DC1 is a domestic corporation. Pursuant to a plan, DC1 and individual B organize a limited liability company (HPS) under the law of Country A. DC1 owns 90% of the membership interests in HPS, and B owns 10% of the membership interests in HPS. HPS is a foreign eligible entity under Treas Reg. §301.7701-2, and DC1 and B make an election under Treas. Reg. §301.7701-3 to treat HPS as a partnership for Federal tax purposes as of the date of the formation of HPS. HPS forms DC2, a domestic corporation. One day after the formation of HPS, DC2 merges with and into DC1. Pursuant to the merger agreement, the DC1 shareholders exchange their DC1 stock solely for membership interests in HPS. After the merger HPS wholly owns DC1, and the former shareholders of DC1 own a greater than 80% interest in HPS by reason of holding stock of DC1. Public trading of the HPS ownership interests begins the day after the date on which the merger is completed. The expanded affiliated group that includes HPS (treated as a foreign corporation for this purpose) has substantial business activities in Country A when compared to the total business activities of the expanded affiliated group. HPS is not treated as a corporation under Code §7704(a) by reason of Code §7704(c). If HPS were a corporation, the condition of Code §7874(a)(2)(B)(iii) would be satisfied.

Under Treas. Reg. §1.7874-2(g)(1), for purposes of Code §7874, HPS is treated as a foreign corporation and the membership interests in HPS are treated as stock of the foreign corporation. However, the foreign corporation is not treated as a surrogate foreign corporation under Code §7874(a)(2)(B) because, after the domestic entity acquisition, the expanded affiliated group that includes HPS has substantial business activities in Country A when compared to the total business activities of the expanded affiliated group. Therefore, under Treas. Reg. §1.7874-2(g)(5), Code §7874 does not apply and the status of HPS as a foreign partnership is not affected. In addition, DC1 is not treated as an expatriated entity under Code §7874(a) by reason of the domestic entity acquisition.

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