

Navigating the IRS's Attack on Perceived Repatriation Transactions

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INTRODUCTION

Over the last couple of years, the state of tax laws relating to a U.S. multinational corporation's ability to “defer” its foreign earnings for U.S. tax purposes has been an area of great interest in the press. Indeed, managing the complex tax laws that comprise the United States' anti-deferral rules (e.g., the Subpart F rules) is a critical issue for many U.S. multinational taxpayers. While the Obama Administration and Congress have been engaged in debate over several issues relative to deferral, the Internal Revenue Service and the Treasury Department (hereinafter, collectively referred to as “the IRS”) as always have been busy advancing the administration of existing law. In some cases, IRS projects in recent years have provided helpful guidance, and even relief, for U.S. multinational taxpayers (e.g., Notice 2008-91¹ and subsequent related guidance,² and the 2008 “contract manufacturing” regulations).³ In other cases, the IRS has determined that action has been necessary to curb certain apparent tax benefits relative to transactions that the IRS perceives to result in repatriations of foreign earnings without the corresponding U.S. tax consequences of a repatriation. The latter situations are the focus of this article.

¹ 2008-43 I.R.B. 1001.

² See Notice 2009-10, 2009-5 I.R.B. 419, and Notice 2010-12, 2010-4 I.R.B. 326.

³ T.D. 9438, 73 Fed. Reg. 79334 (12/29/08).

The IRS has focused on certain cross-border transactions involving the Internal Revenue Code's Subchapter C provisions that it believes result in inappropriate U.S. tax results —such transactions include so-called “Killer B” and “Deadly D” reorganizations, and certain §956 and §304 transactions.⁴ The IRS has viewed these transactions in one form or another as potential repatriation transactions, but has been concerned that taxpayers may be able to execute such transactions without incurring the corresponding U.S. tax consequences (e.g., dividend income) that normally follow from a repatriation transaction. This has prompted a series of IRS notices and regulations to achieve what the IRS believes to be the appropriate U.S. tax consequences of such transactions. To achieve its intended effects, the IRS has employed several approaches including modification of the normal Subchapter C consequences of a particular transaction, as well as deeming certain transactions to occur for tax purposes that do not in fact occur with respect to the legal form of the transaction.

⁴ All “§” references herein are to the Internal Revenue Code of 1986, as amended (“the Code”), and all “Regs. §” references are to the regulations thereunder, unless otherwise stated.

For some of the transactions mentioned above, the IRS has relied on its authority under §367(b)⁵ to promulgate guidance. When it has relied on this statute to address a particular transaction, the

IRS often has cited the legislative history, which provides that §367(b) was enacted to ensure that international tax considerations are adequately addressed when the provisions of Subchapter C of the Code apply to certain non-recognition exchanges involving foreign corporations. The IRS has specifically cited language in the legislative history indicating that

⁵ Section 367(b)(1) provides that in the case of any exchange described in §332, 351, 354, 355, 356, or 361, in connection with which there is no transfer of property described in §367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of federal income taxes. Section 367(b)(2) provides that the regulations prescribed pursuant to §367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a U.S. person, including regulations providing the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to the E&P, or adjustments are made to the basis of stock or securities, and the basis of assets.

it is essential to protect against tax avoidance ... upon the repatriation of previously untaxed foreign earnings.⁶

⁶ H.R. Rep. No. 658, 94th Cong., 1st Sess. 241(1975).

For instance, in the “Killer B” transaction discussed below, under §367(b) a stock purchase by a foreign subsidiary of its U.S. parent’s stock from its U.S. parent pursuant to a triangular reorganization results in a deemed §301 distribution by the foreign subsidiary to its U.S. parent in a separate transaction immediately prior to the reorganization transaction. One may question whether this transaction is a repatriation of foreign earnings. Absent such a recast, the earnings and profits (“E&P”) of the foreign subsidiary in question would be preserved and available for future taxation upon certain events (e.g., a dividend distribution from the foreign subsidiary to its U.S. parent). Thus, it appears that the IRS has equated, in some instances, the transfer of cash or other property by a foreign corporation to a U.S. person as a repatriation of the foreign corporation’s E&P. Consequently, as discussed below, the IRS has interpreted the language of the legislative history of §367(b) very broadly to promulgate rules that ensure certain tax consequences relative to these, and other, transactions.

In addition to the transactions mentioned above, the IRS also has focused on the “boot-within-gain” limitation of §356 and its use in certain reorganization transactions, such as a cross-border cash “D” reorganization.⁷

⁷ Although the boot-within-gain limitation of §356 is not limited to cash “D” reorganizations (e.g., it can apply in certain other reorganization transactions to limit an exchanging shareholder’s gain/income on its exchange), because the use of the boot-within-gain limitation in cash “D” reorganizations has received the most visibility and scrutiny, we focus on cash “D” reorganizations in the article.

In this article, we provide an overview of each of the transactions mentioned above and describe

the IRS's specific response to the transaction types in question. We then conclude with a discussion of the boot-within-gain limitation of §356 and its application in the context of cash "D" reorganizations along with some possible responses by the IRS and the Obama Administration to taxpayers' achieving certain tax results pursuant to such transactions.

REPATRIATION AND "KILLER B," "DEADLY D," AND §956 TRANSACTIONS

In two Notices⁸ that culminated in the issuance of temporary regulations,⁹ the IRS targeted perceived repatriation strategies involving certain reorganization transactions. This guidance specifically addressed certain triangular reorganizations involving one or more foreign corporations (as either a parent or a subsidiary, or both) in which a subsidiary ("S") of a parent corporation ("P") acquired for property P's stock from either P or other persons (e.g., P's existing shareholders) and used the P stock to acquire the stock or assets of a target corporation in the triangular reorganization (i.e., the "Killer B" and similar triangular reorganizations). In the case where S purchased the P stock from P, S would take a cost basis in the P stock under §1012 and would not have any gain when it immediately uses such stock to facilitate the triangular reorganization. P would be protected by §1032 on the purchase of its stock by S.¹⁰ Under the actual form of the transaction, S's purchase of the P stock from P (or P's shareholders) would not result in a §301 distribution from S to P.

⁸ Notice 2006-85, 2006-41 I.R.B. 677; Notice 2007-48, 2007-25 I.R.B. 1428.

⁹ Regs. §§1.367(a)-3T(b)(2)(i)(C) and 1.367(b)-14T. As a result of the temporary regulations, Notices 2006-85 and 2007-48 became obsolete.

¹⁰ In one version of this transaction, which gave rise to the IRS guidance, P is a domestic corporation that wholly owns S (a controlled foreign corporation or CFC, as defined in §957) and S1 (a domestic corporation). S1 wholly owns T (another CFC). S purchases P stock for either cash or a note, and provides the P stock to S1 in exchange for all the T stock in a triangular B reorganization. P and S take the positions discussed above. Additionally, although S's ownership of the P stock could create a §956 issue, because S will dispose of the P stock before the close of a quarter of the taxable year, which is the time at which to measure P's share of the average amount of U.S. property held by S, the issue is avoided. Further, S1's exchange of T's stock is a transaction that potentially is covered by §367(a) and (b). If the T stock is appreciated, S1 would have to enter into a gain recognition agreement ("GRA") under §367(a) to avoid recognizing the gain on the transfer. See Regs. §§1.367(a)-3(b) and -3(d)(1)(iii)(B). Further, assuming a GRA is filed, S1 would not have an income inclusion of its §1248 amount attributable to its T stock (assuming there is a §1248 amount attributable to such stock) as a result of its exchange of its T stock under Regs. §1.367(b)-4(b)(1)(ii). For commentary on the notices and regulations, see Calianno and Petersen, "IRS Issues Notice on 'Killer B' Transactions: Curbing Repatriation or Overreaching?" *J. Int'l Tax* (Jan. 2007), Calianno and Petersen, "Notice 2007-48: A Further Attack on the 'Killer B' and Similar Transactions," *J. Int'l Tax* (Aug. 2007); Calianno and Petersen, "The 'Killer B' Saga Continues — IRS Issues New Regulations," *J. Int'l Tax* (Sept. 2008). Although commonly referred to as the "Killer B" guidance, the guidance addresses not only triangular B reorganizations but also other types of triangular reorganizations, including triangular asset reorganizations. For further details, see T.D. 9400, 73 Fed. Reg. 30301 (5/27/08).

