NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON NOTICE 2012-15:
CROSS-BORDER STOCK SALES
SUBJECT TO SECTIONS 304 AND 367

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Report No. 1268

New York State Bar Association Tax Section

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Background

This report (the "Report")[1] comments on Notice 2012-15 (the "Notice"),[2] which announced that the Internal Revenue Service ("IRS") and the Treasury Department ("Treasury") had reconsidered the proper interaction between Sections 304 and 367 of the Code[3] and had adopted a new regime, effective for transactions occurring on or after February 10, 2012. This new regime describes how Sections 367(a) and (b), as well as Section 1248, will affect the amount, timing and character of income and gain recognized by the seller in a cross-border stock sale subject to Section 304. As acknowledged in the Notice, this is the third regime applicable to such transactions in the past six years.[4]

While the Notice requests comments,[5] this report assumes, based upon the immediate effective date of the Notice and the extensive consideration of the relevant issues over the past six years, that the comments of most interest to the IRS and Treasury concern the effective implementation of the general approach of the Notice by future regulations, not whether the Notice itself is the appropriate approach to addressing these issues. The principal focus of this

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[1] The principal author of this Report is Andrew P. Solomon. Significant contributions were made by Kimberly S. Blanchard. Helpful comments were received by Peter J. Connors, Michael L. Schler, David R. Sicular and Diana L. Wollman. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[2] 2012-9 IRB 424.

[3] References in the Report to "Section(s)", unless otherwise stated, are to sections of the Internal Revenue Code of 1986, as amended (the "Code") and the regulations thereunder.

[4] Final regulations regarding this issue were promulgated in 2006. T.D. 9250, 71 Fed. Reg. 8802 (2/21/2006). Those regulations were then amended by temporary regulations in 2009. See Treas. Regs §§ 1.367(a)-9T and 1.367(b)-4T(e). The Temporary Regulations were in turn replaced by the approach outlined in the Notice.

[5] Notice 2012-15, Section 7.

Report, therefore, is on certain technical issues that may arise, most of which concern how to ensure that the seller of the controlled shares is not subject to double taxation.

The Report will begin with a short recapitulation of the regulatory history. It will then discuss the new approach of the Notice, illustrating how it differs from the regulatory approaches that preceded it. Two sections of commentary will follow. The first will discuss certain specific issues we believe should be clarified in future regulations in order for taxpayers and practitioners to understand how the principles articulated in the Notice will actually apply and interact with the existing rules under Sections 367(a) and (b), as well as under Section 1248. We do not believe that any of these clarifications are controversial. The second will provide specific recommendations on how future regulations should address what we believe are some of the unintended consequences that appear to follow from strict adherence to the Notice. The Report will then conclude with a brief discussion of whether the original approach of the regulatory regime in effect six years ago, modified as necessary to limit basis recovery, might achieve all of the policy objectives of the Notice with far less complexity because it would not rely on the gain recognition regime of Section 367 to prevent double taxation.

Background

Section 304. Section 304 generally provides that if one or more persons are in control of each of two corporations, and, in return for property, one of the corporations (the "acquiring corporation") acquires stock in the other corporation (the "issuing corporation") from the person or persons so in control, then such property shall be treated as if it were distributed in redemption of the stock of the acquiring corporation.[6] The purpose of Section 304 is the same as the purpose of Section 302: to prevent the "bailout" of current and accumulated earnings and profits ("e&p") in a transaction that takes the form of a purchase of stock but is in substance a dividend from the acquiring corporation to the selling shareholder.[7] It therefore prohibits the shareholder from

[6] IRC § 304(a).

[7] H.R. Rep. No. 1337, 83d Cong., 2d Sess. 35-38 (1954).

reporting the income as capital gain from the sale of stock (unless there is no e&p in the acquiring corporation or, in certain cases, the issuing corporation).[8]

For purposes of determining "control" under Section 304, the Section 318 constructive ownership rules apply (subject to certain modifications).[9] If Section 304 applies to recharacterize the deemed redemption of the acquiring corporation's stock as a distribution under Section 301, the transferor and the acquiring corporation are treated "in the same manner" as if (1) the transferor had transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which Section 351(a) applies (a "deemed Section 351 exchange"), and (2) the acquiring corporation had then redeemed the stock it was treated as having issued in the deemed 351 exchange (a "deemed redemption").[10]

The specific hypothetical construct described above was added to Section 304 in 1997.[11] The purpose of the amendment was to rationalize the results of the deemed redemption of the acquiring corporation's stock in cases where the transferor owned no stock of the acquiring corporation directly.[12] The deemed Section 351 exchange/deemed redemption fiction ensures that the provisions of Section 301 apply to the actual transferor of the stock of the issuing corporation.

Like all redemptions characterized as Section 301 distributions, a deemed redemption under Section 304 results in up to three types of proceeds to the transferor: (1) the amount treated as a dividend, which is limited to the e&p of the issuing corporation plus (with one limitation described immediately below) the e&p of the acquiring corporation (the "Section

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8 P.L. 97-248, §226, 1982 U.S.C.C.A.N. (96 Stat.) 324, 490–92 (expanding pre-TEFRA version of Section 304 to include the e&p of the issuing corporation for purposes of determining dividend equivalency).

9 IRC § 304(c)(3).

10 IRC § 304(a).

11 P.L. 105-34, § 1013(a).

12 As explained in the Blue Book, "[I]n some situations where the selling corporation does not in fact own any stock of the acquiring corporation before or after the transaction (except by attribution), it is possible that current law may lead to inappropriate results." JCS-23-97, p. 207.

