REPORT #716

TAX SECTION

New York State Bar Association

Report on Section 304(b)(4)

Table of Contents

TAX SECTION

New York State Bar Association

April 16, 1992

The Honorable Fred T. Goldberg, Jr.
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Ave., N.W.
Room 3120
Washington, D.C. 20220

Dear Assistant Secretary Goldberg:

I enclose a report that addresses the appropriate content of regulations implementing Sections 304(b)(4) of the Internal Revenue Code. The principal draftsman of the report is Dennis E. Ross, previously co-chair of the Tax Section's Committee on Corporations.

Section I of the Report analyzes the background of Section 304, including the dubious rational for its application to corporate transferors and the abuse such application has spawned. It also discusses the legislative history of Section 304(b)(4) which was adopted in 1987 in order to prevent avoidance of corporate level tax on certain dispositions of appreciated subsidiary stock. Section II analyzes amendments to the consolidated return regulations that were adopted on March 13, 1992 and that provide that Section 304 does not apply to any acquisition of stock between members of a consolidated group. It concludes that the amendment is a reasonable exercise of the service's rulemaking authority. Section III analyzes certain transactions not addressed by the regulations, i.e., transactions between members of an affiliated, non-consolidated group. Finally, Section IV discusses the appropriate content of future regulations under Section 304(b)(4), proposing two alternative approaches that could be followed.

I hope that the report will be helpful to you and your staff. We would be pleased to discuss it with them at their convenience.

Very truly yours,

John A. Corry

Identical Letter Sent to
The Honorable Shirley Peterson

cc: The Honorable Shirley Peterson
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, DC 20224

Abraham N.M. Shashy, Jr., Esq.
Chief Counsel
Internal Revenue Service
Room 3026
1111 Constitution Avenue, N.W.
Washington, DC 20224

Alan J. Wilensky, Esq.
Deputy Assistant Secretary
of the Treasury for Tax Policy
3108 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Terrill A. Hyde, Esq.
Tax Legislative Counsel
Department of the Treasury
3046 Main Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Harry L. Gutman, Esq.
Chief of Staff
Joint Committee on Taxation
1015 Longworth House Office Building
Washington, D.C. 20515

New York State Bar, Tax Section
Committee on Corporations[1]

Report on Section 304(b)(4)

This report addresses the appropriate content of regulations implementing section 304(b)(4) of the Internal Revenue Code of 1986 (the “Code”). As is discussed in detail within, section 304(b)(4) was adopted in the Revenue Act of 1987 in order to prevent avoidance of corporate level tax on certain dispositions of appreciated subsidiary stock. The Internal Revenue Service has yet to promulgate regulations under section 304(b)(4), although amendments to the consolidated return regulations proposed in July of 1991 and finalized on March 13, 1992 (the “Regulations”) were intended to implement the policies of section 304(b)(4) in the context of an affiliated group filing a consolidated return.

Section I of the report analyzes the background of section 304, including the dubious rationale for its application to corporate transferors and the abuses such application has spawned. Section II analyzes the Regulations, concluding that they are a reasonable exercise of the Service's rulemaking authority. Section III analyzes certain transactions not addressed by the Regulations, i.e., transactions between members of an affiliated, nonconsolidated group. Finally, Section IV discusses the appropriate content of future regulations under

[1] The principal draftsman of this report is Dennis E. Ross, previously co-chair of the Committee on Corporations. Helpful comments were received from Laura Barzilai, Jose Berra, John Corry, Joel Hodes, James Peaslee, Richard Reinhold, Irving Salem and Michael Schler.

section 304(b)(4), proposing two alternative approaches that could be followed.

I. Background

1. Section 304

Section 304 of the Code applies to two general categories of transactions: (1) a sale of stock by the controlling shareholders of one corporation to another corporation controlled by the same persons (a "brother- sister" transaction); and (2) a sale of stock of a corporation to a controlled subsidiary of such corporation (a "parent-subsidiary" transaction). The scope of those transactional categories is greatly expanded by section 304(c), which tests for the necessary control based on the attribution rules of section 318.[2]

As has often been described,[3] section 304 was enacted as a backstop to the dividend/redemption tests of sections 301 and 302. Prior to the enactment of section 304, it was possible to draw earnings from a corporate group free of ordinary dividend consequences by selling the stock of a controlled corporation to another corporation within the group. *See*, *e.g.*, *John Wannamaker*, 11 T.C. 365 (1948), *aff'd per curiam*, 178 F. 2d 10 (3d Cir. 1949). The selling shareholder's economic ownership of the two corporations would be altered only in form, yet sale treatment

---

[2] The section 318 attribution rules are modified for this purpose, to, *inter alia*, attribute stock ownership to and from corporations based on 5% ownership instead of 50% ownership. Section 304(c)(3)(B).

