A Note From the Editor-in-Chief

GRA Now Necessary for All Outbound Code Sec. 304 Transactions

A common transaction used for restructuring the ownership of foreign subsidiaries is for a U.S. parent (“USP”) to sell the stock of one foreign subsidiary to another foreign subsidiary. For U.S. tax purposes, the transaction is taxed—not as a sale of stock—but as a distribution from the acquiring subsidiary and then from the target subsidiary pursuant to Code Sec. 304. Under new Notice 2012-15, the transaction will now also be taxed as a sale pursuant to Code Sec. 367(a) unless a five-year gain recognition agreement is entered (“GRA”).

To illustrate, assume USP owns all of the stock of two controlled foreign corporations, CFCT and CFCA. CFCA acquires all of the stock of CFCT from USP for $1,000 (the fair market value). Assume further that USP’s basis in the CFCT stock is $300, and that CFCA has E&P of $800 and CFCT has E&P of $500. Under Code Sec. 304(a)(1), USP is treated as first transferring the stock of CFCT to CFCA in a Code Sec. 351 tax-free exchange for CFCA stock, followed by CFCA’s redemption for $1,000 of the deemed issued stock.

The deemed redemption is treated as a distribution subject to Code Sec. 301. Code Sec. 304(b)(2) provides that the deemed distribution is treated first as a dividend out of CFCA’s (the acquirer) E&P, and then as a dividend out of the E&P of CFCT (the target). Under the above facts, USP would have $1,000 of dividend income, with $800 deemed distributed from CFCA and $200 deemed distributed from CFCT.

Recognition of gain under Code Sec. 367(a) is avoided by filling a GRA with respect to the deemed Code Sec. 351 transfer of the CFCT stock to CFCA. While the redemption of the deemed issued CFCA stock generally is a triggering event, an exception applies if another GRA is filed.

Let’s consider another example where USP has substantial basis in the stock of CFCT ($700) and CFCA ($2,000) and neither corporation has any E&P. The $1,000 paid by CFCA to USP for the CFCT stock is analyzed as a redemption of the CFCA stock deemed issued, and is characterized as a return...
of basis to the extent thereof and then as capital gain under Code Sec. 301(c).

One alternative is for the redemption distribution to be applied only against USP’s basis in the CFCA shares deemed issued in exchange for the stock of CFCT (i.e., $700). Under this approach, USP would be subject to tax on $300 under Code Sec. 304. The new Notice requires a GRA to be filed, or USP apparently could also be subject to tax on the $300 of gain with respect to the outbound transfer of the CFCT stock under Code Sec. 367(a) (i.e., total of $600).

An alternative approach is to apply the redemption distribution against the total basis USP has in its CFCA stock. Under this approach, the entire $1,000 deemed redemption distribution would be treated as a nontaxable return of basis. Temporary regulations applied Code Sec. 367(a) to this transaction. Those regulations required that gain be recognized (without exception) in the amount of gain realized with respect to the CFCT stock less the amount of the distribution received by USP in the deemed redemption of the stock of CFCA that is treated as a dividend (i.e., $300 recognized gain). The new Notice would change this rule, favorable to taxpayers, permitting the taxpayer to file a GRA to avoid recognition of the gain under Code Sec. 367(a).

It is noted that the transaction would be characterized as a foreign-to-foreign D reorganization if CFCT were liquidated into CFCA (or an election were made to disregard CFCT) as part of the same plan that included the transfer by USP of the CFCT stock to CFCA. Code Sec. 367(a) should not apply to this transaction, although the tax consequences differ.

In conclusion, Notice 2012-15 provides that Code Sec. 367(a) applies to a deemed outbound transfer of stock in a CFC pursuant to Code Sec. 304; thus, a GRA must be filed to avoid current recognition of gain (in addition to deemed dividends). If a GRA is filed, there is no current gain recognition under Code Sec. 367(a), even if the deemed redemption distribution is applied against the basis of existing shares in the acquiring corporation rather than against only the shares deemed issued. Nevertheless, the application of Code Sec. 367(a) can result in excessive taxation if a GRA is not filed or there is a triggering event during the five-year period.

ENDNOTES

2 If a GRA is entered, any gain is not currently subject to taxation, but is taxable upon the occurrence of a “triggering event.” Reg. §1.367(a)-8.
3 Code Sec. 302(d).
4 See Code Sec. 304(b)(5) (limits the amount of the E&P of the acquiring corporation that is taken into account under certain circumstances).
6 Reg. §1.367(a)-3(a); see also T.D. 9444, Preamble, 74 FR 6824 (Feb. 11, 2009).
7 Code Sec. 367(b) also did not apply under the regulations (Reg. §1.367(b)-4(a)), but now will apply under the Notice (although that section should not have any consequences with respect to the transaction addressed herein).
8 Code Sec. 1248(a) would apply to recharacterize the gain as dividend income to the extent of the relevant E&P of CFCT and its subsidiaries. For this purpose, earnings deemed distributed to USP pursuant to Code Sec. 304 should reduce the relevant E&P. See Rev. Rul. 71-388, 1971-2 CB 314; Rev. Rul. 90-31, 1990-1 CB 147; TAM 199906035 (Feb. 16, 1999).
9 Reg. §1.367(a)-8(i), (m)(1), (k)(14)(i)(ii)-(iii). The Notice permits a single GRA to be filed for the deemed outbound transfer of the CFCT stock and subsequent deemed redemption of the CFCA shares. Reg. §1.367(a)-8(b)(2)(ii).
10 See Reg. §1.1248-1(b) (applies Code Sec. 1248 to gain recognized under Code Sec. 301(c)(3)). See Lowell D. Yoder, The Application of §1248 to §301 Distributions, 41 TAX MONT, INT’L J. 409 (Aug. 10, 2012).
11 A better result would be to clarify that there is no double taxation of the gain. Cf., Reg. §1.367(a)-8(i)(3).
12 Proposed regulations provide this rule.
13 Temporary regulations required that gain be recognized (without exception) in the amount of gain realized with respect to the CFCT stock less the amount of the distribution received by USP in the deemed redemption of the stock of CFCA that is treated as a dividend (i.e., $300 recognized gain). The new Notice would change this rule, favorable to taxpayers, permitting the taxpayer to file a GRA to avoid recognition of the gain under Code Sec. 367(a).
15 This transaction is treated as if CFCA acquired the assets of CFCT, followed by CFCT’s liquidation into USP. Rev. Rul. 2004-83, IRB 2004-32, 157; Rev. Rul. 67-274, 1967-2 CB 141. See also Reg. §1.368-2(l) (provides for cash D reorganizations).