

Part III - Administrative, Procedural, and Miscellaneous

Application of Section 367 to Section 304 Transactions

Notice 2012-15

SECTION 1. OVERVIEW

This notice provides guidance under section 367(a) and (b) of the Internal Revenue Code (Code) in the case of certain transfers of stock to foreign corporations in exchange for property under section 304. The Internal Revenue Service (IRS) and the Department of the Treasury (Treasury Department) will amend the regulations under section 367 to incorporate the guidance described in this notice. The amendments to the regulations will apply to transfers occurring on or after February 10, 2012.

SECTION 2. BACKGROUND

.01 Section 367(a)

Section 367(a)(1) generally provides that if a United States person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361, the foreign corporation shall not be considered a corporation for purposes of determining the extent to which the United States person recognizes gain on such transfer. Section 367(a)(2) and (3) provide specific exceptions to the general rule, and the Secretary has authority under section 367(a)(6) to promulgate regulations providing exceptions for other transfers.

Section 1.367(a)-3 provides exceptions to the general rule of section 367(a)(1) for certain transfers by a U.S. person of stock or securities to a foreign corporation. In some cases, these exceptions require the U.S. person to file a gain recognition agreement (GRA) and other related documents under the provisions of §1.367(a)-8 (GRA regulations). The GRA regulations were revised in 2009 (T.D. 9446, 2009-1 C.B. 607) to provide further guidance, including examples addressing when a GRA needs to be filed, when it will be triggered, and when exceptions to these triggering events apply. The triggering event exceptions address distributions in redemption of stock, including by reason of the application of section 304(a)(1). See §1.367(a)-8(n)(1) and (q)(2), Example 14. The GRA regulations also include a general exception that, under certain circumstances, applies to dispositions or other events not otherwise specifically excepted. See §1.367(a)-8(k)(14).

.02 Section 367(b)

Section 367(b)(1) provides that in the case of an exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 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 section 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 United States person, including regulations providing the circumstances under which gain is recognized or deferred, amounts are included in gross income as a dividend, adjustments are made to earnings

and profits, or adjustments are made to the basis of stock or securities.

Regulations under section 367(b) generally provide that if the potential application of section 1248 cannot be preserved following the acquisition of the stock or assets of a foreign corporation (foreign acquired corporation) by another foreign corporation in an exchange subject to section 367(b), including an exchange described in section 351, then certain exchanging shareholders of the foreign acquired corporation must include in income as a dividend the section 1248 amount (as defined in §1.367(b)-2(c)) attributable to the stock of the foreign acquired corporation. See §1.367(b)-4(b).

.03 Section 304

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 stock of the acquiring corporation. To the extent section 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 section 351(a) applies, and (2) the acquiring corporation then redeemed the stock it is deemed to have issued in the transaction.

.04 Application of Section 367 to Section 304 Transactions

On February 21, 2006, the IRS and the Treasury Department issued final regulations (T.D. 9250, 2006-1 C.B. 588) providing that section 367(a) and (b) shall not

apply to certain transfers of stock of a foreign or domestic corporation to a foreign acquiring corporation to which section 351 applies (deemed section 351 exchange) by reason of section 304(a)(1) (2006 regulations).

The preamble to the 2006 regulations stated that the policies underlying section 367(a) and (b) are preserved even if a deemed section 351 exchange is not subject to section 367(a) and (b) because generally the income recognized by the transferor in the transaction (dividend income, capital gain, or both) should equal or exceed the built-in gain in the transferred stock. The preamble further explained that the application of section 367 to deemed section 351 exchanges results in complexity and uncertainty.

Comments were received, however, stating that the transferor may not recognize income equal to or greater than the built-in gain in the transferred stock if, under section 301(c)(2), the transferor is permitted to recover the basis of shares of the foreign acquiring corporation held before (and after) the transaction. In response to these comments, temporary regulations were published on February 11, 2009 (T.D. 9444, 2009-1 C.B. 603) (2009 regulations), which modified the treatment of section 304 transactions provided by the 2006 regulations. The 2009 regulations retain the general rule that the deemed section 351 exchange will not be a transfer to a foreign corporation subject to section 367(a). However, the 2009 regulations provide an exception if a U.S. person reduces its basis under section 301(c)(2), in whole or in part, in its stock of the foreign acquiring corporation other than the stock deemed issued to the U.S. person in the deemed section 351 exchange. In such case, the U.S. person recognizes gain under section 367(a)(1) equal to the amount by which the gain realized by the U.S. person exceeds the amount of the distribution that is treated as a dividend under

section 301(c)(1) and included in gross income of the U.S. person. Furthermore, the 2009 regulations provide that a U.S. person cannot avoid such gain by entering into a GRA.

