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May 17, 2006

Mr. Eric Solomon
Acting Deputy Assistant Secretary (Tax Policy)
Department of the Treasury
Room 3112 MT
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

The Honorable Mark W. Everson
Commissioner
Internal Revenue Service
Room 3000 IR
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Internal Revenue Service Notice 2005-74

Dear Acting Deputy Assistant Secretary Solomon and Commissioner Everson:

I am pleased to enclose New York State Bar Association Tax Section Report No. 1110, commenting on Internal Revenue Service Notice 2005-74.

The Notice, issued on September 28, 2005, clarifies the effect of various common asset reorganizations on gain recognition agreements ("GRAs"). Under the section 367(a) regulations, taxpayers are generally permitted to enter into GRAs to avoid the recognition of gain on nonrecognition transfers of stock or securities to foreign corporations. A GRA provides that if there is a triggering event before the close of the fifth full taxable year following the year of the initial transfer, the United States person that had originally transferred the stock or securities in the nonrecognition transaction must generally file an amended return for the year of the initial transfer and recognize the gain realized but not recognized on the initial transfer, with interest.

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The Notice provides that subsequent asset reorganizations involving the (i) initial transferor, (ii) the foreign transferee, or (iii) the transferred corporation will be considered triggering events unless specific conditions are met.

Where the initial transferor was a U.S. corporation, and it subsequently transfers its assets in a tax-free asset reorganization to another corporation, section 3.02 of the Notice conditions relief from triggering gain on the initial transfer upon the successor corporation being a member of the original consolidated group immediately after the reorganization. We refer to this requirement as the "consolidation continuity" requirement.

We commend the Treasury and the Internal Revenue Service for clarifying the effect of asset reorganizations on previously-filed GRAs. However, we believe that the regulations should not result in an automatic triggering event upon an asset reorganization of the initial transferor that does not satisfy the consolidation continuity requirement of the Notice. The consolidation continuity requirement will result in many internal restructurings triggering gain recognition, and does not seem to us to be justified by any strong policy. We believe that the government's legitimate interests would be protected, while avoiding inappropriate triggering of gain, if alternative conditions such as the following were adopted:

In the case where the GRA was originally filed by the common parent of a consolidated group and, immediately after the asset reorganization, the successor corporation is included in a consolidated return with one or more members of the original group, it should be sufficient if the common parent of the post-acquisition affiliated group enters into a revised GRA on the terms set forth in section 3.02 of the Notice. This assumes that no event has occurred that would have resulted in the acceleration of deferred items. Where the GRA was filed by an unaffiliated initial transferor and the successor corporation is a domestic corporation that succeeds to substantially all of the assets of the initial transferor, it should be sufficient if the successor corporation (and, if it is a member of a consolidated group, the common parent of such group) enters into a revised GRA on the terms set forth in section 3.02 of the Notice.

Where the GRA was filed by the common parent of a consolidated group, but the successor corporation is either an unaffiliated domestic corporation or is a member of a consolidated group under circumstances not qualifying under the first general rule above, the successor corporation (or common parent of the acquiring group) should be able to enter into a revised GRA on the terms described in section 3.02 of the Notice. In such circumstances, we do not believe that the common parent of the initial transferor's consolidated group or, if none, the initial transferor's shareholder(s) should be required to be secondarily liable under, or otherwise a party to, the replacement GRA, absent an impairment of payment expectations under principles analogous to those in section 1.1001-3 of the Treasury Regulations. An "impairment" standard could be implemented in part by a safe harbor where the acquiring entity or group has a public credit rating of at least an investment grade. A

safe harbor could also be provided for situations in which the common parent of the initial transferor's consolidated group or, if none, the initial transferor's shareholder(s) remain secondarily liable under the replacement GRA. If there otherwise would be an impairment of payment expectations, such common parent or shareholder(s) could be required to remain secondarily liable.

We further suggest that a procedure be provided whereby taxpayers are permitted, at the time of a transfer of stock of an initial transferor to an unrelated party, to arrange for the acquiror to enter into a replacement GRA whereby it would become liable. Whether the initial transferor group or the initial transferor shareholder(s) would remain secondarily liable could depend on a similar "change in payment expectations" standard.

Where the successor corporation is a foreign corporation, we recommend that triggering of the GRA could be avoided if the common parent of the initial transferor's consolidated group (or, if none, the initial transferor's successor by liquidation (or shareholders)) assumes liability with the foreign successor corporation under the revised GRA, and otherwise in the discretion of the Internal Revenue Service.

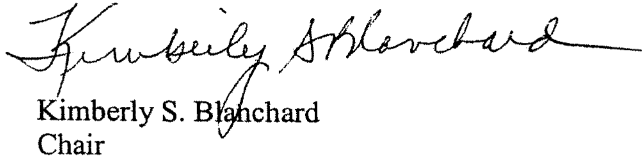
For similar reasons as set forth in our Report, we believe that the consolidation continuity requirement applicable to nontaxable liquidations under existsing section 1.367(a)-8(2)(ii) of the Treasury Regulations should be eliminated in favor of similarly relaxed rules. We recommend that the revisions eliminating the consolidation continuity requirement under the Notice and the Regulations should be made retroactive for all open taxable years, at least in the first two cases described above.

We also provide comments with regard to the appropriate tax treatment of certain upstream and downstream mergers, divisive reorganizations under section 368(a)(1)(D) and triangular reorganizations. For the reasons set forth in the Report, we recommend that the interest charge currently imposed on triggering events be eliminated.

Finally, we recommend that section 1.367(a)-8 of the Treasury Regulations be reissued in temporary and proposed form, reflecting the revisions made by the Notice as well as any revisions made pursuant to comments received.

We appreciate your consideration of our recommendations and comments. We would be pleased to discuss these matters with you further or provide any other assistance that you would find helpful.

Respectfully submitted,



Kimberly S. Blanchard
Chair

Enclosure

cc: Harry (Hal) J. Hicks, III, International Tax Counsel,
Department of the Treasury
Gretchen Sierra, Attorney Advisor, Office of Tax Policy,
Department of the Treasury
Jeffferson VanderWolk, Special Counsel, Associate Chief Counsel (International),
Internal Revenue Service
John J. Merrick, Special Counsel, Associate Chief Counsel (International),
Internal Revenue Service
Charles P. Besecky, Branch Chief, Branch 4, Associate Chief Counsel (International),
Internal Revenue Service

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT WITH RESPECT TO NOTICE 2005-74

May 17, 2006

Report No. 1110

New York State Bar Association Tax Section Report with Respect to Notice 2005-74[1]

This report comments on Notice 2005-74, 2005-42 IRB 726 (the "Notice"). The Notice modified and reclassified the rules relating to "gain recognition agreements" ("GRAs") contained in section 1.367(a)-8 of the Treasury Regulations. Under the section 367(a) regulations, taxpayers are generally permitted to enter into GRAs to avoid the recognition of gain on transfers of stock or securities to foreign corporations in certain nonrecognition transactions. The Notice clarified the effect that certain subsequent asset reorganizations have on GRAs previously entered into by the transferor (referred to herein as "US Transferor").[2] The subsequent asset reorganizations addressed in the Notice include (i) asset reorganizations involving a US Transferor that was itself a corporation, (ii) asset reorganizations involving the foreign transferee (referred to herein as the "Transferee") and (iii) asset reorganizations involving the transferred corporation (referred to herein as "Transferred"). The Notice also requested comments regarding other aspects of the application of section 1.367(a)-8 of the Treasury Regulations, including whether other transactions should be excepted from being treated as "triggering events" pursuant to rules similar to those contained in the Notice.

