NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON CERTAIN INTERNATIONAL ISSUES RELATING TO ALL-CASH ACQUISITIVE D REORGANIZATIONS

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New York State Bar Association Tax Section

Report on Certain International Issues Relating to All-Cash Acquisitive D Reorganizations[1]

I. Introduction

This Report of the New York State Bar Association Tax Section provides recommendations for guidance in connection with the final regulations (the "Final Regulations") issued by Treasury and the Service in December 2009[2] addressing the qualification and treatment of certain acquisitive all-cash reorganizations under section 368(a)(1)(D) of the Internal Revenue Code of 1986, as amended (the "Code").[3]

Under the Final Regulations, a transaction otherwise described in section 368(a)(1)(D) (a "D Reorganization") will be treated as satisfying the requirements of section 368(a)(1)(D) and section 354(b)(1)(B) even if there is no actual issuance of stock or securities of the transferee corporation, if the same person or persons own, directly or indirectly, all of the stock of the transferor corporation ("Target") and the transferee corporation ("Acquiring") in identical proportions.[4] If no consideration is received or the value of the consideration received in the transaction is less than the fair market value of Target's assets, the Final Regulations treat Acquiring as issuing to Target stock with a

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1 The principal drafter of this report was Peter F. G. Schuur. Substantial contributions were made by Erin Cleary. Helpful comments were received from Kimberly S. Blanchard, Peter H. Blessing, Peter J. Connors and Michael L. Schler.

2 *See* T.D. 9475, 2010-4 I.R.B. 304.

3 Unless otherwise indicated, all references in this Report to "section" and "sections" are to the Code, or the Treasury regulations promulgated thereunder. References to the "Service" are to the Internal Revenue Service, references to "Treasury" are to the United States Department of the Treasury.

4 Treas. Reg. § 1.368-2(l)(2).

value equal to the excess of the fair market value of Target's assets over the value of the consideration actually received in the transaction. If the value of the consideration received in the transaction is equal to the fair market value of Target's assets (an "All-Cash D Reorganization"), the Final Regulations treat Acquiring as issuing to Target a "nominal share" of Acquiring stock in addition to the actual consideration. The Final Regulations then treat Target as distributing the nominal share to its shareholders (the "Exchanging Shareholders") as part of the exchange for their Target stock. The Final Regulations further provide that, if appropriate, the nominal share will be treated as further transferred through chains of ownership to the extent necessary to reflect the actual ownership of Target and Acquiring.[5]

This Report responds to the request made by Treasury and the Service for comments on the application of the Final Regulations to All-Cash D Reorganizations involving foreign corporations or shareholders.[6] This Report is divided into three parts. Part II summarizes our specific recommendations for guidance. Part III is divided into three main subparts and includes a discussion of the specific areas in which guidance is needed in the context of an international All-Cash D Reorganization. Part III.A discusses the manner in which any section 1248 amount attributable to the stock of Target can be preserved in the stock of Acquiring or the nominal share. Part III.B discusses the manner in which earnings and profits should be taken into account for purposes of section 902 when an Exchanging Shareholder recognizes gain under section 356(a) that is treated as a dividend under section 356(a)(2) and how section 902 should apply when an Exchanging Shareholder does not actually own stock in Acquiring but recognizes gain under section 356(a) that is treated as a dividend. Part III.C discusses the

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5 Treas. Reg. § 1.368-2(l)(2).

6 Although this Report specifically addresses the need for guidance in certain areas in the context of an All-Cash D Reorganization, it should be noted that similar considerations may generally arise in relation to a foreign-to-foreign D Reorganization in which actual stock is issued by Acquiring.

manner in which an Exchanging Shareholder should be able to access the previously taxed earnings and profits ("PTI") of Target and Acquiring under section 959 before any non-PTI of either corporation.

II. Summary of Recommendations

The following is a brief summary of our comments and recommendations.

A. Section 1248 Amount Recommendations

1. In connection with a foreign-to-foreign All-Cash D Reorganization, section 1248 amounts that are attributable to the stock of Target should be preserved in a manner that is consistent with the manner in which the Treasury regulations under section 1248 generally apply to foreign-to-foreign D Reorganizations. [Part III.A.3]

2. We recommend that Treasury and the Service adopt a shareholder-by-shareholder approach for an All-Cash D Reorganization whereby each section 1248 shareholder's section 1248 amount that is attributable to the stock of Target (i) is accounted for separately and (ii) is attributed to all of the Acquiring shares held by the section 1248 shareholder (and not to the nominal share). Alternatively, if Treasury and the Service do not adopt a shareholder-by-shareholder approach, then we recommend that Treasury and the Service adopt an approach whereby the section 1248 amount attributable to the stock of Target is preserved in the nominal share and additional adjustments are then made to preserve access to the section 1248 amount in appropriate circumstances. [Part III.A.3]

3. If an Exchanging Shareholder is a member of a consolidated group and owns Acquiring stock only by "up-down" attribution under Section 958(b), the Exchanging Shareholder's section 1248 amount should be added to the earnings and profits attributable to the Acquiring stock that the other section 1248 shareholders in the group own (directly or by attribution through foreign entities under section 958(a)), thereby preserving the section 1248 amount within the consolidated group. Alternatively,

if Treasury and the Service do not adopt this approach, we recommend that the nominal share rules be revised to provide an exception that preserves the section 1248 amount notwithstanding the tax consequences that would generally apply to intra-group transactions. [Part III.A.4]

4. We believe that in certain circumstances it would be appropriate to attribute the section 1248 amount from a non-U.S. Exchanging Shareholder to a section 1248 shareholder. For example, if a non-U.S. Exchanging Shareholder is owned by a U.S. shareholder that is a section 1248 shareholder of both foreign Target and foreign Acquiring, the section 1248 amount should be attributed to the U.S. shareholder. [Part III.A.4]

B. Section 902 Recommendations

5. Section 902(a) should apply to the earnings and profits of both Target and Acquiring in a manner that is consistent with section 356(a)(2). Therefore, if the earnings and profits of both Target and Acquiring are available to support dividend treatment under section 356(a)(2), gain that is treated as a dividend under section 356(a)(2) should bring with it deemed paid credits under section 902 in the same manner as an actual dividend from Target and Acquiring. [Part III.B.4]

6. If the earnings and profits of both Target and Acquiring are taken into account for purposes of section 902 when an Exchanging Shareholder recognizes gain that is treated as a dividend under section 356(a)(2), we believe that the earnings and profits of, and the foreign taxes paid by, Acquiring should be taken into consideration before any earnings and profits of, and foreign taxes paid by, Target for purposes of section 902. [Part III.B.5]

7. For purposes of section 902, Treasury and the Service should adopt a limitation similar to the limitation provided in section 304(b)(5)(A) in relation to cross-chain stock sales, so that undistributed earnings and profits and income taxes paid by a

foreign corporation are not taken into account if such earnings or taxes arise when the ownership requirements of section 902 are not satisfied. [Part III.B.6]

C. PTI Recommendations

8. If an Exchanging Shareholder that is a U.S. ten-percent shareholder in a controlled foreign corporation recognizes gain under section 356(a) in connection with a foreign-to-foreign All-Cash D Reorganization, and all or a portion of the gain would be treated as a dividend under section 356(a)(2) but for the application of section 959, the amount treated as a dividend should be excluded from income under section 959 to the extent that such amount is attributable to the Exchanging Shareholder's share of PTI. [Part III.C.4]

9. We believe that section 959 should apply to gain that would be treated as a dividend under section 356(a)(2) (but for the application of section 959) in an All-Cash D Reorganization in a manner that is consistent with the approach adopted by Treasury and the Service for purposes of section 356(a)(2) and section 902. If, in connection with an All-Cash D Reorganization, the amount of dividend income is determined by reference to the earnings and profits of both Target and Acquiring, an Exchanging Shareholder's PTI in Acquiring should be applied against the portion of the dividend that is attributable to the earnings and profits of Acquiring and the Exchanging Shareholder's PTI in Target should be applied against the portion of the dividend that is attributable to the earnings and profits of Target. [Part III.C.5]

10. In connection with a foreign-to-foreign All-Cash D Reorganization, an Exchanging Shareholder should be able to access the PTI of other consolidated group members with respect to Target or Acquiring, regardless of whether the Exchanging Shareholder owns any shares of Acquiring (directly or by attribution through foreign entities under section 958(a)). [Part III.C.6]

11. Since treating the section 356(a)(2) dividend amount that is attributable to PTI as subpart F income would result in double taxation of the PTI, we recommend that the PTI of Target be taken into account for purposes of section 959(b) or, if the dividend amount under section 356(a)(2) is determined by reference to the earnings and profits of both Target and Acquiring, we recommend that the PTI of both Acquiring and Target be taken into account for purposes of section 959(b). [Part III.C.7]

12. We believe that any remaining PTI with respect to Target after giving effect to reductions in PTI attributable to any section 356(a)(2) dividends should carry over to the Acquiring stock that the Exchanging Shareholder owns (directly or by attribution through foreign entities under section 958(a)). [Part III.C.8]

III. Discussion

A. Preservation of Section 1248 Amount

Treasury and the Service are seeking comment on whether any section 1248 amount attributable to the stock of Target can be preserved in the nominal share that the Exchanging Shareholders are deemed to receive in addition to the actual consideration the Exchanging Shareholders receive in exchange for their Target shares in an All-Cash D Reorganization. This Part discusses (i) the general application of the Treasury regulations under section 367(b), and the circumstances in which an Exchanging Shareholder will recognize the section 1248 amount in connection with an All-Cash D Reorganization; (ii) the application of Treasury regulations section 1.1248-8 and the mechanical rules provided therein for determining whether any section 1248 amount will be preserved in connection with a foreign-to-foreign reorganization described in section 368(a); (iii) our recommendation for preserving the section 1248 amount on a shareholder-by-shareholder basis, or, in the alternative, in the nominal share, and some of the technical difficulties inherent in the nominal share approach; and (iv) preserving the section 1248 amount if the Exchanging Shareholder owns Acquiring stock only through attribution.

1. Section 1248 Amount

Section 1248 generally provides that, if a U.S. person sells or exchanges stock in a foreign corporation and the U.S. person owns, or is considered as owning, ten percent of more of the total voting power of the foreign corporation at any time during the five-year period ending on the date of the sale or exchange when the foreign corporation was a controlled foreign corporation, any gain that the U.S. person recognizes on the sale or exchange must be included in income as a dividend to the extent of the earnings and profits of the foreign corporation attributable to such stock.[7] However, earnings and profits of the foreign corporation that are attributable to amounts that the U.S. person previously included in income with respect to such stock under the controlled foreign corporation rules, pursuant to section 951(a), generally are excluded from earnings and profits for purposes of determining the amount of gain treated as a dividend under section 1248(a).[8]

Treasury regulations section 1.367(b)-4(b) (the "section 367(b) regulations") backstops section 1248 by preventing a U.S. person that otherwise would have been subject to section 1248 upon a sale or exchange of stock in a foreign corporation from avoiding the application of section 1248 through a non-recognition transaction involving another foreign corporation. Generally, the regulations apply to an Exchanging Shareholder that is a U.S. person if (i) immediately before the exchange the U.S. person satisfies the ownership requirements of section 1248(a)(2) or (c)(2) with respect to a foreign target corporation (a "section 1248 shareholder");[9] (ii) a foreign acquiring

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[7] § 1248(a).

