former domestic entity shareholder or former domestic entity partner that received such stock, even if the subsequent transfer is related to the domestic entity acquisition. A comment requested adding a de minimis exception to the subsequent transfer rule, similar to the three de minimis exceptions discussed in Part III of this Summary of Comments and Explanation of Revisions. For example, the comment suggested that if, pursuant to a subsequent transfer (or series of transfers) related to the domestic entity acquisition, the former domestic entity shareholders or former domestic entity partners, in the aggregate, dispose of all but a de minimis amount of stock of the foreign acquiring corporation, then the subsequent transfer rule should not apply. In such a case, the requested de minimis exception would provide that the stock received by the former domestic entity shareholders or former domestic entity partners would not be considered by reason of stock and thus would not be included in the numerator of the ownership fraction (though it generally would be included in the denominator of the ownership fraction).

The final regulations do not adopt the comment. The de minimis exceptions, as discussed in Part III of this Summary of Comments and Explanation of Revisions, provide relief for transactions that are in substance cash purchases by the foreign acquiring corporation of the stock of (or interests in) the domestic entity. In contrast, the subsequent transfer rule applies to ensure the application of section 7874 to transactions where a foreign corporation acquires substantially all the property (directly or indirectly) of a domestic entity in exchange for stock. The ultimate use of the stock received by the former domestic entity shareholders or former domestic entity partners is irrelevant to the three-factor test established by the statute. Accordingly, the final regulations do not adopt a de minimis exception for purposes of the subsequent transfer rule.

VII. Applicability Dates

The final regulations generally apply to domestic entity acquisitions completed on or after September 17, 2009, to the extent described in the 2009 notice. The final regulations generally apply with respect to the remainder of the proposed rules in the 2014 proposed regulations to domestic entity acquisitions completed on or after January 16, 2014. However, see § 1.7874–4(k) for certain rules that apply only to domestic entity acquisitions completed on or after the publication of the 2015 notice or these final regulations, as applicable. Similar to the 2014 temporary regulations, these regulations provide that taxpayers may elect to apply all the rules contained in these final regulations to domestic entity acquisitions completed on or after September 17, 2009, and before January 13, 2017 (transition period), if the taxpayer applies all of the rules consistently to all domestic entity acquisitions completed during the transition period.

No inference is intended as to the treatment of transactions under the law before the various applicability dates of these regulations. For example, these transactions could be subject to challenge under applicable provisions, including under section 7874(c)(4) or judicial doctrines such as the substance-over-form doctrine.

Special Analyses

Certain IRS regulations, including these, are exempt from the requirements of Executive Order 12866, as supplemented and reaffirmed by Executive Order 13563. Therefore, a regulatory impact assessment is not required. The Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply because the regulations do not impose a collection of information on small entities. Pursuant to section 7805(f) of the Code, the notices of proposed rulemaking that preceded this regulation were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business. No comments were received.

Drafting Information

The principal author of these regulations is Joshua G. Rabon of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

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

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

Section 1.7874–4 also issued under 26 U.S.C. 7874(c)(6) and (g).

Section 1.7874–5 also issued under 26 U.S.C. 7874(c)(6) and (g).

* * * * *

■ **Par. 2.** Section 1.7874–4 is added to read as follows:

§ 1.7874–4 Disregard of certain stock related to the domestic entity acquisition.

(a) *Scope.* This section identifies certain stock of the foreign acquiring corporation that is disregarded in determining the ownership fraction and modifies the scope of section 7874(c)(2)(B). Paragraph (b) of this section sets forth the general rule that certain stock of the foreign acquiring

corporation, and only such stock, is treated as stock described in section 7874(c)(2)(B) and therefore is excluded from the denominator of the ownership fraction. Paragraph (c) of this section identifies the stock of the foreign acquiring corporation that is subject to paragraph (b) of this section. Paragraph (d) of this section provides a de minimis exception to the application of the general exclusion rule of paragraph (b) of this section. Paragraph (e) of this section provides rules for transfers of stock of the foreign acquiring corporation in satisfaction of, or in exchange for the assumption of, one or more obligations of the transferor. Paragraph (f) of this section provides rules for certain transfers of stock of the foreign acquiring corporation involving multiple properties or obligations. Paragraph (g) of this section provides rules for the treatment of partnerships, and paragraph (h) of this section provides rules addressing the interaction of this section with the expanded affiliated group rules of section 7874(c)(2)(A) and § 1.7874–1. Paragraph (i) of this section provides definitions. Paragraph (j) of this section provides examples illustrating the application of the rules of this section. Paragraph (k) of this section provides dates of applicability.

(b) *Exclusion of disqualified stock under section 7874(c)(2)(B).* Except as provided in paragraph (d) of this section, disqualified stock (as determined under paragraph (c) of this section) is treated as stock described in section 7874(c)(2)(B) and therefore is not included in the denominator of the ownership fraction. Section 7874(c)(2)(B) shall not apply to exclude stock from the denominator of the ownership fraction that is not disqualified stock.

(c) *Disqualified stock*—(1) *General rule.* Except as provided in paragraph (c)(2) of this section, disqualified stock is stock of the foreign acquiring corporation (other than stock described in § 1.7874–2(f)) that is transferred in an exchange described in paragraph (c)(1)(i) or (ii) of this section that is related to the domestic entity acquisition. This paragraph (c) applies without regard to whether the stock of the foreign acquiring corporation is publicly traded at the time of the transfer or at any other time.

(i) *Exchanged for nonqualified property.* The stock is transferred to a person other than the domestic entity in exchange for nonqualified property. See *Example 1, Example 2, Example 6, Example 8,* and *Example 9* of paragraph (j) of this section for illustrations of the application of this paragraph (c)(1)(i).

(ii) *Exchanged for property with associated obligations*—(A) *General rule.* Subject to the limitation provided in in paragraph (c)(1)(ii)(B) of this section, the stock is transferred by a person (transferor) to another person (transferee) in exchange for property (exchanged property) and, pursuant to the same plan (or series of related transactions), the transferee subsequently transfers such stock (or, if the transferee exchanges such stock for other property, such other property) in satisfaction of, or in exchange for the assumption of, one or more obligations of the transferee or a person related (within the meaning of section 267 or 707(b)) to the transferee. See *Example 6* and *Example 10* of paragraph (j) of this section for illustrations of the application of paragraph (c)(1)(ii) of this section.