We commend the Treasury Department and Internal Revenue Service ("IRS") for addressing the issue of asset reorganizations of parties involved in GRAs. This report addresses the transactions outlined in the Notice and offers other recommendations in respect of certain issues reserved in the Notice. We recommend that section 1.367(a)-8 be reissued in temporary and proposed form, reflecting the revisions made by the Notice as well as any further revisions pursuant to comments.

I. Summary of Recommendations

1. Asset Reorganizations Involving the US Transferor. We assume that the requirement of "consolidation continuity" contained in section 3.02 of the Notice (as well as in section 1.367(a)-8(f)(2)(ii) of the Treasury Regulations) reflects a concern that payments expectations may be changed following a subsequent asset reorganization or other transaction

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[1] The principal author of this Report was Peter Blessing, with assistance from Mark Grinfeld. Helpful comments were received from Kimberly Blanchard, David Miller, Andrew Oringer, Michael Schler, Jodi Schwartz and Diana Wollman.

[2] As used herein, an "asset reorganization" generally refers to a reorganization described in sections 368(a)(1)(A) (including under (a)(2)(D)), (a)(1)(C), (a)(1)(D), (a)(1)(F) and (a)(1)(G), which involves a section 361 transfer of assets to another party to the reorganization (and, in the case of a reorganization under section 368(a)(1)(D) or (G), the requirements of section 354(b)(1)(A) and (B) are met). See Notice section 3.01.

involving a US Transferor that has entered into a GRA. We believe that the consolidation continuity requirement should be eliminated. In lieu thereof, alternative conditions such as the following should be sufficient to protect the government's interest:

a. Category 1 transaction (GRA filed by the common parent of an affiliated group that filed a consolidated return and, immediately after the asset reorganization, the successor corporation is included in a consolidated return with one or more members of the original consolidated return and no event that would have resulted in the acceleration of deferred items has occurred): in such a case, it should be sufficient if the common parent of the post-acquisition affiliated group enters into a revised GRA on the terms set forth in section 3.02 of the Notice.

b. Category 2 transaction (GRA filed by an unaffiliated US Transferor and the successor corporation is a domestic corporation that succeeds to substantially all of the assets of the US Transferor): in such a case, it should be sufficient if the successor corporation (and, if it is a member of a consolidated group, the common parent of such group) enters into a revised GRA on the terms, *mutatis mutandis*, set forth in section 3.02 of the Notice.

c. Category 3 transaction (GRA filed by the common parent of an affiliated group that filed a consolidated return, but the successor corporation is either an unaffiliated domestic corporation or is a member of a consolidated group under circumstances not qualifying as a category 1 transaction): in such a case, the unaffiliated successor corporation or common parent of the acquiring group would enter into a revised GRA on the terms described in section 3.02 of the Notice, *mutatis mutandis*. If there is no impairment of payment expectations under principles analogous to those in section 1.1001-3 of the Treasury Regulations, the section 367(a) regulations should not require the common parent of US Transferor's consolidated group (or, if none, US Transferor's shareholder(s)) to be secondarily liable under or otherwise a party to the replacement GRA.

This standard could include as a safe harbor for demonstrating that no credit impairment has occurred that the acquiring entity or group that assumes liability have a public credit rating of at least an investment grade. A second safe harbor could be made available if the common parent of US Transferor's consolidated group (or, if none, US Transferor's shareholder(s)) remains secondarily liable under the replacement GRA. If there were an impairment of payment expectations, such common parent or shareholder(s) could be required to remain secondarily liable as a condition to avoiding a triggering event.

We further suggest that a procedure be provided whereby taxpayers may be permitted the right at the time of a transfer of stock of a US Transferor to an unrelated party to arrange for the acquiror to enter into a replacement GRA whereby it would become liable. Whether the US Transferor group or the US Transferor shareholder(s) would remain secondarily liable could depend on a "change in payment expectations" standard similar to that described above.

d. Category 4 transaction (the section 381 successor corporation is a foreign corporation and the general section 367(a) nonrecognition conditions have been met): in such a case, the common parent of US Transferor's consolidated group or, if none, US Transferor's successor by liquidation (or shareholders) would assume joint liability with the foreign successor corporation under the revised GRA, and otherwise in the discretion of the IRS.

2. Nontaxable Liquidations of US Transferor. The requirement of consolidation continuity in the context of nontaxable liquidations described in section 1.367(a)-8(f)(2)(ii) of the Treasury Regulations seems inappropriate and should be dealt with analogously.

3. Effective Date. Revisions eliminating the consolidation continuity requirement should be made retroactive for all open taxable years, at least in the case of category 1 and category 2 transactions.

4. Elimination of Interest Charge. For the reasons described below in part VII, we recommend that the interest charge currently imposed on triggering events be eliminated.

II. Background

Section 367(a) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a U.S. person transfers property to a foreign corporation, then, subject to certain exceptions, such foreign corporation shall not, for purposes of determining the extent to which gain is recognized on such transfer, be considered to be a corporation. Accordingly, subject to applicable exceptions, a transfer of property to a foreign corporation in what would otherwise qualify as a nonrecognition transaction will be treated as a taxable transaction and gain, if any, will be recognized by the US Transferor.

GRA as Condition to Avoiding Gain Recognition

Section 1.367(a)-3 of the Treasury Regulations provides that, unless certain conditions are met, transfers by a US Transferor of stock or securities of Transferred to Transferee will be a taxable event to the US Transferor, notwithstanding that the transaction would have otherwise qualified as a nonrecognition transaction. One condition to avoid gain recognition is that the US Transferor (or, if the US Transferor is a member of a consolidated group, the parent of the consolidated group of which US Transferor is a member) must enter into a GRA in accordance with section 1.367(a)-8 of the Treasury Regulations if the US Transferor becomes a five-percent or greater shareholder of the Transferee.[3]

A GRA provides that if a "triggering event" (as discussed below) occurs at any time prior to the close of the fifth full taxable year following the close of the taxable year of the initial transfer, generally the US Transferor must file an amended return for the year of the initial transfer and recognize the gain realized but not recognized on the initial transfer, with interest.[4]

3 One might question whether the threshold could be higher (e.g., 10 percent) without undercutting the purpose of the provision. An overly low threshold can result in subjecting taxpayers unnecessarily to the compliance burdens of the regulations.

4 Treas. Reg. §1.367(a)-8(b)(3)(i).

If the US Transferor elects under section 1.367(a)-8(b)(1)(vii) of the Treasury Regulations, then the US Transferor must recognize the gain realized but not recognized on the initial transfer in the period that includes the date of the triggering event. In general, the purpose of these rules is to ensure that the US Transferor does not seek to accomplish indirectly through a foreign transferee what it could not do directly, that is, to disposes of stock or securities on a nonrecognition basis while permitting the foreign transferee to sell the stock of Transferred outside U.S. taxing jurisdiction. The five-year period was considered sufficiently long to prevent abuse.

Below we describe briefly the concepts of (i) triggering events, (ii) nonrecognition transactions not treated as triggering events, and (iii) terminating transactions, which cause a GRA to terminate. This background discussion addresses the regulations prior to the issuance of the Notice.

Triggering Events

The regulations identify certain transactions with respect to the stock of Transferred as triggering events if they occur within the 5-year term of the GRA.[5] These include (i) any taxable sale of the stock of Transferred by Transferee and (ii) subject to qualifying under the exception for nonrecognition transactions described below, any disposition of such stock that is treated as an exchange (e.g., a redemption of stock treated as a distribution in payment in exchange under section 302(a)). In the context of a triangular reorganization resulting in a GRA, a triggering event also includes an indirect disposition of stock of Transferred.[6]

A triggering event also includes a disposition by Transferred of "substantially all" of its assets (within the meaning of section 368(a)(1)(C)), including stock in a subsidiary corporation or an interest in a partnership.[7] Such a transaction is considered an indirect disposition of shares of Transferred. A liquidation of Transferred into Transferee qualifying as a nonrecognition transaction is excepted.

