New York State Bar Association

Tax Section

Report On Proposed Regulations Regarding Cross-Border Mergers

July 26, 2005

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Introduction.

This report ("Report") of the New York State Bar Association Tax Section ("Tax Section") comments on Proposed Regulations issued by the Internal Revenue Service ("IRS") and Treasury Department ("Treasury") under Section 368[2] on January 5, 2005 (REG-117969-00) and Sections 358, 367, 884 and 6038B on the same date (REG-125628-01) (the "Proposed Regulations"). The Proposed Regulations, *inter alia*, change the definition of a statutory merger qualifying as tax-free under Section 368(a)(1)(A) so that a merger is not required to be effected under the laws of the United States and make changes to the regulations under Section 367 motivated, in part, by the need to take into account this expanded definition.

The Tax Section has commented twice before on the question of expansion of the definition of "statutory merger or consolidation."[3] We believe that these Proposed Regulations are a helpful step toward the necessary modification of the definition of a "reorganization" in

1 The principal drafter of this Report was Jodi Schwartz, with able assistance from Annie Jeong. Helpful comments were received from Kimberly Blanchard, Michael Schler, Peter Canellos, David Miller, Willard Taylor, Marc Teitelbaum, David Hariton, David Sicular, Alan Appel, Robert Cassanos and T. Eiko Stange.

2 Except as otherwise noted, Section references are to the Internal Revenue Code of 1986, as amended (the "Code"), and references to Regulations are to the Treasury Regulations promulgated thereunder.

3 NYSBA Tax Section, Report on the Effect on the International Provisions of the Internal Revenue Code of Defining "Statutory" Mergers and Consolidations under Section 368(a)(1)(A) to Include Those Effected Under Foreign Law, 2002 TNT 99-17 (May 22, 2002) (the "2002 Report"); NYSBA Tax Section, Report with Respect to the Regulations that Define a "Statutory" Merger, 2000 TNT 82-22 (April 6, 2000).

light of the increasing internationalization and, in particular, investment in publicly traded foreign corporations. However, additional clarifications are required. In addition, we believe that the Proposed Regulations reach certain results which are questionable from a theoretical and fairness perspective. They also add to the formidable complexity of the Section 367 Regulations, suggesting the utility of a thorough restructuring in lieu of patchwork fixes.

Summary

We applaud the IRS's and Treasury's decision to expand the definition of "statutory merger or consolidation" to allow a merger or consolidation effected under foreign laws to qualify as a "statutory merger or consolidation" for purposes of Section 368(a)(1)(A). We believe, however, that the Proposed Regulations should make it clear that a merger or consolidation effected pursuant to European Union directive is a merger or consolidation and that amalgamations that occur pursuant to foreign laws are "mergers," for purposes of Section 368(a)(1)(A).

In addition, while certain of the changes to existing Section 367 Regulations logically conform the Section 367 Regulations to take into account the expanded definition of "statutory merger or consolidation," we believe that certain of the rules as described under the Proposed Regulations serve to add to the complexity of the already overly complex Section 367 Regulations and would recommend an overall review of those regulations.

We disagree with the restriction imposed by the Proposed Regulations on the existing overlap rule for transactions to which both Sections 367(a) and (b) apply, in particular, with the rule requiring inclusion of the "all earnings and profits amount." Rather than expanding the rules with respect to the all earnings and profits amount, we recommend, for the reasons discussed below, that the IRS and Treasury consider whether any transaction in which a foreign

business is transferred into U.S. corporate solution warrants the inclusion of the all earnings and profits amount.

With respect to the indirect stock transfer rules, we believe that where a foreign corporation acquires a domestic corporation in an asset reorganization and subsequently contributes some of the acquired assets to a controlled foreign subsidiary, a U.S. shareholder of the domestic acquired corporation should be treated as transferring stock of a foreign corporation to a foreign acquiring corporation subject to Treasury Regulation § 1.367(a)-3(b), and not as transferring stock of a domestic corporation to a foreign acquiring corporation subject to Treasury Regulation § 1.367(a)-3(c), as mandated by the Proposed Regulations. Similarly, we believe that, under the Proposed Regulations, the general application of Sections 367(a) and (d) to asset reorganizations in which a foreign corporation transfers part of the assets acquired from a domestic corporation to a controlled domestic corporation is unnecessarily punitive. While we understand the IRS's and Treasury's concern with respect to corporate inversion transactions, we recommend that the limitation on dropdowns under the Proposed Regulations be suspended until further analysis in light of recently adopted Section 7874. Moreover, we recommend that the IRS and Treasury reconsider whether a triangular B reorganization in which a U.S. shareholder exchanges stock of an acquired corporation for stock of a domestic parent in control of a foreign acquiring corporation should be treated as an indirect stock transfer by the shareholder of the acquired corporation to the foreign corporation.

With respect to the basis and holding period rules under the Proposed Regulations, we generally agree with the tracing approach required with respect to different blocks of stock owned by an exchanging shareholder. We question, however, the application of the special basis and holding period rules to certain triangular reorganizations in which a foreign corporation with a Section 367(b) shareholder is the merging or surviving corporation. While these rules may provide a theoretically correct solution to preserving Section 1248 amounts, in practice, they would be onerous to implement.

<u>Comments on Definition of Merger under the Proposed Regulations</u>.

As described in the 2002 Report, Treasury Regulations issued in 1935 provide that a statutory merger must be a transaction effected "pursuant to the corporation laws of the United States or a State or territory, or the District of Columbia."[4] This has effectively meant that a cross-border or foreign-to-foreign merger had to qualify as a Section 368(a)(1)(C) or (D) transaction to be tax free. The issue of mergers involving foreign entities was not addressed in the various sets of proposed regulations dealing with disregarded entities and mergers, including the temporary regulations dealing with mergers involving disregarded entities which were issued in 2003.[5]

The Proposed Regulations expand the definition of statutory merger or consolidation to encompass transactions effected under the laws of foreign countries and U.S. territories by changing the language "a transaction effected under the corporation laws of the United States or a State or territory, or the District of Columbia" to "a transaction effected pursuant to the statute or statutes necessary to effect the merger or consolidation." The preamble states that "the phrase statute or statutes is not intended to prevent transactions effected pursuant to legislation from qualifying as mergers or consolidations where such legislation is

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4 Treas. Reg. § 1.368-2(b)(1) (prior to amendment by T.D. 9038 (Jan. 23, 2003)).