According to the IRS, these transactions were being used as a mechanism to repatriate S's E & P to P without the appropriate tax consequences of such a distribution. The IRS responded by creating certain adjustments and deemed transactions under the authority of §367(b) to recast the actual stock purchase transactions to achieve the desired result of a deemed distribution from

S to P that, in most cases, would result in a negative tax consequence to the taxpayers involved.¹¹

¹¹ For a full discussion of the tax treatment of the distribution from S to P and the deemed transactions that occur depending on the particular facts, see authorities cited in footnote 10.

In issuing this guidance, the IRS relied on its authority under §367(b). In fact, the temporary regulations dealing with these types of transactions¹² include the following language reflecting its view of these types of transactions as being repatriation transactions within the scope of §367(b):

¹² Regs. §1.367(b)-14T.

The purpose of this section is to prevent what is in effect a distribution of property to P without the application of provisions otherwise applicable to property distributions, when in connection with a triangular reorganization S acquires, in exchange for property, all or a portion of the P stock used in the reorganization.¹³

¹³ In Notice 2006-85, in addition to stating that these types of transactions can have the effect of repatriating a foreign subsidiary's E& P without a corresponding dividend when S is a foreign corporation and P is a domestic corporation, it indicated that such transactions also could be used to repatriate U.S. E& P without a withholding tax when S is domestic corporation and P is a foreign corporation and can be used to facilitate the subsequent repatriation of foreign E& P to U.S. shareholders without U.S. income tax when S and P are both foreign corporations.

Thus, even though the stock purchase transaction is in connection with a qualifying reorganization transaction, P (as defined in the regulations) can have a deemed dividend.

“Deadly D” Reorganizations

Following the above guidance, the IRS issued guidance addressing “Deadly D” reorganizations, which the IRS viewed as another type of repatriation transaction. These transactions were addressed initially by Notice 2008-10¹⁴ and subsequently by proposed regulations (REG-209006-89).¹⁵ The type of transaction targeted by this Notice generally involved the interaction of several rules, including the boot-within-gain limitation of §356 (discussed in detail later in this article but not in the Notice), the indirect stock transfer rules under the §367(a) regulations, the §367(a) and (d) rules dealing with certain outbound transfers, the coordination rule under the §367(a) regulations, and §367(a)(5). The following fact pattern illustrates the targeted transaction.

¹⁴ 2008-3 I.R.B. 277. For a variation of the possible transactions targeted, see the Notice.

¹⁵ 73 Fed. Reg. 49278 (8/20/08).

USP, a domestic corporation, owns 100% of the stock of FA, a foreign corporation. USP's basis in its FA stock is \$100x. USP also owns 100% of the stock of UST, a domestic corporation, and USP's basis in its UST stock equals its fair market value ("FMV") of \$100x. UST's property consists of property with a zero tax basis, such as self-created intangibles or fully depreciated tangible property. UST sells its property to FA in exchange for \$100x cash and, in connection with the transaction, UST liquidates and FA transfers all of the property acquired from UST to U.S. Newco, a newly formed domestic corporation, in exchange for 100% of the U.S. Newco stock ("the Transaction"). The Transaction generally would be treated as an all cash "D" reorganization (discussed in detail below) followed by a contribution of assets to a controlled subsidiary as part of the Transaction. The Transaction also would result in an indirect stock transfer by USP because of FA's contribution of the acquired USP assets to U.S. Newco.¹⁶

¹⁶ The Transaction as it relates to USP also would implicate the indirect stock transfer rules under Regs. §1.367(a)-3(d)(1), -3(d)(1)(v) and -3(c) and generally would result in a taxable transaction. Although not discussed in the Notice, USP presumably took the position that it did not have any inherent gain that would be required to be recognized on the indirect stock transfer.

USP took the position that, pursuant to the coordination rule exception of Regs. §1.367(a)-3(d)(2)(vi)(B)(1)(i), UST's transfer of property to FA was not subject to §367(a) or (d) because the basis adjustment requirement of §367(a)(5) is satisfied if USP reduced by \$100x its basis in the FA stock that it held before the Transaction. Thus, USP concluded that it would be able to receive the \$100 of cash without having an income inclusion (via §356) without §367(a) or (d) applying to UST's outbound transfer of its assets to FA.

In the Notice, the IRS determined that the adjustments described in §367(a)(5) could not be satisfied by making adjustments to its "old and cold" FA stock and, therefore, §367(a) and (d) would apply to UST's transfer of its assets to FA.¹⁷

¹⁷ The IRS stated in Notice 2008-10 that it would issue regulations under §367(a) to *clarify* how the two exceptions to the general coordination rule of Regs. §1.367(a)-3(d)(2)(vi)(A) are to be applied. For purposes of the Notice, "Exception One" is described in Regs. §1.367(a)-3(d)(2)(vi)(B)(1)(i) and (ii), and "Exception Two" described in Regs. §1.367(a)-3(d)(2)(vi)(B)(2). Both exceptions require that the domestic controlled corporation/ domestic transferee's (as the case may be) basis in the assets be no greater than the domestic acquired corporation / U.S. transferor (as the case may be) had in such assets. The IRS stated that the rule of Regs. §1.367(a)-3(d)(2)(vi)(B)(1)(i) (i.e., the first of two ways for qualifying for Exception One) will be modified to clarify that the basis adjustment required as provided in §367(a)(5) must be made to the stock of the foreign acquiring corporation received by domestic corporate shareholders of the U.S. transferor in the reorganization such that the appropriate amount of unrecognized gain in the U.S. transferor's property is reflected in such stock. Thus, the basis adjustment requirement cannot be satisfied by adjusting the basis in stock of the foreign acquiring corporation held by such shareholders before the reorganization. The Notice further stated that the regulations will *clarify* that, to the extent the appropriate amount of unrecognized gain in the U.S. transferor's property cannot be preserved in the stock of the foreign acquiring corporation received in the reorganization, the U.S. transferor's transfer of property to the foreign acquiring corporation shall be subject to §367(a) and (d). It also said Regs. §1.367(a)-3(d)(2)(vi)(B)(2) will be modified to clarify that Exception Two shall not apply to a §351 transfer that is also a §361 exchange. Thus, the Notice stated that a §351 transfer that is also a §361 exchange may qualify, if at all, only for Exception One

(Emphases added).

The IRS followed up in 2008 with proposed regulations under §367(a)(5), proposed changes to the coordination rule and other proposed changes to other provisions (see REG-209006-89).¹⁸ In referencing Notice 2008-10 and referencing the repatriation nature of the transaction, the IRS stated in the Preamble:

¹⁸ For a general discussion of the §367(a)(5) proposed regulations, see Calianno, "Section 367(a)(5) — Proposed Regulations Provide Long-Awaited Guidance," *J. Int'l Tax* (Mar. 2009). See also Prop. Regs. §1.367(a)-7 and 1.367(a)-3(d)(2)(vi)(B).

In response to transactions intended to use the coordination rule exception inappropriately to repatriate earnings and profits of foreign corporations without the recognition of gain or a dividend inclusion, the IRS and Treasury Department issued Notice 2008-10 (2008-3 I.R.B. 277). The notice announced that the conditions for the application of the coordination rule exception would be revised to clarify that any adjustment to basis required under section 367(a)(5) must be made to the basis of stock of the foreign acquiring corporation received by the control group members in the asset reorganization such that the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation to the foreign acquiring corporation is reflected in such stock. The notice clarifies that the control group members cannot satisfy the basis adjustment requirement by adjusting the basis of stock of the foreign acquiring corporation held before the reorganization. The notice further states that the revised regulations would confirm that to the extent the appropriate amount of built-in gain in the property transferred by the domestic acquired corporation cannot be preserved in the stock received by the control group members in the reorganization, then the domestic acquired corporation's transfer of property to the foreign acquiring corporation shall be subject to section 367(a) and (d). [Emphasis added.]

