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VIEWPOINTS

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Recently, the IRS and Treasury had a significant policy decision to make: Should section 909[1] (relating to ''split'' foreign taxes) apply to section 901(m) (relating to covered asset acquisitions)? In that instance, the government wisely backed away from the application of section 909 to section 901(m) because, although conceptually compelling and technically correct, it would have heaped complexity on top of complexity and made tax administration and compliance virtually impossible.[2]

In light of that very wise policy decision, it is unclear why the government (*in that same week*) decided, in Notice 2012-15,[3] to reverse its long-standing position that section 367(a) and (b) should generally *not* apply to section 304(a)(1) exchanges and to now require one (*if not two*) gain recognition agreements for certain of those exchanges. While arguably technically correct, that approach is clearly the wrong policy decision. In an area that is already steeped in complexity and notable for its inadvertent foot faults,[4] the requirement that section 367(a) and (b) should apply to all section 304(a) exchanges will make tax administration and compliance even more difficult for all but the most well-advised taxpayers. The possibility of missed GRAs and less than perfect GRAs will increase exponentially, leading to confusion, uncertainty, increased audit activity, and possible double taxation and litigation. For these reasons, we strongly urge the government to reconsider that policy reversal and to quickly back away from Notice 2012-15.

To best understand the significance of the policy reversal that Notice 2012-15 represents and the complexity that it infuses into an already complex area of U.S. tax law, this article first provides an overview of section 367(a) and (b) and section 304. It then examines the regulations that were proposed in 2005 and the final regulations that were issued in 2006, wherein the government reached the very reasoned decision that section 367(a) and (b) should not apply to section 304(a)(1) exchanges. The article then reviews the temporary regulations that were issued in 2009 that made a slight modification to the general rule that section 367(a) and (b) should not apply to section 304(a)(1) exchanges. Next, this article reviews Notice 2012-15 and the new GRA requirements it imposes regarding section 304(a)(1) exchanges. Finally, this article concludes that the IRS and Treasury should abandon the approach taken in Notice 2012-15 and issue the 2009 temporary regulations in final form.

Background

Section 367(a)

Section 367(a)(1) generally provides that if a U.S. person transfers property to a foreign corporation in a specified nonrecognition exchange,[5] the foreign corporation will not be considered to be a corporation for

[1]Unless otherwise indicated, section references herein are to sections of the Internal Revenue Code of 1986, as amended (the ''code''). References to Treas. reg. section are to the Treasury regulations promulgated under the code.

[2]T.D. 9577 (Feb. 14, 2012).

[3]2012-9 IRB 424, *Doc 2012-2851*, *2012 WTD 29-43*.

[4]*See, e.g.*, Greenwald and Ladocsi, ''Manna From Heaven: LMSB Provides Important Relief for 'Available on Request' GRAs,'' *Journal of International Taxation*, Jan. 2011.

[5]Generally, an exchange described in IRC sections 332, 351, 354, 356, or 361 (a ''nonrecognition exchange'').

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determining the extent to which the U.S. person recognizes gain on that transfer. Treating the foreign transferee as not a corporation for U.S. federal income tax purposes in that manner generally makes the coverage of the nonrecognition provisions (to the extent premised upon corporate status of the constituent parties) inapplicable, thus generally rendering the exchange fully taxable. Congress adopted that approach to prevent the avoidance of U.S. tax on transfers of appreciated property outside of the United States.[6]

The code and the regulations, however, provide exceptions to that general rule. Of relevance to the issue at hand, Treas. reg. section 1.367(a)-3 provides exceptions to the general rule of taxability of IRC section 367(a)(1) for some transfers by a U.S. person of stock or securities of a corporation to a foreign corporation, generally requiring, however, that the U.S. person file a gain recognition agreement and other related documents (collectively a GRA) under the provisions of Treas. reg. section 1.367(a)-8 (the GRA regulations) in order for those exceptions to apply. When a GRA is so provided, the GRA regulations further provide that the covered gain may, subject to specific exceptions, be required to be recognized on the occurrence of a subsequent ''triggering'' event (potentially including, of relevance, a redemption of stock received in the original nonrecognition exchange).[7]

Section 367(b)

Section 367(b)(1) provides for potential income recognition for some nonrecognition exchanges[8] not subject to section 367(a)(1). Under the provisions of section 367(b), a foreign corporation involved in a transaction to which its provisions apply will be considered to be a corporation except to the extent provided in regulations that are necessary or appropriate to prevent the avoidance of U.S. federal income taxes.[9] One of the principal underlying policies of section 367(b) is the preservation of the potential application of section 1248 upon a subsequent disposition of covered stock.[10] In that regard, Treas. reg. section 1.367(b)-4(b)(1) generally requires a section 1248 shareholder that is a party to a nonrecognition exchange subject to section 367(b) to include in income its section 1248 amount for the subject foreign corporation at the time of the exchange, if as a result of the transaction section 1248 shareholder status or CFC status is lost.