[3] There is extensive literature on section 304, much of it generated in recent years. Notable articles include, Tiger, *Redemptions through the Use of Related Corporations: New and Old Problems under Section 304*, 39 Tax Law Review 77 (1984).

would provide the shareholder with basis recovery, and capital gain treatment to the extent the sales price exceeded the basis in the shares sold. Congress' initial response to such transactions was to adopt the provisions now reflected in section 304(a)(2), recharacterizing a parent-subsidiary sale as a redemption of the stock of the parent corporation. Section 304 was subsequently expanded to address brother-sister transactions, the principal focus of this report, through the provisions of current section 304(a)(1). Section 304(a)(1) recharacterizes a brother-sister sale as a redemption of the acquiring corporation's stock, with the shift in direct ownership of the acquired corporation's stock accounted for as a contribution to the capital of the acquiring corporation. Treatment of the distribution as a section 301 distribution or sale is determined by reference to the effect of the transaction on the transferor's interest in the acquired corporation, with the amount of any section 301 distribution treated as a dividend being determined as though the sale proceeds were distributed from the acquiring corporation, to the extent of its earnings and profits, and then from the acquired corporation, to the extent of its earnings and profits.[4]

Viewed with the modern eye, the concerns that section 304 addresses seem to some degree exaggerated, and the statute itself a kind of antique musketry, as likely to backfire on the fisc as to hit any intended taxpayer target. At the time of section 304's adoption, the maximum individual tax rate was nearly twice the maximum corporate rate. Such disparities had existed since the early days of the income tax, inviting use of

[4] Section 304 applies only if the transferor receives “property” in exchange for stock, and thus would not apply to the extent the sale proceeds represented stock of the acquiring corporation. See Bhada v. CIR, 89 T.C. 959 (1987), aff'd, 892 F. 2d 39 (6th Cir. 1990).

the corporate form either to accumulate income, and thus defer the high rates of individual taxation, or to convert such income to capital gain, and thus permit the shareholder to recover basis and receive a preferential tax rate. Over time, Congress responded with various measures designed to prevent such uses. Thus, the penalty taxes on accumulated earnings and personal holding companies were intended to force income from corporate solution and through the maw of the individual income tax. Similarly, conversion devices were addressed through a statutory chain of anti-”bailout” provisions, each designed, in one way or another, to prevent corporate earned income from being distributed to shareholders as capital gain.

The interaction of corporate and individual income tax rates, and the relative treatment of dividends and capital gain, has, of course, shifted radically since the time of section 304's enactment. The maximum corporate income tax rate now exceeds that applicable to individuals, and with the elimination of the General Utilities doctrine, the corporate form is far more likely to involve extra tax costs than shelter. As importantly, although capital transactions still permit basis recovery and thus a deferral of income, the preferential rate applicable to capital gains has largely been eliminated.[5] The practical consequence of these changes is readily reflected in recent years' legislative amendments to subchapter C of the Code. Attention has plainly shifted from means by which corporate income may escape individual taxation, to ensuring that such income is in fact subject to corporate level tax. The network of earlier anti-bailout provisions, of which section 304 is a part, are both of less practical consequence, and tied to a policy objective that,

[5] We note that the appropriate taxation of capital gain remains a matter of political and policy debate, and accordingly that the rough parity in the treatment of capital gain and ordinary income that has existed since 198 6 may not survive.

if not dubious altogether, is at least less urgent, i.e., ensuring that income earned in corporate solution is subject to a full, and prompt, additional round of taxation when distributed to individual shareholders.

If the anti-bailout policies of section 304 have elements of anachronism as applied to individual shareholders, the statute's application to a selling corporate shareholder has been a puzzle since its enactment. For corporations, the existence of the dividends received deduction,[6] and the elimination of dividends in a consolidated return context, typically make dividend treatment more advantageous than sale characterization. For corporate shareholders, section 304 has thus commonly served not as a sanction but as a planning tool, throwing the taxpayer into a briar patch of dividend treatment. Moreover, the importance of section 304 as a corporate planning tool has been enhanced over the same period that has seen a diminished significance for section 304 as an anti-bailout measure. As repeal of the General Utilities doctrine has left taxpayers foraging for alternative means to transfer appreciated assets free of current tax, increased attention has focused upon a corporation's ability under section 304 to transfer a subsidiary's stock with dividend consequences.

2. Section 304(b)(4)

Section 304(b)(4) requires “proper adjustments” to the stock basis and earnings and profits of members of an affiliated group in the case of a transfer of stock between members of the

[6] At the time of section 304's enactment, the generally applicable dividend received deduction was 85 percent, with a 100 percent deduction available for dividends paid between affiliated group members.

group that is subject to section 304.[7] Section 304(b)(4) does not itself specify the nature of the required adjustments, indicating only that the adjustments be made "to the extent necessary to carry out the purposes of this section."

The legislative history to section 304(b)(4) indicates that it was adopted as one of a series of amendments responding to so-called "mirror subsidiary" transactions. See H.R. Conf. Rep. No. 495, 100th Cong. 1st Sess. 966, 969-970 (1987). Although such transactions took a number of forms, they had as a common theme the avoidance or limitation of gain recognition upon a corporation's disposition of stock of a subsidiary corporation. Such disposition was typically part of the "bust-up" of a recently acquired target corporation, in which the acquirer stripped from the target assets that it did not wish to retain or, in many cases, needed to sell in order to finance the original acquisition.

The adoption of section 304(b)(4) and the other anti-mirror provisions was generally intended to remove any vestiges of the General Utilities doctrine that might have survived the 1986 Tax Reform Act. Thus, the various mirror techniques were judged by Congress to be inconsistent with the general requirement that corporate level gain be triggered upon a distribution to shareholders of appreciated assets. Although many argued that nonrecognition of gain on a disposition of a subsidiary's stock was not a serious policy problem where no increase was achieved in the subsidiary's asset basis, Congress eventually chose not to facilitate transfers of appreciated assets from a corporate group without current gain recognition.