301(c)(1) amount"), (2) the amount in excess of the Section 301(c)(1) amount but not in excess of the transferor's basis in the shares of the acquiring corporation, which is treated as a tax-free return of capital (the "Section 301(c)(2) amount"), and (3) the remaining amount in excess of the foregoing, which is treated as gain from the sale of the redeemed shares of the acquiring corporation (the "Section 301(c)(3) amount").[13]

The limitation on the use of the acquiring corporation's e&p applies if the acquiring corporation is a foreign corporation, in which case the e&p available for purposes of calculating the Section 301(c)(1) amount generally includes *only* such e&p of the acquiring corporation that (1) is attributable to stock of the acquiring corporation directly or indirectly owned (as determined under the Section 958(a) attribution rules) by the transferor (or a person with a Section 267(b) or 707(b) relationship to the transferor) if such owner is a "United States shareholder"[14] of the acquiring corporation, *and* (2) was accumulated while the acquiring corporation was a controlled foreign corporation ("CFC").[15]

Section 367(a). Section 367(a) generally provides (in relevant part) that if a U.S. person transfers property to a foreign corporation in an exchange described in Section 351, the foreign corporation is not to be considered a corporation for purposes of determining the extent to which gain is recognized on the transfer.[16] The purpose of Section 367(a) is to prevent U.S. persons from making certain types of "outbound" transfers of appreciated property to a foreign corporation without recognizing gain when the foreign transferee may be able to sell such property free of U.S. tax.

Certain exceptions to the Section 367(a) gain recognition rules apply when the transferred property consists of stock or securities.[17] To qualify under many of these exceptions, the

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[13] IRC § 301(c).

[14] IRC § 951(b).

[15] There are additional restrictions imposed if more than 50% of the dividends arising from the acquisition are not subject to tax for the year in which the dividends arise and are not includible in the e&p of a CFC. IRC Section 304(b)(5)(B).

[16] IRC § 367(a)(1).

[17] Treas. Regs § 1.367(a)-3.

transferor must enter into a "gain recognition agreement" ("GRA") with the IRS, the requirements of which are set forth in Treasury Regulations Section 1.367(a)-8. Among other things, these regulations define the circumstances under which a "triggering event" will accelerate the gain that had been deferred under the GRA, permit gain that otherwise would be accelerated by a triggering event to remain deferred by entering into a subsequent GRA, and limit the ability of certain transferors to enter into a subsequent GRA.[18] The basic theory on which the various GRA exceptions is predicated is that the purpose of Section 367(a) is not violated when the transferee foreign corporation retains the transferred stock or securities for a significant period of time.

Section 367(b). Unlike Section 367(a), the primary purpose of Section 367(b) is to ensure that the e&p of a CFC is reported as a dividend by the U.S. person that owned the stock while the e&p was earned. Regulations under Section 367(b)(2) generally provide (in relevant part) that if, in a Section 351 transfer of stock of one foreign corporation to another foreign corporation, gain is not recognized under Section 367(a), then certain transferors must include in income as a dividend the "section 1248 amount" attributable to the stock of the foreign issuing corporation.[19] Generally speaking, income inclusion is required only if Section 1248 would cease to apply with respect to a transferor's direct or indirect interest in the stock of the foreign acquiring or issuing corporation. A Section 1248 inclusion is only required, therefore, if either the acquiring or the issuing corporation is not a CFC of which the transferor is a Section 1248 shareholder following the transfer.[20]

The 2006 Regulations. Prior to the issuance of regulations, whether Section 367 applied to the deemed Section 351/deemed redemption fiction introduced by the 1997 amendments to Section 304 was not entirely clear. Pre-1997 rulings suggested that the IRS believed that Section 367 applied to the deemed capital contribution under the pre-1997 mechanics of Section 304.[21] Prior law, however, did not address how Section 367 might apply after the 1997

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18 Treas. Regs §§ 1.367(a)-8(j)-(k).

19 Treas. Regs § 1.367(b)-4.

20 *Id.*

21 Rev. Rul. 91-5, 1991-1 C.B. 114; Rev. Rul. 92-86, 1982-2 C.B. 199; see also Preamble to REG-150313-01, 67 Fed. Reg. 64331 (10/18/2005), withdrawn by Ann. 2006-30, 2006-19 IRB 879.

amendments. The first set of regulations to address this question (the "2006 Regulations") provided that Section 367 did *not* apply to either the deemed Section 351 exchange or the deemed redemption. Among the reasons expressed for this approach in the preamble to the earlier proposed regulations was to avoid taxing the transferor on income in excess of the fair market value of the transferred stock, which the preamble noted could occur if both Sections 304 and 367 were to apply to the same transaction.[22]

That preamble, as well as the preamble to the 2006 Regulations, explained that the IRS and Treasury believed that Section 304 already achieved the policy objective of Section 367 in this context because the transferor would always recognize the entire gain inherent in the transferred shares, obviating the need to apply Section 367 to the transaction. At the time, the IRS and Treasury had believed that any basis recovery under Section 301(c)(2) would apply only to the transferor's basis in the constructively redeemed shares.[23] As many commentators later observed,[24] however, the basis recovery available to the transferor in the deemed redemption may have included not only its basis in the redeemed shares of the acquiring corporation, but its basis in the actual shares of the acquiring corporation (the "old and cold shares") as well. In such a case, the transferor would recognize less than all of its gain (or in many cases no gain at all).

The 2006 Regulations remained the law until 2009.

The 2009 Temporary Regulations. To address the potential for inappropriate deferral, Treasury issued temporary regulations in 2009 (the "2009 Temporary Regulations") to replace the 2006 Regulations.[25] Under the 2009 Temporary Regulations, if a transferor "takes the position" that it may recover its basis in the old and cold shares under Section 301(c)(2) to defer

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22 REG-127740-04, Fed. Reg. Vol. 70, No. 100, p. 30036, section D.1. (5/25/2005) ("the application of section 367(a) to a section 304(a)(1) transaction may, in certain instances where the U.S. transferor files a GRA, result in a total income inclusion that is greater than the fair market value of the stock being transferred. The IRS and Treasury believe that this result is inconsistent with the policies of section 367").

