A Primer on the Use of § 304 Transactions and
Cash D Reorganizations to Effect Cross-Border Restructurings

Last Updated November 1, 2013

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1. **Introduction to § 304 Transactions and “Cash D” Reorganizations.**

This outline provides an overview of the § 304 brother-sister stock sale, and its cousin, the cash D reorganization, and the major U.S. international tax issues raised in these transactions. Each is a means of re-aligning entities within a foreign corporate structure, repatriating cash in an efficient manner from a local tax and legal perspective, and accomplishing various U.S. tax planning objectives. Since the choice between the § 304 transaction and Cash D transaction often is as simple as filing a check-the-box election with respect to the foreign target, it is within the U.S. tax department’s control to choose between these two economically equivalent transactions. As will be outlined below, the tax rules applicable to each of the transactions differ significantly.

a. **Overview of the “Brother-Sister” § 304 Transaction.** Section 304(a)(1) applies to the sale of a corporation’s stock to another corporation, where both the acquiring corporation (“Acquiring”) and the target corporation (“Issuing”) are under common “control.” The following figure illustrates a § 304(a)(1) transaction:

**Example of a § 304(a)(1) Transaction**

```
      USP
       /\      \$
      /  \      100
     /    \      /
    /      \    /
   /        \  /
  /          \/
 /            /
FS           FA
       / \      \$
      /   \      50
     /     \      /
    /       \    /
   /         \  /
  /           \/
 /             /
FT
```

Note that FS is in “control” of FA by virtue of the § 304(c) constructive ownership rules that apply for this purpose.

In this case, provided that the controlling shareholder’s ownership is not meaningfully reduced, the transaction is recast as if the following steps had occurred:

(i) Shareholder had transferred stock in Issuing Corporation to Acquiring in exchange for newly issued Acquiring shares;
(ii) Acquiring had used the sale proceeds to redeem the newly issued Acquiring shares.

The net effect of § 304 transaction is a § 302 redemption by the Foreign Acquiring that is sourced first from the E&P pool of Acquiring, and then from the E&P of the Issuing corporation. ¹ To the extent the amount of the distribution exceeds Acquiring and Issuing’s combined E&P, it will be first a recovery of capital under § 301(c)(2) and then capital gain from the sale of the newly issued Acquiring shares under § 301(c)(3).

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¹ See § 304(b)(2)(A) & (B).
b. **Overview of the “Cash D” Reorganization.** Section 368(a)(1)(D) defines the non-divisive D reorganization\(^2\) as a transaction one corporation (“Target”) transfers its assets to another corporation (“Acquiring”), if (i) immediately after the transfer, the transferor or its shareholders is in “control” of the acquiring corporation (the “control requirement”) and (ii) stock or securities of the acquiring corporation are distributed to the shareholders of the target in a manner satisfying § 354 (the “distribution requirement”).

While the distribution requirement would seem to literally require the Target’s shareholders to receive at least some equity in Acquiring, the law has developed a “nominal share” concept. Where there is identical ownership of Target and Acquiring, the transfer of Target’s assets to Acquiring solely for cash is deemed to satisfy the distribution requirement.\(^3\) Thus, in cases of 100% common ownership, it is possible to undertake a D reorganization in exchange for all-cash consideration. This is typically effected by a sale of stock in Target, followed by an integrated liquidation of Target into Acquiring by means of a check-the-box election. The IRS treats this integrated transaction as an § 368(a)(1)(D) reorganization with 100% cash consideration.\(^4\)

---

\(^{2}\) To qualify as a non-divisive D, Acquiring must acquire “substantially all” of the assets of the Target. See § 354(b)(1)(A). “The ‘substantially all’ requirement is chiefly determined by focusing on the transfer of the operating assets by the transferor, and not on the unneeded liquid assets such as cash and accounts receivable.” *Atlas Tool Co. v. Commissioner*, 80-1 USTC ¶ 9177 (3d Cir. 1980). Alternatively, a § 368(a)(1)(D) reorganization involving less than substantially all of the Target’s assets may occur in the context of a tax-free spin-off under § 355.


\(^{4}\) Rev. Rul. 2004-83. In PLR 201037026 (Sept. 17, 2010) (rulings on Sub 40 and Sub 9 reorganizations), the IRS extended the integrated transaction approach of Rev. Rul. 2004-83 to a check-the-box liquidation effected before the cross-chain sale of stock. However, this would not appear to be a generally recommended technique.
Under the reorganization rules, Target is deemed to transfer its assets to Acquiring in a tax-free transfer under § 361 for cash and the “nominal share.” Despite the exchange of assets for cash, no gain is recognized provided that all of the cash is distributed to shareholders as part of the plan of reorganization. See § 361(b)(1). Also, the shareholder’s receipt of the boot is governed by § 356, rather than § 301, and therefore, the deemed dividend is limited to the gain realized by the shareholder on the exchange of Target’s stock (“boot-within-gain limitation”). This is in contrast to § 304, which results in a deemed dividend to the extent of Issuing and Acquiring’s combined E&P before allowing any basis recovery.

Further, since the Target is merged into the Acquiring corporation as part of the transaction, its tax attributes carry over to the Acquiring corporation under § 381(c). The Target’s taxable year also closes as part of the transaction.

2. **International Tax Consequences of Brother-Sister § 304 Transactions.**

   a. **Foreign Tax Credits.** If the Issuing and Acquiring are CFCs or other § 902 corporations, the deemed dividend under § 304 carries § 902 indirect credits along with the E&P deemed distributed.5

   In Rev. Rul. 91-5, the IRS ruled that for purposes of sourcing E&P and foreign tax credits, the § 304(b)(2) ordering rules govern. Thus, the deemed dividend will come first from Acquiring’s § 902 pools, and then from Issuing’s § 902 pools.

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5 See Treas. Reg. § 1.902-1(a)(12) (defining “dividend” for § 902 purposes to include § 304 transactions).
USP recognizes total deemed dividends of $100 before § 78 gross-up.

The total FTC is $65 ($60 from FA and $5 from FT).

One issue under § 902 is that the shareholder of Issuing may not directly own any stock in Acquiring, let alone the 10% of voting stock required to claim an indirect credit under § 902. In Rev. Rul. 92-86, the IRS ruled that the 10% ownership requirement of § 902 would be deemed satisfied in any case where the common shareholder’s actual and constructive ownership is sufficient to qualify under § 902. There is no need to analyze the “deemed issued shares” for voting vs. non-voting ownership to qualify under this test.

Rev. Ruls. 91-5 and 92-86 created a potential for abuse in the case of a foreign-parented group. To prevent inappropriate claims of § 902 credits on E&P not subject to U.S. tax, § 304(b)(5)(A) limits the amount of Foreign Acquiring’s E&P that is taken into account to the amount of E&P that accumulated while Foreign Acquiring was a CFC under direct or indirect U.S. ownership.
b. Withholding Taxes. In Rev. Rul. 92-85, the IRS addressed the U.S. withholding tax consequences under § 881 where the § 304 deemed dividend was paid out of the E&P of a U.S. corporation to a foreign person. In Situation 1, FP directly owned US Acquiring and Foreign Issuing. In the case of a § 304 transaction treated as a dividend out of US Acquiring’s E&P, the IRS ruled that:

(i) Withholding taxes would apply under § 881(a) on a dividend from a U.S. person to a foreign person to the extent of the § 304 dividend sourced from US Acquiring’s E&P;

(ii) No withholding tax would apply to the dividend sourced from Foreign Issuing’s E&P;

(iii) The Treaty applicable between Foreign Shareholder and the US would govern the dividend; and

(iv) Since the Foreign Shareholder directly owned 10% of US Acquiring’s stock, the dividend would qualify for the inter-corporate dividend rate of 5% under Article 10(2) of the Treaty.

With respect to holding (iv) above, the IRS stated that FX, the foreign shareholder, would satisfy the 10% ownership requirement of the Treaty because § 304 deemed FX to own 50% of US Acquiring’s stock under § 304. As in the § 902 analysis, it appears that constructive ownership under § 304 would satisfy the Article 10(2) ownership requirement. Query whether § 304 constructive ownership would also satisfy the 12-month holding period requirement found in some treaties as a condition of claiming a zero rate of withholding tax on dividends.