Section 1.367(a)-8(g)(1) of the Treasury Regulations, described further below, suggests that a nontaxable[8] disposition of stock of Transferee may be a triggering event unless the US transferor complies with reporting requirements similar to those in section 1.367(a)-8(g)(2). Similarly, if a US Transferor goes out of existence in a nontaxable asset reorganization or liquidation, such that it itself no longer is able to comply with its obligations under section 1.367(a)-8(g)(2), that may be considered a triggering event. The regulations specifically provide a rule only for the liquidation case, namely that if a US Transferor is liquidated during the term of the GRA in a liquidation that qualifies under sections 332 and 337, recognition under the

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5 Treas. Reg. §1.367(a)-8(e).

6 See Treas. Reg. §1.367(a)-3(d)(2)(iv).

7 Treas. Reg. §1.367(d)-8(e)(3).

8 If it goes out of existence in a *taxable* transaction, the GRA would be terminated. Treas. Reg. § 1.367(a)-8(h).

GRA will be triggered unless a consolidation continuity condition is met and a revised GRA is entered into.[9]

Nonrecognition Transactions

Section 1.367(a)-8(g) provides that if specified conditions are met, certain nonrecognition transactions are not considered triggering events. The exception for nonrecognition transactions reflects the fact that such a transaction is not inconsistent with the purpose of the original GRA in that there has been no "cashing out" by the US Transferor, and a continuation of the GRA on revised terms is warranted.

Two specified types of nonrecognition transactions mirror the triggering events specifically identified as such in the regulations: (i) the disposition of Transferred stock by Transferee and (ii) the disposition of substantially all of the assets of Transferred.[10] In each case, procedural requirements (in particular, entry into a revised GRA) must be met.

In addition, while the disposition of Transferee stock by US Transferor is not expressly described as a triggering event, such a disposition in a nonrecognition transaction followed by compliance by the US Transferor with reporting requirements similar to those in section 1.367(a)-8(g)(2) of the Treasury Regulations is a third category of nonrecognition event described in the regulations.[11] The regulations provide in particular that a liquidation of the US Transferor into its domestic parent company that qualifies under sections 332 and 337 is a nonrecognition event if both companies were members of the same consolidated group at the time of the original transfer and at the time of the liquidation and a revised GRA is entered into.[12]

Finally, a liquidation of Transferred into Transferee qualifying under sections 332 and 337 is not considered a triggering event provided that Transferee does not dispose of substantially all the assets held by Transferred within the remaining period of the GRA.[13]

Terminating Transactions

Certain transactions terminate, rather than trigger recognition under, a GRA.[14] Such transactions can include recognition as well as nonrecognition transactions. Termination reflects the fact that the purpose of the GRA has ceased to exist. When a GRA is terminated, as opposed to triggered, there is no interest charge on the amount of gain realized but not recognized on the initial transfer.

Transactions that terminate a GRA include (i) transactions in which a US Transferor recognizes full gain on the disposition of Transferee stock received in the initial

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[9] Treas. Reg. §1.367(a)-8(f)(2)(ii).

[10] Treas. Reg. § 1.367(a)-8(g)(2),(3).

[11] Treas. Reg. § 1.367(a)-8(g)(1).

[12] Treas. Reg. §1.367(a)-8(f)(2)(ii).

[13] Treas. Reg. §1.367(a)-8(e)(3)(i)(B).

[14] Treas. Reg. §1.367(a)-8(h).

transfer, (ii) transactions in which a domestic Transferred and US Transferor file a consolidated return for the period including the date of the initial transfer and domestic Transferred disposes of substantially all of its assets in a transaction in which all realized gain is recognized currently and (iii) distributions of the stock of Transferred to US Transferor by Transferee in a transaction that qualifies under section 355 or a liquidating distribution under section 332 and 337, provided that immediately after such distribution, US Transferor's basis in Transferred stock received is no greater that the basis US Transferor had in Transferred stock immediately prior to the initial transfer.[15] A transaction that is covered by clause (i) above but is separately described in the Treasury Regulations involves a US Transferor that files a GRA but is liquidated during the term of the GRA in a liquidation that does not qualify under sections 332 and 337.

III. Asset Transfers by US Transferor: Pre-Notice 2005-74 Uncertainty

Prior to the issuance of Notice 2005-74, section 1.367(a)-8(f) of the Treasury Regulations provided the only rules addressing the effect of asset transfers by a US Transferor on GRAs. These rules remain in effect, but have been supplemented by the Notice. If the US Transferor is a corporation and goes out of existence in the initial section 367(a) transfer, the gain realized by the US Transferor may qualify for nonrecognition treatment if (i) the US Transferor is owned by a single US parent corporation, (ii) the US Transferor and its parent file a consolidated return for the taxable year that includes the transfer and (iii) the parent of the consolidated group enters into a GRA. If the US Transferor is liquidated during the term of the GRA (and not as part of the initial transfer), the GRA will be terminated unless the liquidation qualifies for nonrecognition treatment under sections 332 and 337. If the liquidation qualifies for nonrecognition treatment under sections 332 and 337, gain recognition under the GRA will be triggered unless (i) the US Transferor and parent file a consolidated return for the taxable years that include the date of the initial transfer and the liquidation of the US Transferor and (ii) the parent enters into a new GRA.

Thus, prior to the Notice, the only explicit regulatory guidance on the effect of a US Transferor's transfer of assets pursuant to a nontaxable asset reorganizations[16] on a GRA after the initial transfer was limited to transactions where the US Transferor liquidated after the initial transfer. The liquidation of a US Transferor was either a terminating event (if a taxable liquidation), triggering event (if a nontaxable liquidation but either the companies were not members of an affiliated group filing a consolidated return or failed to enter into a new GRA) or nonrecognition event (if the companies were members of an affiliated group filing a consolidated return and entered into a new GRA). This treatment of liquidations could have been construed as the intended, but unstated, treatment of other types of nontaxable asset transfers by the US Transferor, but any such conclusion would have been by inference only. Moreover, taxpayers could construe section 1.367(a)-8(g) as permitting a state-law successor-in-interest of a US Transferor in certain asset transfers to enter into a revised GRA.

[15] Treas. Reg. § 1.367(a)-8(h)(1)-(3).

[16] In the case of taxable transfer of the Transferee stock, the GRA would be terminated in whole or part.

In Private Letter Ruling 200507009, the IRS ruled that a US Transferor's section 368(a)(1)(F) reorganization was not a triggering event resulting in the recognition of gain under a GRA. The taxpayer requesting the ruling was a corporation organized in a non-US jurisdiction that was treated as a US corporation under section 269B (stapled entities). The taxpayer had transferred the stock of one of its wholly-owned foreign subsidiaries to another one of its wholly-owned foreign subsidiaries in a transaction that would qualify for nonrecognition treatment under section 351 and represented that it would enter into a GRA to avoid recognition of gain under section 367(a). The taxpayer proposed to re-organize as a corporation under US law in a transaction that would qualify as an F reorganization, and requested a ruling that the F reorganization would not trigger the GRA.

The IRS framed the issue as whether the taxpayer, as the US Transferor, would remain in existence and continue to be subject to the terms of the GRA for purposes of section 1.367(a)-8(g)(1) of the Treasury Regulations. The IRS concluded that because the taxpayer would be treated as the same corporation immediately after the F reorganization, the taxpayer would not be required to enter into a new GRA.

The consequences of an asset reorganization in which the US Transferor does not remain in existence remained unclear. The PLR could be interpreted to imply that recognition under the GRA is not triggered in an F reorganization only because the US Transferor remains in existence. Under such an interpretation, if the US Transferor were to go out of existence as it would in a typical asset reorganization, the transaction would be treated as a triggering event because the US Transferor, having ceased to exist, would not be able to comply with the requirements under the GRA following the transaction. Despite these inferences, taxpayers reasonably may have believed that, in a transaction in which under applicable state law the successor corporation succeeds to and is bound by the obligations of the predecessor US Transferor, the requirements of section 1.367(a)-8(g)(2) could be met.