23 See T.D. 9444, 74 Fed. Reg. 6824 (2/11/2009).

24 See T.D. 9250 (section A), 71 Fed. Reg. 8802 (2/21/2006).

25 See T.D. 9444, 74 Fed. Reg. 6824 (2/11/2009).

gain in the deemed redemption, the transferor would be required to recognize a like amount of gain under Section 367(a). In any other case, Section 367(a) would not apply.

The 2009 Temporary Regulations achieved this result by treating the portion of any return of capital distribution under Section 301(c)(2) that reduced basis in the old and cold shares as triggering gain on a dollar-for-dollar basis to the transferor under Section 367(a). By also prohibiting the transferor from entering into a GRA,[26] the 2009 Temporary Regulations therefore ensured that the transferor would always recognize the full built-in gain inherent in the issuing corporation's stock transferred to the acquiring corporation, less the amount includible as a dividend under Section 301(c)(1).[27]

It has been widely assumed that Treasury issued the 2009 Temporary Regulations in response to the proposed basis recovery regulations governing dividend-equivalent redemption transactions.[28] This assumption was based in part on the fact that these regulations were issued less than one month before the release of the 2009 Temporary Regulations. That the 2009 Temporary Regulations referred to the shares issued in the deemed Section 351 exchange as shares of "common stock" also suggested that the drafters intended that the proposed basis recovery regulations would treat the deemed issued shares as shares of the same class as the old and cold shares. In such a case, basis first recovery would be potentially available with respect to the transferor's entire basis in the acquiring corporation, not merely the shares it was treated as having received in the deemed Section 351 exchange. More precisely, the proposed basis recovery regulations would apply any distribution in excess of the relevant e&p to reduce the basis of each share of common stock actually or deemed held by the transferor following the deemed Section 351 exchange on a pro rata basis.[29]

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[26] Treas. Regs § 1.367(a)-9T(b). The prohibition upon entering into a GRA made sense because the gain required to be reported was merely a proxy for the Section 301(c)(3) gain that would have been reported under the basis recovery assumptions that motivated the 2006 Regulations. The new prohibition did not represent any special policy issue implicating Section 367.

[27] Under the Temporary Regulations and Section 362, the gain recognized under Section 367(a) was added to the basis of acquiring corporation stock deemed issued in the Section 351 exchange, which in turn reduced the amount of gain actually recognized under Section 304. Treas. Regs § 1.367(a)-9T(e), Example (ii).

[28] REG-143686-07, IRB 2009-8 (February 23, 2009).

[29] Prop. Regs § 1.304-2(a)(4).

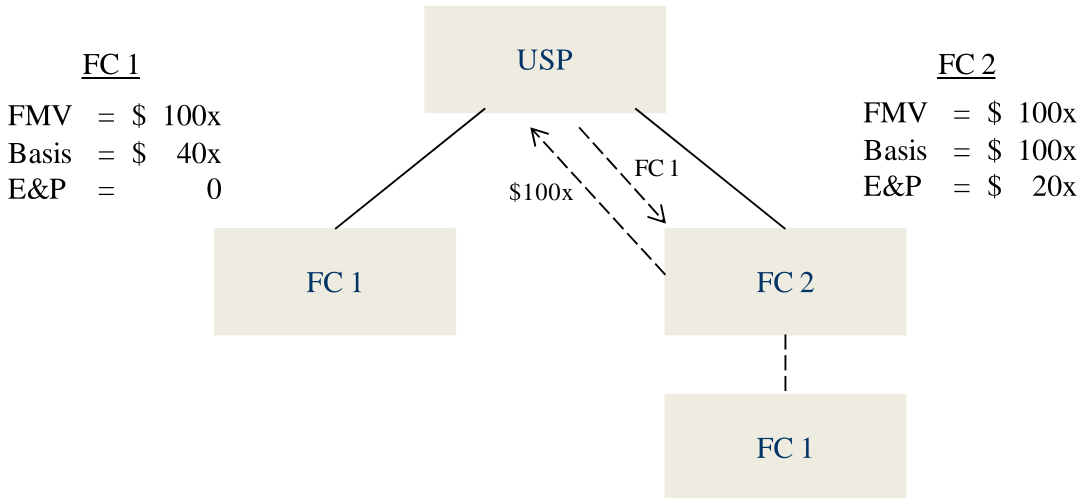
We note, however, that nothing in the examples or text of the 2009 Temporary Regulations suggested that this proposed basis recovery rule produced any unusual result in a Section 304 transaction. That is because all of the examples assumed that the value of the issuing corporation's shares (and thus the total amount deemed distributed) would always exceed the aggregate basis in the deemed-issued and old and cold shares in the acquiring corporation. Had that not been the case – had the aggregate basis exceeded the value of the issuing corporation's shares – application of the pro rata rule would require a valuation of the old and cold shares, and could lead to a result in which gain is recognized on one block of stock while unrecovered basis remained in another block of stock. Such a result seems particularly inappropriate in the context of fictional shares that were deemed to have been issued only to be immediately redeemed, that is, "born to die."[30]

In addition, the 2009 Temporary Regulations appear to have overlooked that any gain recognized under Section 367(a) would increase the basis of the acquiring corporation's shares in the issuing corporation even though it would not be permitted the same basis step-up if the gain had been recognized under Section 301(c)(3). Under the examples in the 2009 Temporary Regulations, therefore, a well-advised transferor would always "take the position" that it was entitled to recover basis in the old and cold shares because by doing so, the acquiring corporation would claim a "free" basis step-up without triggering any additional gain to the transferor.

It is possible that some or all of these infirmities led to the approach taken in the Notice.

[30] See Korenblatt, "IRS Revises Its Approach On Applying Section 367 to Section 304 Transactions," J. Corp. Tax'n 3, 13 (July/August 2012); Blanchard, "A Closer Look at the § 367 Consequences of a § 304 Transfer – Weirder Than You Think," 39 Tax Mgmt Int'l J. 268 (May 14, 2010).