The proposed regulations thus incorporated, with modifications, the clarifications to the conditions for the application of the coordination rule announced in Notice 2008-10.

Section 956 Transactions

In the same year that the IRS issued Notice 2008-10 addressing "Deadly D" reorganizations, the IRS also issued final and temporary §956 regulations targeting certain types of transactions that the IRS viewed as having the effect of repatriating a controlled foreign corporation's ("CFC's")¹⁹ E& P without a corresponding dividend inclusion or an income inclusion under §951(a)(1)(B) by reason of the CFC's investment in U.S. property.²⁰ One of the transactions targeted by these regulations involves one member of a U.S. consolidated group transferring its stock to a CFC that is owned by another member of the consolidated group in exchange for some CFC stock and property (e.g., cash) in a §351 transaction. To avoid an income inclusion, taxpayers asserted that the property issued by the CFC in the transaction generally is not treated as a taxable distribution because of the operation of certain nonrecognition provisions (e.g., §1032) that apply to the transaction.²¹ Additionally, although the CFC owns U.S. property within the meaning of §956(c) (i.e., the stock of the U.S. transferor) and could have an income inclusion under §951(a)(1)(B) if certain conditions are satisfied, the U.S. shareholders (as defined in §951(b)) of the CFC asserted

that there is no income inclusion under §951(a)(1)(B) that may otherwise result from the CFC owning the stock of the U.S. transferor. They asserted that the applicable Subchapter C basis rules under §362(a) treat the U.S. transferor stock held by the CFC as having a zero basis. This is important to the analysis because the CFC's basis in the U.S. property limits the possible income inclusion to its U.S. shareholders.²²

¹⁹ References herein to CFCs are to the term as defined in §957.

²⁰ See T.D. 9402, 73 Fed. Reg. 35580 (6/24/08), and Regs. §1.956-1T(e)(6). For a detailed discussion of these regulations, see Caliano and Spitzenger, "Another Attack on Perceived Repatriations — The IRS Issues Temporary Regulations Under Section 956," 37 *Tax Mgmt. Int'l J.* 732 (Dec. 2008).

²¹ For the full scope of the regulation, see Regs. §1.956-1T(e)(6).

²² See generally §956(a)(1) and Regs. §1.956-1(e).

Relying on the authority under §§367(b) and 956(e),²³ the IRS addressed the scenario above in temporary regulations providing that, solely for purposes of §956, the basis in the U.S. property in this type of transaction will be treated as being no less than the FMV of the property (e.g., the cash) transferred by the CFC in exchange for the U.S. property (i.e., the stock of the U.S. transferor).²⁴ By providing this minimum basis rule for purposes of §956, the IRS has eliminated the ability of a U.S. shareholder of a CFC to avoid a §951(a)(1)(B) income inclusion by relying on the CFC having a zero basis in the U.S. property.²⁵

²³ Section 956(e) provides that the Secretary shall prescribe such regulations as may be necessary to carry out the purposes of §956, including regulations to prevent the avoidance of §956 through reorganizations or otherwise.

²⁴ See generally Regs. §1.956-1T(e)(6).

²⁵ A number of special rules and exceptions must be considered before concluding that a U.S. shareholder of a CFC has a §951(a)(1)(B) inclusion. A discussion of all of those special rules and exceptions is beyond the scope of this article.

The following example from the §956 temporary regulations illustrates the application of this rule:

Facts. USP, a domestic corporation, is the common parent of an affiliated group that joins in the filing of a consolidated return. USP owns 100% of the stock of US1 and US2, both domestic corporations and members of the USP consolidated group. US1 owns 100% of the stock of CFC, a controlled foreign corporation. US2 issues \$100x of its stock to CFC in exchange for \$10x of CFC stock and \$90x cash. US2's transfer of its stock to CFC is described in section 351, US2 recognizes no gain in the exchange under section 1032(a), and CFC's basis in the US2 stock acquired in the exchange is determined under section 362(a).

Analysis. The US2 stock acquired by CFC in the exchange constitutes U.S. property under Regs. §1.956-1T(e)(6)(ii) because CFC acquires the US2 stock from US2, the issuing corporation. Therefore, because CFC's basis in the US2 stock is determined under section 362(a), then for purposes of section 956, CFC's basis in the US2 stock shall, under Regs. §1.956-1T(e)(6)(iii), be no less than \$90x, the fair market value of the property exchanged by CFC for the US2 stock (the \$10x of CFC stock issued in the exchange does not constitute property for purposes of Regs.

§1.956-1T(e)(6)(iii)). Pursuant to Regs. §1.956-1T(e)(6)(iv), for purposes of Regs. §1.956-2(d)(1)(i)(a) CFC shall be treated as acquiring its basis of no less than \$90x in the US2 stock at the time of its transfer of property to US2 in exchange for the US2 stock. The result would be the same if, instead of CFC transferring \$90x of cash to US2 in the exchange, CFC assumes a \$90x liability of US2.²⁶

²⁶ Regs. §1.956-1T(e)(6)(vi) *Ex. 1*.

REPATRIATION AND §304 TRANSACTIONS

The IRS recently has focused on certain §304 transactions that it believes can have the effect of repatriating cash or other property without the consequences that the IRS believes should follow from the transaction.²⁷ Specifically, the IRS has issued guidance expanding the anti-avoidance rule of Regs. §1.304-4T to address certain §304 transactions, as well as modifying regulations under §367(a) and (b) dealing with certain §304(a)(1) transactions.

²⁷ It is worth noting that §304 often is used affirmatively by taxpayers to achieve certain results. For instance, a U.S. corporation may use §304 to access the foreign tax pools of its CFCs under §902 while avoiding foreign withholding taxes that otherwise may result from an actual distribution of the E& P of its CFCs.

By way of background, §304(a)(1) generally provides that, for purposes of §§302 and 303, if one or more persons are in control (as defined in §304(c)) of each of two corporations and, in return for property, one of the two corporations (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from the person (or persons) so in control, then, unless §304(a)(2) applies, the property will be treated as a distribution in redemption of the stock of the acquiring corporation. To the extent that §301 applies to the distribution, the transferor and the acquiring corporation are treated as if: (1) the transferor transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which §351(a) applies; and (2) the acquiring corporation then redeemed the stock that it is deemed to have issued. The determination of the amount of the property distribution that is a dividend (and the source thereof) is made under §304(b)(2) as if the property is distributed by the acquiring corporation to the extent of its E& P, and then by the issuing corporation to the extent of its E& P. Section 304(a)(2) provides rules relating to acquisitions by subsidiaries. Several definitions and special rules in §304 give further guidance on the application of the provision (e.g., §304(b)(5), which may limit the E& P of a foreign acquiring corporation taken into account under §304(b)(2) in certain instances).

Regs. §1.304-4T²⁸ (before its amendment by T.D. 9477 in 2009) was an anti-avoidance regulation that was issued in 1988 in T.D. 8209.²⁹ This regulation was designed to prevent the circumvention of the proper application of §304. Specifically, former Regs. §1.304-4T(a) read as follows:

²⁸ 74 Fed. Reg. 69021(12/30/09). These temporary regulations apply to acquisitions of stock occurring on or after Dec. 29, 2009. Regs. §1.304-4T(d).

