FP, a foreign corporation, wholly owns USP, a domestic corporation. USP wholly owns CFC1, and CFC1 wholly owns CFC2. CFC2 wholly owns CFC3. CFC1, CFC2 and CFC3 are controlled foreign corporations within the meaning of section 957(a). CFC1 owns 30% of the outstanding stock of FS, a foreign corporation. FP owns the remaining 70% of the outstanding stock of FS. The CFC2 stock has a $40x basis and $100x fair market value. The FS stock held by CFC1 has a $60x basis and $100x fair market value. As of December 31, year 1, CFC2 has $20x of section 1248 earnings and profits, CFC3 has $40x of section 1248 earnings and profits, and FS has zero earnings and profits. On December 31, year 1, in a transaction described in section 304(a)(1), CFC1 sells the CFC2 stock to FS for $100x cash. FS is not a controlled foreign corporation (within the meaning section 957(a)) either before or after the sale of the CFC2 stock.

Under section 304(a)(1), CFC2 and FS are treated as if CFC1 contributed the CFC2 stock to FS in a deemed section 351 exchange in exchange solely for $100x of FS stock, and then FS redeemed for $100x cash its stock deemed issued to CFC1. Pursuant to section 304(b)(2), $20x of the distribution is treated as a dividend from the earnings and profits of CFC2. With respect to the remaining $80x, CFC1 takes the position that $40x is applied against and reduces the basis of the FS stock deemed issued in the transaction, and $40x is applied against and reduces the basis of the FS stock held by CFC1 prior to (and after) the transaction.

Because $40x of the distribution received by CFC1 from FS in redemption of the FS stock issued in the deemed section 351 exchange is applied against and reduces, under section 301(c)(2), the basis of the FS stock held by CFC1 before (and after) the transaction, CFC1 must include $40x in income as a deemed dividend. See §1.367(b)-2(e) for the treatment of the $40x income inclusion. In total, CFC1 recognizes dividend income of $60x, $20x from the application of section 304(a)(1) to the sale of the CFC2 stock to FS and $40x as deemed inclusion due to the loss of section 1248 shareholder status.

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