[8] § 1248(d)(1).

[9] A U.S. person will satisfy the ownership requirements of section 1248(a)(2) or (c)(2) if the U.S. person owns (directly or by attribution under section 958) ten percent or more, by vote, of the stock of the foreign corporation at any time during the five-year period ending on the date of the sale or exchange triggering the application of section 1248(a) or (c), respectively. §§ 1248(a)(2), 1248(c)(2)(B).

corporation acquires the assets or stock of the foreign target corporation in a reorganization described in section 368(a) (a "foreign-to-foreign reorganization") or in an exchange described in section 351; and (iii) immediately after the exchange, the acquiring corporation is not a controlled foreign corporation as to which the U.S. person is a section 1248 shareholder.[10] The section 367(b) regulations also apply to an Exchanging Shareholder that is a foreign corporation if a U.S. person is a section 1248 shareholder with respect to the Exchanging Shareholder and with respect to the foreign target corporation immediately before the exchange and, immediately after the exchange, the foreign acquiring corporation is not a controlled foreign corporation as to which the U.S. person is a section 1248 shareholder.[11]

If the section 367(b) regulations apply to an Exchanging Shareholder, the shareholder must include in income as a deemed dividend the amount of net positive earnings and profits that the shareholder would have been required to include in income as a dividend under section 1248 if the shareholder sold the stock (the "section 1248 amount").[12] The section 1248 amount should be limited to the amount of gain realized upon the sale or exchange of the stock because the section 1248 amount is defined by reference to the amount that the shareholder would have been required to include in income as a dividend under section 1248 if the shareholder actually sold such stock, and the amount of dividend income under section 1248 is limited to the gain recognized with respect to the stock.[13]

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[10] Treas. Reg. §1.367(b)-4(b)(1)(i).

[11] Treas. Reg. §1.367(b)-4(b)(1)(i).

[12] Treas. Reg. §§ 1.367(b)-2(b), -2(c)(1).

[13] Treas. Reg. § 1.367(b)-2(c); § 1248(a). In general, the section 1248 determination is also made separately for each share of stock sold or exchanged. Treas. Reg. § 1.1248-1(a)(1).

For purposes of the section 367(b) regulations, the gain realized by the Exchanging Shareholder is determined before taking into account the effect of the deemed dividend.[14] The Exchanging Shareholder is considered to receive the deemed dividend immediately before the Exchanging Shareholder's receipt of consideration for its Target stock, and the shareholder's basis in the Target stock is increased by the amount of the deemed dividend.[15] The deemed dividend also reduces earnings and profits before determining the consequences of gain recognition under section 356.[16] As a result, the basis increase and the earnings and profit reduction resulting from the deemed dividend are taken into account before determining the amount and the character of the gain the Exchanging Shareholder recognizes under section 356.

In the case of a foreign-to-foreign D Reorganization, the section 367(b) regulations require an Exchanging Shareholder that is a section 1248 shareholder with respect to Target to include in income as a dividend the section 1248 amount with respect to its Target stock if, immediately after the exchange, Acquiring is not a controlled foreign corporation as to which the Exchanging Shareholder is a section 1248 shareholder.[17] In addition, if the Exchanging Shareholder is a foreign corporation and a U.S. person is a section 1248 shareholder with respect to the Exchanging Shareholder and Target, the Exchanging Shareholder must include in income as a dividend the section 1248 amount if Acquiring is not a controlled foreign corporation as to which the U.S. person is a section 1248 shareholder.[18]

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14 Treas. Reg. § 1.367(b)-2(e)(3)(i).

15 Treas. Reg. § 1.367(b)-2(e)(3)(ii).

16 Treas. Reg. § 1.367(b)-2(e)(3)(iii).

17 Treas. Reg. § 1.367(b)-4(b)(1).

18 Treas. Reg. § 1.367(b)-4(b)(1).

2. General Rules for Preserving the Section 1248 Amount

Treasury regulations section 1.1248-8 (the "section 1248 regulations") provide rules for the attribution of earnings and profits for purposes of section 1248 in connection with certain non-recognition transactions. Generally, in the case of a foreign-to-foreign D Reorganization, the application of the section 1248 regulations mirrors the application of the section 367(b) regulations. If an Exchanging Shareholder is either (i) a "section 1248 shareholder" of Target (a U.S. person that satisfies the ownership requirements of section 1248(a)(2) and Treasury regulations section 1.1248-1(a)(2) with respect to Target) or (ii) a "foreign corporate shareholder" of Target (a foreign corporation that owns stock of Target and that has a section 1248 shareholder that is also a section 1248 shareholder of Target) then, for purposes of section 1248, the earnings and profits attributable to the Acquiring stock that the Exchanging Shareholder receives will be deemed to include the earnings and profits attributable to the stock of Target the Exchanging Shareholder exchanged, that were accumulated before the reorganization.[19] However, the earnings and profits attributable to Acquiring stock do not carry over under the regulations if, as a result of the exchange, the Exchanging Shareholder is required to include in income as a deemed dividend the section 1248 amount pursuant to the section 1.367(b) regulations.[20] No earnings and profits carryover applies in this case because, by including in income the section 1248 amount, the Exchanging Shareholder is in effect treated as disposing its Acquiring stock for purposes of section 1248.

3. Preserving the Section 1248 Amount in Connection with an All-Cash D Reorganization

We believe that, in connection with a foreign-to-foreign All-Cash D Reorganization, section 1248 amounts that are attributable to the stock of Target should be preserved in a manner that is consistent with the manner in which the section 1248

[19] *See* Treas. Reg. § 1.1248-8(b)(2)(ii).

[20] Treas. Reg. §§ 1.1248-8(a)(1), 1.367(b)-4(d).

regulations generally apply to foreign-to-foreign D Reorganizations. However, for the reasons discussed below, rather than attributing the section 1248 amount to the nominal share, we recommend that Treasury and the Service amend the section 1248 regulations to adopt a shareholder-by-shareholder approach for an All-Cash D Reorganization whereby each section 1248 shareholder's section 1248 amount that is attributable to the stock of Target (i) is accounted for separately and (ii) is attributed to all of the Acquiring shares held by the section 1248 shareholder (and not to the nominal share).[21] Alternatively, if Treasury and the Service do not adopt a shareholder-by-shareholder approach, then we recommend that Treasury and the Service adopt an approach whereby the section 1248 amount attributable to the stock of Target is preserved in the nominal share and additional adjustments are then made to preserve access to the section 1248 amount in appropriate circumstances.

Under our recommended shareholder-by-shareholder approach, if an Exchanging Shareholder is a section 1248 shareholder in Target, the earnings and profits attributable to the Acquiring stock that the Exchanging Shareholder owns after the All-Cash D Reorganization generally would include the earnings and profits attributable to the stock of Target that the Exchanging Shareholder exchanges in the reorganization. In contrast, under the nominal share approach, if an Exchanging Shareholder is a section 1248 shareholder in Target, the earnings and profits attributable to the Acquiring stock that the Exchanging Shareholder owns after the All-Cash D Reorganization generally would not include the earnings and profits attributable to the stock of Target that the Exchanging Shareholder exchanges in the reorganization, but rather such earnings and profits would be attributed to the nominal share deemed issued in the All-Cash D Reorganization. Unlike the shareholder-by-shareholder approach, preserving the section 1248 amount in the nominal share and then making further adjustments to preserve access to the section

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[21] Preserving the section 1248 amount in circumstances in which the Exchanging Shareholder only owns Acquiring stock by attribution is discussed in Part III.A.3, *infra*.

1248 amount in appropriate circumstances would be consistent with the Treasury regulations applicable to domestic All-Cash D reorganizations.[22] However, as discussed in greater detail below, we believe that the adjustments necessary to preserve access to the section 1248 amount unnecessarily complicate preserving the section 1248 amount while reaching the same end result as the shareholder-by-shareholder approach. Therefore, on balance, we favor the shareholder-by-shareholder approach.

Under both the shareholder-by-shareholder approach and the nominal share approach, as under the current section 1248 regulations, if the Exchanging Shareholder is required to include the section 1248 amount into income under section 367(b) (for example, because such Exchanging Shareholder is not a section 1248 shareholder with respect to Acquiring immediately following the reorganization), no section 1248 amount would carry over.[23]

Preserving the section 1248 amount on a shareholder-by-shareholder basis, rather than attributing the section 1248 amount to the nominal share, would be consistent with the proposed Treasury regulations under section 959 (the "proposed section 959 regulations"), regarding the maintenance of PTI accounts, which generally provide for a share-by-share approach for purposes of tracking PTI.[24] Under the proposed section 959 regulations, each U.S. ten percent shareholder of a controlled foreign corporation is required to maintain a PTI account with respect to each share of stock in the foreign

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22 *See* Treas. Reg. §1.358-2(a)(2)(iii) (tax basis preserved in nominal share may be reallocated to a designated share of stock of Acquiring).

23 *See* Treas. Reg. § 1.1248-1(a).

24 We believe that it would also be possible to preserve appropriately the section 1248 amount using a share-by-share approach similar to the section 959 regulations. However, on balance, we prefer the shareholder-by-shareholder approach because it is consistent with the current section 1248 regulations.

corporation.[25] However, the proposed section 959 regulations provide a leveling mechanism to reduce PTI accounts if the total distributions of earnings and profits made with respect to any particular share of stock for the foreign corporation's taxable year would exceed the PTI account with respect to such share.[26] Under the proposed section 959 regulations, if a "covered shareholder" owns more than one share of stock in a foreign corporation and the total amount of any distributions of earnings and profits made with respect to a particular share of stock in a foreign corporation for the foreign corporation's taxable year exceed the shareholder's PTI account with respect to such share, then the shareholder's PTI accounts with respect to the other shares of stock it owns in the foreign corporation will be decreased on a *pro rata* basis in an amount equal to such excess.[27] In the case of a redemption by a foreign corporation that is treated as a distribution of property to which section 301 applies, the proposed section 959 regulations generally apply in the same manner as they apply to any distribution of property to which section 301 applies.[28] However, if the PTI account with respect to the redeemed stock exceeds the amount of earnings and profits that would otherwise be chargeable to such stock under the proposed regulations, then the excess PTI will be reallocated to the PTI accounts with respect to the remaining stock held by the same shareholder in the foreign corporation in a manner consistent with the basis adjustments provided under Treasury regulations section 1.302-2(c).[29] As a result of the leveling and

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[25] Prop. Treas. Reg. § 1.959-1(d)(1). Although the PTI account is share specific, the proposed section 959 regulations permit taxpayers to maintain such account with respect to each block of stock in the foreign corporation.

[26] Prop. Treas. Reg. § 1.959-3(f).

[27] Prop. Treas. Reg. § 1.959-3(f)(i).

[28] Prop. Treas. Reg. § 1.959-3(h)(3)(i). The proposed regulations provide for a similar result in the case of a stock acquisition described in section 304(a)(1) that is treated as a distribution of property to which section 301 applies. *See* Prop. Treas. Reg. § 1.959-3(h)(4)(i).

