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New Temporary Regulations Fundamentally Alter Operation of §304 and the Application of §1248

by Philip A. McCarty, Esq., Kumar Paul, Esq., and Caroline H. Ngo, Esq.
McDermott, Will & Emery LLP

INTRODUCTION

Section 367 generally is an overlay on the nonrecognition rules of Subchapter C when a foreign corporation is a party to a nonrecognition transaction.[1] As discussed below, certain transactions that are subject to §304(a)(1) are treated as a transfer of stock in a transaction to which §351(a) applies. Before February 2006, there was uncertainty surrounding the interplay between §304(a)(1) and §367. This uncertainty was seemingly put to rest through the issuance of final regulations (the ''2006 Final Regulations'')[2] that, without qualification, provided that a §304(a)(1) transaction was not subject to §367(a)[3] or §367(b).[4] The IRS and Treasury concluded that it was unnecessary to apply §367 to a §304(a)(1) transaction because, in all events, the seller, through a combination of dividend income and gain recognized under §301(c)(3), would realize and recognize an amount of income at least equal to the gain inherent in the transferred stock. This was despite observations by commentators to the contrary that there may be a circumstance where the selling shareholder might take a position that less than all the realized gain in the transferred shares may be recognized when §301(c)(3) gain was implicated.[5] In this circumstance, commentators observed that the selling shareholder may contend that the basis of both the stock of the acquiring corporation that, as discussed below, is treated as being issued in a deemed §351 exchange, and the basis of the existing stock of the acquiring corporation held by the selling shareholder, is available for reduc-

[1] Section 367(a)(1) provides the general rule, with exceptions, that if, in connection with any exchange described in §332, 351, 354, 356, or 361, a U.S. person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain is recognized on the transfer, be considered to be a corporation. Section 367(b) applies to exchanges described in §332, 351, 354, 356, or 361 that involve a foreign corporation and to which §367(a) does not apply. All section references herein are to the Internal Revenue Code of 1986, as amended (''the Code''), and the regulations thereunder, unless otherwise stated.

[2] T.D. 9250, 71 Fed. Reg. 8802 (2/21/2006).

[3] *See* Regs. §1.367(a)-3(a) (''However, if, pursuant to section 304(a)(1), a U.S. person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of such foreign corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not a transfer to a foreign corporation subject to section 367(a).'').

[4] *See* Regs. §1.367(b)-4(a) (''However, if pursuant to section 304(a)(1), a foreign acquiring corporation is treated as acquiring the stock of a foreign acquired corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not an acquisition subject to section 367(b).'').

[5] McCarty, Collins, and Lyon, ''New Proposed Guidance on the Interaction of §§304 and 367 — Issues and Unanswered Questions,'' 34 *Tax Mgmt. Int'l J.* 490 (Sept. 2005).

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tion under §301(c)(2) before any gain is recognized under §301(c)(3).

Almost three years later, in February 2009, the IRS and Treasury issued temporary regulations (the ''Temporary Regulations'') intended to prevent taxpayers from taking such a position.[6] However, as discussed below, the Temporary Regulations do an incomplete job and seemingly do not apply to prevent taxpayers from making the basis recovery argument to their advantage in all cases. As part of the same regulations package, the IRS and Treasury modified the definition of what constitutes gain from a sale or exchange of stock for purposes of §1248(a)[7] to include gain that is recognized on a distribution under §301(c)(3). This latter change to §1248 greatly expands the scope of both §1248 and §304, perhaps arguably beyond their statutory boundaries, particularly when a §304(a)(1) transaction results in gain that is recognized pursuant to §301(c)(3). In short, as discussed below, the Temporary Regulations are potentially far-reaching and, depending on the circumstances, have the effect of altering the basic rules of both §1248 and §304(a)(1).

Part II below provides a discussion of the general rules of §§367, 304, 301, and 1248 insofar as they apply to the Temporary Regulations. Part III contains a discussion of the new Temporary Regulations and their genesis. Part IV discusses open issues that are not clearly addressed by the Temporary Regulations. Part V describes the effective date of the Temporary Regulations. Finally, Part VI contains a brief conclusion.

BACKGROUND

The Temporary Regulations are issued under §§367(a), 367(b), and 1248(a). The Temporary Regulations under §367 apply to certain outbound and foreign-to-foreign transfers of corporate stock in connection with a transaction subject to §304(a)(1).[8] The Temporary Regulations under §1248(a) apply to gain recognized by a shareholder under §301(c)(3) in connection with a distribution of property by a corporation with respect to its stock.

Sections 304 and 301 — In General

Section 304(a)(1) is an anti-bailout provision first enacted as a part of the Internal Revenue Code of 1954. It is intended to prevent taxpayers from extracting earnings and profits (E&P) of a controlled corporation as capital gain by the use of a stock sale to a related corporation. In general, §304(a)(1) provides that if one or more persons are in control of each of two corporations, and, in exchange for property, one of the corporations acquires stock in the other from a controlling shareholder, then such property is treated as a distribution in redemption of the stock of the acquiring corporation.[9] The transaction is tested for treatment as a sale or exchange or for treatment as a dividend under §301 by looking at the selling shareholder's continuing ownership interest in the acquired corporation (referred to as the ''issuing corporation'').[10]

If §301 applies to the distribution, the transaction is statutorily recast such that the selling shareholder is treated as contributing the shares of the issuing corporation to the acquiring corporation for stock of the acquiring corporation in a transaction to which §351(a) applies.[11] The deemed-issued shares are then treated as redeemed by the acquiring corporation for the property received by the selling shareholder.[12]

Under §301(c)(1), the portion of the distribution constituting a dividend is included in gross income.[13] For transactions governed by §304(a), the distribution

[6] T.D. 9444, 74 Fed. Reg. 6824 (2/11/2009). The principal additions of T.D. 9444 are in Regs. §§1.367(a)-9T, 1.367(b)-4T(e), and 1.1248-1T(b).

[7] In general, §1248(a) applies to the sale or exchange of the stock of a controlled foreign corporation (''CFC'') or former CFC by a U.S. shareholder.

[8] The Temporary Regulations under §367 should not affect the treatment of §§304 and 301 outside the context of §367.

[9] Section 304(c)(1) defines ''control'' as the ownership of stock possessing at least 50% of the total combined voting power of all classes of stock entitled to vote, or at least 50% of the total value of shares of all classes of stock. The constructive ownership rules of §318 apply in determining control. *See* §304(c)(2).

[10] Section 302 generally provides that if a corporation redeems its own shares from one of its shareholders, the redemption may be treated as a §301 distribution (and hence, a dividend), rather than as a sale or exchange, if there has been no meaningful reduction in the redeemed shareholder's interest in the corporation. *See* §302(d). Section 304(b)(1) provides that, in testing for dividend equivalence under §302(b), such determination is made by reference to the transferring shareholder's interest in the shares of the issuing corporation.

[11] §304(a)(1). Section 351(a) generally provides that a transferor recognizes no gain or loss if property is transferred to a corporation solely in exchange for its stock and the transferor (or transferors) controls the corporation immediately after the exchange. Because §304(a)(1) treats the transfer of shares of the issuing corporation to the acquiring corporation as a transaction to which §351(a) applies, the transferring shareholder should receive a carryover basis in the fictional acquiring corporation shares equal to its basis in the issuing corporation shares immediately before the transaction. §358(a).

[12] §304(a)(1).

[13] More specifically, §301(c)(1) references §316 for the definition of a dividend. Section 316(a) defines a dividend as a distribution of property: (1) out of the corporation's accumulated E&P; or (2) out of the corporation's E&P of the current taxable year (computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year), without regard to the amount of the E&P at the time the distribution was made.