In Situation 2 of Rev. Rul. 92-85, FP owned FS1 and FS2, and FS2 sold US
Issuing to FS1. In relevant part, the IRS ruled:

(i) A dividend sourced from US Issuing’s E&P would be subject to US withholding tax; and

(ii) Since there was no treaty between FS2’s country and the United States, the deemed dividend would be subject to a 30% U.S. withholding tax.

c. Previously Taxed Income (“PTI”). A deemed distribution of E&P under § 304 should carry PTI in the same manner as an actual dividend distribution. Thus, the extent that a U.S. corporation receives a distribution from Foreign Acquiring or Foreign Issuing’s E&P, that distribution should be ordered out of PTI under the normal ordering rules of § 959.

One issue in regard to PTI is whether the PTI exclusion applies where the shareholder does not directly or indirectly own stock in the Acquiring CFC. Under § 959(a), the PTI exclusion at the U.S. shareholder level is available to a distribution through a § 958(a) chain of ownership, which requires direct or indirect ownership.

In PLR 9210031 (Dec. 10, 1991) the IRS held that where Corp A and Corp B were in the same consolidated group, a deemed dividend by Corp C to Corp B attributable to amounts of subpart F income included by Corp A would be excluded from B’s income under § 959. Thus, the Service allowed so-called “PTI-sharing” within the consolidated group. Other private letter rulings also allowed PTI sharing between U.S. affiliates in § 304(a)(1) transactions.

Prop. Treas. Reg. § 1.959-3(h)(4) (2006) would expressly allow PTI sharing within a single U.S. consolidated group by deeming the selling shareholder to have a § 959 PTI account in the Foreign Acquiring Corporation. The proposed regulations also address the basis adjustments that would be required under § 961 and Treas. Reg. § 1.1502-32 to address the movement of PTI within the consolidated group.

As illustrated by Prop. Treas. Regs. §§ 1.959-3(h)(4), Example 1 and Prop. Treas. Regs. § 1.961-2(c), Examples 1 and 2, it appears that a § 304 deemed dividend is sourced first from Acquiring’s live E&P before being sourced from Issuing’s PTI. The Examples do not definitively address this point, however, because the total distribution under § 304 is equal to Acquiring and

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7 See also PLR 9131059 (May 9, 1991) and PLR 9325040 (Mar. 26, 1993). But see PLR 9802018 (limiting CFC’s PTI exclusion for a § 302 redemption to the United States shareholder’s indirect percentage ownership of the CFC’s PTI under § 958(a)).
Issuing’s total E&P (PTI and live E&P). The PLRs cited above also appear to source a § 304 dividend from Acquiring’s PTI and live E&P before considering Issuing’s E&P of any kind:

§ 304 Transactions: PTI Consequences

In the figure above, the § 304 deemed dividend is treated first as a distribution F1 to DS to the extent of FS1’s E&P of $30x, and then as a distribution from F2 to DS to the extent of FS2’s E&P of $50x. Of the distribution from F1, the first $20x is a PTI distribution. Since DP and DS are each members of the same consolidated group, DS is able to access DP’s PTI account as a “covered shareholder” under the Proposed Regulations.8 The movement of PTI generally is reflected in adjustments to basis in the CFC stock.

i. Currency Impacts of PTI distributions. A distribution of PTI is generally excluded from gross income under § 959(a), and results in a reduction in stock basis under § 961(b) to reverse the positive basis adjustment resulting from a subpart F inclusion under § 961(a). Under § 986(c), a distribution of PTI (including a deemed distribution under § 304) also triggers foreign currency gain or loss to the extent the value of the earnings distributed varies from the US dollar amount of the underlying subpart F inclusion.

In TAM 200141003, the IRS addressed the interaction of these rules under the old pre-1997 version of § 304, although a similar analysis would appear to apply under current § 304. There, the Exam team appeared to argue that the § 301(c) source of distributions should look to the U.S. dollar of the PTI, which apparently appreciated, so that a portion of the distribution would taxable as a capital gain. The National Office advised (apparently following the taxpayer’s position) that the § 301(c) tests applied by reference to the

Functional currency amounts of PTI, with the amount of the § 301(c)(1) distribution of PTI and non-PTI E&P then translated into U.S. dollars under § 989’s rules. Any difference between the historic dollar cost and dollar basis of the PTI would trigger § 986(c) gain or loss, outside the operation of the § 301(c) distribution sourcing rules. The basis of USP’s stock, under § 961(b), was then reduced by the U.S. dollar basis of the distributed PTI. In short, the apparent result was to tax the appreciation in the PTI as a foreign source § 986(c) gain, rather than a § 301(c)(3) gain with respect to CFC stock which would generally be U.S. source.

d. **Subpart F Consequences.** If the relevant entities in the § 304 transaction are related CFCs, the § 304 deemed dividend generally would qualify for the § 954(c)(6) look-through rule.\(^9\) Thus, section 304 can be helpful in enabling a cross-chain stock sale that might otherwise give rise to Foreign Personal Holding Income (FPHC) under § 954(c)(1)(B).

It is also possible for a § 304 deemed dividend to qualify for the “same-country exception” where both the Shareholder and the Acquiring and/or Issuing corporation are CFCs organized under the same country’s laws. However, the requirement that the underlying E&P accumulate while both the payor and payee are in a single § 958(a) chain of ownership may be difficult to satisfy unless Shareholder directly owns Foreign Issuing and/or Foreign Acquiring.\(^10\) So long as the § 954(c)(6) look-through rule remains in effect, the same country exception will be of minimal utility if all.

For example, in PLR 201252008 (Dec. 28, 2012), the Service addressed a fact pattern in which one CFC made cross-chain sales of lower-tier CFCs’ stock to other CFCs in the group. Shortly thereafter, the CFC selling stock in the § 304 stock sale paid a dividend on its preferred stock and filed a check-the-box (CTB) election to be deemed to liquidate for U.S. tax purposes. The liquidation was stated to be an insolvent liquidation taxable under §§ 331 and 336, with the holder of the CFC’s common stock recognizing a worthless stock loss under § 165(g)(1). See Rev. Rul. 2003-125. Although not stated in the PLR, CFC-1 apparently relied on the § 954(c)(6) exclusion from subpart F income to exclude any deemed dividends under dividends from its subpart F income.

e. **§ 367(a) Consequences.**

i. **The Former 2006 and 2009 Regulations.**

If the shareholder is a domestic corporation, a § 304 transaction will effectively transfer the stock of Foreign Issuing outbound to Foreign Acquiring in a deemed § 351 transfer. Under § 367(a) regulations issued in

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\(^9\) IRS Notice 2007-9 (defining “dividend” to include deemed dividends resulting from § 304 transactions).

\(^10\) See, e.g., PLR 199907022 (no tacked holding period in a § 351 transfer for purposes of same-country exception’s E&P accumulation requirement).
2006, the IRS exempted this outbound transfer from § 367(a), so that no gain was recognized and no GRA was required. However, in adopting this rule, the IRS assumed that “current law does not provide for the recovery of the basis of any shares other than the basis of the [Foreign Acquiring] stock deemed to be received by P in the section 351(a) exchange (which would take a basis equal to P’s basis in the [Foreign Issuing] stock).”\textsuperscript{11} Thus, the IRS assumed that any gain built-in to Issuing’s stock would be recognized under § 301(c)(3) to the extent the § 304 transaction was not taxable as a dividend. As discussed above, IRS Chief Counsel International’s view of the limited precedent in this area appears to have differed from that of IRS Chief Counsel Corporate. In 2009, the IRS Chief Counsel Corporate issued the proposed basis recovery regulations adopting a completely contrary approach.