Section 304

Section 304 was enacted to prevent withdrawals of corporate earnings by controlling shareholders in transactions that otherwise result in capital gains treatment.[11] In that regard, section 304(a)(1) generally provides that, for purposes of sections 302 and 303, if one or more persons are in control of each of two corporations, and in return for property (including money) one of the corporations (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from the persons so in control, then that property will be treated as a distribution in redemption of the acquiring corporation stock. So treated, these transactions often result in potential section 301 dividend treatment for the transferor equal to the amount received in the exchange.

Section 304 further provides that to the extent that a stock acquisition covered by section 304(a)(1) is treated as a distribution to which section 301 applies, the transferor and the acquiring corporation are treated as if:

- the transferor transferred the stock of the issuing corporation to the acquiring corporation in a transaction to which section 351(a) applies; and
- the acquiring corporation then redeemed the stock it is treated as having issued in the section 351 transaction.

Further, because the acquiring corporation is treated as receiving the stock of the issuing corporation in a transaction to which section 351 applies, the transferor's basis in the stock of the issuing corporation carries over to the acquiring corporation under section 362.

The 2005 and 2006 Regulations

The IRS and Treasury on May 25, 2005, issued proposed, and on February 21, 2006, finalized, regulations providing that section 367(a) and (b) will not apply to certain transfers of stock of a foreign or domestic corporation to a foreign acquiring corporation to which section 351 applies by reason of section 304(a)(1).[12]

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[6]S.R. Rep. No. 169, Vol. 1, 98th Cong. 2d Sess., at 360 (Apr. 2, 1984).

[7]Treas. reg. section 1.367(a)-8(n)(1).

[8]Section 367(b)(1) adds section 355 to the list of nonrecognition exchanges to which its provisions potentially apply.

[9]As discussed above, the status of the constituent party foreign corporation as a corporation for U.S. federal income tax purposes is generally required for the nonrecognition exchange to qualify for nonrecognition treatment.

[10]H.R. Rep. No. 94-658, 94th Cong., 1st Sess., at 242 (Nov. 12, 1975). Section 1248 generally recharacterizes gain recognized by a U.S. person (a section 1248 shareholder) that owns 10 percent or more of the total combined voting power of a controlled foreign corporation (as defined in section 957) upon the disposition of the stock of that CFC as dividend income to the extent of the earnings and profits attributable to that stock (the section 1248 amount).

[11]*See* H.R. Rep. No. 2014, 105th Cong. 1st Sess., at 465 (June 24, 1997).

[12]Reg 127740-04 (70FR30036). T.D. 9250, 2006-1 C.B. 588. Before these regulations, the application of section 367(a) and (b) to some section 304(a)(1) transactions involving a foreign corporation had been addressed in various published guidance. *See, e.g.,* Rev. Rul. 91-5 (1991-1 C.B. 114) (holding that section 367 applied to the deemed contribution to capital of the issuing corporation stock under prior law because section 367(c)(2) resulted

(Footnote continued on next page.)

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In the preamble to each of those regulations, the IRS and Treasury announced that they had determined that the policies underlying section 304 (prevention of withdrawals of corporate earnings through the use of transactions that resulted in capital gains treatment), section 367(a) (prevention of U.S. tax avoidance through transfers of appreciated property to a foreign corporation), and section 367(b) (preservation of the potential application of section 1248) were preserved notwithstanding that section 367(a) and (b) were not applied to the deemed section 351 exchange resulting from the section 304(a)(1) transaction.

In reaching that conclusion, the government noted that in a section 304(a)(1) transaction, the U.S. person, in most or all cases, recognizes an amount of income that is at least equal to the inherent gain in the stock of the issuing corporation without the application of section 367. The government also noted that the application of section 367(a) to a section 304(a)(1) transaction might, in some instances (when the U.S. transferor fails to file a GRA or files a GRA that is subsequently triggered), result in a total income inclusion greater than the fair market value of the stock that was transferred.[13] Finally, the government noted that the application of section 367(a) and (b) to a section 304(a)(1) transaction results in administrative burdens for both the IRS and taxpayers.[14]

The preamble to the 2006 regulations described the result of the potential overlap of sections 367 and 304(a)(1) as ''considerable complexity, uncertainty and the risk of multiple income inclusions,'' and stated that eliminating that overlap would ''serve the interests of sound tax administration.''[15] For those reasons, the 2006 regulations provide that section 367 will not apply to deemed section 351 exchanges resulting from section 304(a)(1) transactions.[16]

in the stock transfer constituting a section 351 exchange). *See also* the preamble to the proposed regulations regarding redemptions taxable as dividends (REG-150313-01, 67 FR 64331 (Oct. 18, 2002)) in which the IRS and Treasury indicated that some international provisions may apply to section 304(a)(1) transfers, and provided as an example the application of section 367 and the regulations thereunder to a deemed section 351 exchange involving foreign corporations.

