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DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

TD 9250

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Application of Section 367 in Cross Border Section 304 Transactions; Certain Transfers of Stock Involving Foreign Corporations

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations that address the interaction of section 304 and section 367. These regulations provide that section 367(a) and (b) do not apply to a deemed section 351 exchange resulting from a section 304(a)(1) transaction. These regulations may apply to taxpayers transferring stock to related foreign corporations.

DATES: Effective Date: This regulation is effective February 21, 2006.

Applicability Dates: For dates of applicability, see §1.367(a)-3(e)(1)(G) and §1.367(b)-6(a)(1).

FOR FURTHER INFORMATION CONTACT: Tasheaya L. Warren Ellison, (202) 622-3870 (not a toll-free call).

SUPPLEMENTARY INFORMATION:

Background

On May 25, 2005, the IRS and Treasury published in the **Federal Register** a notice of proposed rulemaking (REG-127740-04; 2005-24 I.R.B. 1254; [70 FR 30036])

under section 367(a) and (b) of the Internal Revenue Code (proposed regulations) pursuant to the regulatory authority under section 367. The proposed regulations would provide that if, pursuant to section 304(a)(1), a U.S person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of such foreign corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not a transfer to a foreign corporation subject to section 367(a). The proposed regulations would further provide that if, pursuant to section 304(a)(1), a foreign corporation is treated as acquiring the stock of another foreign corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not an acquisition subject to section 367(b).

A public hearing was not held with respect to the proposed regulations because no requests to speak were received. However, several written comments were received.

After consideration of the comments, the proposed regulations are adopted, as revised by this Treasury decision. The comments received and the revisions are discussed below.

Explanation of Provisions and Summary of Comments

A. Nonapplication of Section 367(a) and (b) to Deemed Section 351 Exchanges

Section 304(a)(1) generally provides that, for purposes of sections 302 and 303, if one or more persons are in control of each of two corporations and in return for property one of the corporations (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from the person (or persons) so in control, then such property shall be treated as a distribution in redemption of the acquiring

corporation stock. To the extent the distribution is treated as a distribution to which section 301 applies, 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 section 351(a) applies, and (2) the acquiring corporation then redeemed the stock it is treated as having issued. Under section 301(c)(1), the distribution is first treated as a dividend to the extent of certain earnings and profits of the acquiring corporation and the issuing corporation. See sections 316 and 304(b). Then under section 301(c)(2) and (3), the remaining portion of the distribution is applied against and reduces the adjusted basis of the stock, and finally is treated as gain from the sale or exchange of property.

Section 367(a)(1) provides that if, in connection with certain nonrecognition transactions, including section 351, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. In addition, certain section 351 exchanges can cause the exchanging shareholder to include in income a deemed dividend under section 367(b). §1.367(b)-4.

Under current law, certain section 304(a)(1) transactions can also be subject to section 367. The result of this overlapping application is considerable complexity, uncertainty, and the risk of multiple income inclusions. In such a transaction, a U.S. person could recognize income (dividend or capital gain) equal to the built-in gain in the stock of the issuing corporation under section 367, and income (dividend or capital gain) pursuant to section 304. The total income recognized could exceed the fair market value of the transferred stock of the issuing corporation.

The proposed regulations would exclude from the application of sections 367(a) and (b) a deemed section 351 exchange that arises by reason of a transaction described in section 304(a)(1). The IRS and the Treasury believe that the interests of the government are protected, and the policies underlying section 367(a) and (b) are preserved, in a section 304(a)(1) transaction without regard to the application of section 367. The IRS and Treasury believe that, in most or all cases, the income recognized in a section 304 transaction will equal or exceed the transferor's inherent gain in the stock of the issuing corporation transferred to the foreign acquiring corporation. Elimination of the application of section 367(a) and (b) in this context will also serve the interests of sound tax administration by creating greater certainty and simplicity in these transactions, and by avoiding the over-inclusion of income that could result when section 367 and section 304 both apply to such transactions. As a result, this Treasury decision finalizes the proposed regulations and makes section 367(a) and (b) inapplicable to deemed section 351 exchanges pursuant to section 304(a)(1) transactions.

