



DC1 is a domestic corporation. Individuals A and B equally own DC1. The liabilities of DC1 exceed the value of its assets. Pursuant to a plan, FA, a newly formed foreign corporation, acquires substantially all of the properties held by DC1 in exchange solely for FA stock. Pursuant to the plan, the DC1 stock held by individuals A and B is cancelled, and the creditors of DC1 receive all the FA stock in exchange for their claims against DC1.

Because immediately before the first date on which properties are acquired as part of the domestic entity acquisition the liabilities of DC1 exceed the value of its assets, under Treas. Reg. §1.7874-2(i)(2)(i), for purposes of Code §7874, the creditors of DC1 are treated as shareholders of DC1 and the creditors' claims against DC1 are treated as DC1 stock. Therefore, for purposes of Code §7874(a)(2)(B)(ii), the FA stock received by the creditors of DC1 by reason of their claims against DC1 is considered held by former domestic entity shareholders of DC1 by reason of holding DC1 stock.