IV. Notice 2005-74

The Notice announced that Treasury and the IRS will amend the regulations under section 367(a) to clarify the effect common asset reorganizations involving a US Transferor, Transferee and Transferred, respectively, would have on GRAs previously entered into by a US Transferor. As discussed below, the Notice states that unless specified conditions are met, triggering events will include asset reorganizations involving transfers of Transferee stock by the US Transferor, transfers of Transferred stock by Transferee and transfers by Transferred of substantially all of its assets. The Notice does not address certain triangular asset reorganizations, downstream asset reorganizations of Transferee into Transferred and upstream asset reorganizations of Transferred into Transferee.

Section 5 of the Notice states that regulations incorporating the guidance set forth in the Notice will apply to GRAs entered into with respect to exchanges occurring on or after September 28, 2005. Taxpayers can rely on Notice 2005-74 for exchanges occurring on or after July 20, 1998, provided they do so consistently.

Asset Reorganizations of US Transferor

The Notice provides in section 3.02 that if, while a GRA is in effect, the US Transferor transfers all or a portion of the stock of Transferee to an acquiring corporation (referred to as the "successor" US Transferor) pursuant to an asset reorganization, the exchanges

made pursuant to the reorganization will trigger the GRA unless each of the following conditions is satisfied:

(A) In the year of the initial transfer, the US Transferor was a member of a consolidated group ("original consolidated group"), and the common parent of the original consolidated group entered into the original GRA;

(B) Immediately after the asset reorganization, the successor US Transferor is a member of the original consolidated group;

(C) The U.S. parent of the original consolidated group (or a new U.S. parent, if such corporation became the new common parent of the original consolidated group in a transaction in which the group remained in existence) enters into a new GRA (for the remainder of the original 5-year term) pursuant to which it agrees to recognize gain with respect to the transfer subject to the original GRA, modified by substituting the successor US Transferor in place of the original US Transferor and agreeing to treat the successor US Transferor as the original US Transferor for purposes of section 1.367(a)-8 and the Notice; and

(D) The successor US Transferor provides, with its next annual certification (described in section 1.367(a)-8(b)(5)), the new GRA and a notice of the transfer setting forth the following:

(i) A description of the transfer (including the date of such transfer), and the successor US Transferor's name, address, and taxpayer identification number; and

(ii) A statement that arrangements have been made, in connection with the asset reorganization, ensuring that the successor US transferor will be informed of any subsequent disposition of property with respect to which recognition of gain would be required under the new gain recognition agreement (and any related information that is necessary to comply with section 1.367(a)-8 and the Notice.

These rules are illustrated in the Notice with the following example. Although the example refers to a section 368(a)(1)(D) reorganization, it should be equally applicable to, for example, to a merger under section 368(a)(1)(A).

"Example 1. USP, a domestic corporation, is the common parent of a consolidated group. USP owns 100% of the stock of two domestic corporations that are members of the USP group, S1 and S2. S1 owns 100% of two foreign corporations, FC1 and FC2. In Year 1, S1 ("US Transferor") transfers 100% of the stock of FC1 ("Transferred") to FC2 ("Transferee") in an exchange described in section 351 and USP enters into a gain recognition agreement with respect to such transfer. In Year 4, in a reorganization described in section 368(a)(1)(D), US Transferor transfers all of its assets, including the stock of Transferee, to S2 in exchange for S2 stock. US Transferor transfers the S2 stock to USP in exchange for the US Transferor stock held by USP and the US Transferor stock is canceled. No taxable years of the USP group are short taxable years.

Analysis. Because USP and Successor are, immediately after the reorganization, members of the consolidated group of which US Transferor was a member, and USP was the common parent which entered into the original gain recognition agreement in year 1 pursuant to Treas. Reg. Section 1.367(a)-8(a)(3), the transaction satisfies the requirements of section 3.02(A) and (B) of this notice. As a result, the transfer of the

Transferee stock will not trigger the gain recognition agreement if, pursuant to section 3.02 of this notice, USP enters into a new gain recognition agreement, in which it agrees to recognize gain with respect to the transfer subject to the original gain recognition agreement as described in section 3.02(C) of this notice, and Successor complies with the reporting requirements contained in section 3.02(D) of this notice. For purposes of the new gain recognition agreement, Treas. Reg. Section 1.367(a)-8, and this notice, Successor is the successor US transferor and is treated as the original US transferor, Transferee continues to be the transferee foreign corporation, and Transferred continues to be the transferred corporation. The new gain recognition agreement applies through the close of Year 6 (the remaining term of the original gain recognition agreement filed by USP)."

These rules have raised substantial issues and are discussed further below in Part V hereof.

Asset Reorganizations of Transferee

The Notice in section 3.03 provides that if, during the period a GRA is in effect, the Transferee transfers all or a portion of the stock or securities of Transferred to a foreign acquiring corporation (successor transferee foreign corporation) in an asset reorganization, the exchanges made pursuant to such reorganization will trigger gain recognition under the GRA unless each of the following conditions is satisfied:

(A) The US Transferor, US parent corporation or new US parent corporation, as applicable, enters into a new GRA pursuant to which it agrees to recognize gain (during the remaining term of the original gain recognition agreement), in accordance with the rules of section 1.367(a)-8(b), with respect to the transfer subject to the original GRA, substituting the successor transferee foreign corporation in place of the Transferee, and agreeing to treat the successor transferee foreign corporation as the Transferee for purposes of section 1.367(a)-8 and the Notice; and

(B) The US Transferor provides, with its next annual certification, the new GRA and a notice of the transfer setting forth the following:

(i) A description of the transfer (including the date of such transfer), and the successor transferee foreign corporation's name, address, and taxpayer identification number (if any); and

(ii) A statement that arrangements have been made, in connection with the asset reorganization, ensuring the US Transferor will be informed of any subsequent disposition of property with respect to which recognition of gain would be required under the new GRA (and any related information that is necessary to comply with Treas. Reg. §1.367(a)-8 and the Notice).

We agree with this approach to asset reorganizations involving a Transferee, and accordingly do not address it further herein.

Transfers of Substantially All of Transferred's Assets

The Notice provides in section 3.04 that if, during the period a GRA is in effect, Transferred transfers "substantially all" (which presumably is meant to include "all") of its assets to an acquiring corporation ("successor transferred corporation") pursuant to an asset

reorganization, the exchanges made pursuant to such asset reorganization will trigger gain recognition under the GRA unless each of the following conditions is satisfied:

(A) The US Transferor, US parent corporation, or new US parent corporation, as applicable, enters into a new GRA pursuant to which it agrees to recognize gain (during the remaining term of the original GRA with respect to the transfer subject to the original GRA, modified by:

(i) Substituting the successor transferred corporation in place of the Transferred and agreeing to treat the successor transferred corporation as Transferred for purposes of section 1.367(a)-8 and the Notice; and

(ii) Treating only the assets acquired by the successor transferred corporation from Transferred pursuant to the asset reorganization as the assets subject to the deemed disposition of stock rules under section 1.367(a)-8(e)(3)(i); and

(B) The US Transferor provides with its next annual certification, the new GRA and a notice of the transfer setting forth the following:

(i) A description of the transfer (including the date of such transfer), and the successor transferred corporation's name, address, and taxpayer identification number (if any); and

(ii) A statement that arrangements have been made, in connection with the asset reorganization, ensuring the US Transferor will be informed of any subsequent disposition of property with respect to which recognition of gain would be required under the new gain recognition agreement (and any related information that is necessary to comply with section 1.367(a)-8 and the Notice).