5 Temp. Treas. Reg. § 1.368-2T(b)(1) (2003) (the "Temporary Regulations"); Prop. Treas. Regs. § 1.368-2(b)(1) (Nov 15, 2001) (the "2001 Proposed Regulations"); Prop. Treas. Regs. § 1.368-2(b)(1) (May 12, 2000). In the preamble to the 2001 Proposed Regulations, the IRS and Treasury requested comments on what changes would be appropriate to the definition of "statutory merger or consolidation" so as to include those that occur pursuant to foreign laws.

supplemented by administrative or case law." The Proposed Regulations also delete the specific exception in the Temporary Regulations for mergers involving foreign entities. As a result, a transaction may qualify as a statutory merger or consolidation regardless of whether the following entities are foreign or domestic: (i) the combining entity of the transferor unit; (ii) the combining entity of the transferee unit; (iii) any disregarded entity of the transferee unit that receives assets in the merger; and (iv) any entity between the combining entity of the transferee unit and the disregarded entity receiving the assets.

We believe that the Proposed Regulations appropriately eliminate an unwarranted disparity in the treatment of mergers involving foreign corporations and contain safeguards sufficient to protect against transactions which are not in the nature of "mergers." Two minor technical changes should be considered to clarify (1) that a merger effected pursuant to a European Union directive constitutes a merger "pursuant to [a] statute or statutes" and (2) that amalgamations under laws such as those of Canada or Bermuda would be able to constitute a "merger."

While it is noted above that the preamble recognizes that statutes can be "supplemented" by administrative or case law, the status of the European Union directive should be clarified.

It is also not entirely clear how amalgamations pursuant to the provincial laws of Canada or the Companies Act 1981 of Bermuda would qualify under the Proposed Regulations. Pursuant to such amalgamations, by operation of law, the assets of two previously existing corporations become the assets of a new entity and the two previously existing corporations "continue as one corporation." As the Proposed Regulations are currently drafted, it might be argued that such an amalgamation does not qualify as a merger or consolidation because it cannot really be said that one of the combining units survives the amalgamation while the other ("transferor") unit "ceases its separate legal existence for all purposes." It is possible that an amalgamation properly analyzed under the Proposed Regulations is the equivalent of two forward mergers, i.e., each company merges into a new company with each set of shareholders having an exchange analogous to the U.S. consolidation rules. This would engender results substantially different than an acquisitive merger, a distinction lacking any apparent theoretical basis.

A consolidation in the U.S. context occurs where two corporations combine into a newly created entity with the two combined corporations ceasing their separate legal existences. Triangular reorganizations arguably cannot be consolidations.[6] In Revenue Ruling 84-104, however, the IRS held that the consolidation of a wholly owned bank subsidiary of a bank holding company and a national banking association pursuant to the consolidation provision of the National Banking Act in fact qualified as a reverse triangular merger pursuant to Section 368(a)(2)(E). The IRS stated that because no new corporation was formed and *one of* the combining corporations survived the transaction, the transaction was a merger—even though accomplished under a consolidation statute—and could properly be classified as a reverse triangular merger. It is unclear how the IRS reached this conclusion. Section 215 of the National Banking Act clearly states that the effect of a consolidation is that *each of* the consolidating corporations is "merged into and continue[s]" in the resulting entity.[7] Unlike a merger where one entity is deemed to dissolve with the other surviving, in a consolidation

[6] Treas. Reg. § 1.368-2(j)(2); Rev. Rul. 84-104, 1984-2 C.B. 94; Bittker & Eustice, Taxation of Corporations and Shareholders ¶ 12.25 (7th ed. 2002).

[7] 12 U.S.C. 215(e).

pursuant to the National Banking Act, both consolidating corporations survive the consolidation. It may be that the IRS was merely being pragmatic as the banking laws and Office of the Comptroller of the Currency dictated the form of transaction.

There is no policy reason why amalgamations should not qualify as triangular mergers under either Section 368(a)(2)(D) or (a)(2)(E) (or where appropriate as Section 368(a)(1)(B) transactions). At the very least, the amalgamation of a wholly owned subsidiary of a parent corporation and another corporation (the "target") should be treated as a forward triangular "a2D" merger with respect to the target, and an "F" reorganization with respect to the subsidiary. However, we see no policy reason why greater electivity should not be allowed: the fact that foreign law does not have a notion of a survivor should not preclude any triangular merger from qualifying under any of Section 368(a)(2)(D) or (a)(2)(E), and/or where appropriate, Section 368(a)(1)(B), with the parties being allowed to specify which entity survives for U.S. tax purposes. We recommend the Proposed Regulations be revised to deal with amalgamations and that the ability to utilize the triangular merger provisions of the Code for these transactions be clarified.

<u>Comments on the Proposed Changes to Regulations under Certain International Code Provisions</u>.

The Proposed Regulations contain an extensive series of changes to regulations under certain international Code provisions to "account for statutory mergers and consolidations involving one or more foreign corporations" because "[c]urrent international tax regulations are premised on an A reorganization being limited to a statutory merger or consolidation involving domestic corporations effected pursuant to domestic law." In our 2002 Report, the Tax Section had recommended that Section 367 and the related international provisions of the Code "should apply in the same manner as if that merger or consolidation had been a reorganization under Section 368(a)(1)(C) or (D)," essentially recommending that only cross-references need be changed. It is fair to say the IRS took a far more expansive approach, in some cases making substantive—and not merely conforming—adjustments to the regulatory scheme and taking the opportunity to update the Section 367 Treasury Regulations to reflect a number of changes to the reorganization rules in the domestic context. Having gone well beyond the changes needed merely to conform the Section 367 Treasury Regulations to the change in definition of "statutory merger or consolidation," the Proposed Regulations do nothing to minimize, and in some cases exacerbate, the network of counterintuitive and unclear rules in these Treasury Regulations. Serious consideration should be given to a comprehensive reconceptualization of these Regulations, in light of current reorganization rules, market practices and the enactment of Section 7874.

Section 367 was originally enacted in order to prevent taxpayers from avoiding U.S. tax by transferring appreciated assets outside of the U.S. pursuant to a nonrecognition provision of the Code. This, the "outbound" Section 367 policy, is embodied in the Treasury Regulations under Section 367(a) dealing with transfers of property by U.S. persons to foreign corporations. Section 367(b) covers all other transfers (e.g., repatriation transfers, acquisitions of stock of a controlled foreign corporation ("CFC") by a foreign corporation, etc.). Section 367(b) reflects concerns arising from subsequent enactments and policy reconsiderations. With the enactment of Subpart F in 1962, the Regulations under Section 367(b) came to serve as a back-stop to Sections 951 and 1248 by preventing avoidance of taxation of earnings and profits of CFCs (the "E&P rationale"). In recent years there has been concern about the importation of basis and other attributes arising from activities of foreign corporations not subject to U.S. tax whether or not CFCs (the "anti-importation rationale"), reflected in Section 362(e) of the Code and in recent changes to the Section 367(b) Regulations.