The 2009 regulations made similar revisions to the 2006 regulations under section 367(b). Specifically, the 2009 regulations provide that §1.367(b)-4(b) applies to a deemed section 351 exchange only to the extent the distribution received by the exchanging shareholder in redemption of the stock deemed issued by the foreign acquiring corporation is applied against and reduces, pursuant to section 301(c)(2), the basis of stock of the foreign acquiring corporation held by the exchanging shareholder other than the stock deemed issued to the exchanging shareholder in the deemed section 351 exchange.

.05 Section 1248(a)

Section 1248(a) generally provides that if a U.S. person that satisfies certain ownership requirements sells or exchanges stock in a controlled foreign corporation (or a foreign corporation that was a controlled foreign corporation within the past five years), then the gain recognized on the sale or exchange is included in gross income of such person as a dividend to the extent of the earnings and profits of the foreign corporation (and in certain cases, earnings and profits of foreign subsidiaries of such foreign corporation) that are attributable to such stock. The 2009 regulations provide that for purposes of section 1248(a), gain recognized by a shareholder under section 301(c)(3) in connection with a distribution of property by a foreign corporation with respect to its stock is treated as gain from the sale or exchange of stock of such corporation.

SECTION 3. REVISED APPROACH TO SECTION 304 TRANSACTIONS

After consideration of the comments received and the underlying policies of section 367(a) and (b), the IRS and the Treasury Department believe that the amount of income taken into account as a result of a section 304 distribution generally should not affect the application of section 367 to the deemed section 351 exchange. Furthermore, in the case of a transfer of stock by a U.S. person to a foreign corporation, the revised GRA regulations should substantially reduce the complexity and uncertainty resulting from the filing of a GRA in connection with a deemed section 351 exchange.

Accordingly, the IRS and the Treasury Department believe it is appropriate to revise the approach to the interaction of sections 367 and 304 under the 2006 regulations and 2009 regulations by providing that section 367(a) and (b) apply fully to the deemed section 351 exchange.

SECTION 4. APPLICATION OF SECTION 367 TO SECTION 304 TRANSACTIONS

The IRS and the Treasury Department will amend the section 367 regulations to provide that the section 351 exchange that is deemed to occur in a section 304 transaction is subject to section 367(a) and (b) in the manner described below.

.01 Application of Section 367(a)

To the extent that, 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 (foreign acquiring corporation) in a deemed section 351 exchange, the transfer is subject to section 367(a) and the regulations thereunder, including the exceptions described in §1.367(a)-3(b)(1) and (c)(1), as applicable. Thus, a transferor in a section 304 transaction that is a U.S. person may, in certain cases, be permitted to enter into a GRA

pursuant to §1.367(a)-8 to avoid the recognition of gain under section 367(a)(1).

If the U.S. person (referred to in the GRA regulations as the U.S. transferor) enters into a GRA with respect to a deemed section 351 exchange, the deemed redemption of the stock of the foreign acquiring corporation deemed issued to the U.S. person pursuant to section 304(a)(1) constitutes a disposition of the transferee foreign corporation stock under §1.367(a)-8. See §1.367(a)-8(b)(1)(iii) and (n)(1). As a result, the deemed redemption is generally treated as a triggering event within the meaning of §1.367(a)-8(j). However, consistent with the redemption rules provided in §1.367(a)-8(n)(1), the redemption will not be treated as a triggering event if the U.S. person that transfers the stock in the deemed section 351 exchange (or a U.S. person that is treated as a successor U.S. transferor as a result of the deemed redemption) enters into a new GRA that includes appropriate provisions to account for the redemption, provided the principles of §1.367(a)-8(k)(14)(ii) and (iii) are satisfied. Generally, the requirement to file an initial GRA for the deemed section 351 exchange and a new GRA by reason of the deemed redemption will be satisfied if the U.S. person that transfers the stock in the deemed section 351 exchange files a single GRA with respect to the entire section 304 transaction. See §1.367(a)-8(d)(2)(ii).

.02 Application of Section 367(b)

To the extent that, pursuant to section 304(a)(1), a foreign corporation (foreign acquiring corporation) acquires the stock of a foreign corporation in a deemed section 351 exchange, such exchange is subject to section 367(b) and the regulations thereunder, including §1.367(b)-4. Thus, for example, if a deemed section 351 exchange results in the loss of status as a section 1248 shareholder as provided in

§1.367(b)-4(b)(1)(i), the exchanging shareholder must include in income as a deemed dividend the section 1248 amount attributable to the foreign stock that is transferred in the deemed section 351 exchange.