As in the case of asset reorganizations involving a Transferee, we agree with the Notice's approach to asset reorganizations involving Transferred, and thus do not discuss this issue further herein.

Other Modification

Section 4.03 of the Notice provides a helpful rule for purposes of "round trip" transactions potentially terminating a GRA under section 1.367(a)-8(h)(3) of the Treasury Regulations. Under that provision, a GRA is terminated if immediately following a section 337 liquidation of Transferee or section 355 distribution of the Transferred stock by Transferee, the US Transferor's basis in the stock of Transferred is less than or equal to the basis that it had in the stock of Transferred immediately prior to the initial transfer. For that purpose, under section 4.03 of the Notice, the basis of stock that is issued (or deemed to be issued) by Transferred to Transferee in connection with subsequent transfers of property from Transferee to Transferred is not taken into account. Thus, the basis of shares issued or deemed issued to Transferee for subsequently contributed property, which may be higher than the basis of Transferred shares held by Transferee immediately after the transfer requiring the GRA, may be segregated and not considered to taint the distribution.

V. Comments on Asset Reorganizations of US Transferor under Notice 2005-74

The Notice provides helpful guidance on how asset reorganizations in which the US Transferor goes out of existence affect GRAs. In many typical situations, however, an asset

reorganization will not meet the requirements of the Notice relating to continuing membership in a single consolidated group by the relevant parties. Thus, in these situations, gain recognition will be triggered under a previously-entered GRA by the US Transferor.[17] This "consolidation continuity" issue is discussed below.

Consolidation Continuity Requirement

The Notice provides that, in order for an asset reorganization of a US Transferor to avoid triggering gain recognition under a GRA, the successor corporation must be a member of the original consolidated group (i.e., included in a consolidated return with the US Transferor filed by the same consolidated group as filed the GRA) immediately after the reorganization. This consolidation continuity requirement will result in many internal restructurings triggering gain recognition.

The requirement of consolidation continuity cannot be met in any of the following transactions: (i) where the US Transferor was an unaffiliated corporation, (ii) where the US Transferor was a member of a consolidated group but the successor corporation is a member of a different consolidated group (e.g., one which purchased the shares of the US Transferor), (iii) where the US Transferor was a member of a consolidated group but the successor corporation is an unaffiliated corporation, or (iv) where the successor corporation is a foreign corporation. For example, under the Notice, a transaction involving facts similar to PLR 200507009 (discussed above) presumably would trigger a GRA, because the US Transferor was not a member of the original consolidated group.[18]

As noted above, the pre-Notice regulations included a consolidation continuity requirement to the extent that they expressly addressed a nontaxable asset transfer by the US Transferor. It appears that, in including this requirement in the Notice, Treasury and the IRS intended to carry this concept forward to the other transactions addressed.[19]

In weighing the merits of the consolidation continuity requirement, we believe it is helpful to review the context in which a GRA is entered into. The underlying transaction involves a US Transferor transferring stock or securities to a non-US corporation in a nonrecognition transaction. The US Transferor has transferred an asset, but has received equivalent value. Further, the built-in gain in the transferred asset is replicated in the shares received by the US Transferor. While there may be a concern that a subsequent disposition by the Transferee could be accomplished without current US taxation under certain circumstances (the reason for the GRA requirement), the original built-in gain remains preserved in the shares in the Transferee held by the US Transferor. Furthermore, upon a subsequent asset

[17] See generally Bernard Bress, "Section 367 Gain Recognition Agreements under PLR 200507009 and Notice 2005-74: Toto, I've a Feeling We're Not in Kansas Anymore," 35 TMIJ 3 (Jan. 13, 2006), providing an excellent discussion of the context of and issues under the Notice.

[18] It is not entirely clear whether the Notice was intended to provide for a contrary result on the facts of the PLR, or whether F reorganizations might continued to be viewed as outside the scope of the Notice and the regulations as not involving a section 361 transfer.

[19] The requirement in Treas. Reg. § 1.367(a)-8(f)(2)(ii) that both companies have been members of the same consolidated group at the time of the initial transaction as well as at the time of the subsequent transaction, however, is not reflected in the requirements of the Notice for asset reorganizations.

reorganization involving the US Transferor, this gain is preserved in the successor corporation shares received by the US Transferor and in fact is duplicated in the hands of the successor corporation. Moreover, assuming a GRA is entered into, no tax is due from US Transferor until the replacement property – the shares of Transferee – is disposed of in a taxable transaction. Any tax due upon a triggering event under the GRA is contingent only; it is not a current liability of any person.

We understand that the government has a legitimate interest in preserving its ability to collect tax in the event of a possible future direct or indirect disposition of Transferred or of substantially all of its assets. Insofar as is relevant to the GRA triggering event issue, that interest should be protected to the extent that the ability of the US Transferor or its successor corporation to satisfy the tax, and the Government's ability to collect the tax, are not materially impaired. In this regard, the question of what latitude should be allowed taxpayers to not accelerate gain (the nonrecognition transaction concept) is to be distinguished from the question of which parties continue to be liable under the revised GRA following the transaction. A greater latitude for nonacceleration might (or might not) require continuing liability by the original US Transferor. The approach taken in the Notice, however, is to allow very little scope for nonacceleration, even where all parties remain liable.

In the case of an unaffiliated US Transferor, a consolidation requirement seems to us to be completely irrelevant. What should be relevant, at most,[20] is only whether, taking into account the facts and circumstances immediately after the transfer, the successor corporation (assumed here to be domestic) enters into a revised GRA and has at least the same ability to satisfy the contingent tax obligation. Since, by definition, it is acquiring the assets for equity, its net worth would be correspondingly increased. There would seem to us to be, in general, no impairment of the Government's ability to collect the tax that is directly related to the fact that US Transferor went out of existence.[21] The continued liability of the US Transferor under a revised GRA would thus seem justified, if at all, only as a "safe harbor."

In the case of a US Transferor that was a member of a consolidated group at the time the GRA was entered into, the credit considerations are different than in the case of an unaffiliated US Transferor, because other members of the US Transferor group had several liability under the original GRA, presumably giving the government greater protection in the event the contingent tax liability is triggered. Again, however, whether or not the successor corporation is a member of the same consolidated group, or even any consolidated group, following the transaction does not seem of direct relevance. Assuming the successor corporation (or any common parent of a consolidated group of which it is a member) enters into a revised GRA, the guiding principle should be whether the successor corporation's ability to satisfy the contingent tax liability is not worse than the US Transferor's ability to do so, taking into account the several liability rule of section 1.1502-6 of the Treasury Regulations. The utility of consolidation continuity in such a circumstance may be as a "safe harbor" for demonstrating that

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20 Some of our members observe that, since credit standing is irrelevant to the right to initially enter into a GRA, it should not be a basis on which to require a previous owner of US Transfer to remain liable.

21 The asset reorganization may have been preceded by a transfer of US Transferor to a more leveraged group, and US Transferor itself may have become more leveraged, but those transactions would not be integral to the asset reorganization or any other triggering event.

no credit impairment has occurred. Even for such purpose, however, the requirement should be modified to be deemed satisfied notwithstanding a termination of the original consolidated group under circumstances that would not cause the acceleration of deferred items under the section 1.1502-13 regulations (see Treas. Reg. §1.1502-13(j)(5)).

For example, suppose a member of an affiliated group filing a consolidated federal income tax return transferred one controlled foreign corporation to another three years ago and entered into a GRA in order to avoid current recognition under section 1.367(a)-3(b). Suppose one year ago the common parent of that group was purchased by another group filing a consolidated return and as a result the first group ceased to exist under section 1.1502-75(d)(1). Now suppose, as part of routine post-acquisition restructuring, the US Transferor that entered into the GRA is merged into another member. Under the Notice, recognition of gain under the GRA would be triggered. The clearly is not the correct result from a tax policy standpoint.