In the current regulatory scheme, it is not at all clear which rationales are invoked in any particular provision. Indeed, it appears in many cases that the rationales shift from provision to provision and within provisions. The result is an opaque and confusing regulatory scheme. Adding to the confusion is the tendency to shift between imposing sanctions at the corporate level and at the shareholder level, in some cases using one as the surrogate for the other. In particular, whether a taxpayer is under Section 367(a) or (b) can result in significantly different tax consequences. The overlap issues have been treated inconsistently over the life of the Section 367 Regulations. Regretfully, the Proposed Regulations add even more complexity and confusion. We therefore respectfully suggest that the time is past due to rewrite the Section 367 Regulations on a basis which is conceptually clear, as simple as possible, and fair.

The Proposed Regulations, in relevant part (i) expand Treasury Regulation § 1.367(a)-3(a) to (i) cover "A" reorganizations, (ii) provide a Section 367(a) exception for the outbound transfer of parent stock in connection with a reverse triangular merger, (iii) revise the rules dealing with the overlap of Sections 367(a) and (b), (iv) restrict certain Section 368(a)(2)(C) drop downs, (v) expand the application of the indirect stock transfer rules to triangular B reorganizations and (vi) materially change basis and holding period rules for certain transactions involving foreign corporations with Section 1248 shareholders.

<u>Expand Section 367(a)</u>. Treasury Regulation § 1.367(a)-3(a) currently provides that Section 367(a) does not apply to the exchange under Section 354 by a US person of (i) stock of a foreign corporation in a recapitalization or (ii) stock of a domestic or foreign corporation for

stock of a foreign corporation in an asset reorganization described in Section 368(a)(1)(C), (D) or (F) *unless* the exchange is treated as an indirect stock transfer rather than an asset reorganization. The Proposed Regulations add "A" reorganizations to this list (including triangular mergers) as the 2002 Report suggested. Furthermore, the Proposed Regulations exempt the Section 361 transfer of shares of the parent from the merging company to the target in a reverse subsidiary merger as long as the shares are provided to the merging company pursuant to the plan of reorganization. If the shares are not provided pursuant to the plan (i.e., the merging company previously held shares of the parent), and the target is foreign and the merging company domestic, Section 367(a) would apply to the outbound transfer of shares by the merging company unless another exception applies. We agree that the proposed changes are necessary to implement the proposed definition change to "statutory merger or consolidation."

In accordance with Notice 2005-6[8], the Proposed Regulations also expand the reference to "Section 354" under Treasury Regulation § 1.367(a)-3(a) to "Sections 354 and 356" so that the use of boot would not disqualify an asset reorganization or recapitalization from an exception to Section 367(a). We believe this is the correct approach and commend the IRS and Treasury's decision to include within the exception U.S. shareholders who receive boot in addition to stock in a tax-free recapitalization or asset reorganization.

Sections 367(a) and (b) Overlap Rule Modified. In cases where Sections 367(a) and (b) apply concurrently, Treasury Regulations currently provide that the "all earnings and profits amount" (or "Section 1248 amount" (as defined below) in the case of stock held by a Section 1248 stockholder exchanged for stock that is not stock of a CFC as to which the US

[8] 2005-5 I.R.B. 448.

shareholder is a Section 1248 shareholder after the exchange) does not need to be taken into income under Section 367(b) where the transaction is taxable under Section 367(a). For example, assume Foreign Parent owns U.S. Newco and unrelated U.S. Parent owns Foreign Sub. U.S. Parent's basis in Foreign Sub is $50, Foreign Sub's fair market value is $100 and the all earnings and profits amount is $60. Under current law if Foreign Sub transfers its assets to US Newco for 20 percent of Foreign Parent's stock and liquidates, U.S. Parent can enter into a gain recognition agreement, in which event it will not recognize $50 gain under Section 367(a) but will have Section 367(b) consequences ($60 earnings and profits inclusion). If it does not enter into a gain recognition agreement, it pays tax on a $50 gain, and under Treasury Regulation § 1.367(a)-3(b)(2), no Section 367(b) amount is included. Accordingly, for a greater than 5 percent shareholder who can choose under Treasury Regulation § 1.367(a)-3(b) whether to enter into a gain recognition agreement, the inclusion of the all earnings and profits amount (which is not limited to gain) can be effectively elective. The Proposed Regulations take the view that this electivity is inappropriate and inconsistent with the policies of Section 367(b) applicable to inbound transactions and require Section 367(b) to apply to transactions subject to Treasury Regulation § 1.367(b)-3 before the application of Section 367(a). Thus, in the above example, U.S. Parent would be required to report $60.

While we understand the concern about taxpayer "self-help" where there happens to be an overlap between Sections 367(a) and (b), we see no policy justification in general for requiring U.S. shareholders who are Section 1248 shareholders to pay more tax than they would suffer in a taxable sale, nor do we see a rationale for taxpayers who are not Section 1248 shareholder to be taxed on the all earnings and profits amount in connection with inbound reorganizations. Anti-deferral regimes and Section 1248 apply to tax certain earnings and profits and not others, depending on the type of earnings and the nature of the shareholder. If the income has not been taxed under these rules, and the selling shareholder could sell shares in a completely taxable transaction and pay less tax than the tax payable with respect to the all earnings and profits amount, it is not clear that an abuse has occurred under the E&P rationale when such shareholder's income is limited by the Section 367 Regulations to the difference between amount realized and tax basis.

Rather than using the Proposed Regulations to expand the rules requiring the inclusion of the all earnings and profits amount to more circumstances, we recommend that the IRS and Treasury reconsider whether the inclusion of the all earnings and profits amount is warranted in any context where a foreign business is being transferred into U.S. corporate solution. If anti-deferral regimes have not previously taxed the U.S. shareholders on earnings and profits accrued offshore, it is not clear why the shareholders should be subject to tax on the all earnings and profits amount when the foreign business is transferred to the United States. It seems entirely counterintuitive to penalize shareholders on inbound migrations to such an extent.