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is treated as a dividend to the extent of the lesser of the fair market value of the property or the acquiring corporation's E&P.[14] If the fair market value of the property exceeds the acquiring corporation's E&P, such excess is treated as a dividend to the extent of the issuing corporation's E&P.[15] If the property exceeds the amount that constitutes a dividend, the excess is treated as a nontaxable recovery of basis under §301(c)(2) and then as gain from the ''sale or exchange'' of ''property'' under §301(c)(3)(A).[16] For this purpose, the term ''property'' means money, securities, and any other property, but such term does not include stock in the corporation making the distribution.[17] In this connection, in *Cox v. Comr.*,[18] the Tax Court held that §301(c)(3)(A) ''merely recharacterizes'' the gain arising from a distribution as gain from a sale or exchange of property; it does not create a sale, and, in the absence of evidence of an actual or a deemed sale by operation of law, the court determined that no sale occurred for purposes of reporting gain on the installment method under §453.[19]

Sections 367(a) and (b)

Section 367(a) is an anti-deferral provision that is intended to limit the circumstances under which a U.S. person is able to transfer appreciated property, including stock, to a foreign corporation in a nonrecognition transaction. With certain exceptions, §367(a)(1) provides the general rule that a foreign transferee corporation is not treated as a corporation with respect to property transferred by a U.S. person in a transaction that otherwise qualifies as a tax-free transfer. The effect of not treating the foreign transferee as a corporation is that the transaction becomes fully taxable to the U.S. transferor.

With respect to the transfer by a U.S. person of the shares in a foreign corporation to another foreign corporation where the U.S. transferor owns 5% or more of the transferee corporation, the regulations exempt the transfer from the general rule of §367(a)(1), provided the transferor files a five-year gain recognition agreement (GRA) pursuant to Regs. §1.367(a)-8.[20] Under this agreement, the U.S. transferor agrees to recognize the gain that went unrecognized on the initial transfer if the stock (or substantially all of the assets of the transferred corporation) is disposed of in a taxable transaction during the five-year GRA period.[21]

Section §367(b), on the other hand, is designed to preserve for future U.S. taxation the previously untaxed E&P of a foreign corporation accumulated while it was a CFC.[22] In general, if the stock or assets of a CFC are transferred in a nonrecognition transaction to another foreign corporation, the transaction will be given effect as a nonrecognition transaction, provided the transferee corporation is itself a CFC (or becomes a CFC as a result of the transfer) and any §1248 shareholder of the transferred corporation is a §1248 shareholder in the transferee corporation.[23] If, however, the shares or assets of a CFC are transferred

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[14] §304(b)(2)(A).

[15] §304(b)(2)(B).

[16] In computing gain under §301(c)(3), it is not clear whether the taxpayer is entitled to recover his aggregate stock basis under §301(c)(2) before reporting any gain. *See Johnson v. U.S.*, 435 F.2d 1257 (4th Cir. 1971) (aggregate-basis-recovery method in reporting gain under §301(c)(3) rejected in favor of block-for-block method). While *Johnson* indicates that the results from a §301 distribution should derive from the consideration received in respect of each share of stock, it appears that only the basis of shares within the same class of stock on which the distribution is made is relevant for §301(c)(2) and (3). *See Kinch v. Comr.*, 1 T.C.M. 147 (1942) (class-by-class method for distributions under the predecessor of §301); Prop. Regs. §1.302-5(a) (for redemptions under §301(c)(2), pro rata recovery of basis, on a share-by-share basis, to all shares of the redeemed class); Prop. Regs. §1.304-2(a)(4) (for transactions governed by §304, to the extent that §301(c)(2) applies to the redemption of the common stock of the acquiring corporation issued in the deemed §351 exchange, pro rata recovery of basis, share-by-share, to all shares of common stock, including existing shares of common stock).

[17] §317(a).

[18] 78 T.C. 1021 (1982). In *Cox*, individual taxpayers owned 100% of the stock of corporation A and corporation B. In 1974, the taxpayers sold all their stock in A to B in exchange for five notes payable over five years. After the sale, the taxpayers constructively owned 100% of both corporations. The taxpayers elected to report gain from the sale in their 1974 tax returns using the installment method. The Tax Court held that §304(a)(1) recast the stock sale as a contribution to capital followed by a redemption distribution to which §301 applies and therefore no ''sale'' occurred for purposes of §453. The Tax Court further held that §301(c)(3)(A) only characterizes the income from a distribution in excess of earnings and profits and a shareholder's stock basis; it does not provide a sale. Because all distributions are to be accounted for identically, petitioners must report their entire gain in 1974.

[19] *See also* Rev. Rul. 72-87, 1972-1 C.B. 274, *obsoleted* by T.D. 8734, 1997-2 C.B. 109. In the revenue ruling, the IRS concluded that a distribution treated as gain from the sale or exchange of property under §301(c)(3)(A) was distinguishable from income derived from an actual sale of property, and therefore Regs. §1.1441-2(a)(3), relating to characterization of income derived from the sale of property, was not applicable.

[20] *See* Regs. §1.367(a)-3(b)(1)(i) and (ii).

[21] Regs. §1.367(a)-8(e)(3) and former Regs. §1.367(2)-8T(e)(3).

[22] A CFC is a foreign corporation of which more than 50% of the total combined voting power of all classes of stock or of the value of the corporation's stock is owned, directly or through attribution, by U.S. shareholders on any day during the corporation's taxable year. For Subpart F income purposes, a U.S. shareholder is a U.S. person who owns, directly or by attribution, at least 10% of the total combined voting power of all classes of a foreign corporation's stock that is entitled to vote.

[23] In general, a §1248 shareholder is a U.S. person that at any time within the preceding five years has owned at least 10% of the voting power in the CFC. If no inclusion is required, Regs.

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to another foreign corporation that is not a CFC or, if it is a CFC, any §1248 shareholder of the transferred corporation is not a §1248 shareholder of the transferee corporation, then, pursuant to Regs. §1.367(b)-4, the §1248 shareholder of the transferred corporation is required to include in income immediately before the transfer, as a dividend, its share of the §1248 E&P of the corporation whose shares or assets are transferred.[24]

Sections 1248 and 964(e)

Section 1248, which was enacted in 1962, seeks to ensure that a CFC's accumulated (but untaxed) E&P are taxed at ordinary income rates (as opposed to capital gain rates) when such E&P are indirectly repatriated to the United States through certain dispositions of the CFC stock. Section 1248(a) provides that if a §1248 shareholder sells or exchanges stock in a CFC, any gain recognized on the transaction is included in income as a dividend to the extent of the selling shareholder's share of the §1248 E&P attributable to the shares sold. Under §1248(c)(2), if §1248(a) applies to the sale or exchange of the stock of an upper-tier CFC, the E&P attributable to the shares sold includes the E&P of any lower-tier CFCs that were accumulated during the period of time the selling shareholder held its shares. Section 1248 applies only to U.S. persons. The principles of §1248, however, are applied to a CFC's sale of stock in another CFC by the provisions of §964(e).

Under §964(e), if a CFC sells or exchanges stock in another foreign corporation, gain recognized on the sale or exchange is included in the gross income of the CFC as a dividend to the same extent that it would have been so included under §1248(a) if such CFC were a U.S. person. The portion of gain on the sale of stock in a lower-tier CFC that is treated as a dividend generally falls within the definition of Subpart F income. Section 954(c)(1)(A) defines foreign personal holding company income (FPHCI) for purposes of Subpart F to include dividend income. However, §954(c)(6) excludes from the definition of FPHCI dividends received from a related CFC to the extent considered paid out of the payor's general limitation E&P. In Notice 2007-9,[25] the IRS, in interpreting §954(c)(6), provided that any gain on the sale of stock that is recharacterized as a dividend under §964(e) is excluded from FPHCI. The recharacterization of gain realized by the selling CFC as a dividend facilitates the ability to access the taxes paid by the lower-tier CFC for purposes of claiming indirect foreign tax credits.