Analogy under Dual Consolidated Loss Rules

Issues similar to those discussed above arise under the rules under section 1503(d) dealing with dual consolidated losses ("DCLs"). The DCLs of a "dual resident corporation" cannot reduce the taxable income of any other member of the corporation's affiliated group, unless the consolidated group, unaffiliated dual resident corporation or unaffiliated domestic owner that has a DCL enters into an agreement (a "(g)(2) agreement") certifying, among other things, that no portion of the deductions or losses taken into account in computing the DCL have been, or will be, used to offset the income of any other person under the income tax laws of a foreign country.[22]

The DCL regulations provide that if there is a triggering event during the 15-year period of a (g)(2) agreement (which would be reduced to 7 years under the proposed regulations) and no exception applies, the taxpayer will recapture as income the amount of the DCL and pay an interest charge. Exceptions to triggering events are provided for transfers within a consolidated group. The regulations generally permit avoidance of recapture upon a triggering event provided that: (i) the consolidated group, unaffiliated dual resident corporation, or unaffiliated domestic owner that made the election, and the unaffiliated domestic corporation or new consolidated group, enter into a closing agreement with the IRS providing that both parties will be jointly and severally liable for the total amount of the recapture of the DCL and interest charge upon a subsequent triggering event and (ii) the unaffiliated domestic corporation or new consolidated group files a (g)(2) agreement, whereby it assumes the same obligations with respect to the DCL as the corporation or consolidated group that filed the original agreement with respect to that loss. The proposed regulations would replace the closing agreement requirement with a requirement that the unaffiliated domestic corporation or new consolidated group ("subsequent elector") file its own domestic use election. The original elector would be required to agree to remain liable for the recapture and the interest charge should the subsequent elector fail to make any required payments.

In 2003, Treasury and the IRS issued final regulations that eliminated the need for taxpayers to enter into a closing agreement and for continued liability by the original elector in

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22 Treas. Reg. §1.1503-2(g)(2). The proposed DCL regulations envision a similar procedure, but refer to the agreement as a "domestic use agreement."

two circumstances: (i) if an unaffiliated dual resident company or unaffiliated domestic owner becomes a member of a consolidated group and (ii) if a consolidated group ceases to exist as a result of a transaction described in section 1.1502-13(j)(5)(i), provided that each includible member of the acquired group becomes an included member of the acquiring group.[23] Thus, if an unaffiliated dual resident corporation or domestic owner that is not part of a consolidated group joins a consolidated group or if a consolidated group with a (g)(2) agreement is acquired by a new consolidated group (where each member of the old group joins the new group) then a closing agreement is not required and instead only the transferee consolidated group is required to enter into a new (g)(2) agreement and assume responsibility for the transferor's obligations under its (g)(2) agreement. Because of the several liability imposed on consolidated groups, together with the new (g)(2) agreement, Treasury and the IRS concluded that the government would retain sufficient assurance that the transferor's potential recapture would not be adversely affected.[24]

Thus, by analogy to the DCL regulations, whether an asset reorganization of a US Transferor can avoid acceleration of gain recognition should not depend on whether the successor corporation joins or was a member of the original consolidated group. It should be sufficient that the successor corporation enters into a revised GRA whereby it assumes the obligations of the US Transferor associated with the GRA upon a subsequent triggering event for the remaining term of the original GRA. This would be analogous to the new domestic use agreement to be entered into by a subsequent elector under the proposed DCL regulations (or the closing agreement or, in situations covered by the 2003 regulations, a new (g)(2) agreement, under the current DCL regulations).[25]

Assuming, then, a broad scope for nonacceleration (such as under the DCL rules), the issue of continuing liability of the US Transferor (or other party) must be addressed. We recognize that the general rule in the current and proposed DCL regulations requires the original elector to continue to be contingently liable for future triggering events (though that liability would be secondary under the proposed regulations). In the GRA context of an asset acquisition of US Transferor, US Transferor generally will cease to exist. Hence, any agreement of continued liability would have to be with the common parent of a consolidated group in which it was included, if any, a successor entity, if any, or other shareholders.

Such continuing liability for actions outside of the control of a party raises commercial frictions that we believe are unnecessary in order to leave the government's interests as a creditor unimpaired. Continuing liability of the parties to the initial GRA under a revised GRA entered into by a successor corporation or the common parent of a group in which it is a

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23 Treas. Reg. § 1.1503-2(g)(2)(iv)(B)(2).

24 T.D. 9084, Explanation of Provisions and Summary of Contents. These exceptions are continued in the proposed regulations (referred to as "non-subsequent elector events"). Prop. Treas. Reg. §1.1503(d)-4(f)(2)(ii).

25 It may be necessary under a revised GRA for the successor corporation to agree to include any future recapture amount in income in the year of the triggering event rather than in the year of the initial transfer (e.g., if in its case the earlier year has closed). Cf. Treas. Reg. §1.367(b)-8(b)(1)(vii).

member generally should be limited to circumstances in which the transfer to the successor corporation results in an impairment in payment expectations with respect to the contingent GRA liability. If continuing liability of the original party to the GRA is otherwise provided for, it should only be to provide a safe harbor.

The current regulations have a tool to deal with situations where the IRS needs to ensure the payment of any tax on gain realized but not recognized upon the initial transfer. Section 1.367(a)-8(d) provides that under certain circumstances, the US Transferor may be required to furnish a bond or other security to ensure the payment of any tax upon a triggering event. For the reasons discussed herein, we believe that this authority should be exercisable only in unusual situations where there otherwise would be an impairment of the anticipated ability of the IRS to collect in respect of the GRA.

Optional Revised GRA at Time of Stock Transfer of US Transferor

As discussed above, we are not aware of a reason to require recognition under a GRA to be triggered in a nonrecognition transaction in which the acquiring entity or common parent of a group of which it is a member agrees to assume the contingent liability under a replacement GRA, other than the possibility that the government's anticipated ability to satisfy a claim under the GRA would be impaired as compared with its ability under the original GRA. For transactions falling in category 1 as described in our recommendation in Part I above, that should never be the case, nor, in general, should it be the case for transactions described in category 2, at least not as the result of US Transferor going out of existence.[26]

In the case of a transaction described in category 3, there could more easily be a change in ability to satisfy a claim by reason of the fact that, in many cases, the original party liable – the common parent of the group of which US Transferor is a member – would not be transferred. We note, however, that any such impairment would occur as of the time of a transfer of ownership of US Transferor, whether or not the US Transferor also undergoes an asset reorganization at that time; it is unrelated to the asset reorganization itself. Further, it is at the time that ownership of US Transferor is transferred that the commercial friction of dealing with the contingent GRA liability must be dealt with. Accordingly, we believe that it would be desirable that a procedure be available whereby the parties to a transaction in which a US Transferor leaves the affiliated group, the common parent of which is a party to the original GRA, may cause a replacement GRA to be entered into. We believe that, at least if the acquiror (or, if it is a member of a consolidated group, the common parent thereof) assumes liability under a replacement GRA and as a result there is no meaningful impairment of the government's anticipated ability to satisfy a claim thereunder as compared with under the original GRA, the party to the original GRA should not be required to be secondarily liable under (or even a party to) the replacement GRA. To the extent that it is considered necessary for ease of administration, the successor credit might be required to have a public rating of at least investment grade in order for the original party to be released.[27]

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[26] The surviving corporation may be less creditworthy as the result of, e.g., higher leverage, but that fact would be independent of a stock transfer or asset reorganization of US Transferor per se.

[27] But see our comment at note 21 above.