If the concern underlying the all earnings and profits amount is inappropriate creation of inside asset basis without U.S. tax (the "anti-importation rationale"), one possibility could be to require (or allow taxpayers to elect) a step down in the asset basis brought into the United States to the extent of any previously untaxed earnings and profits in lieu of taxing the all earnings and profits amount, i.e. basis would be reduced by the grossed-up difference between the U.S. tax rate and the effective rate of foreign income taxes paid on such income.[9] Thus, for

[9] We understand that this solution may also result in unintended consequences, particularly because there is no equivalent to Section 704(c) allocations for corporations and, as a result of the step-down, non-U.S. shareholders could suffer a detriment.

example, if U.S. Parent owns 95 percent of Foreign Sub and a domestic individual owns 5 percent, and Foreign Sub is merged into a U.S. subsidiary of Foreign Parent, Foreign Sub's asset basis would be reduced to reflect the untaxed earnings and profits attributable to U.S. holders (in excess of the Section 1248 inclusions). Assume that the untaxed earnings (in excess of Section 1248 inclusions) were $80 and there was $20 of foreign tax paid. Foreign Sub would have had to pay U.S. tax in the amount of $35 (assuming a U.S. tax rate of 35 percent) on the earnings and profits had it earned the income in the United States. Since $20 of tax was paid and U.S. tax would have been $35, $15 has not been paid. Thus, 15/35 of $100 (or $42.86) of the income is effectively income not yet subject to tax. Therefore, asset basis in the Foreign Sub's assets should be reduced by $42.86 to reflect that only $58.14 of earnings were effectively previously taxed at the U.S. tax rate. (We note further that, at a minimum, Section 367(b) should not apply to any amounts subject to Section 362(e)).

Dropdowns following Asset Reorganizations. Proposed Treasury Regulation § 1.368-2(k) will, when finalized, expand the class of reorganizations after which a drop down is permitted. To conform to the changes in the Regulations under Section 368, the IRS and Treasury added an additional category of indirect stock transfers under the Proposed Regulations, generally providing that a transfer of assets to a controlled subsidiary following an asset reorganization would constitute an indirect transfer of stock provided that the transfer of assets by the foreign acquirer to its controlled subsidiary is part of the same transaction.

The Preamble to the Proposed Regulations in Section F reaffirms a result under the current Treasury Regulations governing indirect stock transfers that is highly counter-intuitive and a trap for the unwary. According to the Preamble, "under existing section 1.367(a)-3(d)(1)(v), a U.S. shareholder of an acquired corporation is treated as transferring the stock of the acquired corporation to the foreign acquiring corporation to the extent of the assets transferred to the controlled subsidiary. Thus, if the acquired corporation is foreign, the U.S. shareholder is treated as transferring stock of a foreign corporation to the foreign acquiring corporation in a transaction that is subject to the section 1.367(a)-3(b) stock transfer rules. If the acquired corporation is domestic, the U.S. shareholder is treated as transferring stock of a domestic corporation to the foreign acquiring corporation in a transaction that is subject to section 1.367(a)-3(c). This deemed transfer of domestic stock prevails even if the controlled subsidiary is foreign."

The Preamble acknowledges that "[s]ome commentators have suggested that the determination of whether domestic or foreign stock is deemed transferred should be based on the status of the controlled subsidiary, rather than the status of the acquired corporation. Under this approach, if the acquired corporation were domestic and the controlled subsidiary were foreign, the U.S. shareholders would be deemed to transfer foreign corporation stock subject to section 1.367(a)-3(b), rather than domestic corporation stock subject to section 1.367(a)-3(c)." However, the IRS and Treasury concluded that "consistent with the framework of the current regulations, it is appropriate for the rules to continue to apply based on the stock that is owned and exchanged by the U.S. person in the transaction (rather than on the stock of the controlled subsidiary)." We frankly do not understand that rationale since only the assets and not the stock of the domestic corporation are transferred, and if there is a deemed transfer of stock it should be a deemed transfer of stock of the foreign controlled corporation.

The effect of this rule can be illustrated with an example. Assume domestic corporation P owns domestic corporation D and also owns foreign corporation F, which might be newly formed. D transfers all its assets to F and liquidates in a reorganization under Section

368(a)(1)(C) or (D). P receives additional F stock. Assume the outbound asset transfer is not subject to Section 367(a) because the assets of D are operating assets used outside the United States, or the assets of D are stock of foreign subsidiaries and P enters into a gain recognition agreement with respect to that stock. This transaction is also an outbound stock transfer by P (i.e, the exchange of D stock for F stock), but this transfer is ignored because there is also an outbound asset transfer pursuant to Treasury Regulation § 1.367(a)-3(a).

However, suppose F contributes some of the acquired D assets to a new foreign subsidiary F2. This converts the transaction to an indirect stock transfer under Treasury Regulation § 1.367(a)-3(d)(1)(v). The exemption in Treasury Regulation § 1.367(a)-3(a) described above no longer applies. Under Treasury Regulation § 1.367(a)-3(d)(1) (initial language), if a U.S. person exchanges stock of a U.S. or foreign corporation and receives stock in a foreign corporation in an indirect stock transfer, the U.S. person is deemed to have made an indirect transfer of "such stock" to the transferee foreign corporation. This seems to mean there is an outbound transfer of the stock of D, the U.S. corporation in the example.

P may be exempt from tax on the outbound stock transfer if the transfer meets the requirements of Treasury Regulation § 1.367(a)-3(c)(1) (the so-called "Helen of Troy" rules). However, these rules will never be satisfied when the parties are related, because they require, *inter alia*, that U.S. persons not control the transferee foreign corporation. As a result, the dropdown by F of the assets to F2 means that the entire transaction is a taxable outbound transfer of stock of a domestic corporation to a foreign corporation.

As noted above, there would appear to be no conceptual basis for this result. The only arguable reason for the application of Treasury Regulation § 1.367(a)-3(c) would be resultoriented: to prevent a corporate “inversion”, which is not taking place here merely as a result of the asset drop-down from one foreign corporation to another. If the concern is the possibility that F could sell the stock of F2, this problem could be solved by treating the transfer as an outbound transfer of the stock of foreign corporation F2, in which case § 1.367(a)-3(b) would require D to enter into a gain recognition agreement.

We recommend that the IRS and Treasury reconsider this conclusion at least in the case in which a domestic acquired corporation and the foreign subsidiary to which a portion of the domestic acquired corporation’s assets are transferred have a common parent. If it is determined to retain the result, we would recommend that Treasury Regulations be revised to make this conclusion clear; the text of Treasury Regulation § 1.367(a)-3(d)(1) should at least be revised to clarify that the phrase “such stock” refers to the stock of the transferor corporation (D in this example) and it should also be made explicit that the gain recognition rules in Treasury Regulation § 1.367(a)-3(d)(2)(ii) which treat the transferred corporation as F2 are inapplicable for this purpose.