(B) *Limitation.* The amount of stock treated as transferred in an exchange described in paragraph (c)(2)(ii)(A) of this section shall not exceed—

(*1*) With respect to a transferee that is the domestic entity, the proportionate share of obligations associated with the exchanged property (determined based on the fair market value of the exchanged property relative to the fair market value of all properties with which the obligations are associated) that, pursuant to the same plan (or series of related transactions), is not assumed by the transferor.

(*2*) With respect to any other transferee, the proportionate share of obligations associated with the exchanged property (determined based on the fair market value of the exchanged property relative to the fair market value of all properties with which the obligations are associated) that, pursuant to the same plan (or series of related transactions), is not assumed by the transferor, multiplied by a fraction, the numerator of which is the amount of exchanged property that is qualified property, and the denominator of which is the total amount of exchanged property.

(C) *Associated obligations.* For purposes of paragraph (c)(1)(ii) of this section, an obligation is associated with property if, for example, the obligation arose from the conduct of a trade or business in which the property has been used, regardless of whether the obligation is a non-recourse obligation.

(2) *Stock transferred in an exchange that does not increase the fair market value of the assets or decrease the amount of liabilities of the foreign acquiring corporation.* Stock is disqualified stock only to the extent that the transfer of the stock in the exchange increases the fair market value of the assets of the foreign acquiring corporation or decreases the amount of its liabilities. This paragraph (c)(2) is applied to an exchange without regard to any other exchange described in paragraph (c)(1)(i) or (ii) of this section or any other transaction related to the domestic entity acquisition. See *Example 4* and *Example 7* of paragraph (j) of this section for illustrations of the application of this paragraph (c)(2).

(d) *Exception to exclusion of disqualified stock*—(1) *De minimis ownership.* Except as provided in paragraph (d)(2) of this section, paragraph (b) of this section does not apply if both:

(i) The ownership percentage described in section 7874(a)(2)(B)(ii), determined without regard to the application of paragraph (b) of this section and §§ 1.7874–7T(b) and 1.7874–10T(b), is less than five (by vote and value); and

(ii) After the domestic entity acquisition and all related transactions, each former domestic entity shareholder or former domestic entity partner, as applicable, owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group. See *Example 5* of paragraph (j) of this section for an illustration of this paragraph (d).

(2) *Stock issued to avoid the purposes of section 7874.* The exception in paragraph (d)(1) of this section does not apply to disqualified stock that is transferred in a transaction (or series of transactions) related to the domestic entity acquisition with a principal purpose of avoiding the purposes of section 7874.

(e) *Satisfaction or assumption of obligations.* Except to the extent stock is treated as disqualified stock as a result of being described in paragraph (c)(1)(ii) of this section, this paragraph (e) applies if, in a transaction related to the domestic entity acquisition, stock of the foreign acquiring corporation is transferred to a person other than the domestic entity in exchange for the satisfaction or the assumption of one or more obligations of the transferor. In such a case, solely for purposes of this section, the stock of the foreign acquiring corporation is treated as if it is transferred in exchange for an amount of cash equal to the fair market value of such stock.

(f) *Transactions involving multiple properties.* For purposes of this section, if stock and other property are exchanged for qualified property and

nonqualified property, the stock is treated as transferred in exchange for the qualified property or nonqualified property, respectively, based on the relative fair market value of the property. See also § 1.7874–2(f)(2) (allocating stock of a foreign acquiring corporation between an interest in the domestic entity and other property).

(g) *Treatment of partnerships.* For purposes of this section, if one or more members of the expanded affiliated group own, in the aggregate, more than 50 percent (by value) of the interests in a partnership, such partnership is treated as a corporation that is a member of the expanded affiliated group.

(h) *Interaction with expanded affiliated group rules.* Disqualified stock that is excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section is taken into account for purposes of determining whether an entity is a member of the expanded affiliated group for purposes of applying section 7874(c)(2)(A) and § 1.7874–1(b) and determining whether a domestic entity acquisition qualifies as an internal group restructuring or results in a loss of control, as described in § 1.7874–1(c)(2) and (c)(3), respectively. However, such disqualified stock is excluded from the denominator of the ownership fraction for purposes of section 7874(a)(2)(B)(ii) regardless of whether it otherwise would be included in the denominator of the ownership fraction as a result of the application of § 1.7874–1(c). See *Example 8* and *Example 9* of paragraph (j) of this section for illustrations of the application of this paragraph (h).

(i) *Definitions.* In addition to the definitions in § 1.7874–12T, the following definitions apply for purposes of this section:

(1) *Marketable securities* has the meaning set forth in section 453(f)(2), except that the term marketable securities does not include stock of a corporation or an interest in a partnership that becomes a member of the expanded affiliated group in a transaction (or series of transactions) related to the domestic entity acquisition. See *Example 4* of paragraph (j) of this section for an illustration of this paragraph (i)(1).

(2) *Nonqualified property* is property described in paragraphs (i)(2)(i) through (iv) of this section. Thus, stock in a corporation or an interest in a partnership is nonqualified property to the extent provided in paragraph (i)(2)(ii) or (iv) of this section. Qualified property is property other than nonqualified property.

(i) Cash or cash equivalents.

(ii) Marketable securities, within the meaning of paragraph (i)(1) of this section.

(iii) An obligation owed by any of the following:

(A) A member of the expanded affiliated group, unless the holder of the obligation immediately before the domestic entity acquisition and any related transaction (or its successor) is a member of the expanded affiliated group after the domestic entity acquisition and all related transactions.

(B) A former domestic entity shareholder or former domestic entity partner of the domestic entity that owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote or value) of the stock of, or partnership interests in, the domestic entity before the domestic entity acquisition.

(C) A person that, before or after the domestic entity acquisition, either owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) at least five percent (by vote or value) of the stock of (or partnership interests in) or is related (within the meaning of section 267 or 707(b)) to—

(*1*) A member of the expanded affiliated group; or

(*2*) A person described in paragraph (i)(2)(iii)(B) of this section. See *Example 6* of paragraph (j) of this section for an illustration of this paragraph (i)(2)(iii)(C)(*2*).