The effect of the 2009 Temporary Regulations can be illustrated by the following example:



<u>Section 304</u>
Section 301(c)(1) dividend = $20x
Section 301(c)(2) basis recovery = $80X
($40x against basis of FC2 stock deemed issued for FC1 stock; $40x against basis of pre-existing FC2 stock, reducing such basis to $60x)

<u>Section 367</u>
Section 367 gain = $40x ($60x-20x)
$40x Section 367 basis increase in FC2 stock applies before Section 304

In this example, the sale of the FC1 stock to FC2 for $100x is recast under Section 304 as a deemed transfer of the shares to FC2 in exchange for FC2 stock pursuant to Section 351, followed by a deemed redemption of such stock under Section 302. Because USP owns 100% of the stock of FC2 both before and after the redemption, the entire amount is treated as a distribution under Section 301. Moreover, because USP is a U.S. shareholder of FC1 (a CFC), the e&p of FC2 is added to the e&p of FC1 for purposes of determining the portion of the distribution taxable as a dividend under Section 301(c)(1).[31] Since the combined e&p of FC2 and FC1 is $20x, USP therefore reports $20x of the $100x distribution as a dividend. Of the remaining $80x, for purposes of Section 301(c)(2), $40x is applied against USP's basis in the fictional shares of FC2 issued in the deemed Section 351 exchange and $40x is applied against USP's basis in the old and cold shares of FC2. Under Section 367(a), the application of the

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31 IRC § 304(b)(5).

second $40x against UST's basis in the old and cold shares of FC2 shares triggers $40x of gain under Section 367(a).

In addition to recapturing the "excess" basis recovery under Section 301(c)(2) as gain under Section 367(a), Treasury Regulations Section 1.367(b)-4T(e) subjected the gain to the rules of Treasury Regulations Section 1.367(b)-4(b). If, in a Section 304 transaction, the issuing corporation ceased to be a CFC or the transferor ceased to be a United States shareholder with respect to the CFC, and Treasury Regulations Section 1.367(a)-9T did not apply (e.g., the transferor was a foreign corporation), the amount of any gain recognized was treated as a dividend under Treasury Regulations Section 1.367(b)-(4)(b) to the extent of the applicable Section 1248 amount attributable to the constructively redeemed stock.

The 2012 Notice. The Notice discards both the basic approach of the 2006 Regulations and the modifications to that approach in the 2009 Temporary Regulations. Under the Notice, Section 367(a) and (b) will apply in tandem with Section 304 to any intercompany sale of stock to a foreign corporation by the controlling shareholder *regardless* of the amount of gain recognized by the transferor under Section 304. Specifically, Section 367 applies both to the deemed Section 351 exchange for acquiring corporation stock and to the deemed redemption of such stock. To avoid the potential for taxing the same gain first under Section 304 and then again under Section 367, the Notice allows taxpayers to enter into a single GRA under Section 367(a). The single GRA would govern both the gain realized in the deemed Section 351 exchange and the gain realized in the deemed redemption. Although the current regulations under Section 367(a) actually require two separate GRAs in this context, the Notice states that the IRS will generally treat this requirement as satisfied if the U.S. person files a single GRA.

Under the Notice, Section 367(a) will potentially apply if, in the deemed Section 351 exchange, a U.S. person is treated as transferring stock of an issuing corporation (domestic or foreign) to a foreign acquiring corporation. The U.S. person will not recognize gain, however, to the extent the deemed transfer qualifies for relief under any of the exceptions set forth in Treasury Regulations Sections 1.367(a)-3(b)(1) or (c)(1). To qualify under these exceptions, it is

often necessary for the U.S. person to enter into a GRA under Treasury Regulations 1.367(a)-8. The Notice would permit the U.S. person to do so.[32]

If the U.S. person is eligible to and in fact enters into a GRA, the deemed redemption of the foreign acquiring corporation stock that occurs immediately after the deemed Section 351 exchange would constitute a disposition of those shares and thus a triggering event under Treasury Regulations Section 1.367(a)-8. Notwithstanding the triggering event, the Notice provides that pursuant to the provisions of Treasury Regulations Section 1.367(a)-8(n)(1), the deemed redemption will not be treated as such if the U.S. person that transferred the stock in the deemed Section 351 exchange (or a U.S. person that is treated as a successor transferor as a result of the deemed redemption) enters into a second GRA.

The opportunity to enter into this second GRA, however, is subject to the same conditions that generally apply to these agreements. Among these conditions are those set forth in Treasury Regulations Section 1.367(a)-8(k)(14)(ii): Immediately after the deemed redemption, the U.S. transferor must own, actually or constructively, at least 5% of the vote and value of the outstanding stock of the acquiring corporation. For this purpose, the attribution rules of Section 318 (as modified by Section 958(b)) apply.[33]

The effect of the Notice can be illustrated by the following example, taken from the Notice itself. Certain facts (reflected by question marks in the diagram below) are not provided in the Notice, presumably because they are not relevant to the analysis.

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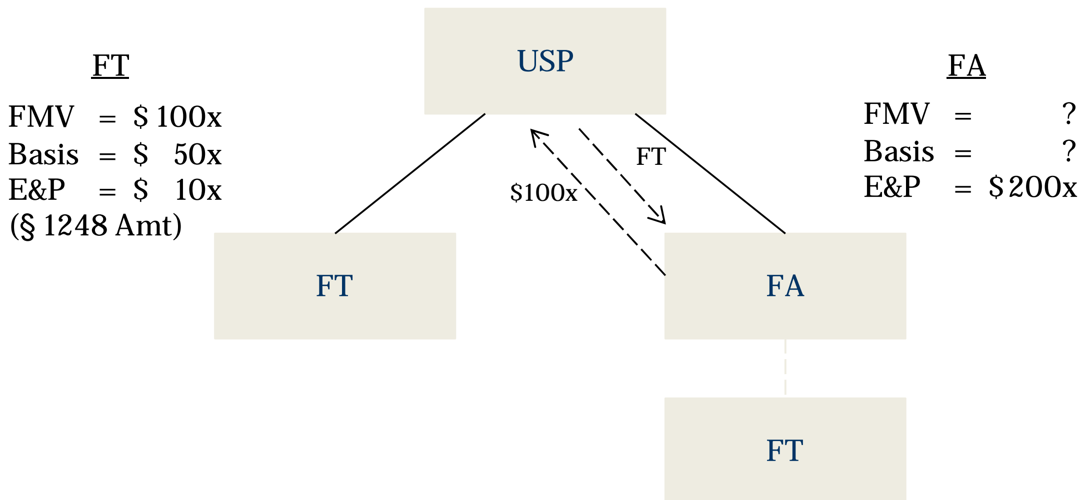
[32] Another exception applies if the shares being transferred are shares of a foreign corporation and the transferor owns (after application of the constructive ownership rules of Section 318 as modified by Section 958(b)) less than 5% of both the vote and value of the stock of the transferee corporation immediately after the transfer. See Treas. Regs § 1.367(a)-3(b)(1)(i). Because Section 304 applies different constructive ownership rules (*i.e.,* Section 318 *without* modification), it is possible for a transferor to qualify under this exception even though the transferor "controls" the transferee.