Commentators did note that in certain cases, depending on how the basis and distribution rules are applied, the amount of income recognized under section 304(a) may not equal or exceed the transferor's inherent gain in the stock of the issuing corporation. In the example cited, P, a domestic corporation, owns all the stock of F1 and F2, both of which are foreign corporations. P has an adjusted basis of \$0 in its F1 stock and \$100x in its F2 stock. P's stock of F1 and F2 each has a fair market value of \$100x. Neither F1 nor F2 has current or accumulated earnings and profits. P sells its F1 stock to F2 for its fair market value of \$100x in a transaction subject to section

304(a)(1). Under section 304(a)(1), the transaction is treated as if P had transferred its F1 stock to F2 in exchange for F2 stock in a transaction to which section 351(a) applies, and then F2 had redeemed such deemed issued stock.

These commentators posit that P in the above example may not recognize income or gain because the adjusted basis of both the F2 stock that is treated as being issued in the deemed section 351 exchange, and the adjusted basis of the F2 stock already held by P prior to the transaction, is available for reduction under section 301(c)(2). On these particular facts (i.e., no earnings and profits in either the acquiring corporation or the issuing corporation), this basis position would mean that income or gain is not recognized as a result of the transaction. The IRS and the Treasury believe, however, that current law does not provide for the recovery of the basis of any shares other than the basis of the F2 stock deemed to be received by P in the section 351(a) exchange (which would take a basis equal to P's basis in the F1 stock). Thus, in the case described, P would recognize \$100x of gain under section 301(c)(3) (the built-in gain on the F1 stock), and P would continue to have a \$100x basis in its F2 stock that it holds after the transaction. This issue will be addressed as part of a larger project regarding the recovery of basis in all redemptions treated as section 301 distributions. This larger project will be the subject of future guidance. Comments are requested about the appropriate treatment of basis in such redemptions.

B. Adjustments under Section 304(b)(6)

Section 304(b)(6) provides that in the case of any acquisition to which section 304(a) applies, where the acquiring or issuing corporation is a foreign corporation, the Secretary shall prescribe regulations, as appropriate, in order to eliminate a multiple

inclusion of any item in income and to provide appropriate basis adjustments (including modifications to the application of sections 959 and 961). The preamble to the proposed regulations requested comments on basis adjustments under section 304(b)(6). The preamble also requested comments regarding similar adjustments that could be made outside the context of section 304(b)(6).

Several comments were received in response to this request, and will be considered in a separate guidance project. The IRS and Treasury request additional comments on section 304(b)(6), particularly comments that would take into account the effect of section 362(e), enacted on October 22, 2004, by the American Jobs Creation Act of 2004 (Public Law 108-357).

Comments also were received regarding the application of section 959 to previously taxed amounts in connection with section 304(a)(1) transactions. These comments are being considered in a separate guidance project under section 959, and therefore are not addressed in these final regulations.

C. Transfer of Issuing Stock in Return for Property and Stock of Acquiring

The proposed regulations would apply to exclude a section 351 exchange from the application of section 367(a) only to the extent the exchange is treated as such by reason of section 304(a)(1). Thus, section 367(a) would continue to apply to applicable transfers of property subject to section 351 by reason other than the operation of section 304(a)(1).

One commentator notes that the proposed regulations would not address the treatment of stock sales for an amount less than the fair market value of the transferred stock where the acquiring corporation would be deemed to issue stock to the transferor

other than as a result of the application of section 304(a)(1). See, for example, section 367(c)(2). The commentator states that in such a case the transfer would be, in part, a section 304(a)(1) transaction and, in part, a section 351(a) exchange (other than by reason of section 304(a)(1)). The commentator requests guidance on such transactions, including, for example, whether such a transaction would be bifurcated and, if so, how the basis in the transferred stock would be allocated between the two parts of the transaction. The same bifurcation and related issues occur in section 304(a)(1) transactions where the acquiring corporation actually issues its own stock in partial consideration for the stock of the issuing corporation.