(iv) Any other property acquired with a principal purpose of avoiding the purposes of section 7874, regardless of whether the transaction involves an indirect transfer of property described in paragraph (i)(2)(i), (ii), or (iii) of this section. See *Example 2* and *Example 3* of paragraph (j) of this section for illustrations of the application of this paragraph (i)(2)(iv).

(3) An *obligation* means any fixed or contingent obligation to make a payment or provide value without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. An obligation includes, but is not limited to, a debt obligation, an environmental obligation, a tort obligation, a contract obligation (including an obligation to provide goods or services), a pension obligation, an obligation under a short sale, and an obligation under derivative financial instruments such as options, forward contracts, futures contracts, and swaps. An obligation does not include any obligation treated as stock for purposes of section 7874 (see, for example, § 1.7874–2(i), which treats certain interests, including certain creditor claims, as stock).

(4) A *transfer* is, with respect to stock of the foreign acquiring corporation, an issuance, sale, distribution, exchange, or any other disposition of such stock.

(j) *Examples.* The following examples illustrate the application of the rules of this section. For purposes of the examples, unless otherwise indicated, assume the following facts in addition to the facts stated in the examples:

(1) FA, FMS, FS, and FT are foreign corporations, all of which have only one class of stock issued and outstanding;

(2) DMS and DT are domestic corporations;

(3) P and R are corporations that may be either domestic or foreign;

(4) PRS is a partnership with individual partners;

(5) The de minimis ownership exception in paragraph (d)(1) of this section does not apply;

(6) None of the shareholders or partners in the entities described in the examples are related persons with respect to each other;

(7) All transactions described in each example occur pursuant to the same plan;

(8) No property is acquired with a principal purpose of avoiding the purposes of section 7874;

(9) FA, FMS, FS, and FT are tax residents in the same foreign country;

(10) For purposes of determining the ownership fraction, no shares of FA stock are excluded from the denominator pursuant to § 1.7874–7T(b) (which disregards stock attributable to passive assets); and

(11) For purposes of determining the ownership fraction, no shares of FA stock are treated as received by former shareholders of DT pursuant to § 1.7874–10T(b) (which disregards certain distributions).

Example 1. Stock transferred in exchange for marketable securities—(i) *Facts.* Individual A wholly owns DT. PRS transfers marketable securities (within the meaning of paragraph (i)(1) of this section) to FA, a newly formed corporation, in exchange solely for 25 shares of FA stock. Then Individual A transfers all the DT stock to FA in exchange solely for 75 shares of FA stock.

(ii) *Analysis.* Under paragraph (i)(2)(ii) of this section, the marketable securities constitute nonqualified property. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the marketable securities constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the marketable securities increases the

fair market value of the assets of FA by the fair market value of the marketable securities transferred. Under paragraph (b) of this section, the 25 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. See also section 7874(c)(4). Accordingly, the only FA stock included in the ownership fraction is the FA stock transferred to Individual A in exchange for the DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 2. Stock transferred in exchange for property acquired with a principal purpose of avoiding the purposes of section 7874—(i) *Facts.* Individual A wholly owns DT. PRS transfers marketable securities (within the meaning of paragraph (i)(1) of this section) to FT, a newly formed corporation, in exchange solely for all the FT stock. Then PRS transfers the FT stock to FA, a newly formed corporation, in exchange solely for 25 shares of FA stock. Finally, Individual A transfers all the DT stock to FA in exchange solely for 75 shares of FA stock. FA acquires the FT stock with a principal purpose of avoiding the purposes of section 7874.

(ii) *Analysis.* Under paragraph (i)(2)(iv) of this section, the FT stock constitutes nonqualified property because a principal purpose of FA acquiring the FT stock is to avoid the purposes of section 7874. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the FT stock constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the FT stock increases the fair market value of FA's assets by the fair market value of the FT stock. Under paragraph (b) of this section, the 25 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Furthermore, even in the absence of paragraph (i)(2)(iv) of this section, the transfer of marketable securities to FT would be disregarded pursuant to section 7874(c)(4). Accordingly, the only FA stock included in the ownership fraction is the FA stock transferred to Individual A in exchange for the DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 3. Stock transferred in exchange for property acquired with a principal purpose of avoiding the purposes of section 7874—(i) *Facts.* DT is a publicly traded corporation. PRS is a foreign partnership that is unrelated to DT. PRS transfers certain business assets (PRS properties) to FA, a newly formed foreign corporation, in exchange solely for 25 shares of FA stock. The shareholders of DT transfer all of their DT stock to FA in exchange solely for the remaining 75 shares of FA stock (DT acquisition). None of the PRS properties is property described in paragraph (i)(2)(i) through (iii) of this section, but FA acquires the PRS properties with a principal purpose of avoiding the purposes of section 7874.

(ii) *Analysis.* Under paragraph (i)(2)(iv) of this section, the PRS properties transferred to FA constitute nonqualified property, because FA acquires the PRS properties in a transaction related to the DT acquisition with a principal purpose of avoiding the purposes of section 7874. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the PRS properties constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not apply to reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the PRS properties increases the fair market value of FA's assets by the fair market value of the PRS properties. Accordingly, pursuant to paragraph (b) of this section, the 25 shares of FA stock transferred to PRS in exchange for the PRS properties are not included in the denominator of the ownership fraction. Furthermore, even in the absence of paragraph (i)(2)(iv) of this section, the transfer of the PRS properties to FA would be disregarded pursuant to section 7874(c)(4). Therefore, the only FA stock included in the ownership fraction is the FA stock transferred to the former domestic entity shareholders of DT in exchange for their DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 4. Stock transferred in exchange for stock of a foreign corporation that becomes a member of the expanded affiliated group—(i) *Facts.* FT, a publicly traded corporation, forms FA, and then FA forms DMS and FMS. FMS merges with and into FT, with FT surviving the merger (FMS–FT merger). Pursuant to the FMS–FT merger, the FT shareholders exchange their FT stock solely for 100 shares of FA stock and FT becomes a wholly owned subsidiary of FA. Following the FMS–FT merger, DMS merges with and into DT, also a publicly traded corporation, with DT surviving the merger (DT acquisition). Pursuant to the DT acquisition, the DT shareholders exchange their DT stock solely for the remaining 100 shares of FA stock, and DT becomes a wholly owned subsidiary of FA. After the completion of the plan, FA wholly owns FT and DT, DMS and FMS cease to exist, and the stock of FA is publicly traded.