[33] As noted in the previous footnote, it is possible for a U.S. transferor to constructively own sufficient shares in the acquired and acquiring corporations to satisfy the control requirement under Section 304 (allowing it to enter into a GRA with respect to the deemed Section 351 exchange), but not enough shares to allow it to enter into a second GRA with respect to the deemed redemption. See diagram on page 18.



Because both Section 304 and Section 367 apply, USP first realizes $50x of gain on the deemed transfer of the FT shares to FA under Section 351, which is treated as occurring before (and independently of) the deemed redemption that follows. USP may defer the $50x of gain by entering into a GRA. USP also realizes a $100x dividend upon the deemed redemption of the FA shares received in the exchange because the combined e&p of FA and FT exceed the $100x value of the FT shares, resulting in a return of capital distribution under Section 301(c)(2) of zero.

Under the Notice, therefore, the total income subject to current or deferred taxation in this example is $150x, which exceeds the fair market value of the FT shares.

With respect to Section 367(b), the Notice likewise applies both the rules of Section 304 and Section 367. The Notice makes clear that if the Section 304 transaction causes the transferor to lose its status as a Section 1248 shareholder of the issuing corporation, then Treasury Regulations Section 1.367(b)-4(b)(1)(i) will require the transferor to include the Section 1248 amount in income as a deemed dividend attributable to the transferred shares of the issuing corporation.

Recommendations Regarding Specific Issues to be Clarified in Future Regulations

The following recommendations concern certain specific issues we believe should be addressed and clarified in future regulations in order to allow taxpayers and practitioners to apply the existing rules under Sections 367(a) and (b) and Section 1248 in a manner consistent with the

principles articulated in the Notice. We anticipate that these recommendations will not be controversial, as we believe that they follow from the same principles.

As noted above, the Notice does not set forth any specific operating rules for the application of Section 367 to a Section 304 transaction; in this section, we suggest ways to fill that gap. We utilize examples below and, given the complexity involved, we recommend that future regulations do so as well.

Among the rules we believe should be confirmed and illustrated with examples are the following:

1. <u>Relationship between Section 301(c)(2) Basis Recovery and Gain Recognized under Section 367(a)</u>.

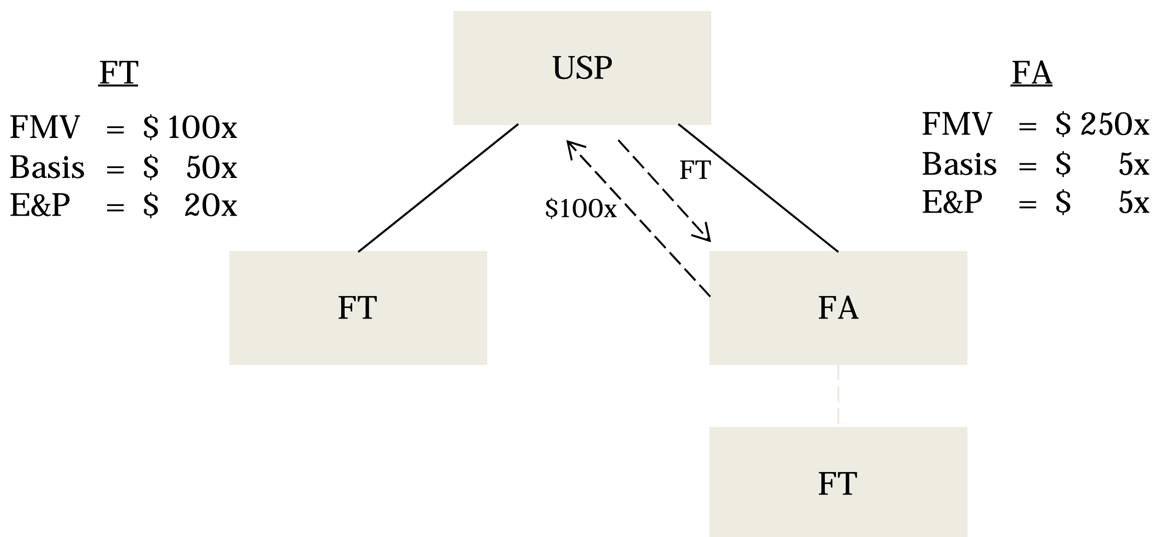
It should be clarified that the basis reduction resulting from the application of Sections 304 and 301(c)(2) to the deemed redemption is ignored for purposes of determining the amount of gain tentatively subject to Section 367(a). This clarification is consistent with the chronology of the two fictional transactions under Section 304. The basis reduction under Section 301(c)(2) only occurs in the deemed redemption and the redemption cannot precede the actual issuance of the redeemed shares. Section 304 deems the shares to be outstanding by treating them as issued in a Section 351 exchange subject to Section 367. Accordingly, because the Section 367 transaction "creates" the shares to be redeemed, the gain subject to Section 367 will already have been realized before the deemed redemption occurs. In fact, to increase the Section 367 gain by the basis reduction attributable to the redemption would not only be inconsistent with the chronology of the two transactions under Section 304, but with the character of the first transaction as a deemed Section 351 exchange.