²⁹ Also included in that regulation package was Regs. §1.956-1T(b)(4), which provided the following:

For purposes of §1.956-1(b)(1) of the regulations, a controlled foreign corporation will be considered to hold indirectly (A) the investments in United States property held on its behalf by a trustee or a nominee or (B) at the discretion of the District Director, investments in U.S. property acquired by any other foreign corporation that is controlled by the controlled foreign corporation, if one of the principal purposes for creating, organizing, or funding (through capital contributions or debt) such other foreign corporation is to avoid the application of section 956 with respect to the controlled foreign corporation. For purposes of this paragraph (b), a foreign corporation will be controlled by the controlled foreign corporation if the foreign corporation and the controlled foreign corporation are related parties under section 267(b). In determining for purposes of this paragraph (b) whether two or more corporations are members of the same controlled group under section 267(b)(3), a person is considered to own stock owned directly by such person, stock owned with the application of section 1563(e)(1), and stock owned with the application of section 267(c).

T.D. 8209 also contained examples illustrating the application of the amended regulations. Query whether the IRS is considering any modifications to this regulation (e.g., to make it self-executing in a manner similar to the §304 regulations described in T.D. 9477 as discussed herein).

At the discretion of the District Director, for purposes of determining the amount constituting a dividend, and source thereof, under section 304(b)(2), a corporation (deemed acquiring corporation) will be considered to have acquired for property the stock of a corporation (issuing corporation) acquired for property by another corporation (acquiring corporation) that is controlled by the deemed acquiring corporation, if one of the principal purposes for creating, organizing, or funding the acquiring corporation, through capital contributions or debt, is to avoid the application of section 304 to the deemed acquiring corporation....

Former Regs. §1.304-4T also included the following example illustrating its application.

P, a domestic corporation, owns all of the stock of CFC1, a controlled foreign corporation with substantial accumulated earnings and profits. CFC1 is organized in Country X, which imposes a high rate of tax on CFC1's income. P also owns all of the stock of CFC2, another controlled foreign corporation, which has accumulated earnings and profits of \$200x. CFC2 is organized in Country Y which imposes a low rate of tax on CFC2's income. P wishes to own all of its foreign corporations in a direct chain and to effectuate a repatriation of CFC2's cash to P. In order to avoid having to obtain Country X approval for the acquisition of CFC1 (a Country X corporation) by CFC2 (a Country Y corporation) and to avoid a dividend to P out of CFC2's earnings and profits that would otherwise occur as a result of the application of section 304, P causes CFC2 to form RFC as a Country X wholly-owned subsidiary and to contribute \$100x to RFC. RFC will purchase, for \$100x, all of the stock of CFC1 from P. Because one of P's principal purposes for having CFC1 owned by RFC is to avoid section 304, under §1.304-4T(a), CFC2 is considered to have acquired the stock of CFC1 for \$100x for purposes of determining the amount constituting a dividend (and source thereof) for purposes of section 304(b)(2).

Under this example, absent the rule provided in former Regs. §1.304-4T(a), §304(b)(2) would have operated to look first to the E& P of RFC, and then to the E& P of CFC1, for the purpose of determining the amount of the property distribution constituting a dividend pursuant to §301(c)(1),

and the source thereof. This would have resulted in the entire \$100x received by P being treated as a dividend from CFC1. However, because one of P's principal purposes for creating, organizing, or funding RFC was to avoid the application of §304 to CFC2, the example provides that CFC2 is considered as the deemed acquiring corporation for purposes of determining the amount constituting a dividend, and the source thereof, under §304(b)(2). The example in this case makes it clear that even though other reasons existed for RFC's creation and role in the transaction, other than the avoidance of any U.S. federal tax consequences, the regulation still allowed CFC2 to be treated as the deemed acquiring corporation because one of the principal purposes for creating RFC was to avoid the application of §304 to CFC2.

Notwithstanding that the example cited above appears to apply the anti-avoidance rule of former Regs. §1.304-4T(a), the actual language of the former temporary regulation stated that the anti-avoidance rule is applied at the discretion of the District Director. In fact, former Regs. §1.304-4T(b) also provided a rule stating that nothing in the regulation could be construed to provide a taxpayer the right to compel the IRS to disregard the form of its transaction for federal income tax purposes. The fact that the temporary regulation is not self-executing is further discussed in the Preamble to T.D. 9477 (discussed below).

Although former Regs. §1.304-4T provided that the form of the transaction could be disregarded only in the case of an acquiring corporation created to avoid the application of §304 to the deemed acquiring corporation, no §304 rule existed at the time specifically preventing the creation of a new issuing corporation to avoid the application of §304 to what might be considered a "deemed issuing corporation."³⁰ As discussed below, under the 2009 §304 temporary regulations, these types of transactions now are specifically addressed.

³⁰ Nonetheless, the IRS might have challenged, or might try to challenge, such transactions. In the Preamble to T.D. 9477, in discussing the effective date of the new temporary regulations, the IRS states that no inference is intended as to the potential applicability of other Code or regulatory provisions or judicial doctrines (including step transaction or substance over form) to transactions described in the regulations. Therefore, the IRS could try to challenge this type of transaction even absent the specific regulatory provisions set forth in T.D. 9477.

The IRS included in the Preamble of T.D. 9477 a statement that it has become aware of certain transactions that are subject to §304 but are entered into with a principal purpose of avoiding the treatment of a corporation as the issuing corporation. Specifically, the IRS cites the following transaction as an example:

[A] domestic corporation (USP) wholly owns two foreign corporations (F1 and F2). The basis and fair market value of the F1 stock is \$100x. F1 does not have positive earnings and profits (or its earnings and profits for purposes of section 304(b)(2) are limited by section 304(b)(5)) but has at least \$100x cash. The basis and fair market value of the F2 stock is \$100x and F2 has earnings and profits of at least \$100x. USP forms a new foreign corporation (F3) and contributes the stock of F2 to F3 in exchange for F3 stock. In a transaction subject to section 304(a)(1), USP then transfers the stock of F3 to F1 in exchange for \$100x cash. Because neither F1 (the acquiring corporation) nor F3 (the issuing corporation) has positive earnings and profits, USP reports the \$100x cash received in redemption of the shares deemed issued by F1 under section 304(a)(1)

as a return of basis under section 301(c)(2).

The IRS further states that it believes that transactions such as the one described above should be subject to an anti-avoidance rule. The IRS views this type of transaction as a repatriation of a particular corporation's earnings without the corresponding U.S. tax consequences.

Consequently, the revised temporary regulation specifically addresses this transaction by providing the following:

For purposes of determining the amount constituting a dividend (and source thereof) under section 304(b)(2), ...[t]he acquiring corporation shall be treated as acquiring for property the stock of a corporation (deemed issuing corporation) controlled by the issuing corporation if, in connection with the acquisition for property of stock of the issuing corporation by the acquiring corporation, the issuing corporation acquired stock of the deemed issuing corporation with a principal purpose of avoiding the application of section 304 to the deemed issuing corporation.³¹

³¹ See Regs. §1.304-4T(b).

Therefore, based on this rule, in the above example, if F3 were to have acquired stock of F2 with a principal purpose of avoiding the application of §304 to F2, F1 would have been treated as acquiring the stock of F2, rather than F3, for purposes of determining the amount constituting a dividend (and the source thereof) under §304(b)(2).³² Consistent with adjustments made to the anti-avoidance rules under T.D. 8209, avoiding the application of §304 to F2 need not have been the only purpose for F3 acquiring stock of F2. Even if there were other valid business reasons for the transaction, the fact that avoidance of the application of §304 was a principal purpose of the acquisition is sufficient to invoke the anti-avoidance rule. Also, as discussed further below, one feature of the temporary regulation is that the anti-avoidance provision is now self-executing — i.e., taxpayers now must self-assess whether such a principal purpose existed and apply §304 accordingly pursuant to these rules.

³² For similar illustration and application of the anti-avoidance rule, see Regs. §1.304-4T(c) *Ex. 2*.