[29] Prop. Treas. Reg. § 1.959-3(h)(3)(ii).

reallocation mechanisms described above, the proposed section 959 regulations in effect track earnings and profits on a shareholder-by-shareholder basis.

The shareholder-by-shareholder approach also generally is consistent with the result that would follow from mechanically applying the section 1248 regulations to the nominal share that the Exchanging Shareholder is deemed to receive in an All-Cash D Reorganization, but avoids a number of technical difficulties that would arise if the section 1248 amount is attributed to the nominal share. Under the nominal share approach, the mechanical application of the section 1248 regulations generally would attribute to the nominal share the earnings and profits attributable to the Target stock that the Exchanging Shareholder exchanged.[30] If the earnings and profits attributable to Target stock are preserved in the nominal share of Acquiring stock, the section 1248 amount generally will be taken into account upon a subsequent disposition of the nominal share under section 1248(a) or the regulations under section 367(b).[31] One problem with this approach is that, since the nominal share apparently has no value, the nominal share can never be sold at a gain.[32] As a result, in contrast to the shareholder-by-shareholder approach, under the nominal share approach, the section 1248 amount that is attributed to

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30 Absent the deemed issuance of the nominal share, the current section 1248 regulations would not attribute the earnings and profits of Target that accumulated before the All-Cash D Reorganization to the nominal share or any stock of Acquiring.

31 In addition, if a controlled foreign corporation sells or exchanges stock in another foreign corporation, gain recognized on the sale or exchange will be included in the controlled foreign corporation's gross income as a dividend to the extent it would have been included as a dividend under section 1248(a) if the controlled foreign corporation were a U.S. person. § 964(e).

32 *See* NYSBA Report on Proposed and Temporary Regulations Regarding All-Cash Acquisitive D Reorganizations (Sept. 25, 2009) (noting that "reality is that the nominal share has no real value; it does not really exist and accordingly no person would purchase it (or for that matter comprehend in a commercial setting what it is)"); *see also* Kevin Dolan et al., *Recent U.S. International M&A Regulations*, 19 J. INT'L TAX'N 38 (2008).

the nominal share under the section 1248 regulations will be trapped in the nominal share and will be inaccessible on a future sale or disposition of the nominal share. Under the section 1248 regulations, a non-Exchanging Shareholder of Acquiring cannot access this section 1248 amount.[33] Therefore, any unrecognized section 1248 amount will be lost. We believe this result conflicts with the general carryover provisions of the section 1248 amount under the section 1248 regulations. As a result, if Treasury and the Service determine that the section 1248 amount should be preserved in the nominal share, we recommend that the section 1248 amount that is attributed to the nominal share be reallocated to the Exchanging Shareholder's other Acquiring shares in a manner that is consistent with the proposed section 959 regulations' mechanism for reallocating PTI.

We note that a similar issue with regard to inaccessible section 1248 amounts may arise in connection with a foreign-to-foreign D Reorganization in which Acquiring stock is actually issued, if the consideration that Acquiring pays to Target includes only a small amount of actual Acquiring stock. If the value of the Acquiring stock that is issued in the D Reorganization is low relative to the section 1248 amount that is attributed to Target shares under the section 1248 regulations, the Exchanging Shareholder may not be able to access the full section 1248 amount upon a subsequent disposition of Target shares because the disposition may not result in the realization of a sufficient amount of gain. As a result, if Treasury and the Service were to issue regulations that preserve the section 1248 amount, under either a shareholder-by-shareholder or a nominal share approach, an All-Cash D reorganization would be subject to different tax treatment than a D reorganization with a small amount of actual Acquiring stock. We believe this result would be undesirable, and that the tax consequences that follow from issuing a small amount of Acquiring stock should be consistent with the tax consequences that follow

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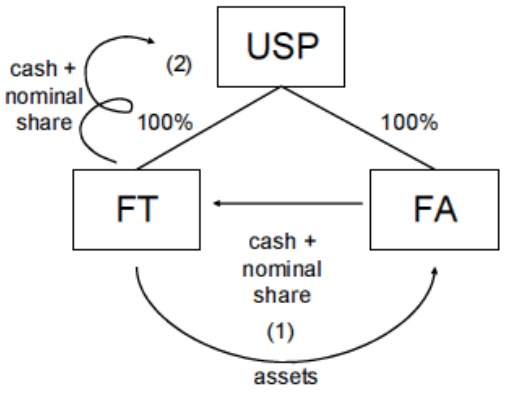
[33] *See* Treas. Reg. § 1.1248-8(b)(4) (except as otherwise provided in the regulations, the earnings and profits of the acquired corporation accumulated prior to the restructuring transaction attributable to the stock of the acquired corporation are not attributed to the non-Exchanging Shareholder's stock in the foreign acquiring corporation).

from an All-Cash D Reorganization. Therefore, while a recommendation on the general application of the section 1248 regulations to foreign-to-foreign reorganizations is beyond the scope of this Report, we believe that, in this case, the better approach would be to modify the section 1248 regulations so that the section 1248 amount is attributed to all of the Exchanging Shareholder's Acquiring stock in a manner that is consistent with our recommended shareholder-by-shareholder approach for All-Cash D Reorganizations.

The shareholder-by-shareholder approach for preserving the section 1248 amount and the difficulties with the nominal share approach are illustrated by the following two examples.

Example 1:

USP owns 100% of FT and 100% of FA. FA acquires all of the assets of FT for cash and FT liquidates, in a foreign-to-foreign All-Cash D Reorganization.



Immediately before the reorganization the Exchanging Shareholder, USP, is a section 1248 shareholder in Target, a controlled foreign corporation. USP is not required to take into account the section 1248 amount in connection with the All-Cash D Reorganization because immediately after the reorganization USP is a section 1248 shareholder of FA, which is also a controlled foreign corporation.[34] Under section 356(a)(2), USP is required to take into account as a deemed dividend the earnings and

[34] Treas. Reg. § 1.367(b)-4(b)(1).

profits of FT (and possibly FA under the holding of *Davant v. Commissioner*)[35] but only to the extent of any gain recognized.[36] Any excess FT earnings carry over to FA under section 381. Under our proposed shareholder-by-shareholder approach for preserving the section 1248 amount, the earnings and profits attributable to USP's FT stock would be attributed to USP's FA stock and therefore would generally be available to be taken into account in connection with a subsequent sale or disposition of the FA stock. In contrast, if the section 1248 regulations apply to the nominal share, the earnings and profits of FT that were accumulated before the reorganization would be attributed solely to the nominal share. However, since the nominal share has no value, USP will not take into account the section 1248 amount upon a subsequent sale of the FA stock unless the section 1248 amount is reallocated to USP's other FA shares.

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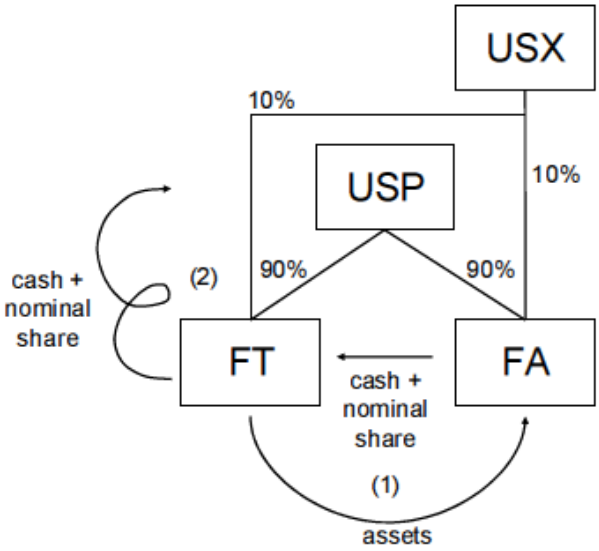
35 *See* discussion *infra* notes 56-58 and accompanying text.

36 *See* § 356(a)(2). In 2010 legislation was introduced (but not enacted) that would have treated the amount of other property or money received in a D Reorganization as a dividend to the extent of the earnings and profits of both Target and Acquiring regardless of the amount of gain recognized. *See, e.g.*, American Jobs and Closing Tax Loopholes Act of 2010, H.R. 4213, 111th Cong. § 422 (2010) (hereinafter referred to as the "Old Extenders Bill"). Any gain remaining under section 356(a)(1) would have then be treated as gain from the exchange of property. Old Extenders Bill § 422. If a similar proposal were enacted, section 1248 amount carryover would only be relevant for an All-Cash D Reorganization in which the purchase price is less than the current and accumulated earnings and profits of Target and Acquiring.

Example 2:

USP owns 90% of FT and 90% of FA. USX owns 10% of FT and 10% of FA. FA acquires all of the assets of FT for cash and FT liquidates, in a foreign-to-foreign All-Cash D Reorganization.



Each of the Exchanging Shareholders, USP and USX, is a section 1248 shareholder in FT, a controlled foreign corporation, immediately prior to the reorganization. Neither USP nor USX is required to take into account its section 1248 amount because immediately after the exchange USP and USX are section 1248 shareholders of FA, which is also a controlled foreign corporation. Under section 356(a)(2), USP and USX are required to take into account as a deemed dividend the earnings and profits of FT (and possibly FA), but only to the extent of any gain recognized.[37] Any excess FT earnings carry over to FA under section 381. Under our proposed shareholder-by-shareholder approach for preserving the section 1248 amount, for purposes of section 1248, (i) the earnings and profits of USP's stock in FA would be increased by the earnings and profits attributable to USP's stock in FT that were accumulated before the reorganization and (ii) the earnings and profits of USX's stock in FA would be increased by the earnings and profits attributable to USX's stock in FT that

[37] *See* § 356(a)(2).

were accumulated before the reorganization.[38] As a result, USP's and USX's section 1248 amount attributable to its shares in FT would be available to be taken into account in connection with a subsequent sale or disposition of USP's or USX's FA stock, respectively. In contrast, under the nominal share approach, the earnings and profits of FT that were accumulated before the reorganization would be attributed solely to the nominal share. However, since USP and USX have separate section 1248 amounts, the earnings and profits would need to be reallocated from the nominal share to USP and USX based on their respective shares of the earnings and profits, with the same end result as the shareholder-by-shareholder approach. We believe that the nominal share approach adds complexity and does not add any particular value in these circumstances.

4. Exchanging Shareholders That Own Acquiring Stock Only Through "Up-Down" Attribution

More complex considerations arise if an Exchanging Shareholder is a section 1248 shareholder in Acquiring following the All-Cash D Reorganization solely by attribution under section 958. If an Exchanging Shareholder owns Acquiring stock by attribution under section 958(b) and the Exchanging Shareholder does not own Acquiring stock by attribution through one or more foreign entities under section 958(a)(2), section 1248 will not apply to the Exchanging Shareholder in connection with a subsequent sale or disposition of Acquiring stock. As a result, the section 1248 amount attributable to the Exchanging Shareholder's Target stock will not be preserved unless the section 1248 amount is attributed to another section 1248 shareholder in Acquiring.