2. <u>Relationship between Section 301(c)(3) Gain and Gain under Section 367(a) When Transferor Does Not Enter into GRA</u>.

We believe that the regulations issued pursuant to the Notice should clarify that gain recognized under Section 301(c)(3) reduces the potential Section 367(a) gain even if the taxpayer does not enter into a GRA. Although that would appear to be the case under the existing rules

(see Treasury Regulations Section 1.367(a)-8(o)(3)), the regulation by its explicit terms applies only when the transferor enters into the first GRA to avoid recognizing gain in the deemed Section 351 exchange, which will then be triggered either immediately in the deemed redemption under Section 304 or in the future by an actual redemption. There would appear to be no reason to treat a deemed Section 351 exchange for which a GRA is available but immediately triggered by the deemed redemption differently from a transaction where no such agreement is initially available.

Consider the following example:



Section 301(c)(1) dividends = $25x
Section 301(c)(2) basis recovery = $26.42x
Section 301(c)(3) gain = $48.57x

Section 367(a) gain = $1.43x
($50x - $48.57x) (§ 1.367(a) – 8(o)(3))
Section 367(b) = no effect

Here, USP would treat $25x of the $100x distribution to USP in the deemed redemption of the FA shares as a dividend under Section 301(c)(1). The remaining $75x of the distribution should not increase the gain realized in the deemed Section 351 exchange to the extent of any basis recovery under Section 301(c)(2) with respect to USP's total basis in the FA shares, which is $55x. The reason why the relevant basis includes USP's basis in the actual FA shares is that

the deemed redemption, and therefore the relevant basis for purposes of calculating the recovery of basis under Section 301(c)(2), is not in USP's FT shares, but in its FA shares (both the fictional shares issued in the deemed Section 351 exchange and the old and cold shares). Moreover, taking this basis recovery into account would have the effect of increasing the actual gain inherent in the FT shares before the deemed exchange. Moreover, the $48.57x "excess" distribution taxable to USP under Section 301(c)(3) (*i.e.,* $5x – (250/350 x $75x))[34] should *reduce* the gain subject to Section 367(a). As such, USP should realize $25x of dividend income in the deemed redemption and $50x of gain in the deemed Section 351 exchange, of which USP may defer $1.43x by entering into a GRA. Whether it does so or not, however, it should not affect the total realized gain to USP.

We note that if the ordering rule were reversed, it would have the effect of allowing USP to defer Section 301(c)(3) gain realized in a redemption by entering into a GRA with respect to the gain realized under Section 367(a).

If the IRS and Treasury believe that they may lack authority to reduce the potential Section 367(a) gain by the Section 301(c)(3) gain without a GRA, double counting should be avoided by some other means. One alternative would be to increase the basis of the deemed-issued shares by the Section 367(a) gain for this purpose and then limit any basis recovery to those shares. The resulting non-pro rata distribution would avoid double taxation by not taking into account any old and cold shares with a lower tax basis.

3. <u>Section 367(a), Section 367(b)(4) and Section 301(c)(1) dividends</u>.

The IRS and Treasury should clarify that the normal rules governing the determination of the Section 1248 amount apply in this context. It is settled law that a shareholder's Section 1248 amount with respect to a transfer of stock of a foreign corporation is reduced by any dividends paid on such stock during the same taxable year, including any dividends paid during the portion

[34] Note that under the share-by-share basis recovery rules of the proposed regulations, 100/350th of the $75x distribution would be applied to the fictional shares of FA issued in the deemed Section 351 exchange, reducing USP's basis in such shares from $50x to $28.58x. USP therefore recognizes $48.57x of gain under Section 301(c)(3) even though it has unrecovered basis in a portion of its FA shares. See Prop. Regs § 1.304-2(a)(4). Under the basis recovery assumptions of the 2006 Regulations, USP would have recognized only $25x of gain under Section 301(c)(3).

of the taxable year that follows the relevant transfer.[35] Any Section 301(c)(1) dividend attributable to the e&p of the issuing corporation should be treated no differently. It should reduce the Section 1248 amount with respect to the stock of the issuing corporation notwithstanding that the dividend is deemed paid after the transfer of the stock of the issuing corporation in the deemed Section 351 exchange.

Recommendations to Avoid Unintended Consequences

This section provides recommendations concerning how future regulations should address what we believe are some unintended consequences that would appear to follow from strict adherence to the principles articulated in the Notice.

While we do not fully understand all of the reasons why the IRS and Treasury chose to abandon the approach of the 2009 Regulations in favor of the alternative approach of the Notice, we assume that the IRS and Treasury did not intend that the same transaction would subject the U.S. transferor to potential double taxation or require the U.S. transferor to recognize phantom income.

The IRS and Treasury may have been concerned that the 2009 Regulations would apply Section 304 such that the amount treated as a dividend under Section 301(c)(1) would be limited to the e&p of the issuing and acquiring corporations (or, in certain circumstances, the issuing corporation alone). If Section 367(b) were applied, or if there had been a sale of the stock of the issuing corporation absent application of Section 304, the amount treated as a dividend would be determined under Section 1248, which includes in its computation the e&p of their subsidiaries as well. The Notice's approach achieves this result, but at the cost of potential double taxation due to the joint application of *both* regimes. We do not believe this was intended. Moreover, at the time the Notice was issued, related temporary regulations were finalized as Treasury

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[35] Revenue Ruling 71-388 provides that, for purposes of determining the portion of any gain on the sale of stock in a CFC reportable as a dividend under Section 1248, the e&p for the year of the sale must be reduced by any post-sale dividends to the buyer during the same year 1971-2 C.B. 314. This holding was confirmed, after the changes adopted in the Tax Reform Act of 1986, by Rev. Rul. 90-31, 1990-1 C.B. 147; see also Technical Advice Memorandum 199906035 (February 16, 1999).

