

US Outbound Tax Newsalert

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IRS and Treasury finalize section 304 anti-avoidance regulations

On December 21, 2012, the IRS and Treasury released final regulations (Treas. Reg. §1.304-4, T.D. 9606) addressing the use of controlled corporations to avoid the application of section 304 (the 'Final Regulation').

The Final Regulation finalizes, without modification, the temporary regulation issued in 2009 (Treas. Reg. §1.304-4T, T.D. 9477) (the '2009 Temporary Regulation') that was scheduled to sunset as of December 28, 2012. The 2009 Temporary Regulation had replaced a temporary regulation originally published June 14, 1988 (the '1988 Temporary Regulation'), which was grandfathered from the three year expiration rule of section 7805(e).

Background

Section 304 re-characterizes certain related-party stock sales as redemptions, which could result in dividend income (i.e., ordinary income) to the selling corporation as opposed to capital gain or loss. Section 304 was designed to prevent the 'bailout' of corporate earnings and profits (E&P) in transactions that in form are sales but in substance are dividend distributions.

The New Final Regulation and the 2009 Temporary Regulation

The Final Regulation finalizes the 2009 Temporary Regulation without modification.



The Final Regulation applies to transactions that are entered into with a principal purpose of avoiding the application of section 304. The Final Regulation is a self executing provision as opposed to the 1988 Temporary Regulation, under which the rule applied at the discretion of the IRS district director.

Under section 304(b)(2), in determining section 301(c) treatment, the E&P of the acquiring subsidiary corporation are taken into account first, followed by the E&P of the issuing corporation. If an acquiring or issuing corporation is used to avoid section 304, the Final Regulation alters which corporation is treated as 'acquiring' and 'issuing' for purposes of determining the distribution amount that constitutes a dividend under section 304(b)(2).

The Final Regulation provides that a corporation (the 'deemed acquiring corporation') would be treated as the acquiring corporation if one of the principle purposes of creating, organizing, or funding the corporation, by any means (through capital contributions or debt), was to avoid the application of section 304 to the deemed acquiring corporation. The 'by any means' language appears to extend the reach of the rule and was new to the 2009 Temporary Regulation. The Final Regulations retain the language.

The Final Regulation further provides that if stock of a corporation (the 'deemed issuing corporation') controlled by the issuing corporation is acquired by the issuing corporation with a principal purpose of avoiding the application of section 304, the acquiring corporation will be treated as acquiring stock of the deemed issuing corporation. While in many instances it may be obvious that a corporation acquired the stock of another to avoid section 304, there will be some instances where the analysis will be more difficult and will require a detailed examination of the facts and circumstances behind the acquisition.

The ability to treat a deemed acquiring or deemed issuing corporation as the actual acquiring or issuing corporation results in a redetermination of which corporation's E&P is considered for section 304(b)(2) purposes. This can cause a dividend distribution to arise from what otherwise was expected to be a section 301(c)(2) return of capital. This can also change the foreign tax credit results from a cross-border section 304 transfer.

The preamble to the 2009 Temporary Regulation states that the anti-abuse rule may apply where the funding of the acquiring corporation is from an unrelated party (*e.g.*, where the deemed acquiring corporation facilitates the repayment of bank debt incurred to acquire the stock of the issuing corporation). For example, the rule could apply if a subsidiary of a corporation with significant earnings borrowed money from a bank to fund the acquisition of a target in a section 304 transaction, and there existed an implicit or explicit guarantee that the parent guaranteed the loan.

That preamble to the 2009 Temporary Regulations claims to clarify that the rule as written in the 1988 Temporary Regulation could apply to funding from an unrelated party, while the regulations' language was not significantly modified around this point in. The preamble to the Final Regulations is silent on the issue, and relevant language in the Final Regulations remains unchanged from the 2009 Temporary Regulations.

Interaction with Notice 2012-15's Section 367 Rules for Cross-Border Section 304(a)(1) Transfers

On February 10, 2012, the IRS and Treasury issued Notice 2012-15 which addresses the application of section 367 to section 304(a)(1) transfers. (See [*US Outbound Newsalert: Government reverses course: Issues Notice 2012-15 requiring GRAs for cross-border section 304 transfers*](#)) The Notice provides rules under section 367, which potentially taxes the gain on the transferred stock. The Notice generally provides that in an outbound section 304(a)(1) transfer, the U.S. transferor must enter into a gain recognition agreement (GRA) to avoid recognizing the gain on the transferred stock.

The Final Regulation should generally have no impact on Notice 2012-15, since the Final Regulation addresses the E&P accessed in the redemption. However, in certain cases the Final Regulation, like the 2009 Temporary Regulation, could increase the section 301(c)(1) dividend amount and thus reduce (or eliminate) section 301(c)(3) gain realized on the redemption. Generally section 301(c)(3) gain recognized on the redemption reduces the amount of gain that much be accounted for on the GRA.

Effective Dates

As the Final Regulation did not change the 2009 Temporary Regulation, the Final Regulation is effective for transfers occurring on or after December 29, 2009.

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