TEMPORARY REGULATIONS

Origins of Temporary Regulations Under §367

The Temporary Regulations under §367(a) and (b) emanate from the 2006 Final Regulations, which made §367(a) and (b) wholly inapplicable to deemed §351 exchanges that arose in certain transactions that implicated §304(a)(1).[26] The Preamble to the 2006 Final Regulations cited complexity, uncertainty, and the risk of multiple income inclusions as the reasons for exempting §304(a)(1) transactions from the application of §367.[27] However, the basic premise of the "exemption" was founded on the belief that a U.S. person through the normal operation of §304 would recognize income (dividend or §301(c)(3) capital gain) at least equal to the built-in gain in the stock of the issuing corporation. Thus, in the view of the IRS and Treasury, there was no need for §367 also to apply.

Commentators, however, did caution that, in certain cases, the amount of income recognized under §304(a) may not equal or exceed the transferor's inherent gain in the stock of the issuing corporation,[28] as illustrated by the following example.

Example 1. Domestic corporation, USP, wholly owns F1 and F2, both foreign corporations. The F1 stock has a $0x basis and a fair market value of $100x. The F2 stock has a $100x basis and a fair market value of $100x. Neither F1 nor F2 has current or accumulated E&P. In a transaction subject to §304(a)(1), USP sells the F1 stock to F2 for $100x cash.

The question raised by Example 1 is whether USP may use its basis in its existing F2 stock ($100x) for purposes of §301(c)(2) to avoid recognizing gain, or whether USP is limited to its basis in the F2 stock that is treated as issued in the deemed §351(a) exchange (such basis would be $0x under §358 — the basis of the F1 stock that USP is treated as transferring to F2 for F2 stock in the deemed §351(a) exchange). If USP could use its basis in its existing F2 stock under

§1.367(b)-4(d) provides special rules that preserve the potentially lost §1248 amount by attributing E&P of the acquired corporation to the shares of stock received in the exchange. *See also* Regs. §1.1248-8; §1.367(b)-13.

[24] Regs. §1.367(b)-4(b).

[25] 2007-1 C.B. 401.

[26] See fns. 3, and 4 and accompanying text.

[27] T.D. 9250, 71 Fed. Reg. 8802, 8803 (2/21/06).

[28] See fn. 5, above.

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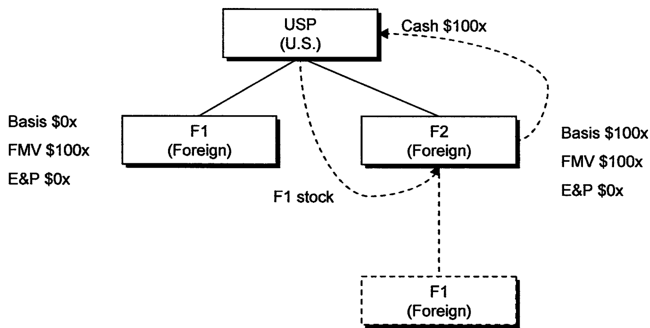


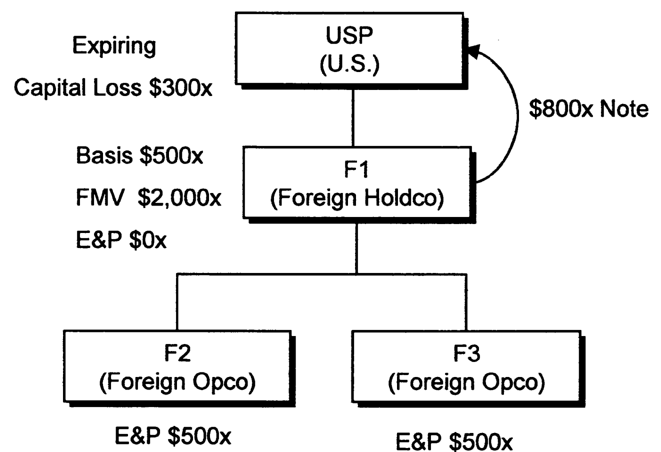
§301(c)(2), USP may avoid gain on the redemption of the deemed-issued F2 shares.

In connection with the 2006 Final Regulations, the IRS and the Treasury maintained that current law did not provide for the recovery of the basis of any shares other than the basis of the F2 stock deemed to be received by USP in the §351(a) exchange, although there existed some guidance to the contrary in connection with basis recovery in the redemption context.[29] Therefore, in the view of the IRS and Treasury, USP would recognize $100x of gain under §301(c)(3) (the built-in gain on the F1 stock), and would continue to have a $100x basis in its existing F2 stock. The Preamble to the 2006 Final Regulations indicated that the basis recovery issue would be addressed as part of a larger project regarding the recovery of basis in all redemptions treated as §301 distributions. Regulations on the subject of recovery of basis were recently proposed,[30] and support the position taken by the commentators in certain circumstances that basis of existing shares of the F2 stock could be used for purposes of §302(c)(2) to avoid recognizing gain.[31] It may well be that the proposed basis recovery regulations prompted the IRS and Treasury to issue the Temporary Regulations as a backstop against taxpayers claiming a full basis recovery to avoid the recognition of §301(c)(3) gain.

Origins of the Temporary Regulations Under §1248

The 2006 Final Regulations made no reference to §1248. The Preamble to the Temporary Regulations does not explain why the IRS and Treasury decided to link §§301(c)(3) and 1248 at this particular juncture. Section 1248 was enacted more than 40 years ago. Anecdotal information suggests that the Temporary Regulations under §1248 may have been conceived to address transactions that the IRS and Treasury viewed as inappropriately using §301(c)(3) as a first step in the repatriation of foreign earnings. An illustration of a simplified potential transaction follows.

Example 2. USP, a domestic corporation, owns 100% of F1, which, in turn, owns 100% of each of F2 and F3. F1, F2, and F3 are foreign corporations. F1 has a fair market value of $2,000x, and USP's basis in its F1 shares is $500x. USP has expiring capital losses of $300x. F1 is a holding company and has no accumulated E&P. Each of F2 and F3 is an operating company with E&P of $500x. On June 30 of year 1, F1 distributes its note of $800x as a §301 distribution to USP.



Because F1 has no E&P, upon the distribution of the note, USP will have a §301(c)(2) recovery of basis of $500x and a §301(c)(3) gain amount of $300x. Before the Temporary Regulations, the §301(c)(3) gain would be capital gain. The U.S. tax on the $300x of §301(c)(3) capital gain would be sheltered by USP's $300x capital loss. Following the distribution, distributions from F2 and F3 to F1 could be used by F1 to repay the principal on the F1 note without income to USP. The distributions from F2 and F3 would increase F1's E&P but such E&P would not be reduced when F1 repays the principal on the F1 note. The transaction effectively allows USP to receive a distribution from F1 without having to treat it as a dividend. (F1 also could have borrowed $800x from a bank, distributed it to USP, and then paid off the loan with dividends from F2 and F3.)

Regs. §1.367(a)-9T

New Regs. §1.367(a)-9T(a) provides generally that if, pursuant to §304(a)(1), a U.S. person is treated as

[29] See fn. 16, above.

[30] REG-143686-07, 74 Fed. Reg. 3509 (1/21/09).

[31] *See* Prop. Regs. §1.304-2(a)(4) ("To the extent that section 301(c)(2) applies to the redemption of the common stock of the acquiring corporation issued in the deemed section 351 exchange, the amount distributed in such redemption shall be applied to reduce the adjusted basis of each share of common stock *directly held* or *deemed held* by the transferor on a pro rata, share-by-share basis." [Emphasis added.]). *See also* Prop. Regs. §1.304-2(c) *Ex. 2.*

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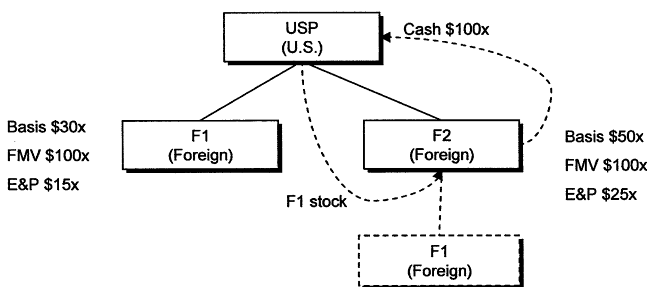
transferring stock of a domestic or foreign issuing corporation to a foreign acquiring corporation in exchange for stock of such foreign corporation in a deemed §351 exchange, the deemed §351 exchange is not a transfer to a foreign corporation subject to §367(a). However, pursuant to Regs. §1.367(a)-9T(b), if the distribution received by the U.S. person in redemption of the foreign acquiring corporation stock deemed issued in the deemed §351 exchange is subject to §301, and if the distribution would otherwise be applied against and reduce (in whole or in part), pursuant to §301(c)(2), the basis of stock in the foreign acquiring corporation held by the U.S. person other than the stock deemed issued to the U.S. person in the deemed §351 exchange, the U.S. person must recognize gain under §367(a)(1).