Regulation Section 1.1248-1(b).[36] Those regulations provide that Section 1248 applies to gain recognized pursuant to Section 301(c)(3).

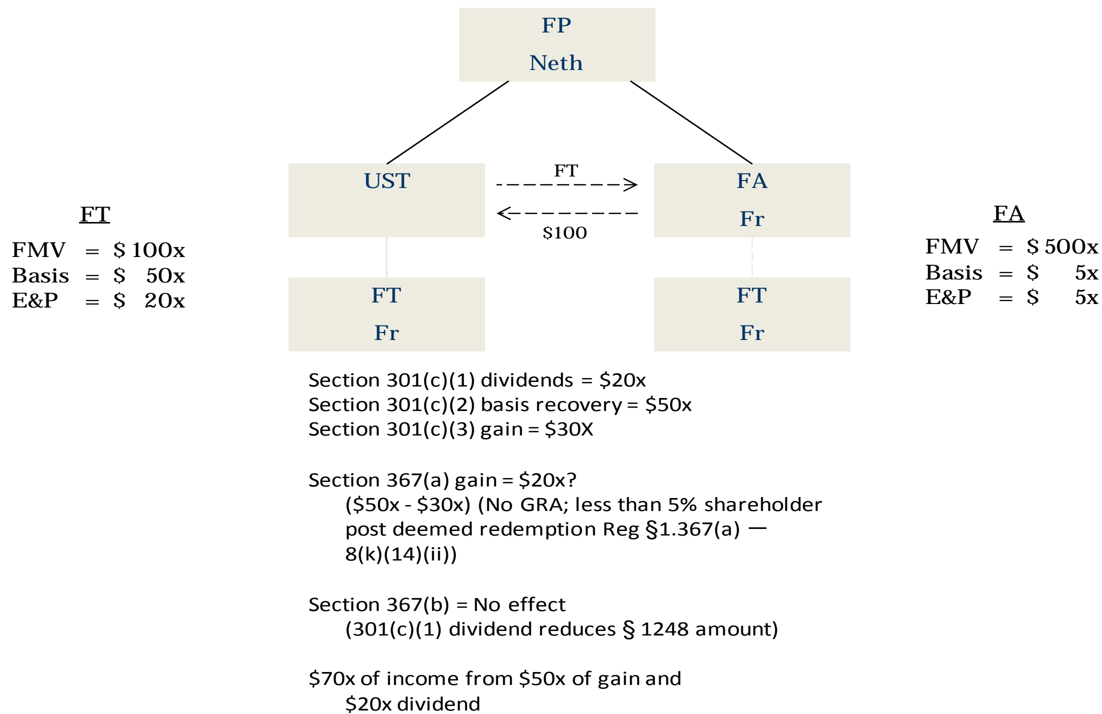
The drafters of the Notice may have believed that allowing the U.S. transferor to enter into a GRA would avoid double taxation and that the problems associated with a GRA-based approach in the past had been solved. As described in the Notice, "the revised GRA regulations substantially reduce the complexity and uncertainty resulting from the filing of a GRA in connection with a deemed Section 351 exchange".[37]

For this solution to avoid potential double taxation, the 5% limitation on the availability of GRA protection should not apply to the deemed Section 351 exchange created by the Section 304 fiction. Applying the 5% limitation in this context is inconsistent with the policy reason for the 1997 amendment to Section 304. As noted above, the reason for the 1997 amendment was to rationalize the operation of Section 304 where the transferor owned no stock of the acquiring corporation. By applying Section 367 in tandem with Section 304 without extending GRA relief to the deemed Section 351 exchange, double taxation may result.

Consider the following example, in which, following the acquisition by FP, a Netherlands corporation, of UST, a US corporation with a French subsidiary (FT), FP wants to transfer FT to its own French subsidiary (FA), and does so by causing UST to sell its FT shares to FA:

[36] T.D. 9585, 77 Fed. Reg. No. 79 (4/24/2012).

[37] Notice 2012-15, 2012-9 IRB 424 (Section 3). We also note that double taxation would be inconsistent with the intent of Section 304, as articulated in the regulatory mandate set forth in Section 304(b)(6): "In the case of any acquisition to which subsection (a) applies in which the acquiring corporation or the issuing corporation is a foreign corporation, the Secretary shall prescribe such regulations as are appropriate in order to eliminate a multiple inclusion of any item in income by reason of this subpart."



UST cannot enter into a GRA with respect to this transaction. While UST may momentarily be treated as owning 5% or more of the stock of the combined FA-FT entity after the deemed Section 351 exchange, it ceases to own any FA stock immediately following the deemed redemption of all of its FA shares. Under Treasury Regulations Section 1.367(a)-8(k)(14)(ii), UST cannot elect to enter into a GRA with respect to the redemption because it does not actually or constructively own 5% or more of the shares of FA. While for purposes of Section 304, UST is deemed to control FA because it is deemed to own the FA shares owned by FP under Section 318, Section 1.367(a)-8(k)(14)(ii) applies the constructive ownership rules of Section 318 as modified by Section 958(b), which prohibits "back-attribution" from a foreign parent to its U.S. subsidiary. Without the opportunity to enter into a GRA, UST is effectively double taxed – it is treated as receiving $70x of income when it has only $50x of gain in the transferred shares. Moreover, it cannot include the extra $20x of income in the basis of any asset.

The same example may also present a Section 367(b)/Section 304 overlap problem. Assume that FT is worth less than 5% of the combined FA-FT entity. In such a case, immediately after the deemed Section 351 exchange of FT for FA shares, UST would not be a 5% shareholder of FA. Under Treasury Regulations Section 1.367(a)-3(b)(1)(i), therefore, UST

does not have to enter into a GRA in order to defer the gain.[38] As the transaction is a tax-free Section 351 exchange, and FT ceases to be a CFC in the exchange, UST must recognize the Section 1248 amount attributable to the shares of FT. In this case, assuming that the Section 301(c)(1) dividend arising from the subsequent redemption reduces that Section 1248 amount, no additional tax would be due. But consider a situation in which the Section 1248 amount in the stock of FT is greater than $100x. In such a case, it would appear that the amount in excess of $100x would also be recognized. Nor could it ever be recovered as a capital loss. The additional income would instead increase the basis of the fictional FA shares issued in the deemed Section 351 exchange, only to vanish in the deemed redemption.