.03 Example

Example. (i) Facts. USP, a domestic corporation, owns all of the outstanding stock of FT and FA, each a foreign corporation. USP's tax basis in the FT stock is \$50x, and the FT stock has a fair market value of \$100x. The section 1248 amount (within the meaning of §1.367(b)-2(c)) with respect to the FT stock is \$10x. FA has earnings and profits of \$200x, all of which are available for distribution taking into account section 304(b)(5). In a transaction to which section 304(a)(1) applies, USP transfers all of its FT stock to FA in exchange for \$100x cash.

(ii) Application of section 304(a)(1). Under section 304(a)(1), USP and FA are treated as if USP transferred its FT stock to FA in a section 351(a) exchange solely for FA stock, and then FA redeemed its deemed issued stock in exchange for the cash. The redemption of the FA stock deemed issued by FA to USP is treated as a distribution to which section 301 applies. The entire distribution is treated under section 301(c)(1) as a dividend (as defined in section 316) out of the earnings and profits of FA.

(iii) Application of section 367(a). Under section 4.01 of this notice, §1.367(a)-3(b) applies to USP's transfer of the FT stock to FA in exchange for FA stock. As a result, USP recognizes gain on the transfer under section 367(a)(1) unless USP enters into a GRA with respect to the transfer pursuant to §1.367(a)-3(b)(1)(ii) and §1.367(a)-8. However, the deemed redemption by FA of the stock it is deemed to issue to USP would constitute a triggering event with respect to such GRA as described in §1.367(a)-8(j). The redemption will not constitute a triggering event, however, if USP enters into a new GRA that includes appropriate provisions to account for the redemption and that is consistent with the principles of §1.367(a)-8(k)(14)(ii) and (iii). After the redemption, USP owns at least 5% of the total voting power and the total value of the outstanding stock of FA. Thus, if USP enters into a new GRA that satisfies the requirements of §1.367(a)-8(k)(14)(iii), the deemed redemption will not constitute a triggering event. In this case, the requirement that an initial GRA be filed for the deemed section 351 exchange and a new GRA be filed by reason of the deemed redemption will be satisfied if USP files a single GRA pursuant to §1.367(a)-8(d)(2)(ii).

(iv) Application of section 367(b). Under section 4.02 of this notice, §1.367(b)-4 applies to USP's transfer of the FT stock to FA in exchange for FA stock. Under §1.367(b)-2(a) and (b), USP is a section 1248 shareholder with respect to FT, a controlled foreign corporation, immediately before the exchange. Section 1.367(b)-4(b)(1)(i) does not apply to require USP to include in income the \$10x section 1248 amount with respect to the FT stock because each of FA and FT is a controlled foreign corporation as to which USP is a section 1248 shareholder immediately after the

exchange.

SECTION 5. FINALIZATION OF THE 2009 REGULATIONS UNDER SECTION 1248

The IRS and the Treasury Department will finalize the portions of the 2009 regulations that address the application of section 1248 to gain recognized with respect to stock upon distributions, including gain under section 301(c)(3), in separate published guidance effective February 10, 2009.

SECTION 6. EFFECTIVE DATE

The regulations described in this notice shall apply to section 304 transactions occurring on or after February 10, 2012. Pending the issuance of the regulations described in this notice, the IRS will not challenge reasonable interpretations of the application of section 367(a) and (b) to deemed section 351 exchanges and related deemed redemptions completed on or after February 10, 2012, including reasonable interpretations of the GRA rules as applied to such deemed section 351 exchanges and deemed redemptions under the principles of §1.367(a)-8(k)(14)(ii) and (iii).

SECTION 7. COMMENTS

The IRS and the Treasury Department request comments on the regulations to be issued under this notice.

SECTION 8. PAPERWORK REDUCTION ACT

The collections of information in this notice were previously reviewed and approved by the Office of Management and Budget in connection with Treasury Decision 9446 in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-2056.

An agency may not conduct or sponsor, and a person is not required to respond

to, a collection of information, unless the collection of information displays a valid control number.

The collections of information are in sections 4.01 and 4.02 of this notice. Responses to the collections of information are required to avoid recognizing gain under section 367, including under an existing gain recognition agreement, and to facilitate electronic filing. The likely respondents are large corporations.

The estimated burden will change as follows:

The estimated total annual reporting burden will increase by 100 hours.

The estimated annual burden per respondent remains 2 hours. The estimated number of respondents will increase by 50.

The estimated annual frequency of responses remains once per year.

Books and records relating to these collections of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

SECTION 9. DRAFTING INFORMATION

The principal author of this notice is Ryan A. Bowen of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury Department participated in its development. For further information regarding this notice contact Mr. Bowen on (202) 622-3860 (not a toll-free call).