
US Outbound Tax Newsalert

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Government reverses course: Issues Notice 2012-15 requiring GRAs for cross-border section 304 transfers

In a fairly dramatic departure from existing law, the government has decided that US shareholders must enter into gain recognition agreements ("GRAs") to prevent immediate gain recognition in outbound stock sales governed by section 304. This is true even if the entire amount of the "section 304 dividend" is treated as a dividend under section 301(c)(1) (because the amount of earnings and profits ("E&P") in the acquiring corporation and the Target exceeds the purchase price). As a result, US shareholders now potentially face multiple gain / income inclusions.

Background

In 2005 and 2006, the government issued proposed and then final regulations which provided that section 367 did not apply to the deemed section 351 transfer of stock occurring pursuant to a section 304(a)(1) transaction.¹ On February 10, 2009, the

¹ Prior to the issuance of these regulations, it appeared the IRS and Treasury believed outbound section 304(a)(1) transfers required a GRA to avoid gain recognition under section 367(a)(1), because, in the context of an outbound section 304(a)(1) transaction, Rev. Rul. 91-5 and Rev. Rul. 92-86 contained references to the then existing GRA rules. The Notice effectively reverts to the government's view of outbound section 304(a)(1) transfers prior to the 2005 proposed regulations.



IRS and Treasury issued temporary regulations (Treas. Reg. §§ 1.367(a)-9T and 1.367(b)-4T(e), the "Temporary Regulations") which addressed the application of section 367 to the deemed section 351 transfer of stock occurring pursuant to a section 304(a)(1) transaction. For deemed outbound transfers of stock in a section 304(a)(1) transaction, the Temporary Regulations generally turned off the application of section 367(a). However, in cases where a taxpayer recovered basis in stock other than the stock deemed issued and redeemed in the section 304(a)(1) transaction (generally pre-existing stock of the foreign acquiring corporation), the Temporary Regulations required the taxpayer to recognize gain under section 367(a)(1) to the extent of that basis recovery. Further, under the Temporary Regulations taxpayers were not able to enter into GRAs to defer the gain on the issuing corporation ("Target") stock transferred outbound in the deemed section 351 transfer.

The Temporary Regulations also contained a similar rule under section 367(b). In section 304(a)(1) transactions in which the Target lost controlled foreign corporation ("CFC") status, or US shareholders lost US shareholder status, the Temporary Regulations created a section 367(b) dividend (or increase to E&P in the case of a CFC exchanging shareholder)² in the event of basis recovery in stock other than the stock deemed redeemed in the section 304(a)(1) transaction.

The Temporary Regulations also contained Treas. Reg. § 1.1248-1T(b), which provides that gain recognized by a shareholder of a corporation under section 301(c)(3) is subject to dividend recharacterization under section 1248(a).

The Temporary Regulations sunset on February 10, 2012. In response, on February 10, 2012, the government issued Notice 2012-15 ("the Notice"), binding reliance guidance which announces the government's intention to issue final regulations under section 367 governing section 304 transactions effective February 10, 2012.

PwC comment letter

On January 4, 2012, PwC issued a comment letter to the government recommending that the government withdraw the part of the Temporary Regulations (Treas. Reg. § 1.367(a)-9T(b)) which triggered immediate gain recognition under section 367(a)(1) on certain section 304(a)(1) transfers and denied taxpayers the ability to defer such gain by entering into a GRA. The comment letter also recommended that if the government disagreed with the first recommendation and decided that section 367 should apply to section 304(a)(1) transfers, the government should allow taxpayers to enter into GRAs for outbound section 304(a)(1) transfers. Regulations to be issued pursuant to the Notice would no longer require gain recognition in certain section 304(a)(1) transfers without the ability to enter into a GRA, but would instead apply sections 367(a) and (b) to all cross-border section 304(a)(1) transfers and now would permit GRAs for outbound section 304(a)(1) transfers. To read the comment letter, please click [here](#) (US Outbound Newsalert dated January 9, 2012).

Section 304(a)(1) transactions under section 367(a)

Under the Notice, all outbound section 304(a)(1) transfers are subject to the concurrent application of section 304(a)(1) and section 367(a). Consequently, such transfers are subject to both the normal dividend, basis recovery, and/or gain regime³

² See Treas. Reg. § 1.367(b)-4(c)(1).

³ See section 301(c).

of section 304(a)(1) and section 367(a) with respect to any gain on the Target's stock. However, in a change from the Temporary Regulations, a taxpayer may enter into a GRA with respect to the gain in the Target's stock. The GRA must explain that the deemed redemption of the acquiring corporation's stock which occurs after the deemed outbound 351 transfer pursuant to section 304(a)(1) qualifies for a GRA triggering event exception⁴ under Treas. Reg. § 1.367(a)-(n)(1)⁵ and the GRA must be filed in accordance with the principles of Treas. Reg. § 1.367(a)-8(k)(14)(ii) and (iii).⁶ If the US transferor does not enter into such a GRA, its gain in the stock of the Target in the section 304 transaction is recognized under section 367(a)(1). Such gain is subject to dividend recharacterization under section 1248(a).

PwC Observes

The Notice fails to address two important questions.

- (1) If the US Shareholder recovers basis in either the shares of the Target or the pre-existing shares of the foreign acquiring corporation, does such recovery impact the amount of gain subject to section 367(a)(1) (i.e., is subject to gain recognition unless a GRA is filed)?