As was the case with the proposed regulations, these final regulations only apply to the extent of deemed section 351 exchanges resulting from section 304(a)(1) transactions. In addition, these regulations could apply to certain transactions that are, in part, still subject to the stock transfer rules of section 367(a) (e.g., a section 304(a)(1) transaction in which both acquiring stock and property are used as consideration). The issues raised by this commentator are relevant to a wide range of transactions, and are not limited to section 304 transactions that are subject to these regulations. As a result, the IRS and Treasury believe that the resolution of these issues is beyond the scope of this project, and this comment is not addressed in these final regulations.

D. Effective Dates

The proposed regulations stated that the rules would apply to section 304(a)(1) transactions occurring on or after the date of publication of the regulations in the **Federal Register**. Several commentators requested that the final regulations be made retroactive at the election of the taxpayer.

These final regulations adopt the general effective date contained in the proposed regulations and therefore apply to section 304(a)(1) transactions occurring on or after February 21, 2006. In response to the comments received, however, the final regulations provide that taxpayers may rely on the final regulations for all (but not less than all) section 304(a)(1) transactions that occurred in all their open tax years; in such cases, any gain recognition agreements filed pursuant to §1.367(a)-8 with respect to such transactions shall terminate and have no further effect.

Effect on other Documents

Rev. Rul. 91-5 (1991-1 C.B. 114) and Rev. Rul. 92-86 (1992-2 C.B. 199) are modified to the extent inconsistent with these regulations.

Special Analyses

The IRS and the Treasury have determined that the adoption of these regulations is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations and because these regulations do not impose a collection of information on small entities, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply. Pursuant to section 7805(f) of the Internal Revenue Code, the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of these regulations is Tasheaya L. Warren Ellison, Office of the Associate Chief Counsel (International). However, other personnel from the IRS and Treasury participated in their development.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1--INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read, in part, as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.367(a)-3 is amended as follows:

1. A sentence is added to paragraph (a) immediately following the second sentence.

2. The new fourth sentence of paragraph (a) is amended by removing the language “However” and adding “In addition” in its place.

3. Adding new paragraph (e)(1)(G).

The additions read as follows:

§1.367(a)-3 Treatment of transfers of stock or securities to foreign corporations.

(a) In general. * * * However, if, pursuant to section 304(a)(1), a U.S. person is treated as transferring stock of a domestic or foreign corporation to a foreign corporation in exchange for stock of such foreign corporation in a transaction to which section

351(a) applies, such deemed section 351 exchange is not a transfer to a foreign corporation subject to section 367(a). * * *

* * * * *

(e) * *(1) * * *

(G) Except as otherwise provided in this paragraph (e)(1)(G), the third sentence of paragraph (a) of this section shall apply to section 304(a)(1) transactions occurring on or after February 21, 2006. However, taxpayers may rely on the third sentence of paragraph (a) of this section for all section 304(a)(1) transactions occurring in open tax years; in such cases any gain recognition agreements filed pursuant to §1.367(a)-8 with respect to such transactions shall terminate and have no further effect.

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Par. 3. In §1.367(b)-4, a sentence is added to paragraph (a) immediately following the first sentence to read as follows:

§1.367(b)-4 Acquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions.

(a) Scope. * * * However, if pursuant to section 304(a)(1), a foreign acquiring corporation is treated as acquiring the stock of a foreign acquired corporation in a transaction to which section 351(a) applies, such deemed section 351 exchange is not an acquisition subject to section 367(b). * * *

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Par. 4. In §1.367(b)-6, paragraph (a)(1) is amended by adding a sentence to the end to read as follows:

§1.367(b)-6 Effective dates and coordination rule

(a) Effective date --(1) In general. * * * The second sentence of paragraph (a) in §1.367(b)-4 shall apply to section 304(a)(1) transactions occurring on or after February 21, 2006;

however, taxpayers may rely on this sentence for all section 304(a)(1) transactions occurring in open tax years.

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Mark E. Matthews,
Deputy Commissioner for Services and Enforcement.

Approved: February 8, 2006.

Eric Solomon,
Acting Deputy Assistant Secretary of the Treasury (Tax Policy).