(ii) *Analysis.* Because FT becomes a member of the expanded affiliated group that includes FA in a transaction related to the DT acquisition, the FT stock does not constitute marketable securities (within the meaning of paragraph (i)(1) of this section) and therefore does not constitute nonqualified property pursuant to paragraph (i)(2)(ii) of this section. Accordingly, no FA stock is disqualified stock described in paragraph (c)(1) of this section and therefore the FA stock transferred in exchange for the FT stock and DT stock is included in the denominator of the ownership fraction. Thus, the ownership fraction is 100/200.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 4,* except that, instead of undertaking the FMS–FT merger, FT merges with and into FA with FA surviving the merger (FT–FA merger). Pursuant to the FT–FA merger, the FT shareholders exchange their FT stock solely for 100 shares of FA stock. At the time of the FT–FA merger, FT does not hold nonqualified property and has no obligations. Accordingly, FA stock transferred by FA to FT in exchange for the property of FT is not disqualified stock described in paragraph (c)(1) of this section. Furthermore, pursuant to paragraph (c)(2) of this section, the 100 shares of FA stock transferred by FT to the shareholders of FT in exchange for their FT stock do not constitute disqualified stock described in paragraph (c)(1) of this section. Although the FT stock is nonqualified property (the FT stock constitutes marketable securities within the meaning of paragraph (i)(2)(ii) of this section because the stock of FT is publicly traded and FT is not a member of the expanded affiliated group that includes FA after the DT acquisition), under paragraph (c)(2) of this section, the transfer of FA stock by FT to the shareholders of FT neither increases the fair market value of the assets of FA nor decreases the liabilities of FA. Accordingly, no FA stock is disqualified stock described in paragraph (c)(1) of this section and, therefore, the FA stock transferred in exchange for the assets of FT and the DT stock is included in the denominator of the ownership fraction. Thus, the ownership fraction is 100/200.

Example 5. De minimis exception—(i) *Facts.* Individual A wholly owns DT. The fair market value of the DT stock is $100x. PRS transfers $96x of cash to FA, a newly formed corporation, in exchange solely for 96 shares of FA stock. Then Individual A transfers the DT stock to FA in exchange for $96x of cash and 4 shares of FA stock (DT acquisition).

(ii) *Analysis.* Under paragraph (i)(2)(i) of this section, cash constitutes nonqualified property. Accordingly, the 96 shares of FA stock transferred by FA to PRS in exchange for $96x of cash constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Furthermore, paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for $96x of cash increases the fair market value of the assets of FA by $96x. However, without regard to the application of paragraph (b) of this section and §§ 1.7874–7T(b) and 1.7874–10T(b), the ownership percentage described in section 7874(a)(2)(B)(ii) would be less than 5 (by vote and value), or 4 (4/100, or 4 shares of FA stock held by Individual A by reason of owning the DT stock, determined under § 1.7874–2(f)(2), over 100 shares of FA stock outstanding after the DT acquisition). Furthermore, after the DT acquisition and all related transactions, Individual A owns less than 5% (by vote and value, applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) of the stock of FA and DT (the members of the expanded affiliated group that includes FA). Accordingly, the de minimis exception in paragraph (d)(1) of this section applies and therefore paragraph (b) of this section does not apply to exclude the FA stock transferred to PRS from the

denominator of the ownership fraction. Therefore, the FA stock transferred to Individual A and PRS is included in the denominator of the ownership fraction. Thus, the ownership fraction is 4/100.

Example 6. Obligation of the expanded affiliated group satisfied with stock—(i) *Facts.* Individual A wholly owns DT. The stock of DT held by Individual A has a fair market value of $75x. Individual A also holds an obligation of DT with a value and face amount of $25x. DT holds property with a value of $100x, and the $25x obligation is associated with the property. FA, a newly formed corporation, transfers 100 shares of FA stock to Individual A in exchange for all the DT stock and the $25x obligation of DT.

(ii) *Analysis.* Under paragraph (i)(2)(iii)(A) of this section, the $25x obligation of DT constitutes nonqualified property because DT is a member of the expanded affiliated group that includes FA, and Individual A (the holder of the obligation immediately before the domestic entity acquisition and any related transaction) is not a member of the EAG after the domestic entity acquisition and all related transactions. Thus, the shares of FA stock transferred by FA to Individual A in exchange for the obligation of DT constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Under § 1.7874–2(f)(2), Individual A is treated as receiving 75 shares of FA stock in exchange for the DT stock (100 x $75x/$100x) and 25 shares of FA stock in exchange for the obligation of DT (100 x $25x/$100x). Thus, 25 shares of FA stock constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock for the $25x obligation increases the fair market value of FA's assets by $25x. Therefore, under paragraph (b) of this section, the 25 shares of FA stock transferred to Individual A in exchange for the obligation of DT are not included in the denominator of the ownership fraction. Accordingly, the only FA stock included in the ownership fraction is the 75 shares of FA stock transferred to Individual A in exchange for the DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 6,* except that instead of acquiring the stock of DT and the $25x obligation of DT, FA acquires the $100x of property from DT in exchange solely for 100 shares of FA stock. DT distributes 75 shares of FA stock to Individual A in exchange for Individual A's DT stock and transfers 25 shares of FA stock to Individual A in satisfaction of DT's obligation to Individual A, and liquidates. The 25 shares of FA stock transferred by FA to DT in exchange for the property of DT and then transferred by DT in satisfaction of DT's obligation to Individual A constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(ii) of this section because the transfer of FA stock in exchange for the property of DT increases the fair market value of FA's assets by $100x (although the amount of disqualified stock is limited to 25 shares of FA stock in this case). Therefore, under paragraph (b) of this section, the 25 shares of FA stock that constitute disqualified stock are not included in the denominator of the ownership fraction. Accordingly, only 75 shares of FA stock are included in the ownership fraction, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75.