In response to the 2009 Proposed Regulations (providing for a pro rata method of basis recovery), the IRS and Treasury issued Temp. Treas. Reg. § 1.367(a)-9T.\textsuperscript{12} Under this regulation, if the taxpayer attempts to use basis in Foreign Acquiring’s old-and-cold shares to offset any portion of the distribution, the taxpayer will recognize gain on a deemed sale of Foreign Issuing’s stock under § 367(a). It is clear that the taxpayer can avoid recognizing gain under § 367(a) by not seeking to recover Foreign Acquiring’s stock basis; i.e., by recognizing gain under § 301(c)(3). Due to the differential adjustments to Foreign Acquiring’s inside basis in the stock of Issuing, it may be advantageous for the taxpayer to recognize gain under § 367(a) rather than § 301(c)(3).

\begin{center}
\textbf{§ 304 Transactions:}
\textbf{§ 367(a) Issues}
\end{center}

\begin{center}
\begin{tikzpicture}
\node (USP) at (0,0) {USP};
\node (FT) at (-3,-1) {FT};
\node (FA) at (3,-1) {FA};
\draw[->] (USP) -- (FT) node[midway,above] {FMV $100};
\draw[->] (USP) -- (FA) node[midway,above] {AB $40};
\draw[->] (FT) -- (USP) node[midway,left] {AB $40};
\draw[->] (FT) -- (FA) node[midway,right] {Sale of FT for $100};
\draw[->] (USP) -- (FT) node[midway,left] {$0$ E&P};
\draw[->] (USP) -- (FA) node[midway,right] {$20$ E&P};
\end{tikzpicture}
\end{center}

\begin{center}
\begin{tabular}{|c|c|c|c|}
\hline
\textbf{§ 304 Distribution} & \textbf{Dividend from FA} & \textbf{Dividend from FT} & \textbf{Recovery of Capital from FT Shares} & \textbf{Gain under §367(a) or §301(c)(3)} \\
\hline
$\$20$ & $\$0$ & $\$40$ & $\$40$ \\
\hline
\end{tabular}
\end{center}

The rule was illustrated by the above example taken from Temp. Treas. Reg. § 1.367(a)-9T(e). In the example, USP owns stock of FT with basis of $40X

\textsuperscript{11} See TD 9250.
\textsuperscript{12} See TD 9444 (Feb. 2009).
and FMV of $100X and stock of FA with basis of $100X and FMV of $100X. FT is sold to FA in a § 304 transaction, in which only $20 of the distribution is treated as a dividend. The shareholder then applies $40 of the basis in each of its block of FA shares (newly deemed issued shares and old-and-cold shares) to cover the distribution under § 301(c)(2).

Since the taxpayer “takes the position” that $40 of FA’s old-and-cold stock basis is recoverable, the taxpayer must recognize $40 of gain on the deemed § 351 transfer of FT’s stock. FA’s § 362 carryover basis in FT’s shares is stepped up to reflect the gain under Treas. Reg. § 1.367(a)-1(b)(4). (Note that if the taxpayer does not “take this position,” arguably there is no step up in FA’s basis in FT shares to reflect the § 301(c)(3) gain, which is recognized on the “outside” of FA after FT has already been transferred into FA). Thus, it would generally be favorable to “take the position” and recognize § 367(a) gain rather than § 301(c)(3) gain.

Per § 7805(e), these regulations sunset in February 2012. Rather than issue the 2009 Temporary Regulations in temporary form, the IRS instead issued a Notice announcing other future guidance headed in a different direction:


The IRS and Treasury announced their intent to promulgate regulations applying §§ 367(a) and 367(b) to deemed outbound transfers of stock pursuant to § 304(a)(1). Section 6 of the Notice states that the regulations will apply to transactions occurring on or after February 10, 2012. Therefore, the filing of a GRA should be considered in any outbound § 304 transactions. However, the IRS also announced that it will not challenge reasonable interpretations of § 367(a) to deemed outbound transfers of stock occurring by operation of § 304(a)(1).

Section 4.01 of the Notice provides that the U.S. transferor “may, in certain cases, be permitted to enter into a GRA pursuant to § 1.367(a)-8 to avoid the recognition of gain under § 367(a)(1).” Then, when the shares deemed received in the foreign transferee are redeemed, the Notice states that under the principles of § 1.367(a)-8(n)(1), the transferor will not recognize gain on a deemed redemption of the shares in a § 304 transaction so long as it executes a substitute GRA.

The Example in Section 4.03 of the Notice illustrates the interaction between § 304 and § 367 in the following basic fact pattern:

US parent owns all of the stock of FT and FA. FT’s stock has a tax basis of $50x and a fair market value of $100X. FA has accumulated E&P of $200. FA purchases FT for $100x.

This fact pattern results in two steps under § 304(a)(1), given that FT and FA are under common control. First, USP contributes the stock of FT to FA in
exchange for $100x of newly issued shares. Second, FA redeems the FT shares in exchange for $100x in a redemption that § 302 treats as a § 301 distribution. Since FA’s E&P covers the entire distribution, FA is deemed to distribute a $100x dividend to USP. USP’s $50x of basis in FA’s shares is re-allocated pro rata to USP’s other shares in FA. See Treas. Reg. § 1.302-2(c).

The innovation of the Notice is to apply § 367(a)’s GRA rules to the two fictional steps as if they actually occurred. In the first step, USP will recognize the $50x of gain on FT’s stock unless USP enters into a GRA. In the second step, the newly issued transferee shares are redeemed under § 302. While this disposition of FA’s shares would generally trigger the GRA, Treas. Reg. § 1.367(a)-8(n)(1) exempts dividend equivalent redemptions from constituting a triggering event if USP enters into a new GRA that redesignates its other shares in FA as subject to the GRA. See also Treas. Reg. § 1.367(a)-8(q), Example 14 illustrates the impact of these rules.

Thus, the results under the Notice’s fact pattern is not to trigger gain under § 367(a) if the GRA procedures are followed. For the well-advised taxpayer, § 367(a) merely represents a trap for the unwary. Under the Notice, § 367(a) applies in much the same way as if USP contributed FT’s shares to FA’s capital in an actual § 351 transfer. Thus, while not as taxpayer favorable as the 2006 and 2009 regulations that simply turned off § 367(a) in a similar case, the Notice nonetheless does not present significant problems for the well-advised.

3. **Other Important Aspects of § 304 Transactions for International Tax Planning**

   a. Basis Recovery under § 301(c)(2). To the extent that a § 304 distribution exceeds Issuing and Acquiring’s combined E&P, the distribution next is treated as the recovery of capital under § 301(c)(2). The shareholder potentially has two sources of § 301(c)(2) basis recovery at its disposal: (1) its basis in Issuing’s stock, which is transferred to Acquiring in a § 351 transfer, and then redeemed; and (2) if the shareholder directly owns stock in Acquiring, the basis in its pre-existing shares in Acquiring.
§ 304 Transactions: Basis Recovery Part 1

\[
\begin{array}{c}
\text{USP} \\
\text{AB } \$50x \\
\text{FMV } \$150x \\
\text{FT} \\
\text{Sale of FT Shares for } \$150 \\
\text{FA} \\
\text{AB } \$100x \\
\text{\$0 E&P} \\
\text{\$50 E&P}
\end{array}
\]

<table>
<thead>
<tr>
<th>Total Distribution</th>
<th>Dividend from FA</th>
<th>Basis Recovery</th>
<th>Capital Gain</th>
</tr>
</thead>
<tbody>
<tr>
<td>$150</td>
<td>$50</td>
<td>$x?</td>
<td>$x?</td>
</tr>
</tbody>
</table>

§ 304 Transactions: Basis Recovery Part 2

<table>
<thead>
<tr>
<th>Block of Stock</th>
<th>Basis</th>
<th>FMV</th>
</tr>
</thead>
<tbody>
<tr>
<td>“Deemed Issued” Shares</td>
<td>$50x</td>
<td>$150x</td>
</tr>
<tr>
<td>“Old and Cold” Shares</td>
<td>$100x</td>
<td>$150x</td>
</tr>
</tbody>
</table>

In the case above, FA makes a §§ 301(c)(2) and 301(c)(3) distribution of $100x. Immediately after the fictional § 351 transfer, USP has shares in FA with a total basis of $150x. If the distribution is treated as made solely with respect to the newly issued FA shares in the § 304 transaction, USP will recognize $50x of capital gain. If the distribution is treated as made pro rata on all of USP’s shares in FA, then potentially all of the $100x is a tax-free return of capital under § 301(c)(2). Thus, the method of basis recovery can be highly relevant to the overall treatment of the § 304 transaction.
i. **Authorities Addressing the Method of Basis Recovery.**

The authorities addressing the shareholder’s method of basis recovery in a § 304 transaction are relatively scarce. However, as discussed below, in the context of an “outbound” § 304 transaction, the § 367(a) regulations may have rendered this issue largely moot.

In *Johnson v. United States*,[13] in the context of a § 301 distribution, the Fourth Circuit held that, in computing basis recovery under § 301(c)(2), the taxpayer must apply the distribution pro rata across all of its shares. Under *Johnson*, if the taxpayer has different blocks of stock with a high basis and a low basis, the taxpayer cannot aggregate the basis for purposes of avoiding recognition of capital gain under § 301(c)(3). In 2009 Proposed Regulations, the IRS stated that it would adopt the approach of *Johnson* in § 304 transactions.