The amount of gain recognized is equal to the amount by which the gain realized by the U.S. person with respect to the transferred stock exceeds the amount of the distribution that is treated as a dividend under §301(c)(1).[32] Further, the transferor cannot avoid gain recognition under the Temporary Regulations by entering into a GRA with respect to the deemed §351 exchange.

Regs. §1.367(a)-9T may be illustrated by the following example.

Example 3. USP owns F1 and F2. Each of F1 and F2 has a fair market value of $100x. USP's basis in the F1 stock is $30x and its basis in the F2 stock is $50x. F1 has E&P of $15x, and F2 has E&P of $25x. USP sells the shares of F1 to F2 for $100x. On the sale, USP realizes gain of $70x (i.e., $100x – $30x). Under §304, USP is treated as contributing the shares of F1 to F2 in a deemed §351 transaction in exchange for shares of F2 that are immediately redeemed for $100x cash.



Under §304(b)(2), USP has a dividend of $25x from F2 and $15x from F1 for a total dividend of $40x. Next, USP has a recovery of stock basis of $30x representing the basis of the F2 stock deemed issued. Under the Temporary Regulations, USP also recognizes §301(c)(3) gain of $30x (i.e., $100x – $25x – $15x – $30x). Before the Temporary Regulations, USP may have taken the contrary position that the remaining $30x represents a nontaxable reduction of USP's basis in its existing F2 shares.[33] If this result were to follow, USP would be able to shift a portion of the gain attributable to the F1 shares to F2 without having to enter into a five-year GRA.

Although the Temporary Regulations are not entirely clear, a taxpayer could either report the above transaction as resulting in a §301(c)(3) gain to USP of $30x or, if it takes the position that it is entitled to reduce its basis in its existing F2 stock, under Regs. §1.367(a)-9T the taxpayer must recognize gain under §367(a)(1) equal to the difference between the amount realized on the transfer of the shares (here, $70x) less the amount treated as a dividend under §304(b)(2) (i.e., $40x) or $30x. Said another way, the amount of gain to be recognized under Regs. §1.367(a)-9T is equal to the amount of the distribution that is applied against basis in USP's existing F2 stock. Under either way of reporting the transaction, USP is required to report additional income of $30x.

Pursuant to Regs. §1.367(a)-9T(c) and (d), the increase to the basis of the stock of the foreign acquiring corporation by reason of gain recognized by the U.S. person is taken into account before determining the consequences of the redemption of the shares of the foreign acquiring corporation. In Example 3 above, the basis of the F1 stock in the hands of F2 is increased by $30x under §362, and the basis of the F2 stock deemed received by USP in exchange for the F1 stock would be increased by $30x under §358 before determining the consequences of the redemption of such stock under §301.

Regs. §1.367(b)-4T(e)

New Regs. §1.367(b)-4T(e)(1) reaffirms the 2006 Final Regulations providing that the general rule of Regs. §1.367(b)-4(b)[34] does not apply to a deemed §351 exchange resulting from a §304(a)(1) transaction. However, Regs. §1.367(b)-4T(e)(2) provides that, notwithstanding the general rule of Regs. §1.367(b)-4T(e)(1), Regs. §1.367(b)-4(b) applies to a deemed §351 exchange to the extent the distribution

[32] Regs. §1.367(a)-9T(b).

[33] Indeed, under the recently proposed basis recovery regulations, USP would have a nontaxable recovery of basis and no §301(c)(3) gain. Specifically, USP would have dividend income of $40x. Next, USP would have a pro rata (based on FMV) recovery of basis of $60x of the F2 common stock directly held and deemed held. After the redemption transaction and a deemed recapitalization provided in the proposed regulations, USP's basis in half of its F2 common stock would be $0x, and USP's basis in the other half of its F2 common stock would be $20x. *See* Prop. Regs. §1.304-2(a)(4).

[34] See fns. 4 and 24 and accompanying text.

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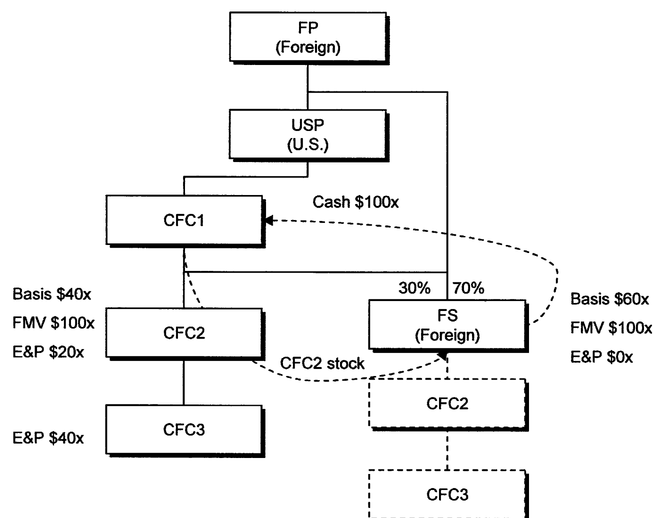
received by the exchanging shareholder in redemption of the stock deemed issued by the foreign acquiring corporation in the §304(a)(1) transaction is applied against and reduces, pursuant to §301(c)(2), the adjusted basis of stock of the foreign acquiring corporation held by the exchanging shareholder before the transaction.

The Temporary Regulations illustrate their potential application under §367(b) by the following example.

Example 4. FP, a foreign corporation, wholly owns USP, a domestic corporation. USP wholly owns CFC1, and CFC1 wholly owns CFC2. CFC2 wholly owns CFC3. CFC1 owns 30% of the outstanding stock of FS, a foreign corporation. FP owns the remaining 70% of the outstanding stock of FS. The CFC2 stock has a $40x basis and a fair market value of $100x. The FS stock held by CFC1 has a $60x basis and a fair market value of $100x. As of December 31, year 1, CFC2 has $20x of §1248 E&P, CFC3 has $40x of §1248 E&P, and FS has $0x E&P. On December 31, year 1, CFC1 sells the CFC2 stock to FS for $100x cash. FS is not a CFC either before or after the sale of the CFC2 stock.



Because CFC1 wholly owns CFC2 before the transaction and is treated, under the constructive ownership rules of §318(a), as indirectly owning 100% of the CFC2 stock after the transaction, pursuant to §304(a)(1) CFC1 is treated as contributing the CFC2 stock to FS in a deemed §351 exchange in exchange solely for $100x of FS stock. FS is then treated as redeeming the newly issued stock for $100x cash.

There are two ways to analyze the transaction. Under the approach preferred by the IRS and Treasury,

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under §304, CFC1 would realize a dividend of $20x (representing CFC2's E&P), a nontaxable §301(c)(2) recovery of basis of $40x (representing the hypothetical basis in the shares deemed redeemed), and a §301(c)(3) gain amount of $40x (i.e., $100x – $20x – $40x). If, as discussed below, new Regs. §1.1248-1T(b) applies for purposes of §964(e), this §301(c)(3) gain with respect to the CFC2 stock would be recharacterized as a dividend. Pursuant to §1248(c)(2), the §1248 E&P attributable to the CFC2 stock would include the §1248 E&P of CFC3 (or $40x). Thus, on the §304 sale of the CFC2 stock to FS, CFC1 would recognize total dividend income of $60x.