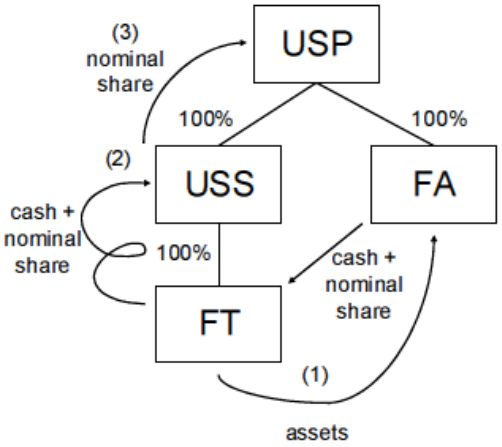
In the circumstances described above, if the Exchanging Shareholder is a member of a consolidated group, we believe that the Exchanging Shareholder's section 1248 amount should be added to the earnings and profits attributable to the Acquiring stock that the other section 1248 shareholders in the group own (directly or by attribution through foreign entities under section 958(a)), thereby preserving the section 1248

[38] *See* Treas. Reg. § 1.1248-8(b)(2)(ii), (b)(7) ex. 4.

amount within the consolidated group. We believe this result is appropriate because the Exchanging Shareholder's section 1248 amount was not recognized in connection with the All-Cash D Reorganization and would otherwise be lost, even though the earnings and profits of Target have carried over to Acquiring where they can be accessed by other members of the consolidated group, including for purposes of section 902.[39] An example illustrating the proposed attribution of the section 1248 amount to other members of the consolidated group is set forth below.

Example 3:

USP owns 100% of USS and 100% of FA. USS owns 100% of FT. USP and USS are members of a consolidated group. FA acquires all of the assets of FT for cash and FT liquidates, in a foreign-to-foreign All-Cash D Reorganization.



USS is a section 1248 shareholder of FT, a controlled foreign corporation, immediately prior to the reorganization and also is a section 1248 shareholder of FA, a controlled foreign corporation, immediately after the reorganization because USS owns 100% of the stock of FA by attribution under section 958(b), thereby satisfying the ownership requirements of section 1248(a)(2). As a result, USS is not required to take into account the section 1248 amount in connection with the All-Cash D Reorganization.[40] Under section 356(a)(2), USS is required to take into account as a deemed dividend the earnings and profits of FT (and possibly FA), but only to the extent of any gain recognized. Any

[39] *See* § 381; Treas. Reg. §1.367-7.

[40] Treas. Reg. § 1.367(b)-4(b)(1).

excess FT earnings will carry over to FA under section 381. However, USS does not own any stock of FA (directly or by attribution through foreign entities under section 958(a)) to which the section 1248 amount associated with USS's Target stock can be attributed. Under our proposal, USS's section 1248 amount would be added to USP's section 1248 amount with respect to its Acquiring stock because USP and USS are members of the same consolidated group.

While it would be possible to reach a similar result using the nominal share approach, several technical difficulties would arise. In Example 3, the Exchanging Shareholder, USS, is deemed to receive the nominal share in exchange for its Target stock.[41] Thereafter, USS is deemed to transfer the nominal share to USP to reflect the actual ownership of Acquiring.[42] Under the section 1248 regulations, the earnings and profits of the nominal share that USS receives would include the earnings and profits of FT that were accumulated before the reorganization.[43] However, it is not clear whether the nominal share would retain the earnings and profits that have been attributed to it if the subsequent transfers do not qualify as restructuring transactions within the meaning of the section 1248 regulations. As a general matter, the deemed distribution of the nominal share of FA stock by USS to USP would be treated as a taxable transaction.[44] Although no gain would be recognized because the nominal share has no value, USS's deemed distribution of the nominal share to USP would re-start USP's holding period in the

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41 Treas. Reg. § 1.368-2(l).

42 *See also* Treas. Reg. § 1.368-2(l)(3), ex. 3.

43 As is the case in Example 1, absent the existence of the nominal share, nothing in the section 1248 regulations would require that the earnings and profits of Target accumulated before the reorganization carry over to the nominal share of Acquiring for purposes of section 1248.

44 § 311(b).

nominal share.[45] As a result, it appears that the section 1248 amount with respect to the FT stock would not be preserved because the deemed distribution to USP is not a "restructuring transaction" within the meaning of the section 1248 regulations.[46] For the reasons described above, we believe this outcome is not appropriate in the context of the consolidated group. Accordingly, if Treasury and the Service do not accept our recommendation that the section 1248 amount should be attributed to Acquiring stock of the other section 1248 shareholders in the consolidated group, but instead adopt a nominal share approach to preserving the section 1248 amount, we recommend that the nominal share rules be revised to provide an exception that preserves the section 1248 amount notwithstanding the tax consequences that would generally apply to intra-group distributions.

In addition to attributing the section 1248 amount to Acquiring stock of other members of the consolidated group, if necessary to preserve the section 1248 amount, we believe that in certain circumstances it would be appropriate to attribute the section 1248 amount to non-group members. The example below illustrates an All-Cash D Reorganization where we believe the section 1248 amount should be attributed from a non-U.S. Exchanging Shareholder to a section 1248 shareholder.

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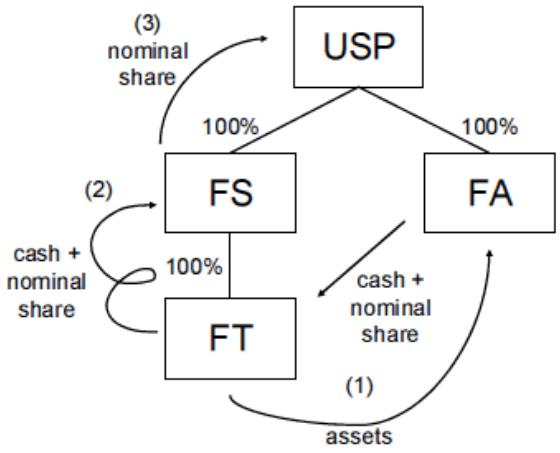
[45] Section 1223 does not provide for a tacked holding period in the case of a taxable distribution of stock.

[46] A "restructuring transaction" is defined under the regulations as a transaction qualifying as a non-recognition transaction within the meaning of section 7701(a)(45) and described in section 351, 354, 356 or 361. Treas. Reg. § 1.1248-8(b)(1)(vii). As a general matter, we question whether inter-group distributions of the nominal share that are deemed to occur under Treasury regulations section 1.368-2(l)(2) are intended to result in deemed section 311 distributions that strip the nominal share of its tax characteristics.

Example 4:

Same as Example 2 except USS is a foreign corporation (FS).



FS is not required to take into account the section 1248 amount in connection with the All-Cash D Reorganization because, while immediately before the exchange, FS is a foreign corporation and USP is a section 1248 shareholder with respect to both FS and FT, immediately after the exchange, the stock received in the exchange (the nominal share) is stock in, and the foreign acquiring corporation is, a controlled foreign corporation (FA) as to which USP is a section 1248 shareholder.[47] Under section 356(a)(2), FS is required to take into account as a deemed dividend the earnings and profits of FT (and possibly FA), but only to the extent of any gain recognized.[48] Any excess FT earnings carry over to FA under section 381.

We believe that USP's section 1248 amount in relation to the FT stock that it owned (indirectly through FS) prior to the reorganization should be preserved because USP is a section 1248 shareholder in FA following the All-Cash D Reorganization. Preserving the section 1248 amount in these circumstances is consistent with the result that follows from a D Reorganization in which FA acquires the assets of FT for cash and actual shares of FA stock, and FT subsequently distributes the cash and stock to FS in

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47 *See* Treas. Reg. § 1.367(b)-4(b)(1).

48 *See supra* note 56-58 and accompanying text.

exchange for FT stock. In that case, under the section 1248 regulations, USP's section 1248 amount with respect to its FT stock would be preserved in the FA stock held by FS where it could be accessed upon either (i) FS's sale or disposition of its FA stock, as a dividend pursuant to section 964(e) or (ii) USP's sale or disposition of its FS stock, under section 1248(c)(2). Although the actual share of FA stock that is issued in the D Reorganization is held by FS whereas the nominal share that is deemed to be issued in the All-Cash D Reorganization is deemed to be held by USP, we do not believe this difference justifies preserving the section 1248 amount if actual shares are issued in a D Reorganization, but not preserving the section 1248 amount in an All-Cash D Reorganization.

As is the case of Example 3, we believe that attributing USP's section 1248 amount with respect to its FT stock to all of its Acquiring stock is better suited to preserving the section 1248 amount than attributing the section 1248 amount to the nominal share. As in Example 3, the strict application of the section 1248 regulations to the transactions that are deemed to occur under the nominal share regulations would not preserve the section 1248 amount. Although the earnings and profits of the nominal share that FS receives would include the earnings and profits of FT that were accumulated prior to the reorganization because FS is a foreign corporate shareholder of FT,[49] FS would be treated as transferring the nominal share to USP pursuant to the nominal share regulations and the deemed distribution of the nominal share by FS would not be treated as a "restructuring transaction" within the meaning of Treasury regulations section 1.1248-8(b)(vii). As a result, it appears that the section 1248 amount with respect to FT stock would not carry over in the nominal share. Nevertheless, we believe that the section 1248 amount should be preserved because USP is a section 1248 shareholder in FA following the All-Cash D Reorganization.

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[49] *See* Treas. Reg. § 1.1248-8(b)(v).

As a general matter, we believe that where a section 1248 shareholder in Target is not required to include in income as a deemed dividend the section 1248 amount pursuant to the section 367(b) regulations because such shareholder is a section 1248 shareholder in Acquiring following an All-Cash D Reorganization, the section 1248 amount should be preserved following the reorganization.

B. Section 902 Considerations

Treasury and the Service have requested comments regarding the manner in which earnings and profits are (or should be) taken into account for purposes of section 902 when an Exchanging Shareholder recognizes gain under section 356(a) that is treated as a dividend under section 356(a)(2) from the earnings and profits of Target and Acquiring (including whether an ordering rule should apply). This Part discusses (i) the general application of the rules under section 356(a)(2) in the context of an All-Cash D Reorganization for purposes of determining the amount of a dividend that will give rise to foreign tax credits under section 902; (ii) the uncertainty under current law as to whether, for purposes of determining the amount treated as a dividend under section 356(a)(2) in an All-Cash D Reorganization, the earnings and profits of both Target and Acquiring or only Target are taken into account; (iii) the source and ordering of deemed dividends attributable to cross-chain stock sales described in section 304(a)(1); (iv) our recommendation that Treasury and the Service adopt a consistent approach for taking into account the earnings and profits of Target and Acquiring under section 356(a)(2) and section 902; (v) the ordering rules that should apply for purposes of taking into account earnings and profits of Target and Acquiring, if the amount treated as a divided under section 356(a)(2) is calculated with respect to the earnings and profits of both Target and Acquiring (including guidance that may be provided by analogy to cross-chain stock sales described under section 304); and (vi) the need for a similar limitation as the limitation provided in section 304(b)(5)(A) in cases where an Exchanging Shareholder owns stock of Acquiring through attribution.