Example 7. ''Over-the-top'' stock transfer—(i) *Facts.* Individual A wholly owns DT. Individual B holds all 100 outstanding shares of FA stock. Individual C acquires 20 shares of FA stock from Individual B for cash, and then FA acquires all of the stock of DT from Individual A in exchange solely for 100 shares of FA stock.

(ii) *Analysis.* Under paragraph (i)(2)(i) of this section, cash constitutes nonqualified property. Accordingly, absent the application of paragraph (c)(2) of this section, the 20 shares of FA stock transferred by Individual B to Individual C in exchange for cash would constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Nevertheless, because Individual B's sale of FA stock neither increases the assets of FA nor decreases the liabilities of FA, such FA stock is not disqualified stock by reason of paragraph (c)(2) of this section. Accordingly, paragraph (b) of this section does not apply to exclude the 20 shares of FA stock sold by Individual B to Individual C, and that FA stock is included in the denominator of the ownership fraction. The 100 shares of FA stock received by Individual A are the only shares included in the numerator of the ownership fraction. Thus, the ownership fraction is 100/200.

Example 8. Interaction with internal group restructuring rule—(i) *Facts.* P holds 85 shares of DT stock. The remaining 15 shares of DT stock are held by Individual A. P and Individual A transfer their shares of DT stock to FA, a newly formed corporation, in exchange for 85 and 15 shares of FA stock, respectively (DT acquisition), and PRS transfers $75x of cash to FA in exchange for the remaining 75 shares of FA stock.

(ii) *Analysis.* Under paragraph (i)(2)(i) of this section, cash constitutes nonqualified property. Accordingly, the 75 shares of FA stock transferred by FA to PRS in exchange for $75x of cash constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Furthermore, paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for $75x of cash increases the fair market value of the assets of FA by $75x. Therefore, under paragraph (b) of this section, the 75 shares of FA stock transferred to PRS are not included in the denominator of the ownership fraction. Although PRS's shares of FA stock are excluded from the denominator of the ownership fraction under paragraph (b) of this section, under paragraph (h) of this section, such shares of FA stock nonetheless are taken into account for purposes of determining whether P is a member of the expanded affiliated group that includes FA and for purposes of determining whether the DT acquisition qualifies as an internal group restructuring. Because P holds 48.6% of the FA stock (85/175) after the DT acquisition and all transactions related to the DT acquisition, it is not a member of the expanded affiliated group that includes FA. In addition, the DT acquisition does not qualify as an internal group restructuring described in § 1.7874–1(c)(2) because P does not hold, directly or indirectly, 80% or more of the shares of FA stock (by vote and value) after the DT acquisition and all transactions related to the DT acquisition. Therefore, the FA stock held by P (along with the FA stock held by Individual A) is included in the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 100/100.

Example 9. Interaction with loss of control rule—(i) *Facts.* P wholly owns DT. P transfers all of its shares of DT stock to FA, a newly formed corporation, in exchange for 49 shares of FA stock (DT acquisition), and R transfers marketable securities (within the meaning of paragraph (i)(1) of this section) to FA in exchange for the remaining 51 shares of FA stock.

(ii) *Analysis.* Under paragraph (i)(2)(ii) of this section, the marketable securities constitute nonqualified property. Accordingly, the shares of FA stock transferred by FA to R in exchange for the marketable securities constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Therefore, under paragraph (b) of this section, the shares of FA stock transferred to R are not included in the denominator of the ownership fraction. Although under paragraph (b) of this section R's shares of FA stock are excluded from the denominator of the ownership fraction, under paragraph (h) of this section, such stock is taken into account for purposes of determining whether P or R is a member of the expanded affiliated group that includes FA. Because P holds 49% of the shares of FA stock (49/100), P is not a member of the expanded affiliated group that includes FA, and P's FA stock is included in both the numerator and the denominator of the ownership fraction. Because R holds 51% of the shares of FA stock (51/100), R is a member of the expanded affiliated group that includes FA and, before taking into account § 1.7874–1(c), R's FA stock would be excluded from the numerator and denominator of the ownership fraction under section 7874(c)(2)(A) and § 1.7874–1(b). However, the DT acquisition results in a loss of control described in § 1.7874–1(c)(3)

because P does not hold, in the aggregate, directly or indirectly, more than 50% of the shares of stock (by vote or value) of R, FA, or DT after the acquisition. Accordingly, the FA stock held by R would be included in the denominator of the ownership fraction under § 1.7874–1(c)(1). Nevertheless, the FA stock held by R is excluded from the denominator of the ownership fraction under paragraphs (b) and (h) of this section. Thus, the ownership fraction is 49/49.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 9,* except that, in exchange for 51 shares of FA stock, R transfers marketable securities (within the meaning of paragraph (i)(1) of this section) with a value equal to that of 16 shares of FA stock and qualified property (within the meaning of paragraph (i)(2) of this section) with a value equal to that of 35 shares of FA stock. Accordingly, 16 of the 51 shares of FA stock transferred to R constitute disqualified stock described in paragraph (c)(1) of this section by reason of paragraph (c)(1)(i) of this section, and 35 of such shares do not constitute disqualified stock. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the marketable securities increases the fair market value of the assets of FA by the fair market value of the marketable securities transferred. Therefore, under paragraph (b) of this section, 16 of the 51 shares of FA stock transferred to R are not included in the denominator of the ownership fraction. Although 16 of the 51 shares of FA stock that are transferred to R are excluded from the denominator of the ownership fraction, under paragraph (h) of this section, all 51 of R's shares of FA stock are taken into account for purposes of determining whether P or R is a member of the expanded affiliated group that includes FA. Because P holds 49% of the shares of FA stock (49/100), it is not a member of the expanded affiliated group that includes FA, and its FA stock is included in both the numerator and the denominator of the ownership fraction. Because R holds 51% of the shares of FA stock (51/100), it is a member of the expanded affiliated group that includes FA and, before taking into account § 1.7874–1(c), its FA stock is excluded from the numerator and denominator of the ownership fraction under section 7874(c)(2)(A) and § 1.7874–1(b). However, the DT acquisition results in a loss of control described in § 1.7874–1(c)(3) because P does not hold, in the aggregate, directly or indirectly, more than 50% of the shares of stock (by vote or value) of R, FA, or DT after the acquisition. Accordingly, the 51 shares of FA stock held by R would be included in the denominator of the ownership fraction under § 1.7874–1(c)(1). Nevertheless, the 16 shares of FA stock that constitute disqualified stock are excluded from the denominator of the ownership fraction under paragraphs (b) and (h) of this section. In addition, the 35 shares of FA stock received by R that do not constitute disqualified stock are included in the denominator. Thus, the ownership fraction is 49/84.