Alternatively, if CFC1 takes the position that part of the distribution received by it in redemption of the FS stock issued in the deemed §351 exchange is applied against and reduces the basis of the existing FS stock held by CFC1 under §301(c)(2), then the general rule of Regs. §1.367(b)-4(b) is applicable. Here, because CFC2 is a CFC at the start of the transaction but is not a CFC at the end of the transaction, CFC1 is required to include in income the §1248 amount attributable to the shares of CFC2. For this purpose, the §1248 amount includes CFC3's E&P of $40x.[35] Thus, in total, as in the first alternative analysis, CFC1 recognizes dividend income of $60x, $20x from the application of §304(a)(1) to the sale of CFC2 to FS and $40x under Regs. §1.367(b)-4(b).

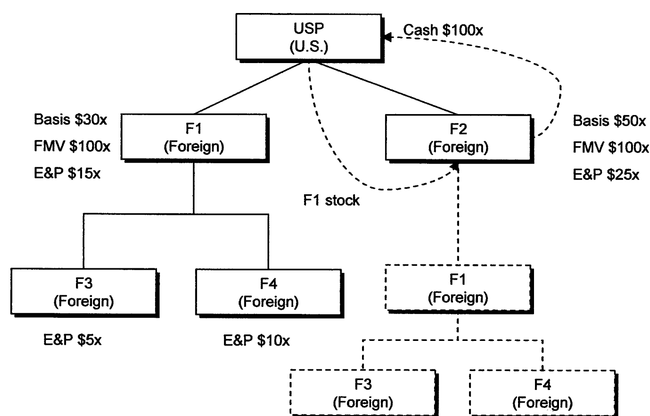
Notwithstanding that in both alternatives CFC1 recognizes the same dividend amount of $60x, there may be a significant difference in the Subpart F consequences. In general, dividends received by one CFC from another CFC constitute Subpart F income to the recipient CFC under §954(c)(1)(A). There are exclusions that may apply, including the high-tax exception of §954(b)(4)[36] and the same-country exception of §954(c)(3).[37] If neither of these exceptions applies, the dividend may also be excludible under the CFC look-through rule of §954(c)(6). Section 954(c)(6) is sufficiently broad to exclude most dividends paid by one CFC to a related CFC from Subpart F income. However, unless extended by statute, §954(c)(6) is set to expire at the end of 2009.[38]

Assuming that the high-tax exception of §954(b)(4) and the CFC look-through rule of §954(c)(6) are not applicable to CFC1's $60x dividend amount,[39] in the first alternative where Regs. §1.367(b)-4 does not apply, all $60x would constitute Subpart F income currently taxable to USP under §951(a). By contrast, in the second alternative where Regs. §1.367(b)-4 does apply, only $20x of the income would be Subpart F income subject to current taxation. The remaining $40x would not be Subpart F income to USP pursuant to Regs. §1.367(b)-4(c), which provides that any §1248 amount that is included as a deemed dividend under the general rule of Regs. §1.367(b)-4(b) is not included in the Subpart F income of the recipient CFC.

Regs. §1.1248-1T

New Regs. §1.1248-1T(b) provides that "gain recognized by a shareholder under section 301(c)(3) in connection with a distribution of property by a corporation with respect to its stock shall be treated as gain from the sale or exchange of stock of such corporation." The Temporary Regulations provide no illustration of the operation of this rule. However, the following example seeks to demonstrate the potential interaction of new Regs. §1.1248-1T(b) and §304.

Example 5. Assume the same facts as Example 3 above, except that F1 also owns F3 and F4, and that F3 and F4 have E&P of $5x and $10x, respectively.



As previously discussed under Example 3 above, USP's sale of F1 stock to F2 for $100x will result in either §301(c)(3) gain of $30x (i.e., $100x – $25x – $15x – $30x) or, under Regs. §1.367(a)-9T, gain on sale of the F1 stock of $30x. Pursuant to Regs. §1.1248-1T(b), either view of the transaction is governed by §1248(a), resulting in a further recharacterization of F1's $30x gain as a dividend to the extent of F3's and F4's §1248 E&P.

[35] *See* Regs. §1.367(b)-2(c).

[36] The high-tax exception to Subpart F income applies if the income is subject to an effective rate of tax greater than 90% of the U.S. rate.

[37] The same-country exception to Subpart F income applies to dividends received by one CFC from a related CFC that is organized in the same country as the first CFC and has a substantial part of its assets used in a trade or business located in such same country.

[38] §954(c)(6)(C).

[39] The same-country exception of §954(c)(3) does not apply to a deemed dividend amount under §964(e). *See* §964(e)(2).

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Example 5 illustrates how new Regs. §1.1248-1T(b) changes the way §304(b)(2) operates when, as illustrated in Example 5, the issuing corporation has foreign subsidiaries that are CFCs. Before the Temporary Regulations, in applying §304(b)(2), a taxpayer would look to the E&P of *only* the acquiring corporation and, if necessary, to the E&P of the issuing corporation in determining the amount that is recharacterized as a dividend. With the modification to §1248, if the §304(a)(1) transaction results in a §301(c)(3) gain amount, a taxpayer will now look to the E&P of foreign subsidiaries of the issuing corporation that are CFCs to determine the total amount that is recharacterized as a dividend.[40] The new rules take into account heretofore untapped sources of E&P to increase the amount of §301(c)(3) gain that can be characterized as ordinary income in a §304(a)(1) transaction.[41]

The §301(c)(3) gain recharacterization brought about by Regs. §1.1248-1T(b) is not limited to §304(a)(1) transactions. In fact, it does not require the occurrence of an actual or deemed sale or exchange transaction to trigger its application. It would even apply to the facts described in Example 2 above, involving §301(c)(3) gain recognized by a shareholder in connection with a straight distribution of property by a corporation with respect to its stock.

In many, if not most, cases, Regs. §1.1248-1T(b) will be beneficial to taxpayers. In Example 5 above, the characterization of §301(c)(3) gain as dividend income by the operation of §1248 should generally facilitate USP reducing the U.S. tax on such dividend income with any foreign tax credits associated with such income. This is an outcome that generally would not be possible if all of the §301(c)(3) gain were characterized as capital gain.

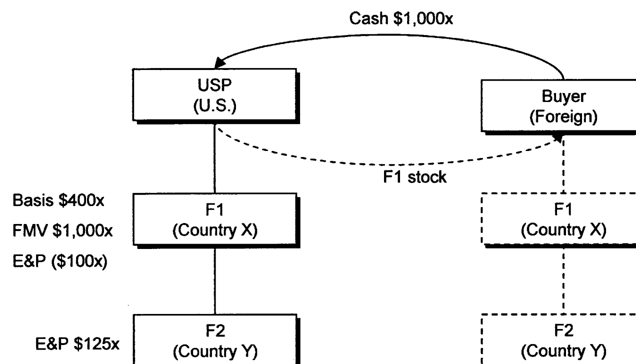
OPEN ISSUES

The Temporary Regulations raise a number of issues that will require further guidance and clarification. The following discussion highlights a few of those issues.

Treatment of Deficits in E&P

One open issue relates to the treatment of deficits in E&P in the application of §1248 to §301(c)(3) gain. As discussed above, any gain recognized by a U.S. shareholder on the sale of stock of a CFC is recharacterized as a dividend under §1248(a) to the extent of the previously untaxed E&P that is attributable to the shares that are sold or exchanged. Further, as discussed above, if a U.S. shareholder sells the shares of an upper-tier CFC, which owns the shares of a lower-tier CFC, the E&P attributable to the shares that are sold include the E&P of any lower-tier CFC that were accumulated during the selling shareholder's holding period for the stock. Under §1248(c)(1), the E&P of any foreign corporation are determined under rules substantially similar to the rules applicable to a domestic corporation.[42] With certain exceptions, the regulations provide that E&P are computed in accordance with the provisions of Regs. §1.964-1, which defines E&P to include deficits in E&P.[43] Thus, deficits in E&P are taken into account in computing the overall amount of gain on the sale of stock in a CFC that is recharacterized as a dividend under §1248(a).