[7] Section 304(b)(4)(B)(i) provides that the section 1504(a) definition of an affiliated group applies. The section 1504(b) exclusions (e.g., foreign corporations and life insurance companies) thus serve to narrow the scope of section 304(b)(4).

The particular transaction identified in the legislative history as illustrating the intended application of section 304(b)(4) involves a sale by a subsidiary member ("X") of an affiliated group of the stock of its appreciated subsidiary ("Y") to a sister member of the group ("Z").[8] As discussed below, the transaction would generally be treated as a brother-sister sale subject to section 304 and thus characterized as a distribution of the sale proceeds to X in redemption of Z stock and a contribution by X of the stock of Y to Z. The legislative history states that adjustments must be made to the stock bases of the members of the group so that neither X, Z nor any other group member in the same chain (save for the common parent) may thereafter be sold without recognition of the appreciation built-in to the stock of Y at the time of the original sale.

Consolidated Groups

1. Cousin-of-Mirror

The transaction identified in the legislative history was often referred to as "cousin-of-mirror", an allusion, of course, to the family of similarly purposed mirror techniques. The general fact pattern, which had been widely discussed in tax periodicals,[9] involved the common parent of a consolidated

---

[8] For ease of reference, the X, Y, Z fact pattern, adding P as common parent of the group, will be used throughout the report in discussing the application of section 304. In this respect, a reference to X will be to the transferor corporation, a reference to Z will be to the acquiring corporation, a reference to Y will be to the acquired corporation (or "issuing" corporation, in the parlance of section 304), and a reference to P will be to the corporation that owns X and Z.

[9] See, e.g., Bowen, et al., "Buyer Strategies for Disposing of Unwanted Assets", Practicing Law Institute Course Handbook Series No. 293; Axelrod, "Section 304, Excess Loss Accounts and Other Consolidated Return Gallimaufry", 36 Tax Notes 729 (August 17, 1987) (referred to hereinafter as "Axelrod").

group (P) planning to sell an appreciated first-tier subsidiary (X) but wishing to retain a second-tier subsidiary (Y) in the same chain. A distribution of Y to P in advance of the sale would both accrue a gain in respect of any appreciation in the stock of Y,[10] and reduce P's basis in X.[11] As a result, following P's subsequent sale of X, the group would have fully recognized gain in respect of appreciation in the stock of Y and/or of X.

The cousin-of-mirror technique, i.e., a sale of Y to a sister member of the group (Z), was intended to permit P to retain Y while selling X without recognizing gain in respect of either. Under a published ruling, X's sale of Y to Z would be treated as a brother-sister transaction subject to section 304. Thus, although X had no direct interest in Z, X would be deemed in receipt of a distribution in redemption of Z stock and would be treated as contributing the stock of Y to Z. Provided the distribution were treated as a dividend, which would depend on Z's (and/or Y's) earnings and profits and on the application of

[10] Although such gain would initially have been deferred under the intercompany transaction rules, it would have been triggered into income upon P's subsequent disposition of X. Treas. Reg. § 1.1502-13(c), (f).

[11] Prior to Notice 87-14, P's basis in X would have been reduced by the amount of the distribution, i.e.. the value of Y stock, and increased by X's gain on the Y stock, which would increase X's earnings and profits. Treas. Reg. § 1.1502-32(b). The net effect would have been a reduction in basis limited to X's basis in Y, even though X's value had been reduced by the full value of the Y stock. Where X was recently purchased, this would build a loss into its stock basis, which could offset the gain recognized on Y stock. This sequence of effects, the gist of the “son-of-mirror” transaction, was addressed in Notice 87-14. To the extent the gain in Y's stock was “built-in”, i.e., economically accrued at the time P acquired X, Notice 87-14 would have prevented a positive basis adjustment. Thus, the net reduction in P's basis in X, assuming the Y gain was entirely built-in, would have equalled the full value of the Y stock. More recently, Treas. Reg. § 1.1502-20 has addressed the same problem by generally prohibiting loss recognition on the sale of a subsidiary from a consolidated group.

section 302, it would shift earnings and profits from Z to X. Treas. Reg. § 1.1502-33 (c)(1).[12] The increase in X's earnings and profits, although possibly limited, as discussed below, to the appreciation in the Y stock, would generate a positive adjustment to P's basis in X pursuant to Treas. Reg. § 1.1502-32(b). Thus, P's basis in X would be increased, despite the fact that, because X was paid full consideration for the stock of Y, there had been no increase in X's economic value.

If X were a long-held subsidiary, with value in excess of stock basis, the increase in basis would leave P in a position to sell the X stock without fully recognizing the pre-existing gain. If, instead, as in the bust-up scenario, X were recently acquired with a basis equal to value, the positive adjustment would create a loss in the stock, which, prior to Notice 87-14 and the loss disallowance regulations, P could have recognized on its sale of X. Although the loss disallowance regulations now prevent P from recognizing such loss, the transaction would still accomplish a basic "mirror" objective, i.e., stripping appreciated assets from a recently acquired target corporation without triggering gain recognition upon a sale of the remaining "unwanted" assets.