In addition to adding regulations to address avoidance of §304 to a deemed issuing corporation in transactions described in §304(a), T.D. 9477 makes other modifications to former Regs. §1.304-4T. The anti-avoidance rule in the case of a deemed acquiring corporation³³ has been revised to apply specifically in cases where the acquiring corporation may receive third-party funding for the acquisition of the issuing corporation. Specifically, former Regs. §1.304-4T applied when “one of the principal purposes for creating, organizing, or funding the acquiring corporation, through capital contributions or debt, is to avoid the application of §304 to the deemed acquiring corporation.” The regulation now provides that the anti-avoidance measure applies when “a principal purpose for creating, organizing, or funding the acquiring corporation *by any means* (including, through capital contributions or debt) is to avoid the application of §304 to the deemed acquiring corporation.” (Emphasis added.) The IRS states in the Preamble to T.D. 9477 that this change is intended to clarify that the rule may apply in cases where the funding is from an

unrelated party. Specifically, the IRS provides, “For example, the regulations may apply when the deemed acquiring corporation facilitates the repayment of an obligation incurred by the acquiring corporation (even if such obligation is with respect to a borrowing from an unrelated party) to acquire the stock of the issuing corporation.”

³³ Regs. §1.304-4T(b), which now reads, in part, as follows:

For purposes of determining the amount constituting a dividend (and source thereof) under section 304(b)(2), ... a corporation (deemed acquiring corporation) shall be treated as acquiring for property the stock of a corporation (issuing corporation) acquired for property by another corporation (acquiring corporation) that is controlled by the deemed acquiring corporation, if a principal purpose for creating, organizing, or funding the acquiring corporation by any means (including through capital contributions or debt) is to avoid the application of section 304 to the deemed acquiring corporation. See paragraph(c) *Example 1* of this section for an illustration of this paragraph.

More importantly, as mentioned above, T.D. 9477 amends former Regs. §1.304-4T to make the anti-avoidance rules described above self-executing. The IRS states in the Preamble, “Current Temp Reg. §1.304-4T applies at the discretion of the District Director. The IRS and Treasury Department believe the anti-avoidance rule of current [Regs.] §1.304-4T *should be self-executing*. Thus, current [Regs.] §1.304-4T is amended accordingly.” (Emphasis added.) The self-executing nature of amended Regs. §1.304-4T could be troubling to some taxpayers. For instance, notwithstanding the existence of valid business purposes for a corporation acquiring shares of an issuing corporation, or a corporation creating an acquiring corporation, in transactions described in §304(a), there need only to be “a principal purpose” of the corporation's connection with the transaction to invoke the rule.

Thus, by revising the rules under Regs. §1.304-4T, the IRS modified and expanded the anti-avoidance rule to address potential repatriations.

Before leaving §304, note that the IRS also issued temporary regulations in early 2009 addressing the application of §367(a) and (b) to certain deemed §351(a) exchanges that occur pursuant to §304(a)(1) transactions (hereinafter, “the 2009 temporary regulations”).³⁴ The 2009 temporary regulations can be viewed as a response to a perceived repatriation transaction where the actual consequences of the §304(a)(1) transaction may have varied from the IRS's original view of what the consequences should be (e.g., the IRS's view that a certain amount of gain would be recognized in the transaction under §301(c)(3)).

³⁴ T.D. 9444, 74 Fed. Reg. 6824 (2/11/09).

As a background note, the IRS in 2006 had finalized regulations that “turned off” the application of §367(a) and (b) to a deemed §351(a) exchange that occurs pursuant to §304(a)(1), that was within the preview of those regulations.³⁵ The IRS assumed at that time that, in the deemed redemption that occurs pursuant to §304(a)(1), a taxpayer could recover, under §301(c)(2), only the basis of the stock deemed issued by the foreign acquiring corporation in the deemed §351(a) exchange. However, some commentators had subsequently suggested that the basis of “old and cold” stock held by the taxpayer in the foreign acquiring corporation also could be recovered

under §301(c)(2) by the taxpayer —potentially leading taxpayers to include a lower amount in taxable income pursuant to the exchange than the IRS anticipated.³⁶ The 2009 temporary regulations recognize that taxpayers may take the position under current law that the tax basis of stock held by the taxpayer (other than basis in deemed issued stock) may be recovered under §301(c)(2) in the deemed redemption. The 2009 temporary regulations provide that §367(a) and (b) will apply to the deemed §351(a) exchange if a taxpayer takes the position that it can recover in the deemed redemption, under §301(c)(2), basis in stock of the foreign acquiring corporation other than the stock of the foreign acquiring corporation deemed issued in the deemed §351(a) exchange.³⁷ These regulations contain a number of special rules a discussion of which is beyond the scope of this article.

³⁵ T.D. 9250, 71 Fed. Reg. 8802 (2/21/06). For proposed regulations that preceded the 2006 final regulations, see REG-127740-04, 70 Fed. Reg. 30036 (5/25/05).

³⁶ For a discussion relating to this issue, see the Preamble to T.D. 9444. For proposed regulations published in 2009 dealing with basis recovery, including basis recovery in §304(a)(1) transactions, see REG-143686-07, 74 Fed. Reg. 3509 (1/21/09). The approach in these 2009 proposed regulations is different from the approach the IRS presumed taxpayers would take when it issued T.D. 9250. For a discussion of the current state of the law as it relates to basis recovery, see the Preamble to REG-143686-07.

³⁷ See Regs. §§1.367(a)-9T and 1.367(b)-4T. Note that if §367(a) applies to the deemed §351(a) transfer, the U.S. person will not be able to enter into a gain recognition agreement to avoid recognizing gain on the outbound transfer of stock. See Regs. §1.367(a)-9T(b). For a full discussion of these temporary regulations, see Calianno, Rode, and Watkins, "A Basis Issue — IRS Revises Section 367 Regulations to Address Section 304(a)(1) Transactions," *J. Int'l Tax* (Nov. 2009).

REPATRIATION AND CASH "D" REORGANIZATIONS

The next transaction, the cash "D" reorganization, has received significant scrutiny because some believe that the boot-within-gain limitation of §356 may be utilized in these transactions to repatriate earnings with little or no income inclusions to the exchanging shareholder(s).

Consider the following fact pattern. USP, a domestic corporation, wholly owns CFC1 and CFC2, pre-existing, foreign subsidiaries that are CFCs. CFC1 and CFC2 each have outstanding a single class of common stock. Both CFCs have substantial E& P that is not previously taxed, and no other type of E& P (e.g., they have no E& P described in §959(a) or (e)). USP's basis in its CFC2 stock is equal to its FMV, which is \$1,000. Assume that CFC1 purchases all of USP's stock of CFC2 in exchange for cash of \$900, and newly issued CFC1 stock worth \$100. Additionally, as part of the overall plan, an entity classification election under Regs. §301.7701-3(c) (i.e., a "check-the-box" election) is filed for CFC2 to change its classification from an association taxable as a corporation to an entity disregarded as separate from its owner (i.e., a "disregarded entity") for U.S. federal tax purposes. As a consequence of the check-the-box election, CFC2 is deemed to distribute all of its assets and liabilities to CFC1 in liquidation.³⁸ USP asserts that CFC1's acquisition of the CFC2 stock followed by CFC2's subsequent deemed liquidation into CFC1 is treated as a reorganization under §368(a)(1)(D).³⁹ USP asserts that §367(a) does not apply to its exchange and §367(b) does not require any inclusion.⁴⁰ Further, USP asserts that it is not required to recognize any gain or income as a result of its exchange, relying on the "boot-within-gain" limitation of §356(a).⁴¹ Specifically, §356(a) provides as follows:

³⁸ See Regs. §301.7701-3(g)(1)(iii). For purposes of this example, it is assumed that CFC2 is an eligible entity for which a check-the-box election may be made.