Example 6. USP, a domestic corporation, owns all the shares of F1, a country X corporation, which, in turn, owns all the shares of F2, a country Y corporation. F1 has a fair market value of $1,000x, and USP's basis in its F1 shares is $400x. F1 has an E&P deficit of ($100x), and F2 has positive E&P of $125x. USP sells its shares in F1 to an unrelated foreign person ("Buyer"). Buyer does not make a §338 election with respect to its acquisition of the F1 stock.



The amount of USP's $600x gain subject to recharacterization as a dividend under §1248(a) is $25x, which represents the sum of F1's E&P deficit of ($100x) and F2's positive E&P of $125x. The issue raised by Regs. §1.1248-1T(b) is how deficits in E&P are to be taken into account in connection with §301(c)(3) gain that is subject to §1248(a). The issue may be illustrated by the following series of examples.

[40] The Preamble to the Temporary Regulations indicates that the gain recognized by USP will be treated as recognized with respect to the F1 stock transferred in the deemed §351 exchange.

[41] Technically, the §301(c)(3) gain in Example 5 is with respect to the deemed-issued shares of the acquiring corporation, F2. However, the §1248 E&P attributable to these deemed-issued shares would include the E&P of F3 and F4. *See* Regs. §1.1248-8.

[42] Regs. §§1.1248-2(d)(1), -3(b)(1).

[43] Regs. §1.964-1(a) ("[T]he earnings and profits (or deficit in earnings and profits) of a foreign corporation for its taxable year shall be computed substantially as if such corporation were a domestic corporation . . . .").

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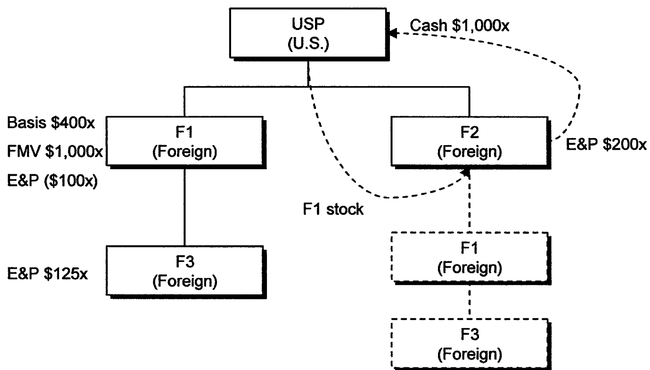
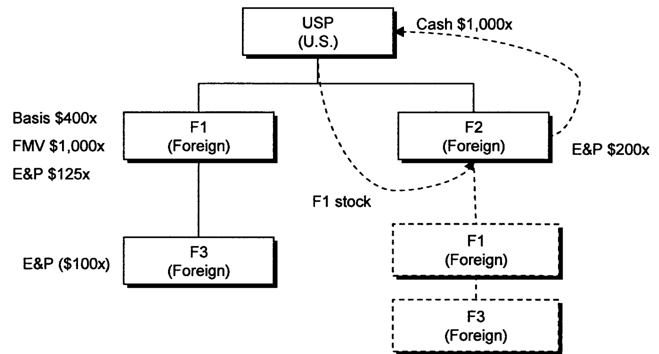
Example 7. USP, a domestic corporation, owns all of the stock of F1 and F2, and F1 owns all of the stock of F3. F1, F2, and F3 are foreign corporations not subject to U.S. tax. USP has owned, directly or indirectly, all of the shares of F1, F2, and F3 since their respective formations. F1 has a fair market value of $1,000x, and USP's basis in its F1 shares is $400x. F2's E&P are $200x, F1 has an E&P deficit of ($100x), and F3 has positive E&P of $125x. USP sells the shares of F1 to F2 for $1,000x in a transaction to which §304(a)(1) applies.



On these facts, pursuant to §304(a)(1), USP is treated as transferring its F1 shares to F2 in exchange for shares in F2 in a transaction to which §351(a) applies, and F2 is then treated as having redeemed the shares for $1,000x. Under §304(b)(2), USP recognizes a dividend from F2 of $200x. The question is whether USP has any additional dividend amount with respect to the F1 stock and, if so, how much.

Before the Temporary Regulations, USP would recognize no dividend with respect to the F1 shares, would have a nontaxable §301(c)(2) recovery of basis of $400x, and would recognize a §301(c)(3) capital gain amount of $400x (i.e., $1,000x – $200x – $400x). Presumably, the effect of Regs. §1.1248-1T(b) is to recharacterize USP's §301(c)(3) amount as a dividend to the extent of the §1248 E&P attributable to the F1 shares, i.e., $25x (i.e., ($100x) + $125x).

While the above result seems to follow from a "straightforward" application of the Temporary Regulations, the result is less clear if the facts of Example 7 are modified such that F1 has positive E&P of $125x and its wholly owned subsidiary, F3, has an E&P deficit of ($100x).



As in Example 7, on the sale for $1,000x, under §304(b)(2), USP has a deemed dividend from F2 of $200x. The question here is what E&P with respect to the F1 shares is taken into account for purposes of determining USP's remaining dividend amount. More specifically, the issue is whether F1's positive E&P of $125x is offset by F3's E&P deficit of ($100x). Before the Temporary Regulations, it was clear that USP would realize an additional dividend as determined under §304(b)(2) of $125x (i.e., the amount of F1's positive E&P), a §301(c)(2) recovery of basis of $400x, and a §301(c)(3) capital gain amount of $275x (i.e., $1,000x – $200x – $125x – $400x). It is unclear whether the Temporary Regulations are intended to modify that result such that F3's deficit in E&P of ($100x) should be taken into account to reduce USP's dividend with respect to F1 by $100x.[44]

The result in Example 7 becomes even more muddled if F1 has both non-§1248 E&P and a §1248 E&P deficit.

Example 8. USP, a domestic corporation, owns all of the stock of F1 and F2, and F1 owns all of the stock of F3. F1, F2, and F3 are foreign corporations not subject to U.S. tax. F1 has a fair market value of $1,000x, and USP's basis in its F1 shares is $400x. F2's E&P is $200x. F1 has non-§1248 E&P of $150x[45] and a §1248 E&P deficit amount of ($100x). Thus, aside from §1248, F1 has positive E&P of $50x. F3 has §1248 E&P of $125x. USP sells the shares of F1 to F2 for $1,000x in a transaction to which §304(a)(1) applies.

Pursuant to §304(b)(2), USP has a dividend from F2 of $200x. USP presumably also realizes a dividend from F1 of $50x (i.e., measured by F1's overall E&P amount). USP next has a nontaxable §301(c)(2) recovery of basis of $400x, and a §301(c)(3) gain amount of $350x (i.e., $1,000x – $200x – $50x –

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[44] If F3's deficit in E&P of ($100x) is to be taken into account to reduce USP's §1248 dividend amount, there would be a corresponding increase in USP's capital gain income.

[45] As discussed, §1248 applies to recharacterize a U.S. shareholder's gain on the sale or exchange of CFC stock as a dividend to the extent of the selling shareholder's share of the untaxed E&P of the CFC that accumulated while the selling shareholder held the stock, including, for this purpose, any tacked holding period under §1223. Any E&P that accumulated before the U.S. shareholder's holding period are not taken into account in applying §1248(a).