[13]*Id.*

[14]*Id.*

[15]T.D. 9250, 2006-1 C.B. 588.

[16]All that said, the government noted that in some cases, depending on how the basis recovery and distribution rules are applied, the amount of income recognized under section 304(a) may not equal or exceed the transferor's inherent gain in the stock of the issuing corporation. Specifically, Treasury and the IRS recognized that when the E&P were insufficient to result in dividend treatment under section 304(a)(1), taxpayers were taking the position that basis in the preexisting shares of the acquiring corporation stock, along with the basis of the stock treated as issued in the deemed section 351 exchange, was available to reduce the gain otherwise realized. *See* the discussion below regarding the 2009 temporary regulations addressing this discrete issue.

The 2009 Temporary Regulations

On February 11, 2009, the IRS and Treasury issued temporary regulations that modified slightly the treatment of section 304 transactions provided by the 2006 regulations.[17] As foreshadowed by the 2006 regulations (see footnote 17 *supra*), the 2009 temporary regulations addressed the narrow issue of the appropriate basis recovery in transactions potentially subject to the overlap of sections 367 and 304(a)(1).

While the carveout of section 367 from section 304(a)(1) transactions implemented by the 2006 regulations was, as described above, premised in part on the determination that generally the income recognized by the transferor in those transactions would equal or exceed the built-in gain in the transferred stock, Treasury and the IRS were concerned that taxpayers were taking positions inconsistent with that view. Specifically, the government was concerned that taxpayers were using preexisting basis in ''old and cold'' acquiring corporation stock to offset gain that would otherwise be recognized on a section 304(a)(1) transaction. In that regard the government cited the following example:

> P, a domestic corporation, owns all the stock of F1 and F2, both of which are foreign corporations. P has an adjusted basis of $0 in its F1 stock and $100 in its F2 stock. P's stock of F1 and F2 each has a fair market value of $100. Neither F1 nor F2 has current or accumulated E&P. P sells its F1 stock to F2 for its fair market value of $100 in a transaction subject to section 304(a)(1). Under section 304(a)(1), the transaction is treated as if P had transferred its F1 stock to F2 in a transaction to which section 351(a) applies, and then F2 had redeemed its stock deemed issued in the transfer.[18]

Regarding that example, the government noted that, under its understanding of the position being advanced by taxpayers, P would not recognize income or gain as a result of the transaction, because the adjusted basis of both the F2 stock that is treated as being issued in the deemed section 351 exchange *and* the adjusted basis of the F2 stock already held by P before the transaction is available for reduction under section 301(c)(2). The government noted its belief that then-current law did not provide for the recovery of the basis of any shares other than the F2 stock treated as received by P in the deemed section 351(a) exchange (which would take a basis equal to P's basis in the F1 stock), and that it was continuing to study that basis recovery issue as part of a larger project, but that it

[17]T.D. 9444, 2009-1 C.B. 2009.

[18]*Id.*

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had determined that it was necessary to revise the final 2006 regulations to deal with this potential issue before the completion of that project.

In that regard, the 2009 temporary regulations retain the general rule that the deemed section 351 exchange will not be a transfer to a foreign corporation subject to section 367(a).[19] However, those regulations provide an exception to that rule if a U.S. person reduces, under section 301(c)(2), in whole or in part, its basis in its stock of the foreign acquiring corporation other than the stock treated as issued to the U.S. person in the deemed section 351 exchange.[20] In that case, the U.S. person recognizes gain under section 367(a)(1) equal to the amount by which the gain realized by the U.S. person on the deemed section 351 exchange exceeds the amount of the distribution that is treated as a dividend under section 301(c)(1) and included in gross income of the U.S. person.[21] Further, the 2009 temporary regulations provide that a U.S. person cannot avoid that gain by entering into a GRA.[22]

Thus, in the hypothetical transaction discussed above, if any amount of the distribution received by P in redemption of the F2 stock was applied against the basis of the F2 stock held by P before the transaction, then, under the 2009 temporary regulations, P would recognize $100 of gain under section 367(a)(1) on its transfer of the F1 stock to F2 in the deemed section 351 exchange. And, importantly, under those regulations, P would not be able to avoid that gain by entering into a GRA.