1. Section 902

Section 902 allows a domestic corporation to claim a foreign tax credit for income taxes paid by a foreign subsidiary under certain circumstances. Under section 902(a), a domestic corporation that owns ten percent or more of the voting stock of a foreign corporation and that receives a dividend from the foreign corporation will be deemed to have paid the same proportion of the foreign corporation's post-1986 foreign income taxes as the amount of the dividend bears to the foreign corporation's "post-1986 undistributed earnings."[50] Section 902(b) provides that dividends paid by certain lower-tier subsidiaries will also bring up foreign taxes paid by the lower-tier foreign subsidiaries. Under section 902(b), if a foreign corporation is a member of a "qualified group" and the foreign corporation owns ten percent or more of the voting power of another member of the qualified group from which it receives dividends, then the foreign corporation will be deemed to have paid the same proportion of the other qualified group member's post-1986 foreign income taxes as would have been determined under section 902(a) if the foreign corporation were a domestic corporation.[51]

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[50] "Post-1986 undistributed earnings" are defined as the amount of earnings and profits of the foreign corporation (computed in accordance with section 964(a) and section 986) accumulated in taxable years beginning after December 31, 1986 as of the close of the taxable year of the foreign corporation in which the dividend is distributed and without diminution by reason of dividends distributed during such taxable year. § 902(c)(1).

[51] § 902(b)(1). "Qualified group" means, with respect to any U.S. corporation that owns ten percent or more of the voting stock of a foreign corporation, as described in section 902(a), (i) the foreign corporation described under section 902(a) and (ii) any other foreign corporation if (A) the U.S. corporation owns at least five percent of the voting stock of such other foreign corporation indirectly or through a chain of foreign corporations connected through stock ownership of at least ten percent of their voting stock, (B) the foreign corporation described in section 902(a) is the first-tier corporation in such chain and (C) the other corporation is not below the sixth tier in such chain.

2. Dividend Treatment Under Section 356(a)(2)

Under section 356(a)(2), if an Exchanging Shareholder in a reorganization receives acquiring stock and other cash or other property in exchange for its target stock, and the exchange has the effect of a distribution of a dividend, then the cash or property will be treated as a dividend, in an amount not to exceed the gain the Exchanging Shareholder recognizes on the exchange of its target stock, to the extent of the Exchanging Shareholder's ratable share of "undistributed earnings and profits of the corporation."[52] The Service has ruled that money or other property which is treated as a dividend pursuant to section 356(a)(2) is also treated as a dividend for purposes of determining the deemed paid foreign tax credit under section 902.[53]

In the case of a D Reorganization, if Target and Acquiring do not have a complete identity of stockholders, under current law, gain that an Exchanging Shareholder recognizes should only be treated as a dividend to the extent of its ratable share of the earnings and profits of Target. If Target and Acquiring have a complete identity of stockholders, as will be the case in any All-Cash D Reorganization, it is not clear under current law whether gain that an Exchanging Shareholder recognizes may also be treated as a dividend under section 356(a)(2) to the extent of its ratable share of the earnings and profits of Acquiring.[54] A literal reading of section 356(a)(2) suggests that only the earnings and profits of Target should be taken into account for purposes of determining the amount of gain that is treated as a dividend under section 356.[55] However, the courts

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52 § 356(a)(2).

53 *See* Rev. Rul. 74-387, 1974-2 C.B. 207.

54 *See supra* note 36.

55 The legislative history to section 203(d)(2) of the Internal Revenue Bill of 1924, the predecessor to section 356(a)(2), indicates that, at the time of enactment, Congress was concerned with a bailout of the earnings and profits of the target corporation, and there is nothing in the legislative history that suggests Congress considered that

have split as to whether a literal reading is appropriate for a D Reorganization in which Target and Acquiring have identical share ownership. The Fifth Circuit held in *Davant v. Commissioner*[56] that, if there is a complete identity of stockholders, the earnings and profits of both Target and Acquiring should be taken into account for purposes of determining the gain that is treated as a dividend under section 356, and the Service took the same position in Revenue Ruling 70-240.[57] However, the Tax Court and the Third Circuit have declined to follow *Davant*.[58]

In Revenue Ruling 74-387,[59] the Service considered a transaction in which a domestic corporation owned directly in excess of ten percent of the stock of Target and Acquiring. An unrelated foreign corporation owned the remaining stock of Target and Acquiring. In a transfer qualifying as a D Reorganization, Acquiring acquired substantially all of the assets of Target solely in exchange for Acquiring stock and cash. Target then distributed the Acquiring stock and cash to its shareholders in exchange for

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under certain fact patterns there could also be a bailout of the earnings and profits of the acquiring corporation.

[56] 366 F.2d 874 (5th Cir. 1966). In *Davant*, the Fifth Circuit rejected the taxpayer's position that the reference in section 356(a)(2) to "the corporation" should only refer to Target. The court noted: "[w]here there is complete identity, as here, the stockholders control both corporations and it is virtually impossible to tell which corporation is in reality "the corporation" distributing the cash. We have two corporations each of which is distributing cash; therefore, we must look at the earnings and profits of both corporations to see if the distribution is essentially equivalent to a dividend or has the effect of a dividend." *Id.* at 889.

[57] 1970-1 C.B. 81. *See also* CCA 2010-32-035 (Apr. 27, 2010).

[58] *See Am. Mfg. Co. v. Comm'r*, 55 T.C. 204 (1970) (the Tax Court cited the legislative history of section 356(a)(2) and the statutory language of section 356(a)(2) in holding that only the earnings and profits of Target are to be considered in determining the amount of a taxable dividend in a reorganization under section 368(a)(1)(D)). *See also Atlas Tool Co. v. Comm'r*, 611 F.2d 990 (3d Cir. 1980); Wilson, 46 T.C. 334 (1966).

[59] 1974-2 C.B. 207.

their Target stock. The gain recognized upon the exchange was treated as a dividend under section 356(a)(2). The Service ruled that the dividend recognized under section 356(a)(2) should be treated as a dividend for purposes of the deemed paid foreign tax credit provided by section 902 to the extent of the domestic corporation's ratable share of Target's accumulated earnings and profits. Revenue Ruling 74-387 is silent on whether Acquiring's earnings and profits would also be taken into account for purposes of section 902. However, presumably the omission was intentional since Revenue Ruling 74-387 cites Revenue Ruling 70-240 which, as discussed above, holds that the earnings and profits of both Target and Acquiring should be taken into account for purposes of determining the amount of the dividend under section 356(a)(2), if there is complete shareholder identity between Target and Acquiring. It is possible that Revenue Ruling 74-387's limited holding regarding the earnings and profits that may be taken into account for purposes of section 902(a) is attributable to the Service's concerns about whether section 902(a) should apply to a dividend paid out of earnings and profits of Acquiring if the Exchanging Shareholder does not own shares in Acquiring that satisfy the ownership requirements of section 902(a).

3. Cross-Chain Stock Sales Described in Section 304(a)(1)

Under section 304(a)(1), if two corporations are under common control and one corporation acquires stock of the other corporation in exchange for property (a "cross-chain stock sale"), such property is generally treated as a distribution in redemption of the stock of the acquiring corporation.[60] To the extent the deemed distribution is treated under section 302(b) as a distribution to which section 301 applies, the cross-chain stock sale is treated as if the issuing corporation had contributed stock to the acquiring

[60] § 304(a)(1). Alternatively, if the corporations are under common control, but the acquiring corporation acquires stock of the issuing corporation from a shareholder of the issuing corporation in exchange for property and the issuing corporation controls the acquiring corporation, then such property is treated as a distribution in redemption of the stock of the issuing corporation. § 304(a)(2).

corporation in exchange for stock of the acquiring corporation in a transaction to which section 351(a) applies, and then the acquiring corporation had redeemed the stock it was deemed to have issued to the issuing corporation.[61] A cross-chain stock sale described in section 304(a)(1) is, in effect, the stock analogue to the cross-chain asset sale that is treated as a D Reorganization.

In contrast to section 356(a)(2), which does not specify which corporation's earnings and profits must be taken into account, in the case of a cross-chain stock sale that is treated as a dividend under section 304(a)(1), section 304(b)(2) provides that both the amount which is a dividend and the source of the dividend are determined as if the property that is treated as distributed were distributed first by the acquiring corporation to the extent of its earnings and profits and then by the issuing corporation to the extent of its earnings and profits.

The Service has ruled that a deemed dividend under section 304(a)(1) is also treated as a dividend for purposes of the deemed paid foreign tax credit. In Revenue Rulings 91-5[62] and 92-86,[63] the Service ruled that the deemed dividend from the earnings and profits of both the acquiring corporation and the issuing corporation pursuant to section 304(b)(2) should be treated as a dividend for purposes of section 902, even if the corporation that is deemed to receive the dividend does not own any stock directly in the acquiring corporation and therefore does not satisfy the ownership requirements of section 902(a). In each ruling, the Service cited the legislative history to the 1984 amendment to section 304(b)(2), which indicated that the foreign tax credit should be

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61 § 304(a)(1) (flush language).

62 1991-1 C.B. 114.

63 1992-2 C.B. 199.

allowed to the same extent as if the distribution had been made directly by the corporation that is treated as having made the distribution.[64]

In Revenue Ruling 92-86, the Service also cited *First Chicago NBD Corp. v. Commissioner*,[65] which the Seventh Circuit decided following the issuance of Revenue Ruling 91-5. In *First Chicago*, the Seventh Circuit held that members of a consolidated group could not aggregate the stock ownership of a foreign corporation for purposes of satisfying the ten percent ownership requirement under section 902. The court indicated that aggregation could only apply with respect to consolidated group members that individually satisfy the ten percent ownership requirement of section 902(a). The court distinguished the members of the consolidated group from the acquiring and issuing corporation in a cross-chain stock sale governed by section 304(a)(1) and the holding of Revenue Ruling 91-5 on the basis that cross-chain stock sales were given special treatment for purposes of section 902 because of the specific legislative history of section 304.[66]

4. Taking into Account Target and Acquiring Earnings and Profits

A recommendation on whether the earnings and profits of both Target and Acquiring should be taken into account for purposes of section 356(a)(2) in connection with a D Reorganization is beyond the scope of this Report. However, we believe that section 902(a) should apply to the earnings and profits of Target and Acquiring in a manner that is consistent with section 356(a)(2). Therefore, if the earnings and profits of both Target and Acquiring are available to support dividend treatment under section 356(a)(2) (the Third Circuit's holding in *Davant*), the section 356(a)(2) dividend should

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64 1992-2 C.B. 199; H.R. Rep. No. 98-861 (Conf. Rep.), 98th Cong., 2d Sess. 1223 (1984).

65 135 F.3d 457 (7th Cir. 1998).