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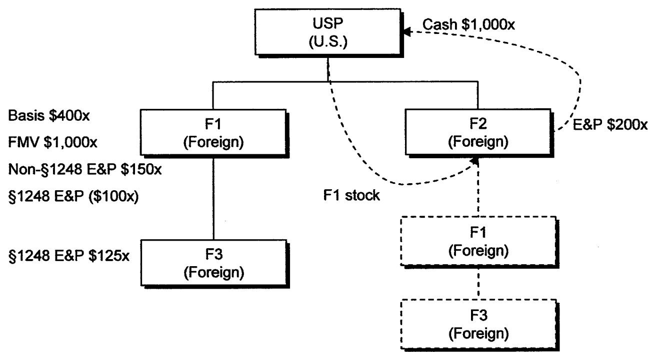
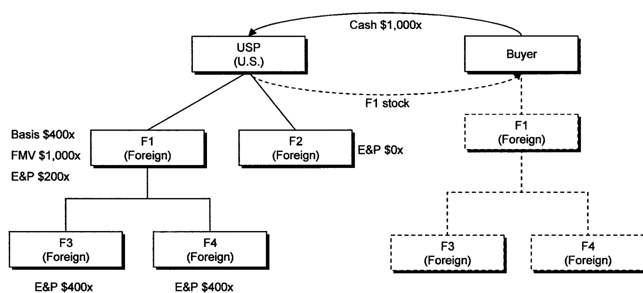


$400x). The §301(c)(3) gain is subject to recharacterization as a dividend under Regs. §1.1248-1T(b). The open issue is whether the §1248 amount is $125x, i.e., the full amount of F3's §1248 E&P, or $25x, i.e., the §1248 E&P attributable to the F1 shares (F3's §1248 E&P of $125x reduced by F1's §1248 E&P deficit amount of ($100x)).

Application of §304(b)(2) to E&P of Issuing Corporation

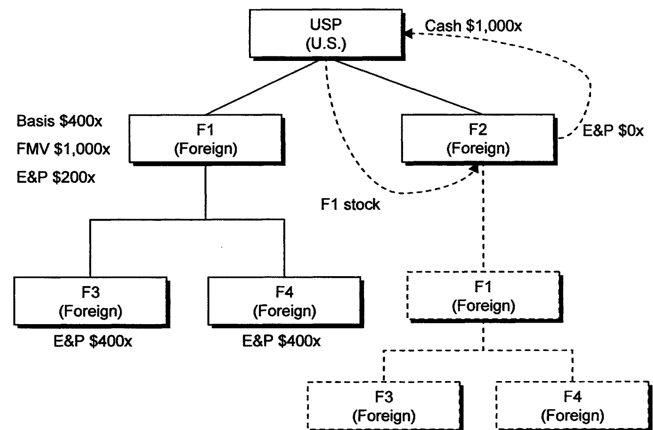
Depending on the facts, the expansion of §1248 to include §301(c)(3) gain can produce some anomalous results that are difficult to rationalize from a policy perspective. These results may be illustrated as follows.

Example 9. USP, a domestic corporation, owns all the stock of F1 and F2. F1 has a fair market value of $1,000x, and USP's basis in the F1 stock is $400x. F1 owns F3 and F4. F1, F2, F3, and F4 are foreign corporations not subject to U.S. tax. F1's E&P are $200x, F2's E&P are $0x, F3's E&P are $400x, and F4's E&P are $400x.



If USP were to sell the shares of F1 to an unrelated third party for $1,000x and recognize $600x of gain (i.e., $1,000x – $400x), the $600x of gain would be recharacterized as a dividend under §1248(a) and (c)(2). Because the total E&P of F1, F3, and F4 exceed $600x, for foreign tax credit purposes the source of the $600x deemed dividend amount would be a dividend of $120x from F1, $240x from F3, and $240x from F4.[46]

Example 10. If, alternatively, USP were to sell the shares of F1 to F2 in a §304(a)(1) transaction at a time when F2 has no E&P, under §304(b)(2) USP would recognize a dividend from F1 of $200x, a §301(c)(2) nontaxable recovery of basis of $400x, and a §301(c)(3) gain amount of $400x.



If §1248(a) applies to the $400x §301(c)(3) gain amount and no adjustment is made to the deemed dividend from F1, the $400x of gain would be recharacterized as a $400x dividend — $200x from F3 and $200x from F4.

In both Examples 9 and 10, USP recognizes $600x of income from the disposition of its F1 shares. Further, in both examples, the $600x of gain is recharacterized as a dividend under §1248(a). However, for foreign tax credit purposes, the source of the dividend differs. As discussed, in Example 9 the deemed dividend is treated as paid $120x from F1, $240x from F3, and $240x from F4. By contrast, in Example 10 the deemed dividend is treated as paid $200x from F1, $200x from F3, and $200x from F4. It is not readily apparent why the differences between these two examples make sense from a policy perspective.

Determination of Current Year E&P and Treatment of Current Year Distributions in Computing §1248 E&P

In the most straightforward of cases where a U.S. parent makes a midyear sale of 100% of the stock of a CFC to an unrelated purchaser and the purchaser does not make a §338 election, the determination of the §1248 E&P attributable to the shares that are sold is difficult at best. Under the so-called "simple method" of Regs. §1.1248-2, total year-of-sale E&P

[46] *See* Regs. §1.1248-1(d)(3), (d)(4) *Ex. (2)*.

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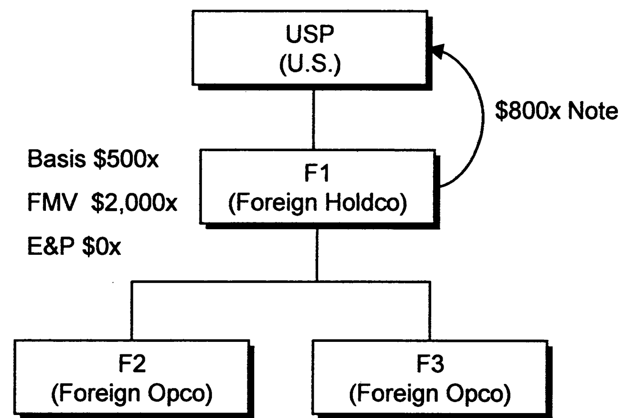
(reduced by year-of-sale distributions) are prorated over the year on a daily basis.[47] In the normal case, the proration of year-of-sale E&P as reduced by year-of-sale dividends has the potential for creating pitfalls and opportunities for the seller.[48]

An open issue in applying Regs. §1.1248-1T(b) is determining when the §301(c)(3) "sale" occurs for purposes of determining the §1248 E&P. Does the deemed sale occur on the date of the distribution that gives rise to the §301(c)(3) gain or does the deemed sale occur at year-end when the §301(c)(3) gain amount is finally determined?

Example 11. USP, a calendar-year domestic corporation, owns 100% of F1, which, in turn, owns 100% of each of F2 and F3. F1, F2, and F3 are calendar-year foreign corporations. F1 has a fair market value of $2,000x, and USP's basis in its F1 shares is $500x. F1 is a holding company and has no accumulated E&P. On June 30 of year 1, F1 distributes its note of $800x as a §301 distribution to USP.

[47] Regs. §1.1248-2(e)(2).

[48] *See* Rev. Rul. 71-388, 1971-2 C.B. 314; TAM 199906035.



If F1 has no E&P for the year, USP will have a §301(c)(2) recovery of basis of $500x and a §301(c)(3) gain amount of $300x. Regs. §1.1248-1T(b) applies to treat the §301(c)(3) amount as a sale or exchange for purposes of §1248(a). However, USP will not know whether and how much of the $800x distribution constitutes a §301(c)(3) gain until year end. As noted, in computing the §1248 E&P attributable to the F1 stock, USP will take into account F2's and F3's E&P. If the deemed sale for purposes of applying §1248 occurs on June 30 (i.e., the date of the distribution), F2's and F3's total E&P for the year would be prorated, and USP would take into account

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only the current year E&P through June 30. However, if the deemed sale occurs at year-end (i.e., when the §301(c)(3) gain amount is finally determined), there would be no need to prorate F2's and F3's current year E&P. F2's and F3's full year E&P would be taken into account in determining the §1248 E&P attributable to the F1 shares.