The IRS and Treasury have asked for comments where the foreign acquiring corporation transfers assets of the acquired corporation to multiple controlled subsidiaries (including both domestic and foreign subsidiaries). It would appear that the general framework of the Treasury Regulations—that there is an indirect stock transfer to the extent of the assets contributed to controlled subsidiaries—would be an appropriate one and that depending upon the conclusion with respect to the status of the transferee, the results under Treasury Regulation §§ 1.367(a)-3(b) and -3(c) would follow.

Asset Transfer Rules and Indirect Stock Transfers. In the case of an indirect stock transfer that also involves a transfer of assets by a domestic corporation to a foreign corporation, Treasury Regulation § 1.367(a)-3(d)(2)(vi) generally provides that Section 367(a) and (d) apply to the transfer of assets prior to application of the indirect stock transfer rules. However, the Regulation also provides that Section 367(a) does not apply to such transfers to the extent that the foreign acquiring corporation transfers the assets received in the asset transfer to a domestic corporation controlled (within the meaning of Section 368(c)) by the foreign acquiring corporation in a transfer described in Section 368(a)(2)(C) or in a transfer described in Section 351, provided the domestic transferee's basis in the assets is no greater than the basis that the domestic acquired corporation had in such assets. The initial asset transfer to the foreign corporation is not subject to Section 367(a) in such cases because the assets re-transferred to the domestic corporation remain subject to U.S. corporate tax.

The IRS and Treasury stated in the Preamble that they are concerned that asset reorganizations subject to this rule may be used to facilitate corporate inversion transactions or to facilitate divisive transactions. The Proposed Regulations seek to address both of these concerns by narrowing the scope of the coordination rule. Under the Proposed Regulations, subject to two exceptions, Sections 367(a) and (d) generally apply to the transfer of assets to a foreign corporation even if the foreign corporation transfers all or part of the assets received to a controlled domestic corporation, resulting in a deemed stock transfer as well.

The first exception applies if the domestic acquired corporation is controlled (within the meaning of Section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in Section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions to be provided in future regulations under Section 367(a)(5) are satisfied.

The second exception applies if the following two conditions are satisfied. First, the indirect transfer of stock of the domestic acquired corporation must satisfy the requirements of Treasury Regulation §§ 1.367(a)-3(c)(1)(i), (ii), and (iv), and -3(c)(6). Generally, these requirements will be satisfied if (a) U.S. transferors do not receive more than fifty percent of the total voting power and value of the stock of the foreign acquiring corporation, (b) neither U.S. persons that are officers or directors of the domestic acquired corporation nor U.S. persons that own five percent of the total voting power or value of the stock of the domestic acquired corporation (immediately before the transfer) own, in the aggregate, more than fifty percent of both the total voting power and value of the stock of the foreign acquiring corporation, (c) the active trade or business test (as described in Treasury Regulation § 1.367(a)-3(c)(3)) is met; and, (d) if U.S. persons transfer ten percent or more of the vote or value of the stock of the domestic acquired corporation in the transaction, certain reporting requirements are met. Second, the domestic acquired corporation must attach a statement to its tax return for the taxable year of the transfer certifying that if the foreign acquiring corporation disposes of any stock of the domestic controlled corporation with a principal purpose of avoiding U.S. tax that would have been imposed on the domestic acquired corporation had it disposed of the re-transferred assets, the domestic acquired corporation will amend its return for the year of the initial transaction and recognize gain (described below). The disposition of stock is presumed to have a principal purpose of tax avoidance if the disposition occurs within 2 years of the transfer. The presumption may be rebutted, however, if the domestic acquired corporation (or the foreign acquiring corporation on behalf of the domestic acquired corporation) demonstrates to the satisfaction of the Commissioner that the transaction did not have a principal purpose of avoidance of U.S. tax that would have been imposed on the domestic acquired corporation on the disposition of the re-transferred assets.

If the domestic acquired corporation recognizes gain pursuant to the statement, it is treated as if, immediately prior to the exchange, it had transferred the re-transferred assets, including any intangible assets, directly to a domestic corporation in exchange for stock of the corporation in a transaction that is treated as a Section 351 exchange, and immediately sold the stock to an unrelated party at fair market value in a sale in which it recognizes gain, if any, but not loss. For purposes of this rule, the deemed transfer to a domestic corporation is treated as a Section 351 exchange regardless of whether all the requirements for nonrecognition under Section 351 are otherwise satisfied.

According to the Preamble, "[t]reating the domestic acquired corporation as recognizing gain on the disposition of stock, rather than assets, is intended to approximate the consequences that would have resulted had the domestic acquired corporation transferred the assets to a corporation and sold the stock received in such transfer prior to the outbound reorganization. In addition, this treatment is consistent with other provisions that address divisive transactions. See, e.g., section 355(e) and section 1.367(e)-(2)(b)(2)(iii)."

The basis that the foreign acquiring corporation has in the stock of the domestic controlled corporation is increased by the amount of gain recognized by the domestic acquired corporation under these rules immediately prior to its disposition; however, the basis of the re-transferred assets held by the domestic controlled corporation will not be increased by such gain.

These new limitations on the coordination rule raise a number of issues. As we read the proposed rule, in contrast to the current rules which state clearly that re-transferred assets do not need to satisfy Section 367(a), the Proposed Regulations narrow the type of transaction eligible for this exception . Thus, a transfer of assets to a foreign corporation followed by a drop down of some of the assets into a domestic corporation would need to qualify under *both* the asset transfer rules and the indirect stock transfer rules unless such a transfer/drop down meets certain prescribed criteria; if it does not, it must satisfy both Section 367(a) and the indirect stock transfer rules and could potentially be taxable to both the corporation and its shareholders. This conclusion should be clearly illustrated in the Treasury Regulations.

As a technical matter, if the domestic acquired corporation has liquidated or merged in the outbound transaction, it is not clear who would be responsible to pay this tax and the liability to pay should be clarified. Furthermore, the failure to allow an asset level step-up if the transaction is taxable as a result of a re-transfer seems unfair and at a minimum inconsistent with the treatment that would have obtained if there had been no initial exception from Section 367(a). As discussed in our recent Bar Report on the Section 355(e) proposed regulations[10], moreover, a deemed Section 351 transaction raises a host of technical concerns that could lead to unintended consequences and planning opportunities. If the IRS and Treasury decide to retain this rule, we recommend that, rather than applying a deemed Section 351 analysis, the regulation simply provide that a taxpayer recognize gain with respect to the re-transferred assets in an amount equal to the difference between the taxpayer's aggregate basis of the assets and the fair market value of the assets on the date of (or immediately before) the transfer.