The 2009 temporary regulations made similar revisions to the 2006 final regulations under section 367(b). Specifically, those regulations provide that Treas. reg. section 1.367(b)-4(b) applies to a deemed section 351 exchange only to the extent the distribution received by the exchanging shareholder in redemption of the stock deemed issued by the foreign acquiring corporation is applied against and reduces (under section 301(c)(2)), the basis of stock of the foreign acquiring corporation held by the exchanging shareholder other than the stock deemed issued to the exchanging shareholder in the deemed section 351 exchange.[23]

Notice 2012-15

After consideration of the comments received and the underlying policies of section 367(a) and (b), the IRS and Treasury reversed course and announced in Notice 2012-15 that they now believe that the amount of income taken into account as a result of a section 304 transaction should *not* affect the application of section 367 to the deemed section 351 exchange arising under that transaction.[24] Accordingly, the IRS and Treasury *now* believe it appropriate to revise the approach to the interaction of sections 367 and 304 under the 2006 regulations and the 2009 temporary regulations by providing that section 367(a) and (b) *will apply fully* to the deemed section 351 exchange arising under a section 304(a)(1) transaction.[25] In that regard, the IRS and Treasury propose to amend the section 367 regulations to provide that the section 351 exchange that is deemed to occur in a section 304(a)(1) exchange (*as well as the deemed section 302/301 distribution*) is now fully subject to section 367(a) and (b).[26]

Application of Section 367(a)

Under the approach advocated by Notice 2012-15, to the extent that under section 304(a)(1) a U.S. person is treated as transferring stock of a domestic or foreign corporation to a foreign acquiring corporation in a deemed section 351 exchange, the transfer would be subject to section 367(a) and the regulations thereunder, including the exceptions described in Treas. reg. section 1.367(a)-3(b) and (c)(1), as applicable.[27] Thus, a transferor in a section 304 exchange that is a U.S. person *must* enter into a GRA under Treas. reg. section 1.367(a)-8 in order to avoid the recognition of gain under section 367(a)(1) on such transaction[28] — *even though the appropriate amounts of dividend income and gain may have already been recognized by operation of section 304.*

If the U.S. person enters into a GRA regarding the deemed section 351 exchange (in order to avoid a second level of tax under section 367(a)), then the deemed redemption of the stock of the foreign acquiring corporation deemed issued to the U.S. person under section 304(a)(1) would constitute a disposition of the transferee foreign corporation stock under Treas. reg. section 1.367(a)-8.[29] As a result, the deemed redemption would be treated as a triggering event within the meaning of Treas. reg. section 1.367(a)-8(j). However, that deemed redemption would not be treated as a triggering event if the U.S. person enters into a *second* GRA covering the redemption.[30] So, for two deemed transactions (with one undoing the other in a nanosecond), the government has determined that, conceptually, two

[19]2009 temp. Treas. reg. section 1.367(a)-9T(a).

[20]2009 temp. Treas. reg. section 1.367(a)-9T(b).

[21]*Id.*

[22]*Id.*

[23]Temp. Treas. reg. section 1.367(b)-4T.

[24]Notice 2012-15, Preamble. Regarding this change, the government notes its view that for a transfer of stock by a U.S. person to a foreign corporation, the revised GRA regulations should substantially reduce the complexity and uncertainty resulting from the filing of a GRA in connection with a deemed section 351 exchange. As discussed further below, the authors do not subscribe to this view.

[25]*Id.*

[26]*Id.*

[27]Notice 2012-15, at section 4.01.

[28]*Id.*

[29]*Id., citing* Treas. reg. section 1.367(a)-8(b)(1) and (n)(1).

[30]*Id.*

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GRAs should be filed and that this process is neither overly complex nor unduly burdensome.[31]

Application to Section 367(b)

To the extent that under section 304(a)(1) a foreign acquiring corporation acquires the stock of a foreign corporation in a deemed section 351 exchange, that exchange is now also subject to section 367(b) and the regulations thereunder, including Treas. reg. section 1.367(b)-4.[32] Thus, for example, if a deemed section 351 exchange results in the loss of status as a section 1248 shareholder, the exchanging shareholder must include in income as a deemed dividend the section 1248 amount attributable to the foreign stock that is transferred in such exchange.

Example

Notice 2012-15 provides the following example.

Facts

USP, a domestic corporation, owns all of the outstanding stock of FT and FA, each a foreign corporation. USP's tax basis in the FT stock is $50, and the FT stock has an FMV of $100. The section 1248 amount regarding the FT stock is $10. FA has earnings and profits of $200, fully available for distribution. In a transaction to which section 304(a)(1) applies, USP transfers all of its FT stock to FA in exchange for $100 of cash.