General Observations on Regs. §1.1248-1T(b)

Aside from wishing to see a clarification of the mechanical application of Regs. §1.1248-1T(b), we have serious reservations whether the regulation is even valid. Section 1248(a) applies to gain recognized on the sale or exchange of the stock of a CFC. Section 301(c)(3) gain is clearly not gain that arises upon a sale or exchange of stock. To the contrary, as discussed, §301(c)(3) is strictly a characterization provision.[49] No shares of stock are actually surrendered or deemed surrendered. We note that the last sentence of §1248(a) states that, for purposes of applying §1248(a), "a United States person shall be treated as having sold or exchanged any stock if, under any provision of this subtitle, such person is treated as realizing gain from the sale or exchange of such stock." Earlier regulations, quite properly, limited this provision to the receipt of a distribution that is treated as being in exchange for stock under §302(a) (relating to distributions in redemption of stock) or §331(a) (relating to distributions in complete liquidation of a corporation).

In contrast, §301(c)(3) gain is not treated as gain from the sale or exchange of stock. Rather, §301(c)(3) characterizes the amount as "gain from the sale or exchange of *property*." (Emphasis added.) For purposes of applying §301(c)(3), the term "property" in §317(a) is expressly defined to exclude stock in the corporation making the distribution. So, by definition, §301(c)(3) gain is not gain from the sale or exchange of stock. In our view, Regs. §1.1248-1T appears to be without statutory basis, and no explanation of the basis for the regulation was provided in the Preamble to the Temporary Regulations. Further, the extension of §1248(a) to §301(c)(3) gain that arises in connection with a §304(a)(1) transaction as illustrated in Examples 5, 7, 8, and 10, above, has the effect of modifying the statutory mandate of §304(b)(2) that the only E&P to be taken into account in determining the amount of a dividend are the E&P of the acquiring corporation and the E&P of the issuing corporation. Nothing in the statute would support looking at or taking into account E&P of lower-tier subsidiaries. We appreciate the IRS's and Treasury's concern about transactions as illustrated in Example 2, but that Example does not justify fundamentally altering §§1248(a) and 304(b)(2) through the promulgation of Regs. §1.1248-1T(b). Moreover, even if the IRS and Treasury believe they have the authority to include §301(c)(3) gain within the purview of §1248(a), we question the need to publish a temporary regulation with an immediate effective date. None of this was explained in the Preamble to the Temporary Regulations.

Nonapplication of Regs. §1.367(b)-4T(e) to Intragroup §304 Transactions

As discussed, based on the language of the Preamble, the IRS and Treasury appear to hold to their belief that, in a §304(a)(1) transaction, a taxpayer may recover its basis only in the shares of the acquiring corporation that are deemed to be exchanged for the shares in the issuing corporation before the recognition of §301(c)(3) gain. Nonetheless, rather than expressly prohibiting a taxpayer from recovering the basis of both the shares that are deemed issued in the transaction plus its basis in any pre-existing shares in the acquiring corporation before the recognition of §301(c)(3) gain, the approach of the Temporary Regulations is to set forth an additional set of rules that comes into play if the taxpayer were to take the position that it is also entitled to recover the basis in the pre-existing shares of the acquiring corporation. The additional rules are intended to ensure that the taxpayer recognizes the same amount of income that would be recognized under the IRS's and Treasury's approach. However, as illustrated in the following example, the approach of the Temporary Regulations does not appear to catch a taxpayer in all instances where the taxpayer may take the position that it is entitled to recover the basis in its pre-existing shares of the acquiring corporation before the recognition of §301(c)(3) gain.

Example 12. USP, a domestic corporation, owns all the stock of FH, a foreign holding company. FH owns F1 and F2. F1 owns F3 and F4. Each of F1, F2, F3, and F4 is a foreign corporation not subject to U.S. tax. FH has a basis in its F1 shares of $200x and a basis in its F2 shares of $800x. F1 and F2 have no E&P. F3 and F4 each has E&P of $400x. FH sells the shares of F1 to F2 for $1,000x.

Under the IRS's and Treasury's preferred approach, upon the sale FH realizes a nontaxable §301(c)(2) amount of $200x and a §301(c)(3) gain amount of $800x. The question is whether the §301(c)(3) amount is gain from the sale or exchange of stock for pur-

[49] See fn. 18 and accompanying text.

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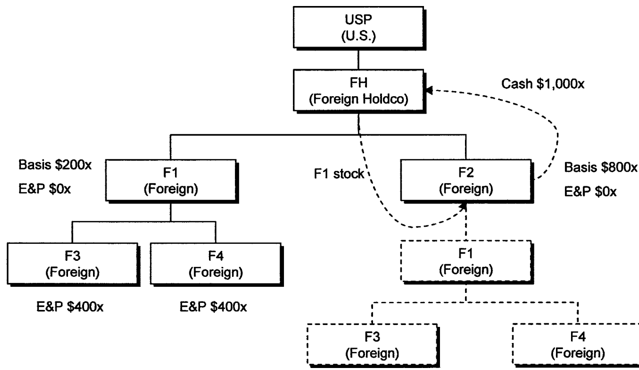

poses of §964(e). If not, then all $800x of gain presumably should be taxable to USP as Subpart F passive basket income. By contrast, if FH's §301(c)(3) gain is treated as gain from the sale or exchange of stock for purposes of §964(e), the full $800x §301(c)(3) amount would be recharacterized as a dividend under the principles of §1248(a) and (c)(2) by treating FH as a U.S. shareholder and looking to the E&P of F3 and F4. So long as §954(c)(6) is in effect,[50] this amount would be excluded from USP's Subpart F income.[51] However, even if §954(c)(6) were not in effect and the $800x were treated as Subpart F income, the $800x of deemed dividend likely would be general limitation E&P to USP for purposes of §904(d).

Alternatively, the Temporary Regulations do not seem to preclude USP from taking the position that FH should treat $200x as a §301(c)(2) recovery of basis with respect to the F1 shares and treat $800x as a §301(c)(2) recovery of basis with respect to its preexisting F2 shares. If USP were to take such a position, Regs. §1.367(a)-9T would not apply to trigger gain because there is no transfer by a U.S. person to a foreign corporation. Similarly, although Regs. §1.367(b)-4T(e)(2) appears to apply, it would not result in the inclusion of any amount in income under Regs. §1.367(b)-4(b) because F1 is a CFC both before and after the transaction and USP is a §1248 shareholder of F1 both before and after the transaction.[52] The Temporary Regulations appear to give USP a choice in its treatment of the transaction with very different end results.

EFFECTIVE DATE

The Temporary Regulations apply to transfers or distributions, as applicable, occurring on or after February 10, 2009,[53] and expire on or before February 10, 2012.[54]

CONCLUSION

The Temporary Regulations under §367 reaffirm the conclusion reached in the 2006 Final Regulations that §367 should not apply to §304(a)(1) transactions. With respect to the application of §1248(a) to §301(c)(3) gain, the Temporary Regulations are far-reaching, to say the least. In this connection, we question the validity of Regs. §1.1248-1T, particularly with respect to §304 transactions. Notwithstanding our views, the Temporary Regulations require a whole different analysis of §304(a)(1) transactions when the issuing corporation has lower-tier CFCs. Taxpayers will now be required to analyze the consequences of taking into account the E&P of lower-tier CFCs of the issuing corporation if the transaction results in any gain under §301(c)(3).

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[50] As noted above, for calendar-year CFCs §954(c)(6) is scheduled to sunset at the end of 2009. *See* §954(c)(6)(C).

[51] *See* Notice 2007-9, 2007-1 C.B. 401.

[52] *See* Regs. §1.367(b)-4(b).

[53] Regs. §§1.367(a)-9T(f), 1.367(b)-4T(f), 1.1248-1T(g).

[54] Regs. §§1.367(a)-9T(g), 1.367(b)-4T(g), 1.1248-1T(h).

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