A Note From the Editor-in-Chief

CFC Purchase of Stock in a Related CFC: Code Sec. 304 vs. D Reorganization Treatment

The U.S. tax consequences of the purchase of stock in a controlled foreign corporation (CFC) by a related CFC can vary significantly depending on whether the target is liquidated. For illustration purposes, assume a U.S. parent corporation (“USP”) owns two CFCs, CFCA and CFCT. For important business reasons, CFCA acquires all of the stock of CFCT from USP for $1,000. If CFCT continues in existence, the transaction is subject to Code Sec. 304. Alternatively, if CFCT liquidates into CFCA (or an election is made to disregard CFCT), the transaction should be treated as a reorganization under Code Sec. 368(a)(1)(D) (a “D reorganization”).

The amount of USP’s income is calculated differently depending on the type of transaction. Under Code Sec. 304, the entire purchase price is income to USP to the extent of the earnings and profits (E&P) of CFCA and CFCT, and any remaining amount is applied against stock basis. On the other hand, with a D reorganization, only the cash purchase price to the extent of the gain with respect to the CFCT stock is taxable income.

Assume that USP has a basis in the CFCT stock of $700. CFCT has $180 of E&P and CFCA has $400 of E&P. Under Code Sec. 304, USP would have $580 of income (i.e., the aggregate of the E&P of the two CFCs). On the other hand, with a D reorganization, only the cash purchase price to the extent of the gain with respect to the CFCT stock is taxable income.

The amount taxable to USP may be characterized as dividend income or capital gain. With a Code Sec. 304 transaction, USP’s income is treated as a dividend to the extent of the earnings of both CFCA and CFCT (i.e., $580). With a D reorganization, the IRS ruled that both the acquirer and target’s E&P are taken into account, but some cases hold that only CFCT’s earnings are counted. If CFCA’s E&P is taken into account, USP would have $300 of dividend income, but if only CFCT’s E&P is counted, USP would have $180 of dividend income and $120 of capital gain.

The dividend amount to USP should be treated as foreign source, general basket income. Such dividends should be accompanied with deemed paid tax credits, but the amount of deemed credits may vary depending on the source of the dividend. Code Sec. 304 takes into...
account first the E&P of the acquirer, and then the E&P of the target. On the other hand, with a D reorganization, the order is unclear, although some commentators suggest that the E&P of the target is taken into account first.

Assume further that CFCT has $20 of foreign tax credits associated with its $180 of E&P, and CFCA has $400 of foreign tax credits associated with its $400 of E&P. With a Code Sec. 304 transaction, USP would have $420 of foreign tax credits, which may eliminate its U.S. tax on the dividend income. With a D reorganization, if only CFCT’s E&P is taken into account, such that $180 of the recognized gain is treated as a dividend, USP would be entitled to $20 of deemed paid foreign tax credits, and pay incremental U.S. tax on the dividend and full tax on the $120 of capital gain. If CFCA’s earnings and profits also are taken into account, but CFCT’s earnings are exhausted first, USP would have $300 of dividend income and be entitled to $140 of foreign tax credits [$20 + (120/400 x $400)]. It is possible that CFCA’s earnings may be considered first, in which case USP could claim $300 of deemed paid tax credits.

Accordingly, if the E&P of the CFCs exceed the gain and are subject to high foreign taxes, the Code Sec. 304 transaction may provide a better result (e.g., excess foreign tax credits), even though USP may have a greater amount of taxable income. On the other hand, if the earnings are subject to a lower tax rate, and the gain is less than the E&P of the two CFCs, a D reorganization may be more desirable (e.g., a lesser amount of taxable income subject to incremental U.S. taxation). As illustrated in the above example, the order of sourcing the deemed dividend may also affect the U.S. tax results.

Dividend treatment also may be beneficial to the extent sourced to previously taxed income (PTI), which is excluded from USP’s income. With a Code Sec. 304 transaction, CFCA’s PTI would be considered first, and then CFCT’s PTI. On the other hand, in a D reorganization, it is possible that only CFCT’s PTI is considered. Alternatively, if the E&P of both CFCs is counted in a D reorganization, the order may be reversed from a Code Sec. 304 transaction. Accordingly, there can be different PTI benefits depending on the particular facts. In addition, under proposed regulations, the application of the PTI rules to a Code Sec. 304 transaction is expressly addressed, whereas the regulations do not directly address D reorganizations.

Additional differences arise between the application of Code Sec. 304 and the D reorganization provisions when the transaction is cross-chain (e.g., where CFCT is owned by a domestic subsidiary of USP). First, the IRS has not expressly addressed whether the acquirer’s E&P should be taken into account in a cross-chain D reorganization. Second, there is authority for deemed paid credits accompanying a cross-chain dividend distribution in a Code Sec. 304 transaction, but there is no similar authority for cross-chain D reorganizations. Third, proposed regulations expressly provide for the application of the PTI rules to cross-chain distributions in a Code Sec. 304 transaction, but there is no direct guidance for D reorganizations. On the other hand, the anti-abuse rule of Reg. §1.304-4T and the special earnings and profits limitation of Code Sec. 304(b)(5) are not applicable to D reorganizations.
ENDNOTES


2. Code Sec. 356(a). Neither transaction should be subject to Code Sec. 367(a), nor should Code Sec. 367(b) require any income inclusion. Reg. §1.367(a)-3(a) and Reg. §1.367(b)-4(b).


6. The amount of income would be increased by the amount of the deemed paid taxes, i.e., grossed-up. Code Sec. 78.

7. Code Sec. 959(a).


10. For additional analysis, see Yoder, A Note from the Editor-in-Chief, International Planning Using Code Sec. 304, INT’L TAX J., at 3 (July–Aug. 2007), and Yoder, Cash D Reorganizations—Selected International Issues, 37 TAX MGMT. INT’L J. 110, (Feb. 2008).