[12] To the extent the deemed distribution exceeded Z's earnings and profits and were treated as distributed from earnings and profits of Y, the effects under the investment adjustment rules could be less favorable. If the distribution were treated as preceding X's deemed contribution of Y, or were otherwise tied to X's ownership of Y stock, it would reduce X's basis therein and as a consequence reduce X's earnings and profits. This would accordingly prevent a net positive adjustment to P's basis in X.

2. Interpretive Issues

Rev. Rul. 70-496. Although the cousin-of-mirror technique was widely discussed, and in receipt of the Service's apparent blessing on at least one occasion,[13] its use in practice faced a number of legal uncertainties. The "loophole" exploited by the cousin-of-mirror transaction was not a feature of the consolidated return regulations, but rather of the peculiar fictions of section 304, and, to some extent, of the Service's approach to them.

Much of the responsibility traces to Rev. Rul. 70-496, 1970-2 C.B. 74, the published ruling alluded to above, that dealt with facts similar to the cousin-of-mirror pattern. Corporation X, which was 70 percent owned by corporation P, sold all of the stock in its subsidiary Y to Z, which was 100 percent owned by P.[14] Since X controlled both Y and Z, the sale was treated as a section 304 brother-sister transaction. X's control of Z, however, was based on attribution rather than direct ownership, and thus the Service faced the question of how to apply Section 3 04 where the transferor had no direct ownership in the acquiring corporation. The Service resolved the threshold issue without discussion, treating Z as making a distribution directly to X, rather to P, the corporation which owned X's stock. This result conforms with the actual flow of funds, and reflects, moreover, the literal terms of the statute, which recharacterize a

[13] See PLR 8710035 (December 9, 1986).

[14] To assist presentation, the letter designations of the corporations in Rev. Rul 70-496 have been conformed with the X, Y, Z fact pattern used in this report.

transaction based on control, and determine control by reference to attributed as well as direct ownership.[15] The Service ruled at the same time, however, that because X had no direct ownership in Z, it would receive no credit for its basis in the Y stock deemed contributed to Z. Such basis instead “disappeared”, and X had gain under section 301(c)(3) to the extent the redemptive distribution exceeded Z's earnings and profits.[16] In effect, the Service ruled that the distribution to X was not to be treated as relating to any stock ownership in Z, even though it was to retain its character as a section 301 distribution.[17]

Rev. Rul. 70-496, of course, did not address the effects of its holdings under the investment adjustment rules, since, on its facts, X and Z were not members of a consolidated group. It is hardly surprising, however, that the ruling's discovery of an entirely disembodied distribution, i.e., one unrelated to any actual or deemed stock investment in the payor, would produce inappropriate results when transferred to the consolidated return context. The investment adjustment rules operate on more or less mechanical premises, and assume that the increase in a parent corporation's earnings attributable to its subsidiary's distribution of accumulated earnings is fully offset by a reduction in the parent's earnings attributable to the negative adjustment in the basis of the subsidiary's stock on account of the distribution. Thus, distributions of accumulated earnings are presumed to have no net effect on the recipient's earnings or

---

[15] See. e.g., Coyle v. U.S. 415 F. 2d 488 (4th Cir. 1968).

[16] Rev. Rul. 70-496 predated the adoption of current section 304(b)(2), which treats the distribution as a dividend to the extent of the combined earnings of the acquiring and acquired corporation.

[17] Rev. Rul. 70-496 provides that Z inherits X's basis in the Y stock deemed contributed. Since X is not a direct shareholder of Z, the logic of the ruling might have treated the transfer as a nonshareholder contribution which would, leave Z with a zero basis in the Y stock. Section 362 (c)(1).

thus on the basis in its stock.[18] The holding of Rev. Rul. 70-496 effectively contradicted that premise, and, as events proved, laid a foundation for future mischief.

Alternative Approach. Whether the holding of Rev. Rul. 70-496 is defensible is a matter for debate.[19] The various fictions of section 304 are plainly a jumble, and there may be no linear sequence of events that would fully account for each of the results deemed to occur. The interpretive difficulties are compounded when, as in Rev. Rul. 70-496, the transferor owns no stock in the acquiring corporation.

If there is no fully satisfactory approach to section 304 in this context, it nevertheless is clear that the holding of Rev. Rul. 70-496 is not compelled by the statute or regulations. Although X has no direct stock ownership in Z either before or after the transaction, it is literally treated under section 304 as having received a distribution in redemption of Z stock. Moreover, that stock is imbued with certain specific characteristics under the existing section 304 regulations, which, in the case of a distribution treated as a sale or exchange under section 302(a), treat the transferor as selling stock with a basis and holding period equal to that of the acquired corporation stock deemed contributed. Treas. Reg. § 1.304-2(a). There would thus seem a basis in the pattern of results under the statute and regulations for treating X as a

[18] Put another way, a subsidiary's earnings increase the parent's earnings in the year generated, and not upon distribution.