66 *See First Chicago*, 135 F.3d at 460.

bring with it deemed paid credits under section 902 in the same manner as an actual dividend from Target and Acquiring.[67]

Allowing an Exchanging Shareholder to access the earnings and profits of both Target and Acquiring for purposes of section 902 is a natural reading of section 902(a) if the Exchanging Shareholder satisfies the ownership requirements of section 902(a) with respect to Target and Acquiring. However, if the Exchanging Shareholder satisfies the ownership requirements of section 902(a) with respect to Target, but not Acquiring, it is not entirely clear how section 902 should apply to gain that is treated as dividend from the earnings and profits of Acquiring. This issue is similar to the issues addressed by the Seventh Circuit in *First Chicago*. However, in connection with an All-Cash D Reorganization, if the earnings and profits of both Target and Acquiring are accessed for purposes of section 356(a)(2), we believe that a different result than *First Chicago* is appropriate. Under *Davant*, the Exchanging Shareholder's gain is treated as a dividend from both Target and Acquiring even if the Exchanging Shareholder does not own any shares in Acquiring because *Davant* in effect treats Target and Acquiring as the same corporation for purposes of section 356(a)(2).[68] We believe that this treatment should also extend to Section 902(a), notwithstanding that the Exchanging Shareholder may not own Acquiring stock that satisfies the ownership requirements of section 902(a). Our recommended approach also would align the tax consequences of a cross-chain asset sale

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67 Although this Report is limited to All-Cash D Reorganizations, we see no basis for treating an All-Cash D Reorganization differently from any other acquisitive D Reorganization for purposes of section 902.

68 *See Davant v. Commissioner*, 366 F.2d 874 (5th Cir. 1966) (earnings and profits of both Acquiring and Target should be taken into account because it is impossible to tell which corporation is in reality distributing the cash).

that qualifies as a D Reorganization with cross-chain stock sales described in section 304(a)(1), which we believe is appropriate from a policy perspective.[69]

5. Ordering of Earnings and Profits

If the earnings and profits of both Target and Acquiring are taken into account for purposes of section 902 when an Exchanging Shareholder recognizes gain that is treated as a dividend under section 356(a)(2), Treasury and the Service will also need to specify the order in which the earnings and profits are taken into account for purposes of section 902. We have considered three approaches for taking into account the earnings and profits of Target and Acquiring for purposes of section 902: (i) aggregating Target and Acquiring earnings and profits; (ii) taking Target earnings into account first; or (iii) taking Acquiring earnings into account first.

Under the aggregation approach, the earnings and profits of, and the foreign taxes paid by, Target and Acquiring each would be pooled together and taken into account for purposes of section 902 on an aggregate basis. The aggregation of earnings and profits and foreign taxes generally would result in a blending of the earnings and foreign tax credit pools of Acquiring and Target. We believe this result would be inconsistent with

[69] We note that the Old Extenders Bill (which was not enacted) would have amended section 356 to mandate that the earnings and profits of both Target and Acquiring be taken into account for purposes of determining the amount of gain treated as a dividend under section 356(a)(2) for all acquisitive D Reorganization, not just reorganizations in which there is complete shareholder identity between Acquiring and Target. *See supra* note 36. The Old Extenders Bill would have been self-executing as to the issue described above since it provided that the amount of the dividend and the source thereof would be determined under the rules of section 304(b)(2) and (5). Therefore, consistent with the Service's approach to section 304(a)(1) in Revenue Rulings 91-5 and 92-86, the earnings and profits of both Acquiring and Target would have been taken into account. *See* Old Extenders Bill § 422(a)(3).

the corporation-by-corporation approach for determining the foreign taxes that a U.S. shareholder is deemed to pay under section 902.[70]

Under a Target earnings and profits first approach, if Target has earnings and profits, the earnings and profits of, and the foreign taxes paid by, Target would be taken into consideration before any earnings and profits of, and foreign taxes paid by, Acquiring. Although we are not aware of any authorities supporting this approach, at least one commentator has identified this as the appropriate result,[71] perhaps because Target corporation is extinguished in connection with the reorganization or because the statutory language of section 356(a)(2) better fits a dividend from Target.

Under an Acquiring earnings and profits first approach, if Acquiring has earnings and profits, the earnings and profits of, and the foreign taxes paid by, Acquiring would be taken into consideration before any earnings and profits of, and foreign taxes paid by, Target. This approach is consistent with the ordering rules provided in section 304(b)(2) for cross-chain stock sales described in section 304(a)(1), pursuant to which the earnings and profits of the acquiring corporation are taken into account before the earnings and profits of the issuing corporation. As discussed above, we believe that it is appropriate for the rules applicable to a cross-chain asset sale that qualifies as a D Reorganization to be consistent with the rules that apply to cross-chain stock sales described in section 304(a)(1). As a result, if Treasury and the Service determine that both the earnings and profits of Target and Acquiring should be taken into account for purposes of section 902,

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70 *See* Treas. Regs. § 1.902-1(c)(1) (separate computation of foreign taxes that a U.S. shareholder is deemed to pay required for dividends from each foreign subsidiary).

71 *See* Lowell D. Yoder, Cash D Reorganizations—Selected International Issues, 37 Tax Mgm't Int'l J. 110 (2008) ("Some commentators have suggested that [Target]'s earnings and profits are considered first, but there is not direct authority supporting that conclusion.").

we recommend that Treasury and the Service adopt an Acquiring earnings and profits first approach.[72]

6. Section 304(b)(5)(A) Limitation

Treasury and the Service have also requested guidance as to whether a limitation similar to that provided in section 304(b)(5)(A) is appropriate in instances where the Exchanging Shareholder owns stock of Acquiring through attribution. The goal of section 304(b)(5)(A) is to prevent a U.S. shareholder from inappropriately claiming foreign tax credits in connection with a transaction described in section 304(a). In enacting section 304(b)(5)(A), Congress was concerned with a case where a foreign-controlled domestic corporation would sell the stock of a subsidiary to a foreign sister corporation and claim that it was entitled to a credit for foreign taxes paid by the foreign sister corporation even though the domestic corporation would not have been entitled to claim such credit if the foreign sister corporation had paid a dividend directly to the foreign common parent.[73] As a result, section 304(b)(5)(A) provides that in the case of an acquisition governed under section 304(a) in which the acquiring corporation is a foreign corporation, the only earnings and profits of the acquiring corporation taken into account for purposes of section 304 are those earnings and profits that are attributable to the stock of the acquiring corporation owned by a United States shareholder (within the meaning of section 951(b)) of the acquiring corporation and the transferor (or a person related to the transferor) and which were accumulated during the period or periods the stock was owned by such person while the acquiring corporation was a controlled foreign corporation.

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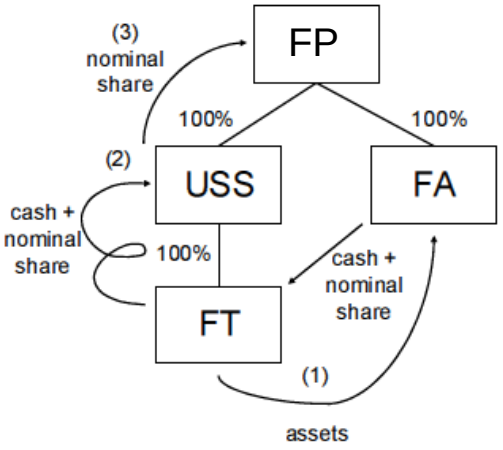
[72] The ordering rules of section 304(b)(2) also apply for purposes of section 306 in determining the amount of a dividend that would result from a section 351 exchange involving the receipt of section 306 stock. *See* § 306(c)(3). The Old Extenders Bill would have adopted our recommended approach by adding a specific cross-reference to section 304(b)(2) to section 356(a)(2). Old Extenders Bill § 422.

[73] *See* H.R. Rep. No. 105-148, pt. 2, at 465-66 (1997) (Conf. Rep.) (*citing* Rev. Rul. 91-5, 1991-1 C.B. 114 and Rev. Rul. 92-86, 1992-2 C.B. 199).

We believe that a limitation similar to the limitation provided in section 304(b)(5)(A) should apply for purposes of determining the deemed paid foreign tax credits to be taken into account under section 902 in connection with an All-Cash D Reorganization to prevent the Exchanging Shareholder from inappropriately claiming foreign tax credits. An example illustrating the considerations relating to the potential application of such a limitation is set forth below.

Example 5:

FP owns 100% of USS and 100% of FA. USS owns 100% of FT. FA acquires all of the assets of FT for cash and FT liquidates, in a foreign-to-foreign All-Cash D Reorganization.



The Treasury regulations under section 1.367(b)-7 provide general rules applicable to the carryover of earnings and profits and related foreign income taxes of a foreign acquiring corporation and a foreign target corporation in a foreign-to-foreign reorganization. Under the regulations, the qualifying earnings and taxes (the post-1986 undistributed earnings and related post-1986 foreign income taxes)[74] attributable to FA, a pooling corporation (a foreign corporation with respect to which the requirements of section 902(c)(3) are met), and FT would generally carryover to FA as the surviving corporation.[75] We believe it would be appropriate for Treasury and the Service to issue regulations that, in these

[74] Treas. Reg. § 1.367(b)-7(d)(1)(i).

[75] Treas. Reg. § 1.367(b)-7(d)(1)(ii).

circumstances, prevent USS from claiming a credit for foreign income taxes of FA under section 902. Allowing a foreign tax credit to be claimed in these circumstances is inconsistent with the general approach adopted under section 902(c)(3), which limits the post-1986 undistributed earnings and the post-1986 foreign income taxes of a foreign corporation for purposes of determining a domestic corporation's section 902 credit to the undistributed earnings and foreign income taxes of such foreign corporation arising in the period beginning on and after the first day of the first taxable year in which the ownership requirements under section 902 are met.[76] Therefore, for purposes of section 902, we recommend Treasury and the Service adopt a limitation similar to section 304(b)(5)(A), so that undistributed earnings and profits and income taxes paid by a foreign corporation are not taken into account if such earnings or taxes arise when the ownership requirements of section 902 are not satisfied.[77]

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[76] Section 902(c)(3).

[77] We note that this issue is not limited to the context of an All-Cash D Reorganization, but is also relevant in the context of foreign-to-foreign D Reorganizations generally. In addition, we note that Congress has recently provided for an alternative limitation in section 304(b)(5)(B), which provides that in the case of a cross-chain stock sale with a foreign acquiring corporation, no earnings and profits are taken into account under section 304(a)(2) if more than fifty percent of the dividends arising from such acquisition would neither be subject to tax for the taxable year in which the dividends arise nor be includible in the earnings and profits of a controlled foreign corporation. In enacting this provision, Congress was concerned with a transaction in which the earnings and profits of the foreign acquiring corporation permanently escaped U.S. taxation in a deemed distribution directly to a foreign transferor. We do not believe a limitation similar to the limitation provided in section 304(b)(5)(B) is necessary or relevant for purposes of section 902 in an All-Cash D Reorganization because the prevailing concern that the earnings and profits of a foreign acquiring corporation may bypass a domestic person in a cross-chain stock sale is not relevant for purposes of section 902.

C. Considerations Regarding PTI Under Section 959

Treasury and the Service are seeking comment as to whether and how, under section 959, an Exchanging Shareholder should be able to access PTI of foreign Target and/or Acquiring before any earnings and profits that are not PTI. This section (i) provides a brief overview of the application of section 959 in the context of the controlled foreign corporation rules; (ii) discusses the proposed regulations under section 959 and their application to section 301 distributions arising in connection with redemptions and cross-chain stock sales described in section 304; (iii) discusses the application of section 959 to section 356(a)(2) dividends; (iv) provides recommendations regarding the order in which PTI of Target and Acquiring should be taken into account; (v) provides a recommendation for accessing the PTI accounts of other members of the consolidated group; and (vi) provides a recommendation regarding the carryover of any PTI following an All-Cash D Reorganization.