³⁹ For treatment of “D” reorganizations, including cash “D” reorganizations, see generally Regs. §1.368-2(l); T.D. 9475, 74 Fed. Reg. 67053 (12/18/09); Rev. Rul. 70-240, 1970-1 C.B. 81; Rev. Rul. 2004-83, 2004-32 I.R.B. 157; *Davant v. Comr.*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967). For a general illustration of when a stock transfer may be integrated with a liquidation of the transferred corporation resulting in a reorganization, see Rev. Rul. 67-274, 1967-2 C.B. 141.

⁴⁰ See Regs. §§1.367(a)-3(a) (excepts §356 exchanges from stock transfer rules of §367(a) in a “D” reorganization that is not an indirect stock transfer) and 1.367(b)-4(b)(1) (§1248/CFC status is maintained after the exchange). Further, there is no gain in the CFC2 stock being exchanged that §1248 could recharacterize as dividend income.

⁴¹ See Regs. §1.356-1(b) for rules relating to exchanges in which an exchanging shareholder surrenders shares of stock of a target corporation for stock of the acquiring corporation as well as cash and other non-qualifying property (i.e., “boot”). It provides, that for purposes of computing the gain, if any, recognized pursuant to §356 and Regs. §1.356-1(a)(1), to the extent the terms of the exchange specify the other property or money that is received in exchange for a particular share of stock or security surrendered or a particular class of stock or securities surrendered, such terms shall control — provided that such terms are economically reasonable. To the extent the terms of the exchange do not specify the other property or money that is received in exchange for a particular share of stock or security surrendered or a particular class of stock or securities surrendered, a pro rata portion of the other property and money received shall be treated as received in exchange for each share of stock and security surrendered, based on the FMV of such surrendered share of stock or security. For examples illustrating this rule, see Regs. §1.356-1(d). See also Regs. §§1.358-2(a)(2) and -2(c). For certain proposed changes to these rules, see REG-143686-07.

Receipt of Additional Consideration. (a) Gain on Exchanges. (1) Recognition of Gain. If section 354 or 355 would apply to an exchange but for the fact that the property received in the exchange consists not only of property permitted by section 354 or 355 to be received without the recognition of gain but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property. *(2) Treatment as dividend.* If an exchange is described in section 356(a)(1) but has the effect of the distribution of a dividend (determined with the application of section 318(a)), then there shall be treated as a dividend to each distributee such an amount of the gain recognized under section 356(a)(1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under section 356(a)(1) shall be treated as gain from the exchange of property.

Thus, based on the application of §356(a), USP is able to receive cash in this transaction (along with some CFC1 stock) without recognizing currently any taxable income. This is because USP's exchange of CFC1 stock with a tax basis of \$1,000 for property consisting of cash of \$900 and CFC2 stock worth \$100 resulted in no gain being *realized*.

Sometimes, taxpayers with the facts of the above transaction will undertake the transaction by using all cash, and no stock of the acquiring/transferee corporation, to achieve a similar result (i.e., an all-cash “D” reorganization). When this occurs, a nominal share of stock in the transferee corporation (e.g., CFC1 in the transaction above) will be treated as distributed by the transferor corporation (e.g., CFC2 in the transaction above) to the shareholder(s) of the transferor

corporation (e.g., USP in the transaction above) in addition to the actual consideration as part of the exchange for stock of such shareholder(s) (e.g., CFC2 stock in the above transaction) in the reorganization.⁴² Taxpayers engaging in all cash “D” reorganizations similarly assert the boot-within-gain rule of §356(a).⁴³

⁴² See Regs. §§1.368-2(l) generally and -2(l)(2) in particular. See also T.D. 9475, 74 Fed. Reg. 67053 (12/18/09).

⁴³ Note that the application of §356(a) to an all-cash “D” reorganization relies on the assumption that some portion of the nominal share of stock described in Regs. §1.368-2(l)(2)(i) will be deemed received in exchange for each share of target stock. While not necessarily controlling for purposes of determining that an exchange falls within §356(a) in the first instance (see, e.g., New York State Bar Association’s Tax Section, *Report on Final Regulations Regarding Allocation of Basis Under Section 358 and Related Matters*, Dec. 13, 2007, p. 21), current regulations under §§356 and 358 (i.e., Regs. §§1.356-1(b) and 1.358-2(a)(2)) appear to reflect a presumption that, absent any specific designation by the taxpayer, all consideration is allocated pro rata to target stock surrendered. In the case of an all-cash “D” reorganization, the Preamble of T.D. 9475 notes that the IRS believes that “all of the normal tax consequences occur from the issuance of a nominal share in a transaction described in [Regs. §1.368-2(l)].” It does not appear unreasonable to believe that this same principle might apply in the case of an all-cash “D” reorganization where the target’s exchanging shareholder owns multiple classes of stock. See, however, REG-143686-07 wherein proposed changes to regulations under §§354 and 356 illustrate instances where non-qualifying property in a reorganization exchange may be allocated (by taxpayer’s specific designation) exclusively to a particular class of stock of the target corporation without any qualifying property being allocated to such class, resulting in a portion of the exchange being governed by §302, rather than §356, relative to the exchanging shareholder. Furthermore, the Preamble to these proposed regulations states, “Finally, the IRS and Treasury Department recognize that the proposed regulations may not address all related issues arising in all cash “D” reorganizations. Specifically, these proposed regulations may heighten the importance of whether the nominal share deemed issued in such a reorganization is received in respect of particular shares surrendered by the exchanging shareholder.” The Preamble goes on to note that comments are requested relative to this issue.

Cross-border cash and all-cash “D” reorganizations raise certain international tax issues for which the IRS has requested comments.⁴⁴ Notwithstanding certain potentially unresolved international tax issues, under current law these types of transactions may present opportunities for an exchanging shareholder to receive cash with little or no current taxable income inclusion (e.g., in cases where the basis in the stock surrendered in the transaction is not significantly less than, or even equal to, the FMV of such stock).

⁴⁴ In final regulations that address all-cash “D” regulations (T.D. 9475), the IRS requested comments on the application of the final regulations to reorganizations involving foreign corporations or shareholders, including comments regarding: (1) whether any §1248 amount attributable to the stock of the transferor corporation can be preserved in the nominal share deemed issued by the transferee corporation; (2) the manner in which E&P are (or should be) taken into account for purposes of §902 when an exchanging shareholder recognizes gain under §356(a) that is treated as a dividend under §356(a)(2) from the E&P of the transferor and transferee corporations (including whether the E&P of the corporation are combined for this purpose or whether an ordering rule applies); (3) whether and how §902 should apply when an exchanging shareholder does not actually own stock in the transferee corporation but the exchanging shareholder recognizes gain under §356(a) that is treated as a

dividend from the E& P of the transferee corporation (including whether a limitation similar to that of §304(b)(5) is appropriate in such cases); (4) whether and how, under §959, an exchanging shareholder should be able to access previously taxed E& P of a foreign transferor and/or transferee corporation before any previously untaxed E& P of either corporation; and (5) whether and how §897 applies if the transferor corporation is a U.S. real property holding corporation with at least one foreign shareholder.

The use of the boot-within-gain limitation of §356 in cash and all-cash “D” reorganizations — particularly in the cross-border context — has been the focal point of scrutiny by the IRS and the Obama Administration. This recent scrutiny arises from the concern that such a transaction may permit a repatriation of a foreign corporation's previously untaxed E& P without a corresponding taxable income inclusion.

In the Preamble of REG-209006-89 (2009), the IRS included the following passages discussing the boot-within-gain limitation of §356:

The IRS and Treasury Department continue to study transactions that have the effect of repatriating earnings and profits of foreign corporations without the recognition of gain or a dividend inclusion. Temporary regulations were recently issued (T.D. 9400 and T.D. 9402) under sections 367(b) and 956(e) to address the inappropriate use of certain cross-border triangular reorganizations and other nonrecognition transactions to repatriate earnings and profits of a foreign corporation without the recognition of gain or a dividend inclusion. The IRS and Treasury Department are evaluating other transactions that have a similar effect to determine whether guidance is appropriate. In particular, the IRS and Treasury Department are analyzing whether it is appropriate for the gain limitation rule of section 356(a)(1) to apply in an acquisitive asset reorganization involving a foreign acquiring corporation, considering that a policy of section 367(b) is “to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings.” H.R. Rep. No. 94-658 (1975). Comments are requested in this regard, including whether the application of any such guidance should be limited to cases where section 356(a)(2) would otherwise apply to the shareholder's receipt of non-qualifying property.