[19] The holding of Rev. Rul. 70-496 has generally been criticized by commentators. See, e.g., Axelrod, supra at 731; Oesterhuis and Hobbet, “Musings on Rev. Rul. 91-5 and Its Implication for Section 304 Transactions”, 50 Tax Notes 1291 (March 18, 1991). Moreover, we take the holding of Rev. Rul. 91-5, 1991-1 C.B. 114, allowing the transferor an indirect foreign tax credit on a section 304 deemed dividend despite an absence of direct ownership in the acquiring corporation, as evidence that the Service is itself does not fully adhere to Rev. Rul. 70-496.

shareholder of Z at the time of the deemed redemption, with a basis in the redeemed stock equal to its basis in the Y stock deemed contributed. Although this would leave unresolved certain, largely metaphysical questions concerning the origin of X's stock ownership in Z, it seems at least as plausible as the disappearing basis result of Rev. Rul. 70-496.[20]

Returning to the consolidated group context, if X were treated as actually holding Z stock, however briefly, the deemed redemptive distribution from Z to X could be tied to that stock and given effect under the investment adjustment rules. The distribution would then reduce X's basis in the Z stock, at least to the extent it was out of Z's accumulated (rather than current) earnings and profits.[21] Treas. Reg. § 1.1502-32(b)(2)(iii). Because reductions in basis in a subsidiary's stock reduce the shareholder's earnings and profits, such reductions tier up under the investment adjustment rules, and P's basis in X stock would be reduced to the same extent. Treas. Reg.§§ 1.1502-33(c)(4)(ii)(a); 1.1502-32(b)(2)(i). As a consequence, the deemed distribution from Z to X, again to the extent from Z's accumulated earnings, would have no net effect on X's earnings and profits or P's stock basis in X, the effect of the deemed basis reduction exactly offsetting the dividend.

[20] Since the section 304 regulations treat the transferor's deemed redemption as occurring “subsequent” to its capital contribution, a logical seeming approach might treat the acquiring corporation stock as issued in exchange for the deemed contribution. Constructing an actual exchange of acquired for acquiring corporation stock, however, would raise its own set of issues. Since the exchange would in many cases be unprotected by section 351, it would in such cases be difficult to rationalize nonrecognition treatment to the transferor, as well as the carryover basis and holding period results provided for in the regulations.

[21] TO the extent Z's current earnings would be allocated to the distribution, the distribution would not reduce X's stock basis, although it would reduce the amount by which P's basis in Z would otherwise be increased. Treas. Reg. § 1.1502-32(b)(2)(iii).

In addition, to the extent of any appreciation in the stock of Y, the distribution to X would exceed its basis in the fictional Z stock (again assuming basis equalling X's basis in the Y stock deemed to have been contributed). That excess distribution would generate an excess loss account with respect to the fictional Z stock redeemed from X. Although the matter is perhaps not entirely clear, it appears that the excess loss account would be triggered upon any subsequent sale or deconsolidation of X, Y or Z.[22] The net effect, then, of treating X as owning Z stock for purposes of the investment adjustment rules could eliminate much of the mischief achievable through the cousin-of-mirror transaction. In many cases, the deemed redemption and capital contribution, which cause no net shift in economic value, would not increase X's earnings and profits or P's stock basis in X.[23] Moreover, similar to the result if X had distributed the stock of Y to P, X could recognize gain equal to the appreciation in Y stock if X, Y or Z subsequently left the group.

Appreciation in Y Stock. As described above, the legislative history to section 304(b)(4) directed that implementing regulations ensure that appreciation in the Y stock at the time of its transfer to Z be recognized when the stock of X, Y or Z was sold. Although this directive no doubt reflects the legislation's focus on the bust-up scenario, it disregards the transaction's potential basis-shifting effects under the investment adjustment rules. These effects, which would offset gain on X where X stock was appreciated, were not necessarily

[22] Treas. Reg. § 1.1502-19(b)(2). Compare Axelrod, supra at 732, with VanderWalk, “Restructuring an Affiliated Group Using Section 304: The Effect of Insufficient Earning and Profits,” 65 Taxes 241 (April, 1987).

[23] Because, however, the transaction would retain its character as a distribution from Z to X, it would reduce the earnings and profits of Z despite the absence of change in its economic position.

dependent on the existence of appreciation in the stock of Y. In the transaction described above, the increase to X's earnings and profits is attributable to the deemed distribution from Z, which is measured by the value of Y stock and not X's basis or gain therein. Thus, in the case where Y stock was not appreciated, there was arguably the same potential for an artificial increase in the earnings and profits and basis of X, leaving P with the same opportunity to sell X at a reduced gain or at a loss.

An uncertainty in this respect is what effect X's deemed capital contribution to Z would have on X's earnings and profits. Under the view of Rev. Rul. 70-496 that X receives no basis increase in any asset on account of its capital contribution, X's economic wealth has been reduced by the contribution with no compensating deduction or capital charge. It should follow that X's earnings and profits would be reduced to the extent of its basis in the Y stock.[24] That reduction would in turn reduce P's basis in X, leaving a net increase in P's basis only to the extent of any appreciation in the stock of Y. To this extent, the basis shifting effect of the cousin-of-mirror technique would have been dependent on the transfer of an appreciated subsidiary.[25]

---

[24] See, e.g., Rev. Rul. 75-515, 1975-2 C.B. 117. Although X's economic wealth is reduced by the full value of the Y stock, the excess of value over basis would remain unrealized and thus should not reduce earnings and profits.

[25] This issue is discussed in Axelrod, supra at 731.