Foreign Acquiror

Subject to the requirements of section 367(a)(5) and section 1.367(a)-3(b) of the Treasury Regulations, an asset reorganization of a US Transferor into a foreign successor corporation may avoid gain recognition under the general section 367(a) rules in respect of the stock of Transferee (though an earnings and profits pickup under section 1.367(b)-4 may be required). Under the consolidation continuity requirement of the Notice, however, this type of asset reorganization of the US Transferor would constitute a triggering event, because a foreign corporation would never (apart from a section 1504(d) corporation) be a member of a consolidated group.

We note that regulations have provided for liability of successor foreign corporations with respect to certain obligations of a US transferring entity. For example, section 1.367(e)-2(a) provides generally that unless certain exceptions are met, if a US corporation makes a distribution of property in complete liquidation under section 332 to a foreign corporation, the domestic liquidating corporation recognizes gain or loss on the distribution of property to the foreign distributee. Section 1.367(e)-2(b), however, provides that a domestic liquidating corporation will not recognize gain or loss if the property distributed was used in the conduct of a trade or business within the United States and if (i) the foreign distributee corporation, immediately thereafter and for the 10-year period beginning on the date of the distribution of such property, uses the property in the conduct of a trade or business within the US, (ii) the domestic liquidating corporation attaches a statement to its income tax return for the year that includes the date of distribution and (iii) the foreign distributee corporation attaches a copy of the property description to its US income tax return for the year that includes the date of distribution. Section 1.367(e)-2(e) provides that by filing the statement required by the domestic liquidating corporation, the domestic liquidating corporation and the foreign distributee agree to be subject to certain rules including that the foreign distributee corporation is required to recognize gain on its income tax return if, within the ten-year period from the date of the distribution, its disposes of the property or if the property ceases to be used in the conduct of a trade or business in the US, unless certain exceptions are met. The foreign distributee corporation is joint and severally liable for any tax owed by the domestic liquidating corporation.

Similarly, section 1.367(a)-3(d)(2)(vi)(C) of the Treasury Regulations provides that for certain transactions, a domestic acquired corporation and a foreign acquiring corporation must file a statement certifying that if the foreign acquiring corporation disposes of any stock of the domestic acquired corporation in certain transactions, (i) the domestic acquired corporation shall recognize gain and (ii) the domestic acquired corporation (or the foreign acquiring corporation on behalf of the domestic acquired corporation) shall file an income tax return for the year of the transfer to report such gain.

Recommendations

We believe that the GRA regulations should not require an automatic triggering event upon every transfer of stock or securities of Transferee pursuant to an asset reorganization of the US Transferor that does not satisfy the consolidation continuity requirement of the Notice. We believe that a reasonable approach could be along the following lines:

a. Category 1 transaction (GRA filed by the common parent of an affiliated group that filed a consolidated return and, immediately after the asset reorganization, the successor corporation is included in a consolidated return with one or more members of the original consolidated return and no event that would have resulted in the acceleration of deferred items has occurred): in such a case, the common parent of the post-acquisition affiliated group enters into a revised GRA on the terms set forth in section 3.02 of the Notice.

b. Category 2 transaction (GRA filed by an unaffiliated US Transferor and the successor corporation is a domestic corporation that succeeds to substantially all of the assets of the US Transferor): in such a case, the successor corporation and, if a member of a consolidated group, the common parent of such group) enters into a revised GRA on the terms, *mutatis mutandis*, set forth in section 3.02 of the Notice.

c. Category 3 transaction (GRA filed by the common parent of an affiliated group that filed a consolidated return, but the successor corporation is either an unaffiliated domestic corporation or is a member of a consolidated group under circumstances not qualifying as a category 1 transaction): in such a case, the unaffiliated successor corporation or common parent of the acquiring group enters into a revised GRA on the terms described in section 3.02 of the Notice, *mutatis mutandis*, but the common parent of US Transferor's consolidated group or, if none, US Transferor's shareholder(s) would not be required to be secondarily liable under or otherwise a party to the replacement GRA assuming that there would be no impairment of payment expectations under principles analogous to those in section 1.1001-3 of the Treasury Regulations. This standard could include as a safe harbor for demonstrating that no credit impairment has occurred that the acquiring entity or group that assumes liability have a public credit rating of at least an investment grade. A second safe harbor for demonstrating that no impairment of payment expectations has occurred (regardless of credit rating) could be made available if the common parent of US Transferor's consolidated group or, if none, US Transferor's shareholder(s) also remains liable, secondarily, under the replacement GRA. If there otherwise would be an impairment of payment expectations, however, such common parent or shareholder(s) could be required to remain secondarily liable as a condition to avoiding a triggering event.

We further suggest that a procedure be provided whereby taxpayers may be permitted the right at the time of a transfer of stock of a US Transferor to an unrelated party to arrange for the acquiror to enter into a replacement GRA whereby it would become liable. Whether the US Transferor group or the US Transferor shareholder(s) would remain secondarily liable could depend on a similar "change in payment expectations" standard similar to that described above.

d. Category 4 transaction (the section 381 successor corporation is a foreign corporation and the general section 367(a) nonrecognition conditions have been met): in such a case, the common parent of US Transferor's consolidated group or, if none, US Transferor's successor by liquidation (or shareholders) assumes liability with the foreign successor corporation under the revised GRA, and otherwise in the discretion of the IRS.

Further, we believe that nontaxable liquidations described in section 1.367(a)-8(2)(ii) should be subject to similarly relaxed rules.

Effective Date

We believe that, at least with respect to transaction categories 1 and 2, any regulations eliminating the consolidation continuity requirement should be retroactive to all open taxable years. Prior to the issuance of the Notice, the existing regulations were unclear as to the consequences of an asset reorganization of a US Transferor. We believe that taxpayers reasonably could have concluded that a successor entity under state law could succeed to the rights and obligations of a US Transferor under a GRA. Further, as we have noted above, we believe that at least in the case of category 1 and 2 transactions (and on their face, in the case of category 3 and 4 transaction as well), there is no significant likelihood that the Government's interests as a contingent creditor would be impaired.

For these reasons, we recommend that, at least in the context of category 1 and category 2 transactions, if the consolidation continuity requirement is eliminated, such action should be retroactive to all open taxable years. A similar approach should be taken with respect to section 1.367(a)-8(f)(2)(ii).

VI. Reserved Issues

The Notice also requested comments regarding the appropriate treatment of certain upstream and downstream reorganizations, divisive reorganizations under section 368(a)(1)(D) or (G) and whether rules similar to those in the Notice should apply to triangular reorganizations. Below are certain recommendations in this regard.

Upstream/Downstream Reorganizations involving Transferee and Transferred

A transaction where Transferred merges into Transferee or where Transferee merges into Transferred can be viewed as at least[28] analogous to an upstream liquidation that qualifies under sections 332 and 337, which qualifies as a nonrecognition transaction for purposes of GRA recapture unless, within the remaining GRA term, the Transferee disposes of substantially all the assets formerly held by Transferred.[29]

If, however, Transferee is a first-tier subsidiary of US Transferor, the GRA arguably should terminate, without gain recognition, because the status in effect prior to the initial transfer requiring the original GRA is restored. It would no longer be possible for a foreign entity to sell stock of Transferred without incurring U.S. tax, because the stock of the newly merged Transferee/Transferred is directly held by the US Transferor, a U.S. taxpayer.[30] Such treatment would be similar to the treatment of a liquidation of Transferred into

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28 In the case of a merger of Transferred into Transferee, if the 80% ownership test of sections 332 and 337 is met, the transaction would be treated as a liquidation under those provisions.

29 See Treas. Reg. §1.367(a)-8(e)(3).

30 While it could be possible to sell assets of Transferred without U.S. tax, that would have been the case without the original transfer.