1. Overview of Controlled Foreign Corporation Rules and Section 959

The controlled foreign corporation rules generally require each U.S. person that owns (directly or by attribution under section 958) ten percent or more of the voting power of the stock of a controlled foreign corporation (a "U.S. Shareholder") to include in income certain income of the controlled foreign corporation, regardless of whether the controlled foreign corporation distributes the income to its shareholders. Under section 951(a)(1)(A), each U.S. Shareholder generally must include in income the U.S. Shareholder's proportionate share of the controlled foreign corporation's "subpart F income." Under section 951(a)(1)(B), each U.S. Shareholder generally must include in income its pro rata share of the earnings of the controlled foreign corporation that are invested in U.S. property.

Section 959 is designed to prevent the double taxation of PTI. Section 959(a) provides that earnings and profits of a foreign corporation that a U.S. Shareholder previously included in income under section 951(a) are excluded from the U.S.

Shareholder's income when the earnings and profits are distributed (directly or indirectly through one or more foreign entities forming a chain of ownership described in section 958(a)) from the foreign corporation to the U.S. Shareholder.[78] Section 959(a) also excludes from income earnings and profits that a U.S. Shareholder has previously included in income under section 951(a) and that would otherwise be included in income again under section 951(a)(1)(B) as a result of the investment of the earnings in U.S. property.[79] Section 959(b) provides that earnings and profits that have been included in the income of a U.S. Shareholder under section 951(a) will not, when distributed through one or more foreign entities forming a chain of ownership described in section 958(a), be treated as gross income of a controlled foreign corporation for purposes of applying section 951(a) to the U.S. Shareholder. Section 959(c) provides an ordering rule for purposes of attributing distributions to various categories of earnings and profits, pursuant to which distributions are attributed (i) first, to PTI attributable amounts included in gross income under section 951(a)(1)(B), as a result of the investment of the earnings in U.S. property, and former section 951(a)(1)(C), as a result of the investment of the earnings excess passive assets ("959(c)(1) earnings and profits"); (ii) second, to PTI taken into account as subpart F income under section 951(a)(1)(A) ("959(c)(2) earnings and profits"); and (iii) finally, to earnings and profits that are not PTI.[80]

Section 959 and the Treasury regulations thereunder do not specify the treatment of PTI in connection with a reorganization described in section 368(a). As a general matter, if a foreign corporation acquires the assets of another foreign corporation in a transaction described in section 381, including an All-Cash D Reorganization, the Treasury regulations under section 367(b) provide that the earnings and profits and related foreign income taxes of the foreign target corporation carry over to the foreign

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78 § 959(a)(1).

79 § 959(a)(2).

80 § 959(c).

surviving corporation.[81] However, the Treasury regulations under section 367(b) reserve on providing guidance regarding the carryover of PTI.[82] The 2006 preamble indicates that the Treasury reserved on issuing regulations under section 367(b) addressing the treatment of PTI until more guidance was provided with respect to section 959.[83] In August 2006, Treasury and the Service issued the proposed section 959 regulations. In the preamble to the proposed section 959 regulations, Treasury and the Service requested comments regarding the proper extension of the principles in the proposed section 959 regulations to transactions governed under section 367(b).[84]

2. Proposed Section 959 Regulations

The proposed section 959 regulations require separate PTI accounts to be maintained at both the shareholder level and the corporate level.[85] Under the proposed regulations, each U.S. Shareholder must maintain separate PTI accounts with respect to its stock in a foreign corporation for the shareholder's section 959(c)(1) earnings and profits and section 959(c)(2) earnings and profits that are attributable to the foreign corporation.[86] A U.S. Shareholder must maintain a separate PTI account with respect to each share of stock in the foreign corporation, although the shareholder may aggregate

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81 *See* Treas. Reg. § 1.367(b)-7.

82 *See* Treas. Reg. § 1.367(b)-7(b)(2).

83 *See* T.D. 9273, 2006-2 C.B. 394.

84 *See* Preamble to the Proposed Regulations Under Section 959 (Aug. 29, 2006). In the Preamble, Treasury and the Service requested comments regarding the extension of the principles in the proposed section 959 regulations (including shareholder-level accounting of PTI and the PTI sharing rules) to Treasury regulations sections 1.367(b)-3 and 1.367(b)-7 as well as proposed Treasury regulations section 1.367(b)(8)).

85 Prop. Treas. Reg. § 1.959-3(a).

86 Prop. Treas. Reg. § 1.959-3(b)(1).

PTI accounts for blocks of stock.[87] In addition to the shareholder-level PTI accounts, the foreign corporation must maintain separate accounts for section 959(c)(1) earnings and profits, section 959(c)(2) earnings and profits, and earnings and profits that are not PTI.[88]

Although the proposed section 959 regulations do not provide rules regarding the treatment of PTI in connection with a reorganization described in section 368(a), the proposed regulations provide rules for the application of section 959 to a cross-chain stock acquisition described in section 304(a)(1) that is treated as a distribution to which section 301 applies.[89] The proposed section 959 regulations generally allow a "covered shareholder" that is a member of a consolidated group to access the PTI accounts of the other members of the group to the extent that a distribution of earnings and profits from a foreign corporation exceeds the covered shareholder's PTI account with respect to the foreign corporation.[90] For this purpose, a "covered shareholder" generally means (i) a U.S. person that owns stock in a foreign corporation (directly or by attribution through foreign entities under section 958(a)) and that has had a section 951(a) inclusion with respect to its stock in the foreign corporation; (ii) a successor in interest; or (iii) a corporation that owns stock (directly or indirectly by attribution through foreign entities under section 958(a)) in a foreign corporation but that has not had a section 951(a) inclusion with respect to the foreign corporation, if the corporation is a member of the consolidated group and another member of the consolidated group is a covered shareholder in the foreign corporation.[91]

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87 Prop. Treas. Reg. § 1.959-1-(d)(1).

88 Prop. Treas. Reg. § 1.959-3(b)(1) and (2).

89 Prop. Treas. Reg. § 1.959-3(h)(4).

90 Treas. Reg. § 1.959-3(g)(1).

91 Prop. Treas. Reg. § 1.959-1(b)(4).

3. Application of Proposed Section 959 Regulations to Cross-Chain Stock Sales and Redemptions Treated as Distributions

In the case of a cross-chain stock sale described in section 304(a)(1) that is treated as distribution to which section 301 applies, the proposed section 959 regulations allow a covered shareholder that is a member of a consolidated group to access the PTI accounts of the other members of the group with respect to each corporation that is treated as distributing its earnings pursuant to section 304(b)(2) (*i.e.*, the acquiring corporation and/or the issuing corporation).[92] Notwithstanding the requirement in the definition that a "covered shareholder" own stock in the foreign corporation (directly or by attribution through foreign entities under section 958(a)), an example in the proposed section 959 regulations provides that, in connection with an acquisition described in section 304(a)(1), a covered shareholder is permitted to access the PTI accounts of other group members with respect to the acquiring corporation even if the covered shareholder does not own stock in the acquiring corporation (directly or by attribution through foreign entities under section 958(a).[93]

The proposed section 959 regulations also provide rules for the reallocation of shareholders' PTI accounts in connection with a redemption of stock that is treated as a distribution of property to which section 301 applies. Under the proposed section 959 regulations, if a shareholder's PTI account with respect to the redeemed stock is greater than the amount that is charged to the account in connection with the redemption, then the remaining balance in the shareholder's PTI account is reallocated to the PTI accounts with respect to the shareholder's remaining stock in the foreign corporation, in a manner

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92 Prop. Treas. Reg. § 1.959-3(h)(4)(i).

93 *See* Prop. Treas. Reg. § 1.959-3(h)(4)(ii) (DS, a member of a consolidated group, is permitted to access the PTI account of DP, the parent of the consolidated group, with respect to the acquiring corporation even though DS does not own stock in the acquiring corporation (directly or by attribution under section 958(a)) as required by clause (iii) of the definition of "covered person").

consistent with the proper basis adjustments in the remaining stock under Treasury regulations section 1.302-2(c).[94]

4. Application of Section 959 to Section 356(a)(2) Dividends

If an Exchanging Shareholder that is a U.S. Shareholder recognizes gain under section 356(a) in connection with a foreign-to-foreign All-Cash D Reorganization, and all or a portion of the gain would be treated as a dividend under section 356(a)(2) but for the application of section 959, the amount treated as a dividend should be excluded from income under section 959 to the extent that such amount is attributable to the Exchanging Shareholder's share of PTI.[95] Treating a section 356(a)(2) dividend as a dividend for purposes of section 959 prevents the double taxation of PTI in connection with the reorganization. This result is consistent with the structure of the section 367(b) regulations, which exclude PTI from the section 1248 amount that an Exchanging Shareholder is required to include in income if the Exchanging Shareholder loses its status as a section 1248 shareholder in connection with a foreign-to-foreign reorganization.[96] Treating a section 356(a)(2) divided attributable to an All-Cash D Reorganization as a dividend for purposes of section 959 is also consistent with the treatment of cross-chain stock sales described in section 304(a)(1) under the proposed section 959 regulations.[97]

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94 Prop. Treas. Reg. § 1.959-3(h)(3).

95 The Service has ruled that gain treated as dividend income under 356(a)(2) is treated as dividends for purposes of section 959 in several private letter rulings. *See* Priv. Ltr. Rul. 93-27-010 (Mar. 25, 1993) (ruling #20), *corrected by* Priv. Ltr. Rul. 93-49-008 (Sept. 9, 1993) (ruling #20); Priv. Ltr. Rul. 91-18-004 (Jan. 30, 1991) (ruling #7); Priv. Ltr. Rul. 91-17-053 (Jan. 30, 1991) (ruling #7); Priv. Ltr. Rul. 89-52-048 (Oct. 2, 1989) (ruling #7); Priv. Ltr. Rul. 89-52-041 (Sept. 29, 1989) (ruling #7).

96 Treas. Regs. § 1.367(b)-4(b). PTI generally is excluded for purposes of determining the section 1248 amount. Treas. Regs. § 1.367(b)-2(c); § 1248(d).

97 *See supra* note 93 and accompanying text.

5. Taking Into Account PTI of Acquiring and Target

As discussed above, it is not clear under current law whether, in connection with an All-Cash D Reorganization, an Exchanging Shareholder is required to take into account the earnings and profits of Target or the earnings and profits of both Target and Acquiring for purposes of determining the amount of dividend income that the Exchanging Shareholder is required to take into account under section 356(a)(2). We have recommended that the Treasury and the Service adopt consistent rules for taking into account earnings and profits for purposes of section 356(a)(2) and section 902,[98] and we believe that section 959 should apply to gain that would be treated as a dividend under section 356(a)(2) (but for the application of section 959) in the same manner.