The kinds of double taxation described above are inconsistent with the statutory mandate under Section 304(b)(6):

> "In the case of any acquisition to which subsection (a) applies in which the acquiring corporation or the issuing corporation is a foreign corporation, the Secretary shall prescribe such regulations as are appropriate in order to eliminate a multiple inclusion of any item in income by reason of this subpart."

To avoid these unintended results, we would recommend that regulations promulgated pursuant to the Notice –

- expand eligibility for a GRA by making the determination of whether the transferor satisfies the 5% shareholder requirement without applying the Section 958(b) limitation on Section 318 attribution, making the attribution rules under Section 367 coterminous with the attribution rules under Section 304; and

- limit the potential Treasury Regulations Section 1.367(b)-4 inclusion under Section 1248 to the gain inherent in the transferred shares to avoid any inclusion of "phantom" Section 1248 amounts.

In making the second recommendation above, we are cognizant of the fact that while Section 1248 is gain limited, Section 367(b) is not. However, Section 367(b) was never intended to result in double taxation. We believe a gain limitation ceiling in this context is necessary to

[38] The same Section 958(b) attribution rules apply in this context as well.

avoid the double taxation that could otherwise result if Section 367(b) were applied to a Section 304 transaction.

Reconsideration of the Notice

As described above, the Notice has the potential to result in double taxation. The potential for double taxation exists not only with respect to the fact patterns just described, but more generally by conditioning the deferral of the second level of tax upon the filing of a GRA. First, an effective GRA will not always eliminate double taxation under the Notice because a "triggering event" may occur within the five-year term of the GRA. Second, many taxpayers are likely to fail to enter into a GRA simply because it is not intuitively obvious that Section 367 applies to a Section 304 transaction. Requiring a GRA to avoid double taxation is therefore a trap for the unwary (and, for that reason, may also be more burdensome for the IRS, which may receive many requests for "9100 relief" from affected taxpayers).

Given the potential for double taxation, we believe the IRS and Treasury should consider returning to a modified form of the approach taken in the 2006 Regulations and the 2009 Temporary Regulations. We recognize that Treasury and the IRS may have abandoned the approach of earlier regulations due to the uncertain application of the basis recovery rules, in particular whether basis recovery is limited solely to the shares of the acquiring corporation deemed issued in a Section 304 transaction or also applies to the old and cold shares as well. We also recognize that the 2009 basis recovery regulations, which remain in proposed form, have not eliminated this uncertainty.[39] But it is not apparent that applying Section 367 to an outbound Section 304 transaction is necessary to address these uncertainties.

We believe that the IRS and Treasury can solve the excess basis recovery problem by exercising their regulatory authority to provide special basis recovery rules under Sections 304 and 367 and then reverting back to the general approach of the 2009 Temporary Regulations. Under these special rules, only the basis in the deemed-issued shares may be recovered in the deemed redemption. If this were done, the premise underlying the 2006 Regulations (and

[39] Prop. Regs §§ 1.302-5 and 1.304-2.

continued in the 2009 Regulations) would be restored and there would be no reason to apply Section 367 to the deemed Section 351 exchange created by the Section 304 fiction.

It is also possible that the IRS and Treasury believe that the tax consequences of a cross-border Section 304 transaction should not differ from the tax consequences of an actual Section 351 exchange, followed by an actual redemption of the newly-issued shares in a later transaction. In a Section 304 transaction, however, the transferor is not availing itself of any nonrecognition rule in order to transfer property offshore without current taxation. It is simply selling shares for cash or other property in a taxable transaction. Thus, we do not believe that there is any policy reason to equate a single Section 304 transaction with an actual Section 351 exchange followed by an actual redemption.

We also note that if, pursuant to the Notice, the Section 351 fiction is given effect for purposes of Section 367, the basis of the acquiring corporation's stock in the issuing corporation will be increased by any gain recognized under Section 362 even though no such basis increase would be available to the acquiring corporation in an actual redemption that triggers gain to the transferor under Section 301(c)(3). It is not apparent to us why the acquiring corporation should be entitled to any basis credit under these circumstances. The same basis increase was also available under the 2009 Temporary Regulations in any case in which the transferor took the position that it was entitled to recover basis in the old and cold shares of the acquiring corporation. Our modified approach would eliminate this unwarranted benefit.

In addition to avoiding double taxation and basis duplication, our modified approach would also moot the various complex issues associated with applying two very different regimes, the Section 301(c) waterfall and the Section 367 rules (including the rules applicable to GRAs), to a single Section 304 transaction. It would become unnecessary to determine which set of rules is applied first (as discussed above). The problems associated with the lack of any GRA rule for less than 5% shareholders would disappear. Inadvertent failures to enter into a GRA would no longer loom, and the complex process for monitoring whether the GRA needs to be renewed because of a triggering event would disappear.

Finally, we believe that this simpler approach would not undermine any of the policy objectives of Section 367. The notional Section 351 contribution and redemption construct created by Section 304 was enacted in 1997 to ensure that Section 304 operated appropriately even when the transferor did not directly own any stock of the acquiring corporation. There is no reason to treat the deemed Section 351 fiction in the same manner as an actual Section 351 transaction implicating Section 367. The policy of Section 367(a) – to tax gain on the transfer of property by a U.S. person to a foreign person – and the policy of Section 367(b) – to tax the e&p of CFCs upon repatriation – would both be preserved by application of the rules of Section 301(c).

We therefore request that Treasury and the IRS reconsider the approach adopted in the Notice in light of the issues raised in this Report.