The concern of the IRS relating to the boot-within-gain limitation of §356 and its assertion in reorganizations such as cash “D” reorganizations and repatriations of foreign earnings is similar to concerns giving rise to past guidance relative to cross-border tax-free reorganization transactions.⁴⁵ Some commentators have suggested that untaxed E& P of the target corporation in such a transaction might be reduced or eliminated pursuant to §312 as a result of the boot distribution, even if no amount is taxable to the exchanging shareholder.⁴⁶ This arguably could be viewed as indicative of a repatriation. On the other hand, from a policy perspective, one might argue that, when there is no inherent gain in the stock being exchanged in the reorganization, the exchanging shareholder should not be required to include an amount in income.⁴⁷

⁴⁵ It is worth noting that, to the extent §356(a)(2) applies, the IRS position is that the E& P of the both the transferor and transferee corporations are taken into account. See Rev. Rul. 70-240, 1970-1 C.B. 81; *Davant v. Comr.*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967). But see *American Mfg. Co. v. Comr.*, 55 T.C. 204 (1970), and *Atlas Tool Co. v. Comr.*, 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir. 1980), *cert. denied*, 449 U.S. 386 (1980), for cases limiting boot dividend to transferor's E& P. For a general discussion of this issue, see Bittker and Eustice, *Federal Income*

Taxation of Corporations and Shareholders (WG& L), §12.44.

⁴⁶ See 782 T.M., *Boot Distributions and Assumption of Liabilities* (U.S. Income Series) at IV, C, 8 (“Since §312 contains no specific rules about the effect of a boot-distribution on E& P, the general rules of §312 seem to require a reduction in E& P by the amount of distribution without regard to the amount actually taxable to the recipient shareholders.”). See also Bittker & Lokken, *Federal Taxation of Income, Estates and Gifts*, at Part 13, §95.3.2; and Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders (WG& L)*, §14.23[2] and fn. 89. For further guidance, see Regs. §§1.312-1(a), -11(c) and 1.381(c)(2)-1(c)(1); and Rev. Rul. 72-327, 1972-2 C.B. 197.

⁴⁷ Keep in mind that the tax treatment of §368(a) reorganizations is the exception to the general rules governing taxable exchanges under §1001. An exchange taxed under §1001 (that is not a §304 exchange) would not produce taxable income to the taxpayers in the exchange to the extent no gain was realized. Alternatively, as discussed below, from a policy perspective, some would compare this transaction to a §304 transaction that can result in dividend income even in situations in which there is no inherent gain in the stock being “sold” in the §304 transaction. Nevertheless, these types of transactions have some inherent differences (e.g., in a §304 transaction the target corporation remains a separate subsidiary). Additionally, it has been suggested that the treatment of such transactions should conform the rules relating to the treatment of “boot” received by a shareholder in a reorganization of corporations under common control or a restructuring of a single corporation to the rules relating to the redemption of stock, such that the amount recharacterized as a dividend, if any, would not be limited to the gain on the transaction. See Joint Committee on Taxation, *Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986, Volume II: Recommendations of the staff of the Joint Committee on Taxation to Simplify the Federal Tax System*, pp. 267–68(2001).

Moreover, one may question whether the IRS would be overreaching to apply §367(b) to override §356 in such instances, absent a statutory change to §356. The IRS, however, has interpreted its authority under §367(b) broadly (e.g., the “Killer B” guidance), and likely would assert that any such guidance under §367(b) targeting these types of transactions would be within the purview of its regulatory authority. If the IRS were to issue guidance as described in the Preamble to REG-209006-89, it would create a dichotomy between §356 exchanges with a domestic acquiring corporation (to which the guidance would not apply), and §356 exchanges with a foreign acquiring corporation (to which the guidance could apply, depending on how the rule would be drafted). Nevertheless, such guidance may prove unnecessary if a 2011 proposal by the Obama Administration to amend §356 is ultimately adopted as law.⁴⁸

⁴⁸ Query whether the IRS will issue any such regulations while this legislative proposal is being considered.

Before discussing the Obama Administration's 2011 proposal targeting the boot-within-gain rule of §356, it is worth considering the Obama Administration's 2010 proposal relating to the boot-within-gain rule of §356. That proposal, similar to the possible IRS proposal described in the Preamble to REG-209006-89, was designed to prevent taxpayers in certain situations from relying on the boot-within-gain rule of §356 to avoid a taxable income inclusion.⁴⁹ Specifically, the Department of the Treasury's *General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals* (i.e., “the Green Book”) stated the following:

⁴⁹ Of course, any IRS change would rely on its authority under §367(b) to achieve the desired result if it were to address such exchanges, whereas any Obama Administration proposal would rely on a statutory change to §356 to address such exchanges.

The proposal would repeal the boot-within-gain limitation of current law in the case of any reorganization in which the acquiring corporation is foreign and the shareholder's exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2). The proposal would be effective for taxable years beginning after December 31, 2010.⁵⁰

⁵⁰ 2010 Green Book, p. 35.

In discussing this provision in the Green Book, the Treasury noted that, in cross-border reorganizations, the boot-within-gain rule of current law can permit U.S. shareholders to repatriate previously untaxed E& P of foreign subsidiaries with minimal U.S. tax consequences. It cited as an example a shareholder that exchanges stock in the target corporation with little or no built-in gain at the time of the exchange where the shareholder would recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or a significant amount (or all) of the consideration received in the exchange is boot. The Treasury further stated that this result applies even if the corporation has previously untaxed E& P equal to or greater than the boot and concluded that this result is inconsistent with the principle that previously untaxed E& P of a foreign subsidiary should be subject to U.S. tax upon repatriation.

The Joint Committee on Taxation, in a report discussing this proposal, reiterated the concerns raised in the Green Book and then compared the results of a cash "D" reorganization with that of a transaction described in §304(a)(1) using the following example.⁵¹ Assume that P, a U.S. domestic corporation, wholly owns CFC1 and CFC2. P's shares in CFC1 have a tax basis of \$400 and an FMV of \$500. CFC1 and CFC2 each have previously untaxed E& P of \$200 and \$300, respectively. Assume that CFC2 purchases P's CFC1 shares in exchange for \$500 cash. If a check-the-box election is made to treat CFC1 as a disregarded entity pursuant to the same plan in which CFC1's shares are transferred to CFC2, the transaction is treated as a cross-border reorganization to which the boot-within-gain rule applies to limit taxable gain to \$100 (\$500 FMV less \$400 tax basis). If a check-the-box election were not made for CFC1, or CFC1 were not otherwise liquidated, §304(a)(1) would apply to the transaction and the \$500 in cash would be treated as a dividend to the extent of the previously untaxed E& P of CFC2 (\$300), and then CFC1 (\$200).

⁵¹ See Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal, Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment* (Sept. 2009).

The Joint Committee further noted that, in a transaction involving closely held participants, a taxpayer with previously untaxed E& P in its CFCs may, at its option, prevent application of the §304 requirement of full dividend inclusion to the extent of E& P, and instead invoke the boot-

within-gain rule under §356(a)(2), by choosing to liquidate the target corporation as part of the transfer.⁵² Therefore, the report notes that eliminating the application of the boot-within-gain rule in the case of any reorganization in which there is a foreign acquirer and in which the exchange has the effect of distribution of a dividend under §356(a)(2) is consistent with the principle that previously untaxed E& P of a foreign subsidiary should be subject to U.S. tax upon repatriation.