The loss of basis suffered by the transferor in Rev. Rul 70-496 was not, however, a necessary consequence of the transaction. The Service has ruled that basis will not disappear in a section 304 transaction, despite the absence of direct ownership in the acquiring corporation, if the transferor retains stock in the acquired corporation. Rev. Rul. 71-563, 1971-2 C.B. 175. Thus, if X retained some stock in Y, perhaps even a single share, its basis in the balance of the Y stock transferred should be added to the basis in the Y stock retained. Although X would suffer much the same economic loss with respect to the stock transferred, the earnings and profits effect should be deferred until the loss is recognized for taxable income purposes. Unlike the case where the basis has "disappeared," and thus will not be recognized as a loss at some future date, the addition of basis to the retained shares preserves the loss for later recognition. The same deferred accounting should apply for earnings and profits purposes, permitting a net increase in X's earnings and profits and P's basis without regard to whether the transferred Y stock was appreciated.[26]

Zenz Issues. A possible limitation on the use of the cousin-of-mirror technique was the risk that the deemed redemptive distribution would be characterized as a sale or exchange under section 302(a). If the deemed redemption of Y stock were treated as a sale or exchange, the dividend exclusion and costless boost in X's earnings and profits upon which the transaction is premised would no longer occur.

[26] The same result was reached in PLR 8710035 (December 9, 1986), although on a completely opposite analysis. Thus, the Service ruled that the retention of a share of Y's stock did not prevent the basis in the Y stock that was sold from "disappearing," but apparently did not require an earnings and profits adjustment to X as a result of the loss in basis.

As to whether the transaction would be treated as a sale or exchange, section 304(b)(1) provides that the tests of section 302 are applied by reference to the stock of the acquired corporation. In a sale between affiliates, the transferor's ownership of the acquired corporation would, by attribution, remain undiminished after the sale, resulting in section 301 treatment. In a cousin-of-mirror transaction, however, the sale between affiliates was generally a prelude to a sale of the transferor. Returning to the factual pattern above, if P were to sell X soon after X's sale of Y, pursuant to a previous understanding or agreement, it is possible that the transactions would be integrated for purposes of applying section 302 under the doctrine of Zenz v. Quinlivan. 213 F. 2d 914 (6th Cir. 1954). If so, X's interest in Y would be terminated, since there would no longer be a basis for attributing Z's post-transfer ownership of Y to X (through P). In order to avoid that result, the cautious taxpayer would have been forced to delay negotiations for a sale of X until after Y had been sold to Z.

II. The Regulations

On March 13, 1992, the Service finalized amendments to the regulations under section 1502 of the Code providing that section 304 would not apply to any acquisition of stock between members of a consolidated group. Treas. Reg. § 1.1502-80.[27] Thus, under the Regulations, a sale of stock between consolidated group members would not be recharacterized under section 304, but instead respected as a sale and subject to the rules governing deferred intercompany transactions. Although the Regulations do not purport to be an implementation of the "proper adjustments" rule of section 304(b)(4), the preamble states that the purposes of section 304(b)(4) can be realized, with less attendant complexity, if section 304 does not apply to sales of stock between consolidated group members.

1. Technical Issues

There is no question that the Regulations effectively respond to the specific concern addressed in the legislative history to section 304(b)(4). Since section 304 would not apply to X's sale of Y, it would be respected as a sale and accounted for under the deferred intercompany transaction rules. Under those rules, gain in respect of any appreciation in the stock of Y would initially be deferred, but would be triggered into X's

[27] The Regulations also contain amendments to Treas. Reg. § 1.1502-13T addressing the circumstances in which gain deferred from an intercompany transaction will be triggered into income. The amendments provide rules for the inclusion of deferred gain recognized upon an intercompany sale of a subsidiary in the event of a "disposition" of the subsidiary within the meaning of Treas. Reg. § 1.1502-19(b)(2). In general, the amendments require certain inclusions of deferred gain in circumstances where the subsidiary is deconsolidated, even though the group retained its original share holdings (e.g., through the issuance of new shares to an unaffiliated corporation). The proposed amendments would parallel provisions of Treas. Reg. § 1.1502-14T, concerning inclusion of deferred gain recognized upon an intra-group distribution of a subsidiary's stock.

income if the stock of X, Y or Z (or of any member above them in the same chain) was sold.[28]

In addition, regardless of whether the stock of Y is appreciated, treatment of the transaction as a sale would prevent any artificial increase in either the earnings and profits of X or in P's basis in X. X's earnings and P's basis would be increased only as and to the extent X recognized gain with respect to the Y stock. Given the loss disallowance regulations, any increase in P's basis in X would not produce a loss that would offset gain recognized in respect of Y or gain in the X stock that was unrelated to gain in Y.

2. Authority

The Regulations can be said in the above respects to hit their technical marks, which we believe include not simply the bust-up case illustrated in the legislative history, but also the basis-shifting effects that may shield appreciation in a long-held X.[29] On the other hand, the means chosen to these ends are plainly broader than Congress appeared to contemplate in adopting

---

[28] Creation of deferred gain in respect of the stock of a consolidated group member would appear to preclude as a practical matter the group from selling the member's stock in a subsequent transaction and electing asset sale treatment under Section 338(h)(10). The deemed liquidation of the member whose stock is sold would apparently trigger the stock gain, resulting in effective double taxation. Treas. Reg. § 1.1502-13(f)(6).

We note that the Service indicated in the preamble to the Regulations that it is studying this issue, which has previously arisen where the stock of a member is distributed within the group in a transaction subject to Section 311. The inability in such cases to achieve single level taxation on a subsequent deemed sale of assets is plainly counter to the purposes behind section 338(h)(10).