Pro rata recovery of basis with respect to all shares in a § 304 transaction also is supported by the legislative history of § 1059(e) (requiring basis reduction for certain dividend-equivalent redemptions to reflect a corporate shareholder’s DRD). § 1059(e)(1), in the flush language, states that for purposes of § 1059, the basis reduced after a § 302 redemption should be limited to the stock basis in the redeemed shares. As reflected in the 1984 Conference Report, Congress appears to have understood that basis generally is recovered pro rata from all shares and intended § 1059(e) to be a change in law.

In TAM 9748003, the IRS ruled that in a § 304 transaction occurring under pre-1997 law, the shareholder would recover the combined basis in Foreign Acquiring and Foreign Issuing before recognizing any gain under § 301(c)(3). The § 304 rules prior to the 1997 Act called for a deemed capital contribution, rather than a § 351 exchange of shares for newly issued shares, and thus may have provided more support for aggregating the shareholder’s basis in Acquiring and Issuing.[14]

In FSA 200111004 (Nov. 14, 2000), Chief Counsel Corporate revisited the question of basis recovery under post-1997 law in a § 304 transaction where the Acquiring corporation was an S Corporation. The Chief Counsel ruled that aggregate basis recovery would be available. However, the distribution of E&P in that case was governed by § 1368, the Subchapter S previously taxed income rules, which like § 959, provide for recovery of PTI at the earliest possible time.

Finally, in 2009, the IRS and Treasury proposed regulations that adopt the approach of *Johnson* for dividends and deemed dividend recovery.

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13 71-1 USTC ¶9148, 435 F2d 1257 (4th Cir.).
14 In one case under pre-1997 law, the IRS and taxpayer effectively stipulated that the aggregate basis recovery method should be applied. *See Cox v. Commissioner*, 78 T.C. 1021 (1982).
transactions, including § 304 transactions.\textsuperscript{15} According to the IRS, “the results of a section 301 distribution should derive from the consideration received in respect of each share of stock, notwithstanding designations otherwise.” Thus, basis recovery does not depend on which shares (within a single class of stock) are identified as being redeemed. Further, the Proposed Regulations would provide that “a dividend equivalent redemption results in a pro rata, share-by-share distribution to all shares of the ‘redeemed class’ held by the redeemed shareholder immediately before the redemption.”

The Proposed Basis Recovery Regulations would also require the shareholder to create a new block of stock whenever it made a capital contribution to the corporation.\textsuperscript{16} This would be a significant extension of current law. Under the current regulations, different blocks of stock with uneven basis may arise where the taxpayer transfers stock to a subsidiary in a tax-free reorganization, including a § 351 transfer of stock or securities that is also a B Reorganization, provided that no liabilities are assumed by the transferee.\textsuperscript{17} A different block of stock would also arise if the taxpayer purchases shares from a third party at a different price.\textsuperscript{18}

\textbf{PLR 201043021} illustrates a case where a taxpayer avoided the creation of multiple blocks of stock under Treas. Reg. § 1.358-2(a) by transferring several CFCs to a Holding Company in exchange for voting and non-voting stock. The IRS ruled that the voting and non-voting stock would be deemed received with respect to each CFC’s stock in a § 351 exchange and cause § 368(a)(1)(B) not to apply, so that the basis tracing rules of the current regulations were inapplicable. The aggregate basis of the three transferred CFCs would be spread pro rata across each of the Holding Company’s shares under Treas. Reg. § 1.358-2(b).

\textbf{ii. IRS Commentary Regarding the “Redeemed Shares Only” Approach.}

In TD 9250 (underlying § 367(a) regulations), the IRS and Treasury stated that they believed the “better view” was that the shareholder could recover basis in a § 304 transaction only from the Foreign Acquiring shares newly issued in exchange for Foreign Issuing, and not from any “old and cold” shares in Foreign Acquiring. The Preamble above did not cite any precedent in support of this “better view,” which rather appeared to be intended to safeguard against the perceived abuse under § 367(a) of sheltering gain in Foreign Issuing’s stock with basis in other shares in Foreign Acquiring. As noted above, the 2009 Temporary Regulations under § 367(a) and Notice 2012-15 appear to endorse the

\textsuperscript{15} See REG-143686-07; 2009-8 IRB 579; 74 F.R. 3509-3526 (Jan. 21, 2009).


\textsuperscript{17} Treas. Reg. § 1.358-2(a)(2)(viii).

\textsuperscript{18} See § 1012; see, e.g., Johnson v. United States, supra.
use of this approach.

iii. The “Disappearing Basis” Issue

Assume that the shareholder’s basis in the transferred shares in the Issuing Corporation is not recovered because the distribution is treated as dividend. What happens to the unrecovered basis?

Treas. Reg. § 1.302-2(c) states that the taxpayer shall make “proper adjustments” to preserve unrecovered basis.

If the shareholder directly holds stock in the Acquiring Corporation, the unrecovered basis would be properly allocable to the shareholder’s remaining shares in Acquiring. See Treas. Regs. §§ 1.304-2(c), Example 1 and 1.302-2(c), Example 1. It appears that this allocation should be made even if the taxpayer continues to own shares in the Issuing Corporation.

However, if the shareholder does not directly hold stock in the Acquiring Corporation (as in the diagram below), there are two possible ways of making a “proper adjustment” to basis. As stated by the courts, the taxpayer’s basis should not simply “disappear” in this case. First, the shareholder could allocate the basis to its remaining shares (if any) in the Issuing Corporation. This approach has support of the Fourth Circuit’s dicta in Coyle, as well as the approval of the Service in Rev. Rul. 71-563. Second, the shareholder could allocate the unrecovered basis to the Acquiring Shares held by a related taxpayer. At least where the related taxpayers are both members of the same consolidated group and thus are effectively treated as a single taxpayer, this approach has support in Example 2 of Treas. Reg. § 1.302-2(c) (Husband and Wife example). It also finds support in the Fourth Circuit’s decision in Coyle.

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19 Other authority in the § 302 context expressly provides that the shareholder’s unrecovered basis would be prorated among the classes of stock that it holds in the company making the redemption distribution. See Rev. Rul. 66-37 (where all of the taxpayer’s preferred stock in 100% owned subsidiary was redeemed, basis from preferred was re-allocated pro rata across the common stock); PLR 9346020 (where certain classes of stock were redeemed, the basis was allocated between the remaining common and Series D preferred in proportion the value of each class);

The “Disappearing Basis” Problem

What happens to USP’s unrecovered basis of $25x in the deemed-issued FA shares?

The basis-shifting between related taxpayers under Treas. Reg. § 1.302-2(c) presents justifiable concerns to the Service in cases where one of the parties has net operating losses or is a tax-indifferent party. In Notice 2001-45, the IRS described certain abusive transactions taking advantage of the proper adjustments rule and provided that these
transactions would be treated as “listed transactions.” Subsequently, in litigation involving OPIS transactions, the taxpayers argued that Treas. Reg. § 1.302-2(c) would provide them with favorable basis shifts when stock was redeemed from a foreign tax-indifferent party. The IRS asserted, on several grounds of economic substance and step transaction, that the loss resulting from the basis shift should be disallowed. However, in each case, the IRS did not argue that Treas. Reg. § 1.302-2(c) was inapplicable to shift basis among related parties.

The 2009 Proposed Regulations discussed above would prevent basis shifting more broadly by requiring the taxpayer to treat its unrecovered basis as a deferred capital loss under principles analogous to § 267(f). However, if the shareholder retains a single share of the redeemed class, that single share would apparently continue to be allocated the shareholder’s remaining basis and reflect a large built-in-loss.

In PLR 200810015 (Dec. 2007), the IRS approved proper adjustments to basis that reallocated Sub 2’s excess basis (or ELA) in Sub 3’s stock to the other consolidated group member’s remaining shares in Sub 3. Since all corporations were in a single consolidated group, they were in materially the same situation as the Husband and Wife in the § 302 example. Nonetheless, the ruling indicates that, pending revisions to the § 302 regulations, the IRS will continue to follow Treas. Reg. § 1.302-2(c) in non-abusive cases. See also PLR 9815050 (Jan. 1998).


