DC1, a domestic corporation, has owned all of the outstanding stock of CFC1, a foreign corporation, since its formation on January 1, year 1. CFC1 has owned all of the outstanding stock of CFC3, a foreign corporation, since its formation on January 1, year 1. DC2, a domestic corporation unrelated to DC1, has owned all of the outstanding stock of CFC2, a foreign corporation, since its formation on January 1, year 2. On December 31, year 3, pursuant to a restructuring transaction that is a reorganization described in section 368(a)(1)(B), CFC1 transfers all of the stock of CFC3 to CFC2 in exchange for 40% of CFC2’s stock. On December 31, year 3, CFC2 and CFC3 have, respectively, $40 and $20 of earnings and profits. On December 31, year 5, when the accumulated earnings and profits of CFC3 are $50 ($20 of earnings and profits as of December 31, year 3, plus $30 of earnings and profits generated from January 1, year 4, through December 31, year 5), CFC2 sells the stock of CFC3 in a transaction to which section 964(e) applies.

There is $50 of earnings and profits attributable to the CFC3 stock sold by CFC2. The earnings and profits attributable to the CFC2 stock held by CFC1 will be reduced by $32. This amount consists of all of the $20 of earnings and profits accumulated by CFC3 before the restructuring transaction and 40% of the $30 of earnings and profits accumulated by CFC3 after the restructuring transaction (40% of $30 = $12). The earnings and profits attributable to the CFC1 stock held by DC1 will also be reduced by $32, or the amount of earnings and profits that would have been attributable to the CFC1 stock held by DC1 as of December 31, year 5. The earnings and profits attributable to the CFC2 stock held by DC2 will be reduced by $18, or the amount of earnings and profits that would have been attributable to the CFC2 stock held by DC2 as of December 31, year 5. This amount consists of 60% of the $30 (60% of $18) of earnings and profits accumulated by CFC3 after the restructuring transaction.