[29] Although the legislative history to section 304 (b)(4) reflects a particular concern with the separation of appreciated Y from X in a section 304 transaction, we do not believe there is any serious argument that section 304(b)(4) should be inapplicable where X is appreciated but Y is not. The statute reflects no such limitation on its face, and the example from the legislative history is identified as merely illustrative.

section 304(b)(4). Certainly there is nothing on the face of section 304(b)(4) that states or implies a mandate for the repeal of section 304 in the context of affiliated groups. Section 304(b)(4) requires “adjustments” as necessary to carry out the purposes of this “section”. Taken literally, that is a reference to the purposes of section 304, which are at best obscure in the context of an intercorporate transaction, and in any event suggest no rationale for making section 304 inapplicable in the context of affiliated groups.

If one, instead, reads the “purposes” referred to in section 304(b)(4) as the fairly specific “anti-mirror” objectives identified in the legislative history, there is still no direct support for repeal of section 304 with respect to affiliated groups. Section 304(b)(4) originated in a House bill that would have applied a somewhat altered set of fictions to a section 304 transaction between commonly controlled corporations.[30] See H.R. Conf. Rep. No 495, 100th Cong., 1st Sess. at 968. Thus, the stock sold would be treated as distributed by the transferor to the common parent and then contributed to the acquiring corporation, with the purchase price also deemed to return via distribution and contribution through the common parent. This approach, which in many respects would approximate sale treatment,[31] was rejected in conference in favor of the statute as enacted. The Conference Report suggests, moreover, that the proper adjustments were to be

---

[30] The House bill was far broader in scope than section 304(b)(4) as enacted, since it applied not simply to affiliated groups but to a broader category of commonly controlled corporations. As one consequence, the bill would have affected transactions in which the transferor, the acquiring corporation or both were foreign corporations.

[31] Perhaps most importantly, under this approach the deemed distribution to the common parent would have accrued a deferred gain in the stock sold, basis reduction in the selling corporation's stock, and a cost basis to the acquiring corporation.

developed within the framework of the basic recharacterization required by section 304. See. H.R. Conf. Rep. 100-495, 100th Cong., 1st Sess. at 969-970.[32]

It is our understanding that the Service itself does not believe that section 304(b)(4) authorizes a repeal of section 304 with respect to affiliated groups. This belief is no doubt reflected in the fact that the Regulations were not promulgated under section 304, but rather as an amendment to the consolidated return regulations. This is not a complete response to the authority question, however, since it is an assertion of the Service's authority under the consolidated return regulations simply to void the application of a basic statutory provision.

The question of the Service's authority under the consolidated return regulations has, of course, received both recent and vigorous attention in connection with the now finalized loss disallowance rules of Treas. Reg. § 1.1502-20.[33] While the question continues to trouble a broad spectrum of tax professionals, we do not believe the Regulations create significant additional cause for concern. Thus, we believe the Regulations are a reasonable exercise of the Service's rulemaking authority under section 1502, taking account not only of the purposes of section 304(b)(4), but, as importantly, of the

---

[32] On the other hand, the same report states that no inferences were intended as to the Service's authority to amend the consolidated return regulations consistent with the purposes of section 304(b)(4). Although the intention of that statement is not entirely clear, it may well indicate a recognition that a different technical approach to cousin-of-mirror transactions may have been appropriate in the context of a consolidated group.

[33] See The New York State Bar Association Report on Treasury Regulation section 1.1502-20, Tax Notes Today (91 TNT 37-21), February 19, 1991.

limited rationale for applying section 304 in the domestic corporate sector.[34]

As discussed above, the dividend generating effects of section 304 for corporate taxpayers seem an incidental consequence of the statute's purpose to prevent earnings bailouts by individual shareholders. Within a consolidated group, where dividends are excluded, and gains on intra-group transactions deferred, the rationale for recharacterizing sales as distributions seems additionally remote. Perhaps section 304's principal historical function in this context has been to permit transfers of subsidiaries within a group without creating deferred gains. Although there may be substantial policy arguments that such nonrecognition, carryover basis stock transfers should be permitted, Congress decided otherwise when this specific issue was raised in 1984.[35] Moreover, as indicated in the legislative history to section 304(b)(4), it was this precise aspect of section 304 that Congress intended to change. See H.R. Conf. Rep. No. 495, 100th Cong. 1st Sess. at 969-970.

Finally, we believe that the “simplification” rationale alluded to in the preamble to the Regulations is, in this case, persuasive. Although there may be practical differences between a repeal of section 304 for consolidated groups and the basis and earnings and profits adjustments authorized under section

[34] The Regulations and section 304(b)(4) do not address cases in which the transferor or acquiring corporation are foreign, since such transactions would not involve transfers between members of an affiliated group under section 1504(a). The report, for that reason, does not address section 304's application in the foreign context. Since the interaction of section 304 with the variety of special rules applicable to foreign corporations directly or indirectly owned by U.S. corporations raises a number of distinct issues, the questions raised in this report about section 304's application to transactions between domestic corporations have no necessary bearing on its appropriateness in a foreign context.

[35] See The Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1984, p. 152 (1984).