PLR 201330004 illustrates a case where the taxpayer sold [21]% of stock of a domestic affiliate cross-chain in a § 304 transaction as a step preceding a § 331 liquidation of the Issuing Corporation. Specifically, a domestic consolidated group member, S3, sold at least 21% of the stock of its wholly owned subsidiary, S6, to S5, a domestic affiliate that was controlled but not consolidated with S3 and S6. The IRS ruled that this transaction would be treated as a dividend equivalent redemption under § 302(d), and as a dividend to the extent of S5 and S6’s earnings and profits. One day after the cross-chain sale, S6 liquidated in a transaction that the IRS ruled was governed by Section 331. Any loss recognized by S3 or by S5 on the liquidation would be outside the scope of § 267(f). It is unclear from the face of the ruling whether S5 recognized a loss on the transferred shares, or whether the basis corresponding to the built-in-loss was properly allocated to S3’s remaining [79]% of the stock of S6.

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22 Blum v. Commissioner, TC Memo 2012-16; Reddam v. Commissioner, TC Memo 2012-106.
v. **Acquiring’s Inside Basis in Shares of Issuing.**

Under § 362(b), Acquiring would normally take a carryover basis in the Issuing shares deemed transferred to Acquiring in the § 351 transfer. This basis should not be affected by the shareholder’s recovery of basis under § 301(c)(2) or recognition of capital gain under § 301(c)(3), both of which are applied to the Acquiring shares deemed issued in the § 351 transaction.\(^{23}\)

If the transferred Issuing Shares reflect a built-in-loss on the date of the transfer, § 362(e)(2) would apply to the deemed § 351 transfer.\(^{24}\) Under the default rule, Acquiring’s inside basis in the shares would be reduced to fair market value. Alternatively, the shareholder could elect under § 362(e)(2)(C) to reduce the outside basis in the Acquiring shares deemed issued in the § 351 transfer. The IRS is considering whether to deem shareholders in § 304 transactions to make automatic elections to reduce outside basis in § 304 transactions. Until that rule is implemented, a taxpayer transferring built-in-loss shares in a § 304 transaction should carefully consider the § 362(e)(2)(C) election.

b. **Amounts Taxable under § 301(c)(3).**

i. If the § 304 distribution exceeds the E&P of Acquiring and Issuing, and the available stock basis, then any remaining amounts are taxable as “a sale or exchange of property” under § 301(c)(3).

ii. **Character of the § 301(c)(3) Distribution.** The reference to a “sale or exchange of property” rather than sale or exchange of stock creates some ambiguity as to whether the gain is treated as a sale of the stock in the distributing corporation.

For § 1248 purposes, the IRS has now issued final regulations to confirm that the § 301(c)(3) gain will be treated as a sale or exchange of the distributing corporation’s stock for § 1248 purposes. See Treas. Reg. § 1.1248-1(b) (last sentence). Thus, even if the Foreign Acquiring Corporation and Foreign Issuing Corporation’s E&P are depleted, the § 301(c)(3) gain may be characterized as a dividend carrying indirect foreign tax credits from lower-tier CFCs.

**Impact of § 301(c)(3) Gain on Acquiring’s Inside Basis in Issuing.** In *Fehrs Finance Corp. v. Commissioner*, 58 T.C. 174 (1972), the Tax Court considered whether a § 301(c)(3) gain on the § 304 transaction would increase Foreign Acquiring’s stock basis in Foreign Issuing’s stock to reflect the amount of gain recognized by the shareholder. In holding affirmatively, the Court relied on the plain language of

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\(^{23}\) See Prop. Treas. Reg. § 1.304-2(c), Example 2.

\(^{24}\) See REG-110405-05, Prop. Treas. Reg. § 1.362-1(d), Example 8 (Oct. 21, 2006).
§362(as), stating “[t]he respondent argues that section 362(a) provides for an increase in basis by reason of a gain recognized on the transfer and that such language does not apply to gains recognized under section 301(c)(3). There is nothing in the statute or the legislative history to support such contention. The words of section 362(a) are clearly broad enough to apply to a gain recognized under section 301(c)(3), and accordingly, we reject such contention of the respondent.”\textsuperscript{25} Although the court construed the pre-1997 version of § 304, which applied a capital contribution mechanic, rather than a § 351 transfer, it would seem that the same reasoning would continue to apply under the current version of § 304.

c. The “Control” Requirement.

i. Definition of Control. For § 304 to apply to sale of stock, the person or persons selling the stock must be in “control” of both the Issuing and Acquiring corporation within the meaning of § 304(c). Section 304(c) requires ownership of 50% or more of the vote or value of the stock in each entity, directly or indirectly through a chain of 50%-owned corporations. In determining control, constructive ownership rules apply based on § 318 principles. Under constructive ownership principles, if a Subsidiary sells Issuing to an Acquiring corporation owned by the common parent, the Subsidiary will be deemed to “control” both corporations. See, e.g., Rev. Rul. 70-496. Thus, in a typical internal restructuring, § 304’s control requirement will be satisfied.

ii. Upstream Transactions. One case where the control requirement would not be met is illustrated by Rev. Rul. 74-605. There, X owned Y, which owned Z, which owned S. Z sold the stock of S to its Parent, Y. By virtue of § 318 attribution, § 304(a)(1) might be read literally to apply because Z and Y are both under the common ownership of X. However, the IRS concluded that § 318 attribution generally does not apply so as to deem a corporation to own shares in itself, which would be the result in Rev. Rul. 74-605 if Z were deemed to own the Y stock owned by X. Thus, Rev. Rul. 74-605 sensibly concludes that the sale of stock is taxable under § 1001 rather than § 304, and does not cause a deemed dividend from Y to its subsidiary Z.

Specifically, the ruling concludes that the § 318 attribution rules cannot be applied to deem Z to be in control of Y by virtue of the stock owned by X. Therefore, the ruling turns off the “down” attribution of X’s stock in Y to Z. One question not addressed in the ruling is whether the § 318 attribution rules would continue to attribute apply if Y owned only a portion of the shares of Z. As one commentator has

\textsuperscript{25} See id. at 191.
suggested, reading Rev. Rul. 74-605 in a literal manner might suggest that § 304 could effectively become elective by selling one share in the shareholder corporation to the Acquiring corporation before the transaction.

Also, although the IRS has not directly addressed the point, the language of the D reorganization “control” test in § 368(a)(2)(H) is modeled closely after § 304(c). Thus, the conclusion of Rev. Rul. 74-605 would seem to also apply for purposes of analyzing an upstream cash D reorganization.

d. Sale or Exchange Treatment.

i. Testing for Sale or Exchange Treatment under § 302(b). Although unusual in the context of an internal restructuring, § 304 transactions also can result in a redemption that is treated as a sale or exchange under § 302(b). Section 302(b) sets forth five alternative tests under which a redemption is treated as a sale or exchange rather than a dividend –

1. The redemption under all of the facts and circumstances is “not essentially equivalent to a dividend.”

2. The redemption is “substantially disproportionate” (i.e., after the redemption, the shareholder’s equity interest by vote and by value each is reduced to 80% or less than the shareholder’s pre-redemption interest). Special conditions to apply this test:

   a. Shareholder cannot have >50% voting control after the redemption.

   b. If corporation has both common and Shareholder’s ownership of “common stock” must separately meet the 80% test.

In CCA 201236025, the IRS applied the definition of “common stock” found in Treas. Reg. § 1.305-5(a) for purposes of § 302(b). There, the corporation had outstanding voting convertible preferred stock. The

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26 See Dolan et al., *International Mergers and Acquisitions*.

27 This test looks to whether there is “a meaningful reduction in the shareholder’s proportionate interest in the corporation.” *United States v. Davis*, 70-1 USTC ¶9289, 397 US 301 (1970). Courts and the Service generally look to the three attributes of stock ownership (voting power, the right to dividends, and the right to liquidation proceeds) in determining whether a shareholder’s proportionate interest is reduced. *See Himmel v. Commissioner*, 338 F. 2d 815 (2d Cir. 1964); Rev. Rul. 75-502 and Rev. Rul. 78-401. On the other hand, the IRS has sometimes treated retention of voting control as a “super-factor” that precludes a “meaningful reduction” in interest. *See Rev. Rul. 77-218.*
preferred participated with dividends declared on the common, and had paid dividends in 3 of the last 4 years. Accordingly, the IRS advised that the preferred would be treated as “common” for § 302(b) purposes by applying the standards used in § 305(b).

c. Transaction cannot be part of a plan or series of transactions to periodically reduce each shareholder’s ownership interest, without resulting a substantially disproportionate redemption.

