P, a corporation, owns 55 of the 100 outstanding shares of USS, a domestic corporation. A, a person unrelated to P, holds the remaining 45 shares of USS stock. USS forms FS, a foreign corporation, and transfers all its assets to FS in exchange for all 100 shares of the stock of FS, in a reorganization described in section 368(a)(1). P and A exchange their shares of USS stock for 55 shares and 45 shares of FS stock, respectively, under section 354.

FS has acquired substantially all the properties held directly or indirectly by USS pursuant to a plan. P, the common parent of the EAG after the acquisition, did not hold directly or indirectly 80 percent or more of the stock (by vote and value) of USS before the acquisition, and after the acquisition P does not hold directly or indirectly 80 percent or more of the stock (by vote and value) of FS. Thus, the acquisition is not an internal group restructuring described in Reg. 1.7874-1(c)(1), and the general rule of Reg. 1.7874-1(b) applies. Under Reg. 1.7874-1(b), the FS stock held by P, a member of the EAG, is not included in either the numerator or the denominator of the ownership fraction. Accordingly, the ownership fraction is 45/45. If the no substantial business activities condition in section 7874(a)(2)(B)(iii) is satisfied, FS is a surrogate foreign corporation which is treated as a domestic corporation under section 7874(b). The analysis is limited to a discussion of issues under section 7874, even though the example may raise other issues (for example, under section 367).

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