[10] NYSBA Tax Section, Report on Proposed Regulations Dealing with "Predecessors" and "Successors" in Section 355(e), 2005 TNT 123-13 (June 28, 2005).

More importantly, these expanded requirements, including the "special" two-year gain recognition agreement provided for, seem unnecessary where the assets remain in U.S. corporate tax solution with carryover basis. An outbound merger or "C" reorganization of assets not eligible for Section 367(a) exemption is taxable to the transferor corporation and not its shareholders. It is ironic that a subsequent transfer of assets to a U.S. controlled corporation would have the potential to give rise to both a corporate-level tax (under Section 367(a)) and a shareholder-level tax (as a result of the indirect stock transfer rules) . This result is highly counterintuitive—the parties could actually be worse off because they re-transferred assets back to U.S. corporate solution.

The concern that the Preamble expresses with respect to the potential for a divisive transaction is best protected by the various requirements of tax-free status—continuity of business enterprise, Treasury Regulation § 1.368-2(k)—and by the current requirements for a gain recognition agreement on the indirect stock transfer. While we remain concerned with respect to corporate inversion transactions, the Tax Section has recently recommended a review of the rules of Treasury Regulation § 1.367(a)-3(c) in light of the adoption of Section 7874 and various technical issues with respect to those rules; at a minimum this new limitation on dropdowns which expands the application of that Treasury Regulation rule should await such a study.[11]

<u>Expanded Scope of Indirect Stock Transfer Rules to Triangular B Reorganizations</u>. Under the current Treasury Regulations, a U.S. shareholder who transfers stock of an acquired corporation in exchange for voting stock of a foreign parent in control of the

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[11] Letter from NYSBA to Acting Deputy Assistant Secretary Solomon and Commissioner Everson (April 26, 2005) (reprinted in 2005 TNT 80-14 (April 27, 2005).

acquiring subsidiary is treated as if such shareholder made an indirect stock transfer of the acquired corporation's stock to the foreign corporation in a transaction subject to Section 367(a). This rule applies even where the acquiring subsidiary is domestic. Thus, a U.S. shareholder who owns five percent or more of the stock of the controlling foreign corporation is required to recognize gain on the stock transfer unless the shareholder files a gain recognition agreement.

The Proposed Regulations, in contradiction to the rationale that there is a deemed stock transfer to the parent, expand this rule to apply to triangular B reorganizations where a U.S. shareholder exchanges stock of an acquired corporation for stock of a *domestic* parent that controls a foreign acquiring subsidiary. Thus, the gain recognition agreement may be triggered if, within five years of the initial transfer, the domestic controlling parent disposes of the stock of the foreign acquiring subsidiary or the foreign acquiring subsidiary disposes of the acquired corporation's stock even though no gain recognition agreement would be required if the transfer had been to the domestic parent in a straight B Reorganization.

We disagree with the result of the Proposed Regulations and believe that a gain recognition agreement is unnecessary in this situation. Although a straight B reorganization followed by a drop down to a foreign corporation would have been an indirect stock transfer, it is unclear what is being protected in a situation in which a domestic controlling parent later sells stock of a foreign acquiring subsidiary. Even if the first tier subsidiary had a high basis in its assets that it could use to offset gain inherent in the stock of the domestic acquired corporation, the same result would have occurred had the domestic parent simply acquired the domestic corporation's stock in a straight B reorganization and sold both the domestic and the foreign subsidiary.

<u>Basis and Holding Period Rules</u>. The Proposed Regulations provide basis and holding period rules for certain transactions involving foreign corporations with Section 1248 shareholders in order to preserve Section 1248 amounts. A Section 1248 shareholder is a U.S. person that satisfies the ownership requirements of Section 1248(a) with respect to a foreign corporation. Section 1248(a) applies to a U.S. person that owns stock (directly, indirectly, or constructively) with 10 percent or more of the voting power in the foreign corporation at any time during the 5-year period ending on the sale or exchange of the stock when the foreign corporation was a CFC. Gain recognized by a Section 1248 shareholder on the sale or exchange of stock of the foreign corporation is included in gross income as a dividend to the extent of the earnings and profits of the foreign corporation that are attributable to the stock sold or exchanged and that were accumulated while the stock was held by the U.S. person when the foreign corporation was a CFC (the "Section 1248 amount").

The basis and holding period rules of the Proposed Regulations also apply to a foreign corporate shareholder of a foreign corporation that is a party to the reorganization, provided that the foreign corporate shareholder has at least one U.S. person that is a Section 1248 shareholder with respect to the foreign corporate shareholder and the foreign corporation. This rule is designed to preserve application of Section 964(e) to the foreign corporate shareholder with respect to lower-tier foreign corporations. Under Section 964(e), if a CFC sells or exchanges stock in another foreign corporation, gain recognized on the sale or exchange is included in the income of the CFC as a dividend to the same extent that it would have been included under Section 1248(a) if the CFC were a U.S. person. Such dividend income may be treated as subpart F income that is included in the income of U.S. shareholders of the CFC.

The Proposed Regulations apply to certain Section 354 exchanges involving foreign corporations, including exchanges of multiple blocks of stock. The Proposed Regulations seek to preserve the bases and holding periods in different blocks of stock in certain foreign target corporations by requiring the exchanging shareholder to establish the particular shares of stock that were received in exchange for shares of a particular block of target stock. If the exchanging shareholder cannot establish the particular shares of target stock that were received for shares of a particular block of stock, then the shareholder must designate which shares of stock were received in exchange for shares of a particular block of stock, provided that the designation is consistent with the terms of the exchange. These tracing methods are used to determine the resulting tax consequences when stock received in a nonrecognition exchange is subsequently sold or otherwise exchanged. If the exchanging shareholder cannot establish, and does not designate, the particular shares received, the shareholder is treated as selling or otherwise exchanging a share received in a nonrecognition exchange for a share that was purchased or acquired at the earliest time.