3. The redemption effects a complete termination of the shareholder’s interest in the corporation

4. The redemption is in partial liquidation of the corporation

5. The redemption is made by a RIC to meet an investor demand for a redemption

ii. Firm and Fixed Plan Test. In analyzing a deemed redemption under § 304, the same step-transaction principles applicable to a § 302 redemption also apply. See Zenz v. Quinlivan, 213 F.2d 914 (6th Cir. 1954). Thus, a § 304 related part stock sale, occurring as part of an integrated transaction in which the issuing corporation is disposed of would generally be treated as a sale or exchange under § 302(b). See Merrill Lynch v. Commissioner, 120 TC 12 (2004).

iii. Consequences of Sale or Exchange Treatment. In a § 304 transaction treated as a sale or exchange, the shareholder recovers its basis in the Issuing corporation’s shares and then recognizes any gain from the sale or exchange of the stock. Under § 1248, gain from the sale or exchange of stock in a Foreign Issuing that is a CFC could be re-characterized as a deemed dividend. However, since the § 1248 amount is limited to the Issuing Corporation’s § 1248 E&P is calculated on a ratable share concept (rather than based on the total E&P of the corporation), the deemed dividend under § 1248 (and related FTC) may be less than it would be in the case of a § 304 transaction treated as a dividend.

e. Other Issues Arising in § 304 Transactions.

i. Section 304 Anti-Abuse Rule. Treas. Reg. § 1.304-4 prevents taxpayers from interposing a CFC with no E&P or high-taxed E&P to avoid the application of § 304 to the “true” Issuing or Acquiring corporation. For example, Example 1 illustrates a case where a “blocker” corporation with no E&P is formed to make the acquisition using cash obtained from the “true” Acquiring corporation, so as to cause the deemed dividend to be sourced from Foreign Issuing’s
relatively high-taxed E&P. In this case, the anti-abuse rule would apply and look through the blocker to the true Acquiring corporation. Similarly, the rule can also apply to interjection of a new Issuing Corporation in a § 304 transaction.

ii. Definition of “Property” under § 304. Property is defined for § 304 purposes as money or any other property other than stock in the Foreign Acquiring corporation. See § 317(a). Stock in acquiring is not included.

In Bhada v. Commissioner, 89 T.C. 959 (1987), aff’d, 892 F.2d 39 (6th Cir. 1989), the Tax Court relied on the definition of “property” under § 317 to conclude that § 304(a)(2) did not apply to an early inversion transaction. There, the public stockholders of the McDermott, Inc., a U.S. corporation, exchanged their McDermott Inc. shares for new shares in McDermott International, previously a wholly-owned CFC of McDermott, Inc.

For example, in TAM 200919032, the IRS ruled that the application of § 367(a) to cause an outbound stock transfer to be taxable as a busted § 351 exchange, did not cause § 304 to apply. Thus, the taxpayer could rely on the Foreign Acquiring corporation’s § 902 credits by converting the § 367(a) busted exchange into a § 304 deemed dividend. The IRS reasoned that § 367(a) treats the transferee as “not a corporation” only for purposes of determining the transferor’s recognition of gain on the exchange, and did not cause stock in the transferee to be “property” within the meaning of § 317.

Debt instruments issued by Acquiring qualify as property for § 304 purposes. However, any use of a debt to accomplish a § 304 transaction should pass muster under debt-equity principles. The use of “contingent payment rights” in § 304 transactions treated as distributions is not particularly well-settled. However, if the § 304 transaction is treated as a dividend, then the contingent payment right is probably treated as part of an “open” § 301 dividend transaction in which the § 304 dividend is re-calculated to take into account later E&P at the time when cash payments are made.28

Non-qualified Preferred Stock (“NQPS”). NQPS, even though treated as taxable boot under § 351(b), is nonetheless treated as “stock” for purposes of § 304. Thus, an exchange of Issuing shares for NQPS of Acquiring is not governed by § 304, but rather is treated as a § 351

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28 See, e.g., Fehrs Finance Co. v. Commissioner, 58 TC 174 (1972), aff’d, 487 F2d 184 (8th Cir. 1974) (§ 304 transaction in exchange for an annuity contract not treated as property for U.S. federal income tax purposes); Maher v. Commissioner, 469 F.2d 225 (8th Cir. 1972) (assumption of contingent liability under a guarantee in exchange for shares treated as a § 304 deemed dividend as the Acquiring corporation was called upon to satisfy the guarantee).
transaction with taxable boot to the extent of the NQPS. This would have the effect of converting what would otherwise be a § 304 deemed dividend from Acquiring and Issuing’s E&P into a taxable § 1001 exchange of Issuing’s shares for boot. This would generally result in a deemed dividend under § 1248 sourced solely from the E&P of the Foreign Issuing corporation.

Note also, however, that NQPS is treated as “stock” for purposes of § 306. Under § 306(c)(3), this creates the unappealing possibility that the NQPS might carry a § 306 taint determined by reference to both Acquiring and Issuing’s E&P under § 304(b)(2) principles.

iii. Distributions of Appreciated Property. Distributions of appreciated property by Acquiring result in a taxable E&P event at the Acquiring Corporation under § 311(b). Thus, using appreciated stock in a third corporation or another appreciated asset to effect a § 304 transaction typically is not attractive.

iv. Assumption of Liabilities / § 351 Overlap Rule. As a general matter, a transfer of Foreign Issuing stock to Foreign Acquiring solely in exchange for shares of Foreign Acquiring would be governed by § 351, not § 304. In the case of a distribution of boot in a § 351 transaction where the transferred property is stock in an Issuing Corporation, however, § 304 takes precedence over § 351 and treats the “boot” as received in a § 304 transaction. In the case of cash or other property used as boot, this result is not surprising.

However, under § 304(b)(3)(B), assumption of liabilities generally is treated as “boot” that is taxable under § 304 even if the liabilities do not exceed the basis in the transferred stock. There is an exception for “acquisition indebtedness” used to acquire the stock of Issuing from an unrelated person.29

Importantly, under Rev. Rul. 68-55, liabilities assumed by the transferee in a § 351 exchange are allocated proportionately across all of the property transferred in the § 351 transaction. Thus, § 304 can be triggered where, for example, the U.S. taxpayer incorporates DRE 1, a foreign business with assets and operating liabilities, and also transfers stock in Sub 1 as part of the same § 351 transfer. Under Rev. Rul. 68-55, a portion of DRE 1’s operating liabilities would be treated as assumed in exchange for the stock in Sub 1, causing § 304 to apply.

PLR 201047023 illustrates the interaction between the § 304(b)(3)(B) Acquisition Indebtedness exception and Rev. Rul. 68-55. There, in one step of a multi-step acquisition transaction, the taxpayer

29 See § 304(b)(3)(B); see also Rev. Rul. 80-240 (illustrating common law predecessor to the statutory acquisition indebtedness exception).
transferred Sub 1 stock and Sub 2 stock to a NewCo, in exchange for stock in NewCo and assumption of the Acquisition Indebtedness as to Sub 1 stock. There, the IRS helpfully ruled that, for § 304 purposes, the Acquisition Indebtedness would be allocated solely to Sub 1 stock (where it constituted Acquisition Indebtedness), and not to the Sub 2 stock (where it would not qualify for the Acquisition Indebtedness exception). Interestingly, the IRS did not require a representation from the taxpayer that the value of Sub 1 stock exceeded the amount of the Acquisition Indebtedness. The IRS also respected the incorporation of Sub 1 and Sub 2 as separate from earlier steps in which DREs with operating liabilities were separately incorporated.

4. Detailed Analysis of the “Cash D” Reorganizations.

a. Regulatory Basis for the “Cash D” Reorganization. The concept of a tax-free reorganization in which the only consideration is cash is somewhat surprising, as a pure “cash-out” type transaction represents a complete break of proprietary interest and normally is not the sort of business re-adjustment subject to the reorganization rules. Nonetheless, to combat “liquidation-reincorporation” cases, the IRS successfully developed the theory that a reorganization of assets into a new corporation under common control in exchange solely for cash was a D reorganization, where the cash was treated as boot taxable as a dividend (rather than liquidation proceeds taxable as capital gains).

