

**Reg.1.367(b)-5(g),
Example 1**

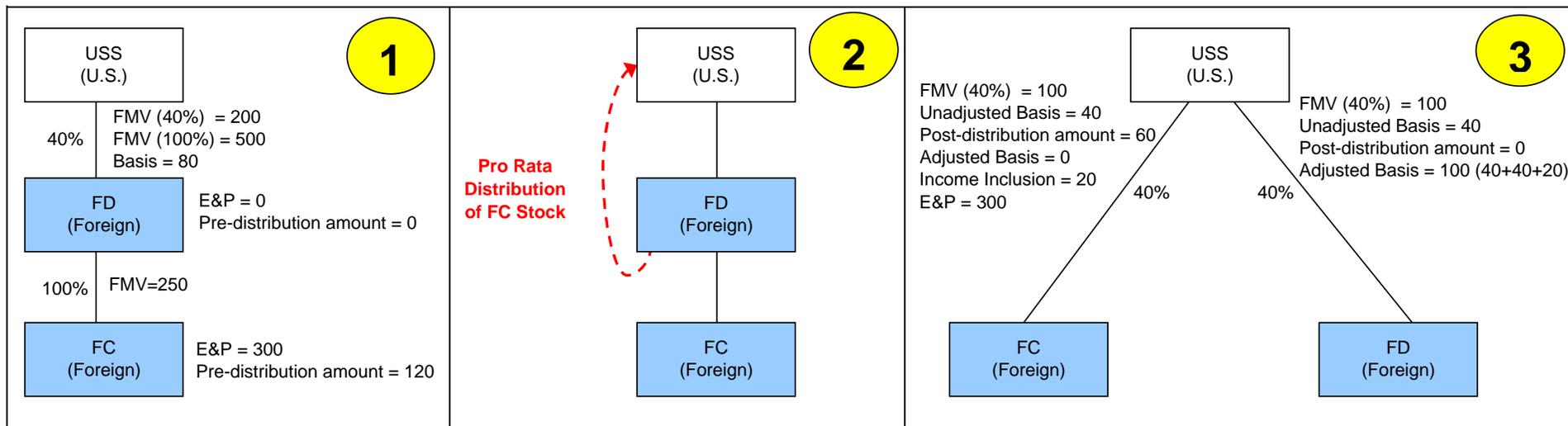
**Pro-Rata Spin-Off
By a CFC**

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Initial Structure

Spin-Off

Ending Point



USS, a domestic corporation, owns 40 percent of the outstanding stock of FD, a controlled foreign corporation (CFC). USS has owned the stock since FD was incorporated, and FD has always been a CFC. USS has a basis of \$80 in its FD stock, which has a fair market value of \$200. FD owns 100 percent of the outstanding stock of FC, a foreign corporation. FD has owned the stock since FC was incorporated. Neither FD nor FC own stock in any other corporation. FD has earnings and profits of \$0 and a fair market value of \$250 (not considering its ownership of FC). FC has earnings and profits of \$300, none of which is described in section 1248(d), and a fair market value of \$250. In a pro rata distribution described in section 355, FD distributes to USS stock in FC worth \$100; thereafter, USS's FD stock is worth \$100 as well.

USS must compare its predistribution amounts with respect to FD and FC to its respective postdistribution amounts. USS's predistribution amount with respect to FD or FC is its section 1248 amount computed immediately before the distribution, but only to the extent such amount is attributable to FD or FC. Under Reg. 1.367(b)-2(c)(1), USS's section 1248 amount computed immediately before the distribution is \$120, all of which is attributable to FC. Thus, USS's predistribution amount with respect to FD is \$0, and its predistribution amount with respect to FC is \$120. These amounts are computed as follows: If USS had sold its FD stock immediately before the transaction, it would have recognized \$120 of gain (\$200 fair market value - \$80 basis). All of the gain would have been treated as a dividend under section 1248, and all of the section 1248 amount would have been attributable to FC (based on USS's pro rata share of FC's earnings and profits (40 percent x \$300)).

USS's postdistribution amount with respect to FD or FC is its section 1248 amount with respect to such corporation, computed immediately after the distribution. Under Reg. 1.367(b)-2(c)(1), USS's section 1248 amounts computed immediately after the distribution with respect to FD and FC are \$0 and \$60, respectively. These amounts, which are USS's postdistribution amounts, are computed as follows: Under the normal principles of section 358, USS allocates its \$80 predistribution basis in FD between FD and FC according to the stock blocks' relative values, yielding a \$40 basis in each block. If USS sold its FD stock immediately after the distribution, none of the resulting gain would be treated as a dividend under section 1248. If USS sold its FC stock immediately after the distribution, it would have a \$60 gain (\$100 fair market value - \$40 basis), all of which would be treated as a dividend under section 1248.

The basis adjustment and income inclusion rules apply to the extent of any difference between USS's postdistribution and predistribution amounts. In the case of FD, there is no difference between the two amounts and, as a result, no adjustment or income inclusion is required. In the case of FC, USS's postdistribution amount is \$60 less than its predistribution amount. Accordingly, USS is required to reduce its basis in its FC stock from \$40 to \$0 and include \$20 in income as a deemed dividend. Under Reg. 1.367(b)-2(e)(2), the \$20 deemed dividend is considered as having been paid by FC to FD, and by FD to USS, immediately prior to the distribution. The deemed dividend is not included by FD as foreign personal holding company income under section 954(c). The basis increase provided in Reg. 1.367(b)-2(e)(3)(ii) does not apply with regard to the \$20 deemed dividend. USS increases its basis in FD by the amount by which it decreased its basis in FC, as well as by the amount of its deemed dividend inclusion (\$40 + \$40 + \$20 = \$100)