Example 10. Stock issued in lieu of assuming associated obligation—(i) *Facts.* Individual A wholly owns DT. The stock of DT has a fair market value of $100x. Individual B wholly owns FT, a foreign corporation, which conducts two businesses, Business C and Business D. Business C comprises property with a gross fair market value of $70x and $20x of associated obligations. Business D comprises property with a gross fair market value of $45x and $35x of associated obligations. Individual A transfers all of the shares of DT stock to FA, a newly formed corporation, in exchange for $100x of FA stock (DT acquisition). In transactions related to the DT acquisition, FA acquires all of the Business C property from FT in exchange for $70x of FA stock and then FT transfers $30x of the FA stock to its creditors in satisfaction of $30x of its obligations. None of the Business C property is nonqualified property.

(ii) *Analysis.* Under paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section, the $30x of FA stock transferred to FT (the transferee) in exchange for the Business C property (the exchanged property) and then transferred by FT in satisfaction of $30x of its obligations is disqualified stock, except to the extent limited by paragraph (c)(1)(ii)(B) of this section. Under paragraph (c)(1)(ii)(B)(*1*) of this section, the proportionate share of obligations associated with the exchanged property that is not assumed by FA must be determined. The proportionate share of obligations associated with the exchanged property is $20x, calculated as $20x (the obligations associated with the Business C properties) multiplied by $70x/$70x (the fair market value of the exchanged property, $70x, relative to the fair market value of all the Business C property, $70x). The proportionate share of obligations associated with the exchanged property that is not assumed by FA is $20x, calculated as the proportionate share of obligations associated with the exchanged property ($20x) less the obligations assumed by FA ($0x). Under paragraph (c)(1)(ii)(B)(*2*) of this section, the amount of disqualified stock is limited to the proportionate share of obligations associated with the exchanged property that is not assumed ($20x) multiplied by a fraction, which in this case is $70x/$70x (the amount of exchanged property that is qualified property, $70x, divided by the total amount of exchanged property, $70x). Accordingly, $20x of FA stock is disqualified stock under paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section. Paragraph (c)(2) of this section does not reduce the amount of disqualified stock described in paragraph (c)(1)(ii) of this section because the transfer of the FA stock in exchange for the exchanged property increases the fair market value of FA's assets by $70x (although the amount of disqualified stock is limited to $20x of FA stock in this case). Therefore, under paragraph (b) of this section, the $20x of FA stock that constitutes disqualified stock is not included in the denominator of the ownership fraction. Accordingly, only $150x of FA stock is included in the denominator of the ownership fraction, calculated as the $100x of FA stock received by Individual A plus the $70x of FA stock received by FT less the $20x of FA stock that is disqualified stock. Thus, the ownership fraction is $100x/$150x. The result would be the same if, in transactions related to the DT acquisition, FT instead sold the $30x of FA stock for $30x cash and then transferred the cash in satisfaction of $30x of its obligations.

(iii) *Alternative facts.* The facts are the same as in paragraph (i) of this *Example 10,* except that FA acquires only $42x of the Business C property in exchange for $30x of FA stock and the assumption of $12x of the obligations associated with the Business C property. Under paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section, the $30x of FA stock transferred to FT (the transferee) in exchange for the Business C property (the exchanged property) and then transferred by FT in satisfaction of $30x of its obligations is disqualified stock, except to the extent limited by paragraph (c)(1)(ii)(B) of this section. Under paragraph (c)(1)(ii)(B)(*1*) of this section, the proportionate share of obligations associated with the exchanged property that is not assumed by FA must be determined. The proportionate share of obligations associated with the exchanged property is $12x, calculated as $20x (the obligations associated with the Business C property) multiplied by $42x/$70x (the fair market value of the exchanged property, $42x, relative to the fair market value of all the Business C property, $70x). The proportionate share of obligations associated with the exchanged property that is not assumed by FA is $0, calculated as the proportionate share of obligations associated with the exchanged property ($12x) less the obligations assumed by FA ($12x). Accordingly, as a result of the application of paragraph (c)(1)(ii)(B)(*2*) of this section, no FA stock is disqualified stock under paragraph (c)(1) of this section by reason of paragraph (c)(1)(ii) of this section. As a result, $130x of FA stock is included in the denominator of the ownership fraction, calculated as the $100x of FA stock received by Individual A plus the $30x of FA stock received by FT. Thus, the ownership fraction is $100x/$130x.

(k) *Applicability dates*—(1) *General rule.* Except to the extent otherwise provided in paragraph (k) of this section, this section applies to domestic entity acquisitions completed on or after September 17, 2009. Paragraphs (i)(1) and (i)(2)(iv) of this section apply to domestic entity acquisitions completed on or after November 19, 2015. Paragraph (d)(1)(i) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. Paragraphs (c)(1)(ii), (d)(1)(ii), (i)(2)(iii), and (i)(3) of this section apply to domestic entity acquisitions completed on or after January 13, 2017. For domestic entity acquisitions completed before November 19, 2015, see § 1.7874–4T(i)(6) and (i)(7)(iv) (the predecessors of paragraphs (i)(1) and (i)(2)(iv) of this section) as contained in 26 CFR part 1 revised as of April 1, 2016. For domestic entity acquisitions completed on or after September 22, 2014, and before April 4,

2016, see § 1.7874–4T(d)(1)(i) as contained in 26 CFR part 1 revised as of April 1, 2016. For domestic entity acquisitions completed before January 13, 2017, see § 1.7874–4T(c)(1)(ii), (d)(1)(ii), (i)(7)(iii) (the predecessor of paragraph (i)(2)(iii) of this section), and (i)(8) (the predecessor of paragraph (i)(3) of this section) as contained in 26 CFR part 1 revised as of April 1, 2016.