Treas. Reg. § 1.368-2(l)(2) codifies this case law, and provides that an asset reorganization among corporations that owned by shareholders in identical proportions will be deemed to be a reorganization, notwithstanding that the only consideration is cash. To satisfy the requirement of § 354(b)(1)(B) that “stock or securities” of the Acquiring corporation be “distributed” as part of the plan reorganization, the regulations assume that a Nominal Share is issued as part of the reorganization and then distributed through the intervening chains of ownership as necessary to reflect the stock ownership of the target after the transaction.

Example 1 illustrates a classic “liquidation-reincorporation” case involving two corporations wholly owned by the same individual.

Example 3 illustrates a common fact pattern in a multinational group where Acquiring and Target are each lower-tier subsidiaries in different ownership chains. As a result of the intermediate ownership, the “nominal share” is deemed distributed up to the common parent in a series of § 301 distributions.

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30 Although not cited in the PLR, Rev. Rul. 98-10 provides analogous support for this tracing approach. There, as part of a B reorganization, bond holders in the Target received bonds in the Acquiror. Some of the bond holders were also shareholders; but the IRS treated the bond exchange as occurring separately from the § 368(a)(1)(B) reorganization.

31 See, e.g., Atlas Tool, supra. and cases cited therein.
and then re-contributed down to the direct shareholder of the Acquiring corporation under § 351.

Example 6 of the regulations illustrates a case where shareholder groups of Acquiring and Target have more than de minimis variations. As a result, the asset transfer does not qualify as a D reorganization, and is taxable at the corporate level.  

As a reorganization under § 368, a D Reorganization must meet the non-tax business purpose requirement of *Gregory v. Helvering* – i.e., it must further some purpose germane to the business of the corporation and not be used simply as a device to avoid taxes. While not as stringent as the business purpose test under § 355, the § 368 business purpose test is a higher threshold than is required for a § 304 transaction. Query whether in the case of an “integrated transaction”-type of D reorganization described in Rev. Rul. 2004-83, the taxpayer must show a business reason for electing to check-the-box and apply § 368(a)(1)(D) rather than § 304, or simply a business purpose for the restructuring and sale of stock for cash (a much easier thing to show in most cases).

The remainder of this discussion assumes that the business purpose test is satisfied. Even in a § 304 transaction, it would be prudent to establish and document a business purpose in light of the codification of the economic substance doctrine in § 7701(o).

b. Consequences of a Boot Distribution in a Cash D Reorganization.

§ 356(a)(1) provides that boot in a reorganization is taxable only to the extent of the shareholder’s gain recognized in the exchange. To the extent the boot has the effect of a distribution of a dividend under the § 302 standards discussed in Section II.F above, it is taxable as a dividend under § 356(a)(2).

c. Obama Budget Proposals.

i. Obama’s FY 2010 Budget – proposed to repeal the limitation where Acquiring is foreign and target shareholder is a domestic corporation.

ii. Obama’s FY 2011/2012 Budgets – repeal boot within gain limitation for all boot distributions that are equivalent to dividends.

32 * See also Warsaw Photographic Associates, Inc. v. Commissioner*, 84 T.C. 21 (1985) (refusing to apply liquidation-reincorporation doctrine where there was substantial variation in ownership).

33 *See Treas. Regs. §§ 1.368-1(b), 1.368-1(c) and 1.368-2(g).*

34 *See, e.g., H.R. 62, International Tax Competitiveness Act of 2011*
d. **Combined E&P vs. Only the Target’s E&P.**

i. **Rul. 70-240.** In Rev. Rul. 70-240, the IRS relied on the Fifth Circuit’s decision in *Davant* to hold that in a D reorganization involving identity of shareholder ownership, both acquiring and the target would be treated as “the corporation” for purposes of § 356. Thus, boot would be re-characterized as a dividend to the extent of the two corporation’s combined E&P (a result similar to a § 304 transaction). The ruling did not state which corporation’s E&P would be deemed distributed first, since it was a domestic ruling where the source of the distribution was not relevant.

ii. **CCA 201032035.** The IRS recently re-visited Rev. Rul. 70-240 in the context of two cross-border cash D reorganizations. The CCA assumes that the D reorganizations had a business purpose, although this point was challenged by Exam. The CCA is notable for several reasons. First, the National Office accepted the taxpayer’s position that the boot limitation of § 356(a)(2) governs the amount of cash that was taxable as gain or a dividend. Second, the IRS adhered to its “longstanding position” in Rev. Rul. 70-240 that both FSub 1’s and the foreign targets’ E&P would be included in the boot dividend. In support of this conclusion, the IRS not only cited *Davant* but also pointed to the Supreme Court’s decision in *Clark* as indirectly supporting the Rev. Rul. 70-240 position. Third, the IRS did not address the question of which entity’s E&P would take priority, although it did note the issue.
iii. Case law contrary to Rev Rul. 70-240. Courts (other than the Fifth Circuit in *Davant*) have interpreted “the corporation” in § 356(a)(2) to refer to solely the target corporation’s E&P. See *American Manufacturing Co. v. Commissioner*, 55 T.C. 204 (1970); *Atlas Tool Co. v. Commissioner*, 614 F.2d 860 (3d Cir. 1980); *Estate of Bell v. Commissioner*, T.C. Memo. 1971-285. The Tax Court’s reasoning in *American Manufacturing* is particularly helpful in referring to the fact that any loophole here must be closed by Congress.

Note also that Rev. Rul. 70-240’s reliance on *Davant* is flawed in that it confuses identity of shareholder interest with corporate identity. In *Davant*, the Fifth Circuit held that the liquidation reincorporation case before it was an F reorganization with a separate dividend, as well as a D reorganization. Now it is clear that the reorganization involved in *Davant* would only be a D reorganization governed by § 356, not an F governed by § 1.301-1(l) in light of the TEFRA amendments clarifying that § 368(a)(1)(F) applies to a change in form of “one corporation.” Thus, it is questionable whether the Fifth Circuit would reach the same conclusion on these facts now.

iv. Ordering between Foreign Acquiring and Foreign Target’s E&P. There does not appear to be any authority addressing this question. In Report No. 1227 (Dec. 29, 2010), New York State Bar put forward three possible approaches: (1) Target first; (2) Acquiring first, and (3) a § 381 approach. The NYSBA report expressed a preference for the “Acquiring First” approach so as to conform to § 304(b)(2).

e. Carryover of Basis, E&P and Other Attributes.
i. **Unabsorbed Basis and the Nominal Share.** Assume that CFC-T has stock basis of $100x and FMV of $70x and is merged into CFC-A in an all-cash transaction in exchange for $70x. Under § 356(c), the $30x loss shall not be recognized.

In TD 9475 (finalizing Reg. § 1.368-2(l)(2)), the IRS indicated that any unabsorbed basis would attach to the nominal share, which would be deemed distributed and re-contributed to the shareholder of Acquiring if necessary. It also stated that the nominal share was not merely a means to deem the § 354 distribution requirement to be satisfied but would have significance for federal tax purposes. In a cross-border context, the deemed distribution of the nominal share could result in a disallowed loss under § 311(a); however, it could also result in a reduction to E&P in an amount equal to the basis of the nominal share under § 312(a)(3).

Several commentators argued that the nominal share concept should allow a related shareholder in the acquiring company to preserve basis, rather than the shareholder of the transferor recognizing a disallowed § 311(a) loss on the distribution of the nominal share. In TD 9558, the IRS issued temporary regulations to clarify that: (1) in a case where the shareholder of target directly owns stock in acquiring, the shareholder can designate which shares will receive any unrecovered basis under § 358 (Example 15); and (2) in a case where the shareholder doesn’t directly own stock in the acquiring company, the unrecovered basis does, in fact, attach to the nominal share, which is deemed distributed and re-contributed to reflect the actual ownership of the issuing company (Example 16). Thus, as a planning matter, in the case of a CFC shareholder, any unrecovered basis will reduce E&P under § 312(a)(3) on the deemed distribution of the nominal share. In the case of a consolidated group member, the deemed distribution should give rise to a deferred intercompany loss under Reg. § 1.1502-13(f)(2). The taxpayer desirous of planning around these results could have the acquiring company issue a small number of actual shares of stock, which would serve as the receptacle for any unrecovered basis.

ii. **E&P Carryover.** At the corporate level, the Acquiring corporation in a cash D will succeed to the Target’s E&P, foreign taxes and other attributes under § 381. The E&P that carries over may be reduced under § 312 to reflect the boot dividend. One uncertain question is the extent to which the distribution of boot that is treated as a recovery of capital under § 356(a)(1) nonetheless reduces the amount of Target’s E&P that carries over to Acquiror.