⁵² See Rev. Rul. 2004-83, 2004-2 C.B. 157.

The Joint Committee did note that the provision, as it was drafted, arguably could be viewed as over-inclusive in some instances and under-inclusive in some instances. For instance, it could apply even though there may not be a “repatriation” to a U.S. person (e.g., the provision could apply to a lower-tier cash “D” reorganization involving an exchanging shareholder that is a CFC, assuming the conditions of the proposal would be satisfied). Alternatively, the report noted that some may question why boot received in such a transaction involving a foreign acquiring corporation should be differentiated from boot received in a similar transaction involving a domestic acquiring corporation.⁵³

⁵³ The Joint Committee report noted as an instance of the under-inclusive nature of the provision the situation in which the provision could be used to avoid U.S. withholding tax. Specifically, it noted that the proposal did not address domestic-to-domestic reorganizations with a foreign shareholder where there may be the potential for withholding tax avoidance. Under such circumstances, it stated that the amount of boot recharacterized as a dividend and subject to withholding tax would continue to be limited under the boot-within-gain rule.

Lo and behold, the Obama Administration's 2011 revenue proposal, released in February 2010, included an updated version of the repeal of the boot-within-gain limitation of §356 discussed above. The proposal continues to cite as a rationale for the modification of §356 concerns relating to cross-border reorganizations, such as the cash “D” reorganization example discussed above, in which a U.S. exchanging shareholder may receive cash or other boot in the exchange with little or no dividend income because of the boot-within-gain limitation of §356.⁵⁴ Nonetheless, the more recent proposal no longer is limited to a foreign acquiring corporation. Specifically, the 2011 Green Book describes the proposal as follows:

⁵⁴ In discussing this proposal, the Department of the Treasury's General Explanation of the Administration's Fiscal Year 2011 Revenue Proposals (the “2011 Green Book”) noted the following on page 38:

There is not a significant policy reason to vary the treatment of a distribution that otherwise qualifies as a dividend by reference to whether it is received in the normal course of a corporation's operations or is instead received as part of a reorganization exchange. Thus, repealing the boot-within-gain limitation for an exchange that has the effect of the distribution of a dividend will provide more uniform treatment for dividends that is less dependent on context. Moreover, in cross-border reorganizations, the boot-within-gain limitation can permit U.S. shareholders to repatriate previously untaxed earnings and profits of foreign subsidiaries with minimal U.S. tax consequences. For example, if the exchanging shareholder's stock in the target corporation has little or no built-in gain at the time of the exchange,

the shareholder will recognize minimal gain even if the exchange has the effect of the distribution of a dividend and/or a significant amount (or all) of the consideration received in the exchange is boot. This result applies even if the corporation has previously untaxed earnings and profits equal to or greater than the boot. This result is inconsistent with the principle that previously untaxed earnings and profits of a foreign subsidiary should be subject to U.S. tax upon repatriation.

The proposal would repeal the boot-within-gain limitation of current law in the case of any reorganization transaction if the exchange has the effect of the distribution of a dividend, as determined under section 356(a)(2) and would be effective for taxable years beginning after December 31, 2010.

If either the Obama Administration's 2011 proposal or, alternatively, regulations under §367(b) relative to reversing the boot-within-gain limitation of §356 as discussed above become effective, it will give rise to many international tax issues that will need to be addressed with further guidance. For instance, consider the type of transaction described at the very beginning of this discussion involving USP, CFC1, and CFC2. The goal of repealing the boot-within-gain limitation of §356 (via either legislative or regulatory action) in this type of transaction would be to prevent what is perceived as a repatriation of previously untaxed E& P with minimal U.S. tax consequences by treating proceeds received in the transaction by USP as a dividend distribution — presumably to the extent of E& P, rather than (as under current law) to the extent of gain realized (and then only to the extent of E& P). One issue that arises would be which corporation's E& P are considered for this purpose (e.g., just the transferor's E& P, or both the transferor and transferee's E& P). If both the transferor's and the transferee's E& P are accessed, the order in which they are included must also be determined. It is worth noting that the IRS approach in applying §356(a)(2) has been to take into account both the transferor and transferee corporations' E& P.⁵⁵ Would an approach similar to Regs. §1.1502-13(f)(3) possibly be considered to treat CFC2 in the example above as making a distribution to USP immediately after the reorganization equal to the amount of "boot"? Guidance also would be needed on how any proposal would interact with the rules relating to previously taxed E& P under §959.

⁵⁵ See Rev. Rul. 70-240, 1970-1 C.B. 81; *Davant v. Comr.*, 366 F.2d 874 (5th Cir. 1966), *cert. denied*, 386 U.S. 1022 (1967). But see *American Mfg. Co. v. Comr.*, 55 T.C. 204 (1970), and *Atlas Tool Co. v. Comr.*, 70 T.C. 86 (1978), *aff'd*, 614 F.2d 860 (3d Cir. 1980), *cert. denied*, 449 U.S. 386 (1980) for cases limiting boot dividend to transferor's E& P. For a general discussion of this issue, see Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders (WG& L)*, §12.44.

The Joint Committee discussed some of these issues in the context of how the Obama Administration's 2010 proposal may operate.⁵⁶ Further, some of the international tax issues that the IRS requested comments on when it finalized the regulations addressing all-cash "D" reorganizations may be relevant to this inquiry as well.⁵⁷

⁵⁶ In discussing the 2010 proposal, the Joint Committee stated the following:
While the proposal is clear in its intent to repeal the boot-within-gain limitation under the aforementioned circumstances, it does not specifically discuss the manner in which the boot will be taxed to the extent it is not subject to the boot-within-gain limitation. As discussed above, §356(a)(2)

requires treating the gain as a dividend to the extent of accumulated E& P with any additional gain being treated as gain from the exchange of property. Since the intent of the proposal is only to repeal the applicability of the boot-within-gain limitation rule and not the treatment of the transaction as one to which §§354, 355 and 356 apply, one could conclude that §356(a)(2) would still apply but would treat the entire amount of boot as a dividend to the extent of accumulated E& P. To the extent the boot received exceeds the accumulated E& P and there is any remaining gain, such gain would be treated as gain from the sale or exchange of property. To the extent there is any remaining boot over and above the gain, presumably it would be treated as a tax-free return of basis. Nonetheless, the intended treatment of this additional boot may require further clarification.

⁵⁷ See Preamble to T.D. 9475 for the issues for which comments were requested.

In any event, based on the language in the Preamble to REG-209006-89 and the Obama Administration's 2011 proposal targeting the boot-within-gain limitation of §356, it appears that this provision's continued applicability to limit a taxable dividend inclusion in certain cross-border cash "D" reorganizations may be short-lived. The extent to which a given transaction will be affected will depend on whether the repeal of the boot-within-gain rule is addressed via statutory or regulatory change, and the mechanics of how any new rules will operate.

CONCLUSION

The foregoing discussion highlights a number of transactions that, in recent years, have attracted the attention of the IRS relative to concerns that taxpayers are engaging in strategies to repatriate E& P of foreign corporate subsidiaries in a manner that avoids the attendant U.S. tax consequences that the IRS believes are appropriate. In these cases, the IRS has responded with notices and regulations altering the results of the transactions as described in the relevant guidance. Furthermore, the IRS has signaled its view that taxpayers asserting the boot-within-gain limitation of §356 in certain types of reorganizations (e.g., cash "D" reorganizations) may have the effect of repatriating foreign earnings in a manner that should be accompanied by a current income inclusion (even in cases where the exchanging shareholder has little or no gain in the stock exchanged), and that recognition of a dividend in such transactions should not be "gain limited" as under current law. The Obama Administration, in both its 2010 and 2011 budget proposals, has shown similar concerns indicating that legislative action may be taken relative to this rule if the exchange has the effect of the distribution of a dividend under §356(a)(2). As to these transactions, we will have to wait and see.

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