US Transferor that qualifies under sections 332 and 337, which terminates a GRA if the US Transferor's basis in Transferred is no greater than it was prior to the initial transfer.[31]

Triangular Asset Reorganizations

Triangular asset reorganizations of Transferred or Transferee are similar to the asset reorganizations in examples in sections 3.02 and 3.03 of the Notice, except that a triangular asset reorganization involves four parties instead of three. Therefore, if Transferred or Transferee transfer assets in a triangular asset reorganization after the initial transfer requiring the GRA, a triggering event of the original GRA entered into by US Transferor should not be required provided the GRA is modified to reflect the new parties.

For example, if pursuant to a plan of reorganization the assets of Transferred are transferred to a foreign acquiring corporation ("Acquiring") in exchange for stock in Acquiring's parent company ("Parent"), the revised GRA should provide for a triggering event if (i) Transferee disposes of its stock in Parent or (ii) Parent, if foreign, disposes of its Acquiring stock. If US Transferor sells its Transferee stock in a taxable transaction, or Parent is a U.S. corporation and sells its Acquiring stock in a taxable transaction, the GRA should terminate.

Similarly, if pursuant to a plan of reorganization the assets of Transferee are transferred to Acquiring in exchange for stock in Parent, the revised GRA should provide for a triggering event if (i) Acquiring disposes of its stock in Transferred, or (ii) Parent, if it is foreign,[32] disposes of its Acquiring stock. The GRA should terminate if Parent is a U.S. corporation and sells its Acquiring stock in a taxable transaction.

These rules would conform with the current rules in section 1.367(a)-3(d)(2)(iv) for dealing with an original transfer taking the form of a triangular reorganization.

Distributions in Section 355 Transactions

Section 1.367(a)-8(h)(3) of the Treasury Regulations provides that if, during the term of the GRA, Transferee distributes the stock of Transferred to the US Transferor in a transaction that qualifies under section 355, the GRA will terminate provided that immediately after the distribution, the US transferor's basis in Transferred is less than or equal to the basis it had in Transferred immediately prior to the initial transfer that required the GRA.

Under sections 355(b) and (c), the US Transferor's basis in Transferee is allocated between the stock of Transferee retained by US Transferor and the stock of Transferred that is distributed to US Transferor, based on the fair market values of Transferred and Transferee. It is possible that upon a distribution of Transferred stock to US Transferor in a section 355 transaction, that US Transferor's basis in Transferred after the distribution will be greater than US Transferor's basis in Transferred prior to the original transaction that necessitated the GRA. Under Treas. Reg. Section 1.367(a)-8(h)(3), as currently drafted, the GRA would be triggered under such circumstances.

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[31] See Treas. Reg. §1.367(a)-8(h)(3).

[32] If Parent is a foreign corporation, the reorganization would require the US Transferor to enter into a new and separate GRA to defer gain recognition on the subsequent transaction. Treas. Reg. §1.367(a)-3(b). The reorganization may result in an earnings and profits inclusion under section 1.367(b)-4.

In such situations, the regulations should provide US Transferor with an election to (x) take a basis in the stock of Transferred that is no greater than the basis in Transferred prior to the transaction that required the GRA (in which case the GRA should terminate because the US Transferor is in the same position that it was in prior to the original transaction) or (y) trigger the GRA. If the US Transferor elects to take the lower basis in Transferred shares, the remaining basis should attach to the shares of Transferee.[33]

A section 355 distribution of US Transferor, whether or not within a consolidated group and whether or not pro rata, should not result in a triggering event even under the existing regulations, at least if it is not made in connection with a termination of the consolidated group. Under the approach of the current rules, the common parent of the group would continue to be liable under the GRA and, if US Transferor is not the common parent, it could be required to enter into a revised GRA and also become liable. For the reasons discussed in part V above, however, we believe the Treasury Regulations should permit US Transferor to assume sole liability under the revised GRA and the common parent of the distributing group to be relieved of liability, at least if there would be no change in payment expectations with respect to the contingent liability under the GRA.

A section 355 distribution of Transferee within a consolidated group should not be a triggering event, including under the existing regulations (though section 1.367(a)-8(g)(1) raises a question if procedural requirements are not met).

If Transferee is distributed out of the consolidated group, it would seem that the GRA should terminate to the extent that gain is required to be recognized (see sections 367(b), 367(e), 1248(f)). To the extent gain is not required to be recognized, we would treat the termination as a nonrecognition transaction to the extent that either (i) the distributees whose status resulted in nonrecognition of gain and who hold at least 10% of the shares of Transferee immediately after the transaction agree to become liable under a revised GRA, or (ii) the US Transferor agrees to continue to be liable under a revised GRA meeting the requirements of section 1.367(a)-8(g)(2)(iv).

VII. Other Comments

Restatement of Section 1.367(a)-8

Wholly apart from the need for substantive changes to the rules under section 1.367(a)-8, we recommend that the rules be restated so that, in particular, each of the rules providing for triggering events, nonrecognition events and terminating events, respectively, be set out clearly. By way of illustration, even after the Notice, the effect of a disposition of shares of Transferee in a nontaxable transaction that is not an asset reorganization, such as a section 368(a)(1)(B) reorganization or a section 355 distribution, is unclear; while such a transfer is within the coverage of section 1.367(a)-8(g)(1) there is no corresponding provision of the GRA that section 1.367(a)-8(g)(1) references (unlike in the case of transfers described in section

[33] See Prop. Treas. Reg. §1.1291-6(c)(2)(iv) (where controlled corporation is section 1291 fund, basis in its shares following a section 355 distribution is lower of section 358 basis or carryover basis); cf. IRC §358(g); Treas. Reg. §1.358-6(c)(2)(ii) (allowing a corporation to chose to compute the basis of a target corporation's stock in accordance with section 358 or section 362 in a reverse triangular merger that qualifies as either a section 351 transaction or a section 368(a)(1)(B) reorganization).

1.367(a)-8(g)(2), which implicitly refer back to requirements in sections 1.367(a)-8(b)(3)(i) and 1.367(a)-8(b)(5)(i)). Section 1.367(a)-8 should be reissued as temporary and proposed regulations reflecting the revisions made by the Notice, as revised pursuant to comments.

Imposition of Interest Charge

In the event of a triggering event, the regulations impose an interest charge on the amount of tax that would have been due had the original transfer been taxable. We believe that an interest charge under these circumstances is inappropriate.

The transfer of stock or securities of Transferred to Transferee generally would not in and of itself provide any U.S. tax benefit to the US Transferor. Such a transfer pursuant to a nonrecognition transaction may be likened to a transfer from one corporate pocket to another. No potentially abusive transaction has occurred unless and until the shares are re-transferred by the Transferee to a third party.[34] Thus, we do not believe that any tax policy is served by treating such a re-transfer as a deemed transfer by the US Transferor as of the date of initial transfer by the US Transferor for purposes of imposing an interest charge, rather than a transfer as of the date of the third party transfer.

If, instead of a triggering event, the US Transferor were to go out of existence (an event terminating the GRA under the regulations), no interest charge is imposed. We do not discern a compelling policy rationale for the difference in treatment of these situations. The artificiality of the distinction is quite clear in the case of the liquidation of (or asset transfer by) a US Transferor, which is a terminating event without interest if the liquidation or asset transfer is taxable, but a triggering event with interest if nontaxable and either the transferee is not a member of the same consolidated group or a new GRA is not entered into.

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[34] In many cases, there is no intent at the time of the initial transfer to retransfer the shares and there would be a U.S. tax cost under subpart F or otherwise to a sale by Transferee. We realize that this is not the case if a foreign operating corporation is transferred and an election is made to treat the corporation as a disregarded entity, which later is sold. While such a case may warrant application of the GRA rules even if the transfer is not of stock, imposition of an interest charge would not seem warranted.