Several authorities bear on this question:

1. § 312(a) – on a distribution of property by a corporation with
respect to its stock, the E&P account shall be reduced by the amount of money distributed and adjusted basis of other property.

2. § 312(d) – distribution to a distributee of stock or securities, or other property, by or on behalf of the corporation, shall have no effect on the E&P account if no gain or loss was recognized by the distributee on the receipt of the stock, securities or other property.

3. § 312(n)(7) – in a redemption taxable as a sale or exchange, the amount of the distribution charged to E&P shall not exceed the shareholder’s ratable share of accumulated E&P.

4. Treas. Reg. § 1.312-11. This regulation implements § 312(d), and states that in tax-free reorganizations, distributions of stock or securities do not reduce E&P, if there is no gain or loss recognized to the distributees. However, in a liquidation not pursuant to a reorganization in which no gain or loss is recognized to the distributee, then E&P is reduced by the distribution, but only to the extent of the amount not properly chargeable to the capital account.

5. Rev. Rul. 72-327 & GCM 34804. The ruling addresses the following fact pattern: X merges into Y. X’s corporate shareholder, M, received Y stock worth $100x and boot with a fair market value of $40 and basis to Y of $10. M’s basis in X’s shares was $90x, and M’s ratable share of Y’s E&P under § 356(a)(2) was $30x.

Thus, M’s total realized gain was $50x, of which $40 was recognized under § 356(a)(1) (lesser of boot or realized gain). M received a boot dividend of $30x (lesser of taxable boot or E&P).

The ruling held that Y recognized $30x of gain under § 1001 on the use of appreciated property to pay a boot dividend. Further, Y succeeded to X’s E&P under § 381.

X’s E&P was not affected by its receipt and distribution of boot pursuant to the reorganization plan under § 361 and § 312(f)(1). However, X’s E&P was diminished by $40x under § 312(a)(3) to reflect the amount of boot distributed. Note that this E&P reduction exceeded the amount of the boot dividend includible by M under § 356(a)(2).

Does the above Rev. Rul. apply to a boot distribution where no gain is realized or recognized because of § 356(a)(1), or does
§ 312(d) govern in that case? If so, should the recognition of $1 of boot gain really change the resulting E&P reduction?

6. JCT Explanation of President’s 2010 Budget Proposals (“JCS-4-09”) – the JCT appears to assume that E&P remains available for future distribution to the extent that § 356(a)(1) limits the shareholder’s boot dividend. “[U]nder present law, any previously untaxed earnings and profits not deemed distributed by virtue of the boot-within-gain limitation rule will be preserved for future taxation.”

f. Characterization Questions in D Reorganizations.

i. D Reorganization / F Reorganization Overlap. In a restructuring of CFCs, an existing F7 was reincorporated in Country E as NewCo1 in an F reorganization. Shortly before the F reorganization, F7 made a § 301 distribution of property. As part of the same plan as the F reorganization, the existing shareholder contributed cash and business assets to F7 in exchange for a note and equity.

![Diagram of D Reorganization / F Reorganization Overlap]

The IRS characterized the merger of F7 into NewCo as an F reorganization, and treated the note a separate § 302 redemption of NewCo’s stock on the authority of Treas. Reg. § 1.301-1(l) and Rev. Rul. 61-156. The fact that assets were simultaneously transferred into NewCo did not affect the characterization, since they did not prevent

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35 For an excellent discussion of this issue, see Cummings, “Corporate E&P and Reorganization Boot,” 2010 TNT 60-8 (Mar. 30, 2010).
the transaction as being a change in the form of incorporation of one company (F7).

This case illustrates that a D reorganization requires a combination of two or more corporations with operations and/or tax histories. If the transaction involves solely one operating company, § 368(a)(1)(F) and § 301 will apply, rather than § 368(a)(1)(D) and § 356. Query whether D reorganization treatment would have been obtained if the taxpayer had re-ordered the steps above so that the § 351 asset transfers preceded the reorganization of F7 into NewCo.

ii. Ordering of Steps and Integrated Transaction Treatment. In PLR 201037026 (Sept. 17, 2010) (rulings on Sub 40 and Sub 9 reorganizations), the IRS ruled that the same integrated transaction approach applied to a cross-chain sale where the check-the-box elections occurred prior to the sale. As in Rev. Rul. 2004-83, the sole consideration for the cross-chain transfer was cash.

It would seem important to the IRS’s conclusion that the Acquiring entity was not owned within the same “qualified group” within the meaning of Treas. Reg. § 1.368-1(d) under the shareholder of the checked subsidiary (Sub7). If the assets were transferred to a member of the shareholder entity’s “qualified group” (rather than a brother sister entity), Treas. Reg. § 1.368-2(k) would seem to prohibit the treatment of the integrated transaction as a cross-chain D
reorganization. See, e.g., PLR 201127004 (July 2011) and PLR 200952032 (Dec. 2009).

5. **International Tax Consequences of Cash D Reorganizations.**

a. **Foreign Tax Credits.**

i. Rev. Rul. 74-387 – where USP owned 10% of each of FT and FA, and received boot in an asset reorganization of FT into FA, the IRS ruled that this was a “dividend” for purposes of § 902. The 10% ownership requirement was not at issue, since USP directly owned at least 10% of the stock of each of FT and FA.

ii. § 902 Ownership Requirement. As noted above, in the § 304 context, the IRS favorably determined in Rev. Rul. 91-5 and Rev. Rul. 92-85 that the shareholder’s constructive ownership of the Foreign Acquiring corporation in a § 304 transaction satisfies the § 902 ownership requirement. There is no similar rule for purposes of cash D reorganizations. However, the rulings in the § 304 area above would provide analogous support.

b. **Withholding Tax.** The IRS’ historical position was that a boot dividend in a reorganization is not FDAP income subject to withholding tax.\(^{36}\) Under the current § 1441 regulations, items of U.S. source income generally are treated FDAP unless they are gains from property or specifically excluded from treatment as FDAP under regulations. Nonetheless, it might be argued that a boot dividend should not be subject to FDAP withholding because, like an actual gain from the sale of property, it depends on the shareholder’s basis in the surrendered shares under § 356(a)(1).

c. **PTI.** As with a § 304 deemed dividend, boot treated as a dividend under § 356(a)(2) should carry PTI. In a number of PLRs, the IRS has ruled that the PTI exclusion is available with respect to a boot dividend sourced out of PTI. See PLRs 9349008, 9327010, and 9117053. This is consistent with the § 959 Proposed Regulations under which any distribution treated as a dividend allows for the recovery of PTI.\(^{37}\) However, for a persuasive contrary view, *see* Scanlon, “Having Your Basis and PTI Too?” 29 DTR J-1 (Feb. 14, 2012).

d. **Subpart F Consequences.** As with a § 304 deemed dividend, a boot dividend from one CFC to another CFC generally should qualify for the § 954(c)(6) look-through rule.

e. § 367(a) Consequences. Treas. Reg. § 1.367(a)-3(e), Example 16 illustrates a case of where US’s foreign subsidiary F1 is merged directly into F2 in an

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\(^{36}\) PLR 5901265280A (applying I.T. 3781, 1946-1 C.B. 119).

\(^{37}\) See Prop. Treas. Reg. § 1.959-1(c)(1).
asset reorganization under § 368(a)(1)(D) in exchange for shares in F2. The US company’s § 354 exchange of F1 shares for F2 shares is not subject to the GRA rules, barring a subsequent contribution of F1’s assets to a new subsidiary that causes the indirect stock transfer rules to apply.

f. Certain § 304 rules inapplicable to Cash D Reorganizations?

To address certain perceived abuses of § 304 transactions, the IRS and Treasury, and indeed Congress, have engrafted certain anti-abuse rules onto the § 304 regime. See, e.g., Treas. Reg. § 1.304-4 (anti-abuse rule for sourcing E&P); § 304(b)(5) (limitation on consideration of E&P and § 902 credit pools of certain foreign acquiring corporations). Does these rules apply by analogy to cash D reorganizations? Could the IRS reach a similar result on audit under any common law doctrines?