A Note From the Editor-in-Chief

New Code Sec. 367(a) Regulations Apply to International Code Sec. 304(a)(1) 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. This transaction receives special treatment under Code Sec. 304.

For example, assume that 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. CFCA has $800 of earnings and profits and $800 of foreign taxes associated with such earnings. CFCT has $500 of earnings and profits and $50 of associated foreign taxes.

Under Code Sec. 304(a)(1), USP is treated as first transferring the stock of CFCT to CFCA in exchange for CFCA stock in a Code Sec. 351 transaction. Subject to an exception discussed below, Code Sec. 367(a) does not apply to the deemed outbound transfer of the CFCT stock to CFCA.

Second, CFCA is treated as redeeming for $1,000 its stock deemed issued to USP. This 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) earnings and profits in the amount of $800, and then as a dividend of $200 out of the earnings and profits of CFCT (the target).

For foreign tax credit purposes, the deemed dividend generally should be considered as foreign source income within the general limitation category. USP would have a dividend of $1,000 and deemed paid credits of $820.

Restructuring through a sale of one CFC to another CFC also can be used when the U.S. parent has substantial basis in the stock of the target and neither the acquirer nor the target have a material amount of earnings and profits. For example, assume the facts above, except neither CFCT nor CFCA has any earnings and profits, and USP has a basis in the CFCT stock of $700 and a basis in the CFCA stock of $2,000. The $1,000 paid by CFCA to USP is treated first as a return of basis, and then as capital gain under Code Sec. 301. A question arises concerning whether the total basis USP has in the CFCA stock can be counted for this purpose ($2,700), or only the basis in the shares deemed issued in exchange for the stock of CFCT ($700)?

The IRS has indicated in the past that the “better view” is that only USP’s $700 of basis in the CFCA shares deemed is-
sued for the CFCT stock is taken into account, which would result in $300 of gain. In contrast, proposed regulations would provide that all of the basis USP has in the stock of CFCA is taken into account, which could result in the entire $1,000 being treated as a return of basis.

Nevertheless, recently issued temporary regulations apply Code Sec. 367(a) to the above transaction if the distribution is applied against the basis of existing shares USP holds in CFCA. The regulations require 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). This regulation should not apply, however, if the taxpayer instead applies the distribution against the basis of only the CFCA shares deemed issued.

There may be some concern that a Code Sec. 301 distribution is considered as made pro rata against the basis of each relevant share. In such case, it is possible to have gain as to some shares and unused basis as to other shares. Nevertheless, if the distribution in the above example is applied against only the basis of the shares deemed issued by CFCA in the Code Sec. 351 transaction, then under current law such shares should have equal basis. Accordingly, the entire $700 of basis should be available before recognition of any gain.

U.S. tax may be reduced by distributing $300 of high taxed earnings or previously taxed income to CFCA or CFCT during the year of the transaction. As a result, the deemed $1,000 distribution to USP should be considered as a distribution of $300 of high taxed earnings (or PTI) and a distribution of $700 as a return of basis with respect to the CFCA shares deemed issued, and the temporary regulations should not apply.

In conclusion, the new Code Sec. 367(a) regulations may apply to a deemed outbound transfer of stock in a CFC pursuant to Code Sec. 304, but not where the deemed redemption distribution is applied only against the basis of the shares deemed issued. If the proposed basis regulations become effective, a taxpayer will be required to apply distributions against the basis of all outstanding shares in the acquiring company, thereby triggering the application of the new regulations.

ENDNOTES

1 This construct applies because USP directly owns 100 percent of CFCT before the transaction and indirectly owns 100 percent of CFCT after the transaction.
2 Reg. §1.367(a)-3(a); see Reg. §1.367(b)-4(a) (Code Sec. 367(b) also does not apply). See also T.D. 9444, Preamble; 74 FR 6824 (Feb. 11, 2009).
3 Code Sec. 302(d).
4 Code Secs. 861(a)(2) and 904(d)(3)(B).
5 Rev. Rul. 91-5, 1991-1 CB 114; Rev. Rul. 92-86, 1992-2 CB 199. The deemed distribution of $200 of CFCT’s low taxed earnings may be avoided by having CFCA acquire the CFCT stock for $800 of cash (or a note) and $200 of CFCA stock. See Reg. §§1.367(a)-3(b)(1)(ii) and 1.367(a)-8 (gain recognition agreement required with respect to the CFCT stock transferred for the CFCA stock).
9 If CFCT owns subsidiaries, a portion of the gain may be recharacterized as dividend income under Code Sec. 1248.
10 Reg. §1.367(a)-9T(b). Until the proposed basis regulations are finalized, presumably a taxpayer could take the position that the distribution is applied only against the basis of the CFCA shares deemed issued, which under the example, also would result in $300 of gain. See also Reg. §1.1248-1T(b) (applies Code Sec. 1248 to gain recognized under Code Sec. 301(c)(3)).
11 See W.T. Johnson, CA-4, 71-1 ustc ¶9148, 435 F2d 1257. Commentators have asserted that such a distribution should be considered as applying against all basis in the aggregate before gain is recognized. The preamble to the proposed regulations states: “[t]he tax law does not provide rules concerning whether a shareholder recovers its stock basis in the aggregate, or alternatively, whether a shareholder is required to recover stock basis share-by-share.” 74 FR, at 3,510.
12 See Rev. Rul. 85-164, 1985-2 CB 117. Also, the preamble to the proposed basis regulations states that the tracing rules provided by the Code Sec. 358 regulations do not apply to Code Sec. 351 exchanges that do not qualify as reorganizations, and the proposed regulations would extend the tracing principles to certain Code Sec. 351 exchanges. 74 FR, at 3,509, 3,512–13; see Proposed Reg. §1.358-1(g).
13 The $300 of gain may be avoided by having CFCT first distribute $700 to USP, followed by USP transferring the stock of CFCT to CFCA for CFCA stock.