Application of Section 304(a)(1)

Under section 304(a)(1), USP and FA are treated as if USP transferred its FT stock to FA in a section 351(a) exchange solely for FA stock, and then FA redeemed such stock in exchange for $100 of cash. The redemption of the FA stock deemed issued by FA to USP is treated as a distribution to which section 301 applies. The entire distribution is treated under section 301(c)(1) as a dividend as coming out of the E&P of FA.

Application of Section 367(a)

Treas. reg. section 1.367(a)-3(b) applies to USP's deemed transfer of the FT stock to FA in exchange for FA stock. As a result, USP recognizes gain on the transfer under section 367(a)(1) unless USP enters into a GRA regarding the transfer. However, the deemed redemption by FA of the stock it is deemed to issue to USP would constitute a triggering event regarding that GRA. This redemption will not constitute a triggering event, however, if USP enters into a new GRA that includes appropriate provisions to account for the redemption. In that case, the requirement that an initial GRA be filed for the deemed section 351 exchange and a new GRA be filed by reason of the deemed redemption will be satisfied if USP files a single GRA.

Application of Section 367(b)

Treas. reg. section 1.367(b)-4 applies to USP's transfer of the FT stock to FA in exchange for FA stock. Treas. reg. section 1.367(b)-4(b)(1)(i) does not, however, apply to require USP to include in income the $10 section 1248 amount regarding FT stock because each of FA and FT is a CFC as to which USP is a section 1248 shareholder immediately after the exchange.

Effective Date

The regulations described in Notice 2012-15 will apply to section 304 transactions occurring on or after February 10, 2012.[33] So the rules of Notice 2012-15 apply *now* — if USP transfers F1 to F2 in a section 304(a)(1) exchange and fails to enter into a GRA that takes into account both the deemed section 351 exchange and deemed section 302 redemption, it will be required to recognize gain under section 367(a).[34]

Comments Requested/Conclusion

The IRS and the Treasury request comments on the regulations proposed to be issued under Notice 2012-15.[35] While arguably a technical reading of the rules, Notice 2012-15 is, as recognized by the 2006 and 2009 regulations, the wrong policy decision. In an area that is already steeped in complexity and notable for its inadvertent foot faults, the requirement that section 367(a) and (b) should apply to all section 304(a) transactions will make tax administration and compliance

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[31]That said, in Notice 2012-15, the government announced that:

> Generally, the requirement to file an initial GRA for the deemed section 351 exchange and a new GRA by reason of the deemed redemption will be satisfied if the U.S. person that transfers the stock in the deemed section 351 exchange files a single GRA with respect to the entire section 304 transaction.

While this is less troubling than the need to file two GRAs, the other issues regarding the proposed change discussed herein fully remain.

[32]Notice 2012-15, at section 4.02.

[33]Notice 2012-15, at section 6.

[34]In section 6 of Notice 2012-15, the government states:

> Pending the issuance of the regulations described in this notice, the IRS will not challenge reasonable interpretations of the application of section 367(a) and (b) to deemed section 351 exchanges and related deemed redemptions completed on or after February 10, 2012, including reasonable interpretations of the GRA rules as applied to such deemed section 351 exchanges and deemed redemptions under the principles of Treas. reg. section 1.367(a)-8(k)(14)(ii) and (iii).

It is unclear what is covered by this reasonable interpretation provision. For example, could a taxpayer, before the issuance of the regulations proposed by the notice, take the position that section 367(a) and (b) do not apply to a deemed section 351 exchange, and therefore not file a GRA? Or is this reasonable reliance limited to interpretations of the more technical requirements covered by the notice? It appears that the latter view may be the better view, but the government certainly should clarify.

[35]Notice 2012-15, at section 7.

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even more difficult for all but the most well-advised taxpayers. The possibility of missed GRAs and less than perfect GRAs will increase exponentially, leading to confusion, uncertainty, increased audit activity, and possible double taxation and litigation. Said differently, *in a world of limited tax resources, section 367(a) and (b) should not apply to section 304(a)(1) exchanges.* Recognizing all of that, Treasury and the IRS came to the correct result in the 2006 and 2009 regulations. For these reasons, we strongly urge the government to reconsider this policy reversal, to quickly back away from Notice 2012-15, and to finalize the 2009 temporary regulations. We urge other stakeholders to respond to the government's request for comments and to likewise urge the government to reinstate the better-reasoned approach of the 2006 and 2009 regulations. ◆

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