These Proposed Regulations apply the principles of the recently proposed Section 358 Regulations (REG-116564-03) that determine the basis of stock or securities received in Section 354 exchanges ("Proposed Section 358 Regulations") to certain exchanges of stock of a foreign corporation by either a Section 1248 shareholder, or a foreign corporate shareholder where at least one U.S. person is a Section 1248 shareholder with respect to such foreign corporate shareholder and the foreign corporation whose shares are exchanged ("Section 367(b) shareholder"), to ensure the preservation of Section 1248 amounts. The Proposed Regulations also include specific guidance on the shareholder's holding period in the stock received in the Section 354 exchange. Consistent with the Proposed Section 358 Regulations, the Proposed

Regulations do not apply to Section 351 exchanges or to exchanges to which both Section 351 and Section 354 (or Section 356) apply, if, in addition to stock being received, other property is received or liabilities are assumed.

Consistent with our Report on the Proposed Section 358 Regulations[12], we agree generally with the tracing approach contained in the Proposed Regulations. We would recommend consideration of the clarifications contained in Section IV.A.2 and B to the 358 Report The Preamble to the Proposed Regulations requests comments on the preservation of the Section 1248 amount in Section 351 transactions in which liabilities are assumed or other property is received. In that context, we further recommend that consideration be given to extending the basis tracing regime to all Section 351 transactions as recommended in Section IV.C of the Section 358 Report.

Finally, in the context of reorganizations where no stock is issued, we believe that the basis of stock after a reorganization in which no stock was issued should be treated as if the appropriate amount of stock had been issued with basis traced from exchanged shares to shares deemed received and then the number of shares in each block were reduced ratably in a recapitalization in a manner consistent with Section IV.D of the Section 358 Report.

<u>Basis and Holding Period Rules Applicable to Triangular reorganizations</u>. The Proposed Regulations provide special basis and holding period rules for triangular reorganizations where the merging or surviving corporation is a foreign corporation with a

[12] NYSBA Tax Section, Report on Proposed Regulations Regarding Allocation of Basis under Section 358, 2005 TNT 103-52 (May 31, 2005) (the "358 Report").

Section 367(b) shareholder. These rules apply to reorganizations described in Section 368(a)(2)(D) and (a)(2)(E) and to parenthetical Section 368(a)(1)(C) reorganizations.

The Preamble to the Proposed Regulations states that the IRS and Treasury are concerned that, in certain exchanges involving foreign corporations, application of the over-the-top basis rules of Treasury Regulation §§ 1.358-6(c)(1) and (c)(2) would not properly preserve the Section 1248 or Section 964(e) amounts with respect to the stock of the target or surviving corporation in triangular "A" and "C" reorganizations. The Proposed Regulations provide that, in determining the stock basis of the surviving corporation in certain triangular reorganizations, outside stock basis will be used instead of inside asset basis pursuant to Treasury Regulation § 1.358-6.

Under this stock basis approach for triangular reorganizations, the Proposed Regulations provide for a divided basis and holding period in each share of stock in the surviving corporation to reflect the relevant Section 1248 amounts in the subsidiary and target stock. In particular, each share of surviving company stock in a forward triangular merger, and each share of Target stock in a reverse triangular merger, where parent is a Section 367(b) shareholder immediately after the transaction, is divided into portions reflecting the basis and holding period of the stock before the transaction. However, the Proposed Regulations contain a de minimis exception to this rule. Under this exception, if the value of the stock immediately before the transaction is de minimis (for example, where subsidiary is a corporation formed to facilitate the transaction), then each share of the surviving corporation is not divided; instead, the basis of the stock is added to the basis of the stock of the surviving corporation held by parent. The value of the stock would be de minimis for this purpose if it is less than 1 percent of the value of the surviving corporation immediately after the transaction.

If there are two or more blocks of stock held by a Section 367(b) shareholder immediately before the transaction, then each share of the surviving corporation is further divided to account for each block of stock. If two or more blocks of stock are held by one or more shareholders that are not Section 367(b) shareholders, then shares in these blocks are aggregated into one divided portion for basis purposes. If none of the shareholders is a Section 367(b) shareholder, then the over-the-top basis rules of Treasury Regulation § 1.358-6 apply instead of the rules in the Proposed Regulations.

The Proposed Regulations provide special rules when stock of the surviving corporation has a divided basis and holding period. Earnings and profits accumulated prior to the reorganization are attributed to a divided portion of a share of stock based on the block of stock which has basis and holding period that the divided portion reflects. Post-reorganization earnings and profits are attributed to each divided share of stock pursuant to Section 1248 and the regulations thereunder. The amount of earnings and profits attributed to a divided share of stock pursuant to Section 1248 are further attributed to a divided portion of such share of stock based on its fair market value in relation to the other divided portions. Finally, shares of stock are no longer divided into separate portions if Section 1248 or Section 964(e) becomes inapplicable to a subsequent sale or exchange of the stock.

One example provided in the Proposed Regulations illustrates the basic application of these rules. In the example, US1, a domestic corporation, owns all the stock of FT, a foreign corporation with 100 shares of stock outstanding valued at $10x per share. US1 acquired the FT stock on two different dates and owns two different blocks of FT stock for purposes of Section 1248. The first block, consisting of 60 shares, has a holding period of ten years, a tax basis of $300x (or $5x per share), and $240x (or $4x per share) of earnings and profits attributable to such shares for purposes of Section 1248. The other block of stock consists of 40 shares, has a holding period of two years, a tax basis of $600x (or $15x per share), and $80x (or $2x per share) of earnings and profits attributable to such shares for purposes of Section 1248. A domestic corporation, US2, owns all the stock of FP, a foreign corporation, which in turn owns all the stock of FS, a foreign corporation. In an A reorganization, FT merges with and into FS, with FS surviving. Pursuant to the reorganization, US1 exchanges its FT stock for 50 shares of FS stock valued at $1000x in an exchange that qualifies under Section 354. As the example explains, US1 is a Section 1248 shareholder of FT immediately before the transaction and exchanges FT stock for stock of a CFC (i.e., FS) as to which US1 is a Section 1248 shareholder immediately after the exchange and is not required, with respect to the exchange, to include income under Treasury Regulation § 1.367(b)-4(b). Thus, 30 shares of the FS stock received by US1 in the transaction have a holding period of ten years, a tax basis of $300x (or $10x per share) and $240x (or $8x per share) of earnings and profits attributable to such shares for Section 1248 purposes, and 20 shares of the FS stock received by US1 in the transaction have a holding period of two years, a tax basis of $600x (or $30x per share), and $80x (or $4x per share) of earnings and profits attributable to such shares for Section 1248 purposes.