(2) *Transitional rules for domestic entity acquisitions completed on or after September 17, 2009, but before January 16, 2014.* For domestic entity acquisitions completed on or after September 17, 2009, but before January 16, 2014, except as provided in paragraph (k)(3) of this section, this section shall be applied with the following modifications:

(i) Nonqualified property does not include property described in paragraph (i)(2)(iii) of this section.

(ii) A transfer is limited to an issuance of stock of the foreign acquiring corporation.

(iii) The determination of whether stock of the foreign acquiring corporation is described in paragraph (c)(1) of this section is made without regard to paragraphs (c)(1)(ii), (c)(2), and (e) of this section.

(iv) Paragraphs (d) and (h) of this section do not apply.

(3) *Election for domestic entity acquisitions completed on or after September 17, 2009, and before January 13, 2017.* If, pursuant to paragraph (k)(1) or (2) of this section, a paragraph of this section would not otherwise apply to a domestic entity acquisition completed on or after September 17, 2009, and before January 13, 2017 (transition period), a taxpayer may elect to apply the paragraph if the taxpayer applies the paragraph consistently to all acquisitions completed during the transition period. The election is made by applying the paragraph to all such acquisitions on a timely filed original return (including extensions) or an amended return filed no later than six months after January 13, 2017. A separate statement or form evidencing the election need not be filed.

1.7874–4T [Removed]

■ **Par. 3.** Section 1.7874–4T is removed.

■ **Par. 4.** Section 1.7874–5 is added to read as follows:

§ 1.7874–5 Effect of certain transfers of stock related to the acquisition.

(a) *General rule.* Stock of a foreign acquiring corporation that is described in section 7874(a)(2)(B)(ii) shall not cease to be so described as a result of any subsequent transfer of the stock by the former domestic entity shareholder or former domestic entity partner that received such stock, even if the subsequent transfer is related to the domestic entity acquisition.

(b) *Example.* The rule of this section is illustrated by the following example:

Example. (i) *Facts.* Individual A wholly owns DT, a domestic corporation. FA, a newly formed foreign corporation, acquires all of the stock of DT from Individual A in exchange solely for 100 shares of FA stock. Pursuant to a binding commitment that was entered into in connection with FA's acquisition of the DT stock, Individual A sells 25 shares of FA stock to B, an unrelated person, in exchange for cash. For federal income tax purposes, the form of the steps of the transaction is respected.

(ii) *Analysis.* Under § 1.7874–2(f)(1), the 100 shares of FA stock received by Individual A are stock of a foreign corporation (FA) that is held by reason of holding stock in a domestic corporation (DT). Accordingly, such stock is described in section 7874(a)(2)(B)(ii). Under paragraph (a) of this section, all 100 shares of FA stock retain their status as being described in section 7874(a)(2)(B)(ii), even though Individual A sells 25 of the 100 shares in connection with the acquisition described in section 7874(a)(2)(B)(i) pursuant to the binding commitment. Therefore, all 100 of the shares of FA stock are included in both the numerator and denominator of the ownership fraction.

(c) *Certain transfers involving expanded affiliated group members.* For rules addressing whether certain stock is treated as held by members of the expanded affiliated group for purposes of applying section 7874(c)(2)(A) and § 1.7874–1, see § 1.7874–6T.

(d) *Definitions.* The definitions provided in § 1.7874–12T apply for purposes of this section.

(e) *Applicability dates.* This section applies to domestic entity acquisitions that are completed on or after January 16, 2014.

§ 1.7874–5T [Removed]

■ **Par. 5.** Section 1.7874–5T is removed.

■ **Par. 6.** Section 1.7874–7T is amended by revising paragraph (c)(2) and paragraph (h) to read as follows:

§ 1.7874–7T Disregard of certain stock attributable to passive assets (temporary).

* * * * *

(c) * * *

(2) After the domestic entity acquisition and all related transactions, each former domestic entity shareholder or former domestic entity partner, as applicable, owns (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group.

* * * * *

(h) *Applicability dates.* Except as otherwise provided in this paragraph (h), this section applies to domestic entity acquisitions completed on or after September 22, 2014. Paragraph (c)(2) of this section applies to domestic entity acquisitions completed on or after January 13, 2017, and paragraphs (c)(1), (d), and (f)(2) and (4) of this section apply to domestic entity acquisitions completed on or after April 4, 2016. Paragraphs (f)(1)(i)(A)(*2*) and (f)(1)(i)(D) of this section, as well as the portion of paragraph (f)(1)(i)(C) of this section relating to property that gives rise to income described in section 1297(b)(2)(B), apply to domestic entity acquisitions completed on or after November 19, 2015. However, for domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to apply paragraphs (c)(1), (d), and (f)(2) and (4) of this section. For domestic entity acquisitions completed on or after September 22, 2014, and before January 13, 2017, taxpayers may elect to apply paragraph (c)(2) of this section or § 1.7874–7T(c)(2) as contained in the Internal Revenue Bulletin (IRB) 2016–20 (see *https://www.irs.gov/irb/2016-20_IRB/ar05.html*). In addition, for domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to apply paragraph (f)(2) of this section by substituting the term ''expanded affiliated group'' for the term ''modified expanded affiliated group.'' Furthermore, for domestic entity acquisitions completed on or after September 22, 2014, and before November 19, 2015, taxpayers may elect to apply paragraphs (f)(1)(i)(A)(*2*) and (f)(1)(i)(D) of this section, as well as the portion of paragraph (f)(1)(i)(C) of this section relating to property that gives rise to income described in section 1297(b)(2)(B).

* * * * *

■ **Par. 7.** Section 1.7874–10T is amended by revising paragraph (d)(2) and paragraph (i) to read as follows:

§ 1.7874–10T Disregard of certain distributions (temporary).

* * * * *

(d) * * *

(2) After the domestic entity acquisition and all related transactions, each former domestic entity shareholder or former domestic entity partner, as applicable, owns (applying the attribution rules of section 318(a) with

the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the expanded affiliated group.