As a result, if, in connection with an All-Cash D Reorganization, only the earnings and profits of Target are taken into account for purposes of section 356(a)(2) and section 902, then only PTI attributable to Target should be taken into account for purposes of determining what portion of the gain that otherwise would be treated as a dividend under section 356(a)(2) should be excluded under section 959(a). However, if, in connection with an All-Cash D Reorganization, the amount of dividend income is determined by reference to the earnings and profits of both Target and Acquiring, the PTI of both Target and Acquiring should be taken into account. If the PTI of both Target and Acquiring should be taken into account, the question then arises whether the Exchanging Shareholder's PTI accounts should be aggregated and applied to offset the aggregate earnings of Target and Acquiring, which was the approach the Service adopted in at least one private letter ruling,[99] or whether the Exchanging Shareholder's PTI in Acquiring should be applied against the portion of the dividend that is attributable to the earnings and profits of Acquiring and the Exchanging Shareholder's PTI in target should be

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98 *See* Part III.B.4.

99 Priv. Ltr. Rul. 93-27-010 (Mar. 25, 1993), *corrected by* Priv. Ltr Rul. 93-49-008 (Sept. 9, 1993) (ruling # 20).

applied against the portion of the dividend that is attributable to the earnings and profits of Target. On the balance, we believe the latter approach is more appropriate because it matches PTI to the related earnings and profits, and is consistent with the approach of the proposed section 959 regulation to section 304 transactions, which appear to apply the acquiring and issuing PTI accounts separately against the deemed distribution from acquiring and issuing, respectively.[100]

6. Accessing PTI of Other Consolidated Group Members

We believe that, in connection with a foreign-to-foreign All-Cash D Reorganization, an Exchanging Shareholder should be able to access the PTI of other consolidated group members with respect to Target or Acquiring. Allowing the Exchanging Shareholder to access the PTI of other group members would be consistent with the proposed section 959 regulations' approach to section 304, which allows the transferring shareholder to access shareholder PTI accounts of the other members of the consolidated group, for both the issuing and the acquiring corporation.[101] As in the case of the section 304 example in the proposed section 959 regulations, we believe that the Exchanging Shareholder should be able to access the PTI of other group members with respect to Acquiring regardless of whether the Exchanging Shareholder owns any shares of Acquiring (directly or by attribution through foreign entities under section 958(a)), because the ability to access the PTI of another group member should not depend on whether the Exchanging Shareholder directly or indirectly owns any Acquiring shares.

Our recommended approach is illustrated in the following example.

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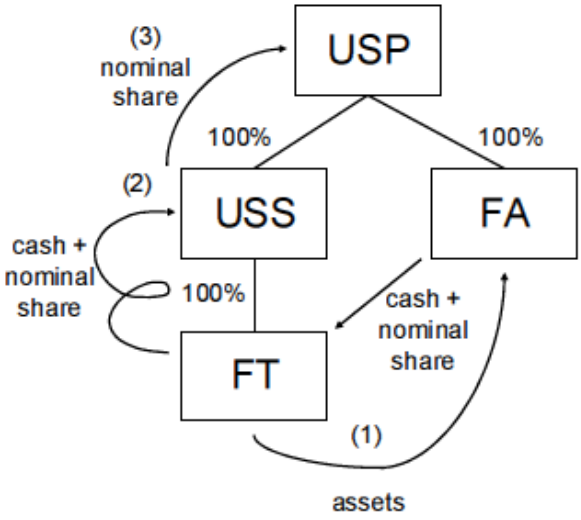
100 *See* Prop. Treas. Reg. §1.959-3(h)(4)(ii) (selling shareholder's attributed PTI account with respect to the acquiring corporation is applied against the deemed distribution from the acquiring corporation and the selling shareholder's actual PTI account with respect to the issuing corporation is applied against the deemed distribution from issuing).

101 *See supra* notes 92-93 and accompanying text.

Example 6:

Assume USP owns 100% of the stock of USS and 100% of the stock of Acquiring, and USS owns 100% of the stock of FT. USP and USS are members of a consolidated group. USS's shares in FT have a $100 value and a $50 tax basis. Assume that FA has $20 of PTI described in section 959(c)(2) and $10 of earnings and profits that are not PTI, and that FT has $10 of PTI described in section 959(c)(2) and no other earnings and profits. Acquiring purchases all of the assets of FT for $100 and thereafter FT liquidates in a transaction that qualifies as an All-Cash D Reorganization.



USS is not required to include in income the section 1248 amount because USS was a section 1248 shareholder in FT immediately prior to the reorganization and, immediately after the reorganization, USS is a section 1248 Shareholder in FA (by attribution under section 958(b)) and Acquiring is a controlled foreign corporation.[102] USS will recognize $50 of gain under section 356(a)(1). Assume that the amount of gain that is treated as a dividend under section 356(a)(2) is based on the earnings and profits of both FA and FT. In these circumstances, we believe USS should be treated as receiving a $30 distribution from FA. Since USS and USP are members of the same consolidated group, USS should be able to access USP's $20 of PTI with respect to FA and exclude $20 of the distribution from income under section 959(a). The remaining $10 should be treated as a dividend from FA. In addition, USS should be treated as receiving a $10 distribution from FT, which should be excluded from income under section 959(a). The remaining $10 of boot would be treated as gain from the sale of FT stock.

[102] *See* Treas. Reg. §§ 1.367(b)-4(b)(1), 1.367(b)-2(b).

7. Section 959(b) Recommendation

Issues similar to the ones discussed above in relation to section 959(a) arise under section 959(b) in connection with a foreign-to-foreign All-Cash D Reorganization, if the Exchanging Shareholder is a foreign corporation through which a U.S. Shareholder owns (directly or through one or more foreign entities under section 958(a)) Target shares. In this situation, unless an exception applies, we believe that any gain recognized in connection with the All-Cash D Reorganization that is treated as a dividend under section 356(a)(2) should be treated as subpart F income that is taxable to the U.S. shareholder under section 951(a)(1)(A).[103] Since treating the section 356(a)(2) dividend amount that is attributable to PTI as subpart F income would result in double taxation of the PTI, we recommend that the PTI of Target be taken into account for purposes of section 959(b) or, if the dividend amount under section 356(a)(2) is determined by reference to the earnings and profits of both Target and Acquiring, we recommend that the PTI of both Acquiring and Target be taken into account for purposes of section 959(b). As discussed above in relation to section 959(a), we believe our recommendation for section 959(b) is consistent with the approach of the proposed section 959 regulations to cross-chain stock sales described in section 304(a)(1), and that it is appropriate for All-Cash D Reorganizations to be subject to rules that are consistent with the rules applicable to transactions described in section 304(a)(1).[104]

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[103] In 2007, the Service issued a notice indicating that, for purposes of section 954(c)(6), the term "dividend" included gains treated as dividends pursuant to section 356(a)(2). *See* Notice 2007-9, 2007-5 I.R.B. 401. Although, the look-through rule provided in section 954(c)(6) is no longer applicable for tax years beginning after December 31, 2009 (unless the rule is extended), we believe the general principle expressed by the Service in Notice 2007-9 remains valid and that gain treated as a dividend under section 356(a)(2) should be treated as subpart F income under section 951(a). In addition, the Service has provided guidance that, for purposes of section 965 (temporary dividends received deduction), a cash dividend includes cash amounts treated as a dividend pursuant to section 356(a)(2).

[104] *See supra* notes 92-93 and accompanying text.

8. Recommendations Regarding Carryover of PTI

In connection with an All-Cash D Reorganization, an Exchanging Shareholder may have remaining PTI with respect to Target, after giving effect to reductions in PTI attributable to any section 356(a)(2) dividends that are attributable to an All-Cash D Reorganization. We believe that any remaining Target PTI should carry over to the Acquiring stock that the Exchanging Shareholder owns (directly or by attribution through foreign entities under section 958(a)), so that the Exchanging Shareholder's PTI carryover is available to exclude from income amounts that would otherwise be treated as dividend income or Subpart F income to the Exchanging Shareholder if the Exchanging Shareholder owns shares in Acquiring.

We believe the carryover of unused PTI in connection with an All-Cash D Reorganization to the Acquiring stock that the Exchanging Shareholder owns (directly or by attribution through foreign entities under section 958(b)) is appropriate because the shareholder may otherwise be subject to double tax on the PTI when Acquiring distributes its earnings. In addition, we believe the carryover of unused PTI to the Exchanging Shareholder's Acquiring stock is consistent with the approach of the proposed section 959 regulations to stock redemptions that are treated as dividends, pursuant to which the remaining balance in the Exchanging Shareholder's PTI account with respect to the stock that has been redeemed, after giving effect to the amount that is charged to the account in connection with the redemption, is reallocated to the PTI accounts with respect to the shareholder's remaining stock in the foreign corporation.[105]

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[105] *See* discussion in III.C.3, *supra*. We note that the NYSBA Report on Temporary and Proposed Regulations Regarding All-Cash Acquisitive D Reorganizations (Sept. 2009) suggested the approach of spreading the remaining basis of the transferor shares among all of the shares of the transferee (although noting the potential for inconsistent results where a *de minimis* amount of transferee stock is actually issued in the reorganization).

For reasons that are similar to those discussed in Part III.A, above, with respect to the section 1248 amount, we believe that attributing carryover PTI on a shareholder-by-shareholder basis or, consistent with the proposed section 959 regulations, on a share-by-share basis, is preferable to attributing an Exchanging Shareholder's carryover PTI to the nominal share deemed to be issued by Acquiring. Attributing carryover PTI to the nominal share would raise a number of technical issues, which do not arise under a shareholder-by-shareholder (or share-by-share) approach. For example, how would the Exchanging Shareholder be able to access the PTI if it was solely attributable to the nominal share? Would post-reorganization distributions from Acquiring to the Exchanging Shareholder be deemed to first be made with respect to the nominal share so that the Exchanging Shareholder could access the PTI? How would the PTI that is attributed to the nominal share be allocated among multiple Exchanging Shareholders?

Consistent with our recommendations regarding to the application of section 959 to amounts that would otherwise be treated as dividends or subpart F income under section 356(a)(2), we believe that carryover PTI attributable to an All-Cash D Reorganization should be available to exclude from income amounts that would otherwise be treated as dividend income or subpart F income even if the Exchanging Shareholder does not own Acquiring stock (directly or by attribution through foreign entities under section 958(a)), if the Exchanging Shareholder is the member of the same consolidated group as a corporation that owns Acquiring stock (directly or by attribution through foreign entities under section 958(a)). If carryover PTI is not taken into account, the consolidated group may be subject to double taxation on the carryover PTI when Acquiring distributes its earnings. We believe this recommendation is consistent with the proposed section 959 regulations, which allow a covered shareholder that is a member of a consolidated group to access the PTI accounts of other consolidated group members if a distribution of earnings and profits would exceed the covered shareholder's PTI.[106]

[106] Prop. Treas. Reg. § 1.959-3(g).

Under section 961, a U.S. Shareholder of a controlled foreign corporation generally increases its basis in the stock of the controlled foreign corporation owned by such U.S. Shareholder by the amount of subpart F income inclusions, and the U.S. Shareholder subsequently reduces its basis in the stock of the controlled foreign corporation when it receives a distribution of PTI. We note that, if PTI carryover is attributed to another member of the Exchanging Shareholder's consolidated group, appropriate basis adjustments will need to be made under section 961 when carryover PTI is distributed to the group member to which the PTI has been attributed.