The Tax Section believes that these rules, while perhaps resulting in an intellectually pure approach to Section 1248, may give rise to extraordinary complexity particularly in the case of shares which are widely held or where Section 1248 shareholders hold less than 50 percent of the target. While we understand the reasoning behind the use of stock basis, we question whether the absence of a toll charge when Section 1248 amounts are transferred in a triangular reorganization justifies the level of complexity and complication resulting from this approach. We are also concerned that the use of outside stock basis could also be subject to manipulation and present an improper tax planning device for taxpayers.

If the IRS and Treasury decide to retain these rules, we recommend that Treasury Regulation § 1.358-6 should continue to apply where Section 1248 shareholders hold less than 50 percent of the target. We also agree with the approach described in the Preamble which would allow taxpayers to elect to apply the current basis regime under Treasury Regulation § 1.358-6 in exchange for reporting the Section 1248 amount in full.

Application to Section 367(b) Regulations for Triangular Reorganizations with Domestic Parent. Under the current Treasury Regulations, in a triangular reorganization (such as a triangular reorganization described in Section 368(a)(1)(C)) that is within the scope of Treasury Regulation § 1.367(b)-4, a Section 367(b) shareholder must include in income the Section 1248 amount if, for example, it receives stock of a domestic corporation in exchange for its stock in a CFC. This is the case because, immediately after the exchange, the Section 367(b) shareholder does not hold stock in a corporation that is a CFC as to which such shareholder is a Section 367(b) shareholder. On the other hand, pursuant to the basis rules contained in Proposed Treasury Regulation § 1.367(b)-13, the Section 1248 amount with respect to the stock of the foreign acquired corporation that is exchanged can be properly preserved in the stock of a foreign corporation owned by a domestic corporation when the Section 367(b) shareholder receives stock of the domestic corporation in a triangular reorganization. Consequently the Proposed Regulations provide that a Section 367(b) shareholder receiving stock of a domestic corporation in a triangular reorganization is not required to include in income the Section 1248 amount under Treasury Regulation § 1.367(b)-4(b)(1)(i), provided that the domestic corporation, immediately after the exchange, is a Section 1248 shareholder of the surviving corporation (or, in the case of a parenthetical Section 368(a)(1)(B) reorganization, of the acquired corporation) that is itself a CFC. Assuming the Proposed Regulations on triangular basis are adopted, this result seems entirely consistent.

Application of Section 367(b) Regulations to Certain Outbound Reorganizations. If a domestic corporation is a Section 1248 shareholder with respect to a foreign corporation and transfers the stock in such foreign corporation to another foreign corporation in a Section 361 transfer, the domestic corporation must include in income the Section 1248 amount, if any, with respect to the stock of the transferred foreign corporation. See Section 1248(f)(1) and Treasury Regulation § 1.367(b)-4(b)(1)(ii), Example 4.

According to the Preamble, taxpayers have suggested that this rule may result in income inclusions in some cases where the Section 1248 amount could be preserved, such that a current inclusion may not be necessary or appropriate. In the context of a transferor described in Section 367(a)(5), Treasury Regulations which implement Section 367(a)(5) and provide for an adjustment of basis and holding period in the foreign stock received to the basis and holding period the domestic corporation had in the transferred foreign corporation's stock could preserve Section 1248 amounts in the stock in the hands of the transferor. Thus, in conjunction with Proposed Treasury Regulation § 1.367(b)-13, the Section 367(b) Regulations could allow for the deferral of Section 1248 treatment to the future when the shares received are disposed of.

For example, assume US1, a domestic corporation, owns all the stock of US2, a domestic corporation, in which it has a tax basis of $175. US2 owns all of the stock of FT, a foreign corporation, valued at $200. US2 has a tax basis of $100 and a holding period of ten years in such stock, and $300 of earnings and profits are attributable to such stock for Section

1248 purposes. In a C reorganization, US2 transfers all of its assets to FC, a foreign corporation, in exchange for 200 shares of FC stock valued at $200 and immediately liquidates, distributing the FC stock to US1. The exchange by US2 qualifies for tax free treatment under Section 361. If our recommendation were followed, the FC stock owned by US1 would have a tax basis of $100 (or $.50 per share), a holding period of ten years and $300 of earnings and profits attributable to such stock for purposes of Section 1248, rather than the basis of $175 it would have had under general principles of tax law.

As long as Section 367(a)(5) basis rules can apply, the existence of multiple Section 1248 shareholders should not affect this analysis; if minority shareholders are not Section 1248 shareholders after the transaction, Section 1248(f) should just tax the gain to the extent of the stock held by such non-Section 1248 shareholders. Comments were requested in the Preamble regarding circumstances involving multiple assets (including appreciated and depreciated assets) being transferred as part of the Section 361 transfer, and liabilities being assumed in connection with the transaction. Using the principles of the Section 358 Report and Proposed Treasury Regulation § 1.367(b)-13, it would be appropriate, we believe, to apply the Section 367(a)(5) basis adjustment to adjust the relative proportion of stock that is received in exchange for foreign shares to the net basis of the shares transferred and to allocate the liabilities among the assets transferred in accordance with the principles described in the Section 358 Report.

<u>Nonrecognition Transactions under the FIRPTA and PFIC Provisions</u>. Section 897(a) generally treats gain or loss from the disposition of a U.S. real property interest by a nonresident alien individual or a foreign corporation as gain or loss that is effectively connected with the conduct of a trade or business within the United States. Temporary regulations were

issued under Sections 897(d) and (e) providing guidance on the application of Section 897 to certain corporate transactions involving U.S. real property interests.[13] These rules do not specifically address A Reorganizations. Pursuant to our 2002 Report, we recommend that the references in those temporary regulations to reorganizations under Section 368(a)(1)(C) be expanded to apply to Section 368(a)(1)(A) transactions.

Section 1291(f) provides authority to issue regulations concerning the exchange of stock in a passive foreign investment company ("PFIC") in a nonrecognition transaction. The current proposed regulations, issued in 1992 (the "Proposed PFIC Regulations"), provide rules for the disposition of PFIC stock by U.S. shareholders in nonrecognition exchanges.[14] We do not believe the Proposed PFIC Regulations require amendment solely to reflect that, under the Proposed Regulations, A reorganizations would no longer be limited to statutory mergers between domestic corporations. This is because the Proposed PFIC Regulations generally are not concerned with the type of reorganization pursuant to which PFIC stock is transferred.

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13 See Temp. Treas. Regulation §§ 1.897-5T and -6T; Notice 89-85, 1989-2 C.B. 403.

14 See Prop. Treas. Reg. § 1.1291-6.