* * * * *

(i) *Applicability date.* Except as otherwise provided in this paragraph (i), this section applies to domestic entity acquisitions completed on or after September 22, 2014. Paragraph (d)(2) of this section applies to domestic entity acquisitions completed on or after January 13, 2017, and paragraph (d)(1) of this section applies to domestic entity acquisitions completed on or after November 19, 2015. Paragraph (g) of this section applies to domestic entity acquisitions completed on or after April 4, 2016. However, for domestic entity acquisitions completed on or after September 22, 2014, and before November 19, 2015, taxpayers may elect to apply paragraph (d)(1) of this section. For domestic entity acquisitions completed on or after September 22, 2014, and before January 13, 2017, taxpayers may elect to apply paragraph (d)(2) of this section or § 1.7874–10T(d)(2) as contained in the Internal Revenue Bulletin (IRB) 2016–20 (see *https://www.irs.gov/irb/2016-20_IRB/ar05.html*). In addition, for domestic entity acquisitions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to determine NOCDs consistently on the basis of taxable years, in lieu of 12-month periods, in a manner consistent with the principles of this section. See paragraph (h)(5) of this section.

* * * * *

■ **Par. 8.** Section 1.7874–12T is amended by revising the introductory text of paragraph (a) to read as follows:

§ 1.7874–12T Definitions (temporary).

(a) *Definitions.* Except as otherwise provided, the following definitions apply for purposes of this section and §§ 1.367(b)–4T, 1.956–2T, 1.7701(l)–4T, 1.7874–2, 1.7874–2T, 1.7874–4, 1.7874–5, and 1.7874–6T through 1.7874–11T.

* * * * *

§§ 1.7874–1, 1.7874–6T, 1.7874–7T, 1.7874–9T, and 1.7874–10T [Amended]

■ **Par. 9.** For each provision listed in the table below, removing the language in the ''Remove'' column and adding in its place the language in the ''Add'' column:

Provision	Remove	Add
§ 1.7874–1(c)(1), second sentence	§ 1.7874–4T	§ 1.7874–4
§ 1.7874–1(c)(1), second sentence	§ 1.7874–4T(h)	§ 1.7874–4(h)
§ 1.7874–6T(g), *Example 4*(iii), first sentence	§ 1.7874–4T(i)(7)	§ 1.7874–4(i)(2)
§ 1.7874–7T(b)(1), first sentence	§ 1.7874–4T(b)	§ 1.7874–4(b)
§ 1.7874–7T(c)(1)	§ 1.7874–4T(b)	§ 1.7874–4(b)
§ 1.7874–7T(f)(1)(i)	§ 1.7874–4T(i)(7)	§ 1.7874–4(i)(2)
§ 1.7874–7T(f)(2), introductory text	§ 1.7874–4T(b)	§ 1.7874–4(b)
§ 1.7874–7T(f)(3)(i)	§ 1.7874–4T(b)	§ 1.7874–4(b)
§ 1.7874–7T(f)(3)(ii)	§ 1.7874–4T(b)	§ 1.7874–4(b)
§ 1.7874–7T(g), *Example 1*(i), penultimate sentence	§ 1.7874–4T(i)(7)	§ 1.7874–4(i)(2)
§ 1.7874–7T(g), *Example 1*(ii), first sentence	§ 1.7874–4T(c)	§ 1.7874–4(c)
§ 1.7874–7T(g), Example 1(ii), first sentence	§ 1.7874–4T(b)	§ 1.7874–4(b)
§ 1.7874–7T(g), *Example 2*(i), last sentence	§ 1.7874–4T(i)(7)	§ 1.7874–4(i)(2)
§ 1.7874–7T(g), *Example 2*(ii), first sentence	§§ 1.7874–4T(b) and	§§ 1.7874–4(b) and
§ 1.7874–7T(g), Example 3(i), penultimate sentence	§ 1.7874–4T(i)(7)	§ 1.7874–4(i)(2)
§ 1.7874–9T(e)(3), introductory text	§ 1.7874–4T	§ 1.7874–4
§ 1.7874–10T(d)(1), introductory text	§§ 1.7874–4T(b) and	§§ 1.7874–4(b) and
§ 1.7874–10T(f)(3)(iii)(B)	§§ 1.7874–4T and	§§ 1.7874–4 and

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: December 6, 2016.

Mark J. Mazur

Assistant Secretary of the Treasury (Tax Policy).

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ENVIRONMENTAL PROTECTION AGENCY

40 CFR Part 63

[EPA–HQ–OAR–2010–0895; 9958–01–OAR]

RIN 2060–AS90

National Emission Standards for Hazardous Air Pollutants: Ferroalloys Production

AGENCY: Environmental Protection Agency (EPA).

ACTION: Final rule; notice of final action on reconsideration.

SUMMARY: This action sets forth the Environmental Protection Agency's (EPA's) final decision on the issues for which it announced reconsideration on July 12, 2016, that pertain to certain aspects of the June 30, 2015, final amendments for the Ferroalloys Production source category regulated under national emission standards for hazardous air pollutants (NESHAP). The EPA is amending the rule to allow existing facilities with positive pressure baghouses to perform visible emissions monitoring twice daily as an alternative to installing and operating bag leak detection systems (BLDS) to ensure the baghouses are operating properly. In addition, this final action explains that EPA is maintaining the requirement that facilities must use a digital camera opacity technique (DCOT) method to demonstrate compliance with opacity limits. However, this final action revises the rule such that it references the recently updated version of the DCOT method. In this action, the EPA also explains that no changes are being made regarding the rule provision that requires quarterly polycyclic aromatic hydrocarbons (PAH) emission testing for furnaces producing ferromanganese (FeMn) with an opportunity for facilities to request decreased compliance test frequency from their permitting authority after the first year. Furthermore, in this action, the EPA is denying the request for reconsideration of the PAH emission limits for both FeMn and silicomanganese (SiMn) production furnaces.

DATES: This final action is effective on January 18, 2017. The incorporation by reference of certain publications listed in the rule is approved by the Director of the Federal Register as of January 18, 2017.

ADDRESSES: The EPA has established a docket for this action under Docket ID