No. It appears that section 301(c)(2) recovery with respect to either the shares of the Target or the pre-existing shares of the acquiring corporation does not impact the amount of gain subject to section 367(a)(1). The GRA amount should not be affected by section 301(c)(2) recovery, since doing so would increase the amount of gain which would be recognized by the US shareholder upon the ultimate disposition of the Target.⁷

⁴ Under the rules of Treas. Reg. § 1.367(a)-8(j)(4), a redemption of the stock of the corporation which receives foreign stock in an outbound section 351 transfer (the "transferee foreign corporation") is a triggering event which triggers the gain on the initial GRA. However, a redemption of the stock of the transferee foreign corporation which does not give rise to section 301(c)(3) gain qualifies under Treas. Reg. § 1.367(a)-8(n)(1) for a triggering event exception if the US transferor files a new GRA to account for the redemption.

⁵ Treas. Reg. § 1.367(a)-8(n)(1) provides, in relevant part, that "a redemption . . . of stock of the transferee foreign corporation received in the initial transfer that is treated by reason of section 302(d) as a distribution of property to which section 301 applies shall constitute a disposition for purposes of this section unless the US transferor enters into a new gain recognition agreement that includes appropriate provisions to account for the redemption."

⁶ Under Treas. Reg. § 1.367(a)-8(k)(14)(ii), the US transferor may enter into a new GRA so long as after the excepted triggering event the US transferor "retains a direct or indirect interest in the transferred stock or securities." Under Treas. Reg. § 1.367(a)-8(k)(14)(iii), the GRA must explain all subsequent triggering events during the year and why they meet exceptions, and the GRA must explain, in the case of a redemption, why the redemption qualifies for a triggering event exception. Presumably now such a GRA would cite to Notice 2012-15 to establish it complies with the principles of Treas. Reg. § 1.367(a)-8(k)(14).

⁷ For example, if neither the acquiring corporation nor the Target have E&P, and all of the purchase price of \$100 was recovered from the basis of the Target and the basis of the acquiring corporation, and the Target stock had a \$50 built-in-gain, a later disposition of the Target by the foreign acquiring corporation should trigger a GRA of \$50, the actual

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- (2) If the US Shareholder recovers all available basis and then recognizes some gain under section 301(c)(3), how is that gain taken into account under section 367(a)(1)?

While not made explicitly clear in the Notice, it appears the amount of the section 367(a)(1) gain, and thus the amount of the GRA, is the amount of gain in the Target stock reduced for any section 301(c)(3) gain recognized on such stock in the section 304(a)(1) transaction.⁸

We anticipate finalized regulations issued under the Notice will clarify these rules.

Section 304(a)(1) transactions under section 367(b)

Under the Notice, all section 304 exchanges in which the Target is a CFC will be subject to a potential dividend inclusion under section 367(b). A section 367(b) dividend (or an increase in the exchanging shareholder's E&P in the case of an exchanging shareholder which is a foreign corporation) will occur if the exchanging shareholder receives back (in the deemed section 351 transfer) stock in a corporation which is either not a CFC or with respect to which the US shareholder of the Target is not a US shareholder.

As a practical matter, such instances are rare, since in order for section 304(a)(1) to apply, the exchanging shareholder must be in control of both the acquiring corporation and Target. For this purpose "control" is generally defined in section 304(c) as at least 50 percent of the vote or value, applying section 318 attribution. However, such instances are possible in structures with a foreign parent and a US consolidated group with CFCs.

Also note that section 304 transfers of CFCs are subject to section 367(b) notice requirements.⁹

Example

Section 4.03 of the Notice includes an example of the new application of section 367 to a section 304(a)(1) transfer. In the example, USP, a domestic corporation, wholly owns FA and FT, both of which are CFCs. USP's basis in the stock of FT is \$50x, and FT's stock has a fair market value of \$100x. The section 1248 amount with respect to the FT stock is \$10x. FA has E&P of \$200x, all of which are available for distribution under section 304(b)(5).¹⁰ USP sells all of the FT stock to FA for \$100x.

gain, and not \$150, the built in gain of \$50 plus the section 301(c)(2) recovery amount of \$100.

⁸ See Treas. Reg. § 1.367(a)-8(o)(3), which provides that gain recognized under section 301(c)(3) with respect to stock of the transferee foreign corporation reduces the amount of the gain subject to the GRA.

⁹ See Treas. Reg. §§ 1.367(b)-1(c)(2)(iii) and, 1.367(b)-4(b)(1)(i)(A).

¹⁰ Under section 304(b)(2), dividends resulting from section 304(a) transactions are sourced first out of the E&P of the acquiring corporation, and then out of the E&P of the Target. Under certain circumstances, inapplicable in the example, section 304(b)(5) prevents the sourcing of section 304(a) dividends from the E&P of a foreign acquiring corporation.

Section 304(a)(1) results in a section 301(c)(1) dividend to USP of \$100x. Further, both sections 367(a) and (b) apply to the transaction. Section 367(a)(1) applies to trigger USP's \$50x gain in the FT stock on the deemed outbound section 351 transfer. In order to defer the \$50x gain USP has in its FT stock, USP must file a GRA. Additionally, section 367(b) applies to the transaction. However, since in the deemed section 351 transfer USP receives FA stock, which is the stock of a CFC with respect to which USP is a US shareholder, USP will not have to recognize as a deemed dividend the section 1248 amount of \$10x in the UST stock.

Section 301(c)(3) and section 1248(a)

The Temporary Regulations which have now sunset included a rule in Treas. Reg. § 1.1248-1T(b) providing that gain recognized by a shareholder under section 301(c)(3) in connection with a distribution of property by a CFC with respect to its stock is subject to dividend recharacterization under section 1248(a). The Notice indicates that, effective February 10, 2009 (the date of the Temporary Regulations), final regulations will include this rule.

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