304(b)(4), we believe the Regulations can be seen as a reasonable, if not exact, proxy for a more complicated set of specific adjustments under section 304(b)(4).

Thus, the Service, whether operating under section 304(b)(4) or by revisiting the holding of Rev. Rul. 70-496, could have roughly approximated the deferred gain consequences that result from treating the transfer of the acquired corporation's stock as a sale at the outset. As discussed above, had a different approach been taken in Rev. Rul. 70-496, the deemed redemptive distribution of acquiring corporation stock might have been treated as generating an excess loss account to the extent of appreciation in the acquired corporation's stock. An excess loss account is not the exact equivalent of a gain that is recognized but deferred under the intercompany transaction rules, but has many of the same characteristics. Moreover, creation of an excess loss account for the transferor might have been supplemented with specific basis adjustments under section 304(b)(4) to ensure that gain in respect of the acquired corporation stock would be recognized in the event the excess loss account were eliminated without recognition of gain.[36]

[36] If, for example, Z were completely liquidated under section 332, any excess loss account in its stock would be eliminated. Treas. Reg. § 1.1502-19(e). Absent basis adjustments under section 304(b)(4), this would leave P free to sell the stock of X without triggering gain recognition in respect of the Y stock.

In sum, whatever practical differences there are between the approach of the Regulations and the results that might have been achieved working through section 304, they are not so substantial as to be inconsistent with the results generally intended under section 304(b)(4).[37] Taking account of that fact, and of section 304's generally problematic application in the domestic corporate sector, we believe the Regulations have sufficient grounding in basic corporate tax policies to represent a reasonable exercise of the Service's rulemaking authority under section 1502.

III. Nonconsolidated Groups

1. Cousin-of-Mirror II

Section 304(b)(4) applies to affiliated groups without regard to whether the group files a consolidated return. There is, of course, no direct analogue to the investment adjustment rules for affiliated groups that do not make the consolidated return election. The cousin-of-mirror technique may be equally available, however, and to some extent more advantageous, for an affiliated group not making a consolidated return election. Application of section 304 again permits an appreciated subsidiary to be separated from its parent without recognition of gain. In addition, the transaction could achieve earnings and basis shifting effects similar to those under the in-vestment adjustment rules, and yet would be free of the restrictions imposed on consolidated groups under the loss disallowance regulations.

[37] In reaching that conclusion, we have assumed that the “netting rule” of Treas. Reg. § 1.1502-20(a)(4) would permit the deferred gain or loss recognized on an intragroup sale to be offset against any loss or gain recognized on a subsequent sale of the stock outside the group.

Assume the same group of corporations described above, and that the group has not made the consolidated return election. X again sells the stock of Y to Z, in a transaction again recharacterized under section 304 as a contribution of the Y stock to Z and a deemed distribution to X in redemption of Z stock. Since X is deemed to transfer Y to Z by capital contribution, a potentially appreciated asset has been stripped from X without recognition of gain, the bust-up objective common to mirror transactions.

In addition, however, and regardless of whether Y stock is appreciated, the transaction may enable P to shelter pre-existing appreciation or create a loss in the X stock. Thus, assuming sufficient earnings and profits in Z (and/or Y), and that the tests of section 302 are navigated, X is in receipt of a dividend that should be entitled to a deduction under section 243.[38] At this point, since the value of X would not have changed and the dividend from Z to X would not affect P's basis in X, a sale of X by P would trigger whatever appreciation previously

[38] There is some question as to the availability and level of deduction that would be permitted. Since X owns no stock in Z, it literally could fail the 45 day holding period requirement of Section 246(c)(1) and thus be denied a deduction altogether. This plainly conflicts, however, with the approach of Rev. Rul. 91-5, supra, in which the transferor was allowed the indirect foreign tax credit on a deemed dividend under section 304 despite having no direct ownership in the acquiring corporation. In support of its conclusion, the ruling cites legislative history to the effect that a foreign tax credit or dividend received deduction would be allowed to deemed distributions under section 304 to the same extent as if the distribution "had been made directly." As to the level of the deduction, section 243 allows a 100 percent deduction for "qualifying dividends," defined generally as dividends between affiliated group members attributable to earnings and profits from years in which the members were affiliated. Thus, in the case of a long-held X, the entire dividend could receive the deduction. Where X was recently acquired, the deduction would be limited to 80 percent, assuming X would be treated as owning 20 percent of Z. Section 243(c).

existed in the X stock. Having received both cash and an increase in its earnings and profits,[39] however, X is in a position to distribute to P the value of the Y stock as a dividend. That dividend would also be sheltered by the deduction under section 243,[40] and, assuming that the basis reduction rules of section 1059 would not apply, appreciation in the X stock would be eliminated to the extent of the dividend, and a loss created to the extent the dividend exceeded such appreciation.[41]

2. Section 1059

As with cousin-of-mirror in a consolidated return context, the viability of the above transaction turns on the collateral significance accorded events deemed to occur by section 304; in particular, how the deemed redemption of Z stock is treated under the provisions of section 1059.[42] Section 1059 applies generally to the receipt of an “extraordinary dividend” by a corporate shareholder on stock that it has not held for more than two years. The amount of such dividend excluded from income under section 243 is applied to reduce the shareholder's basis in the stock. Where the excluded dividend exceeds basis, the excess

---

[39] AS discussed above at note 24, if X receives no credit for its basis in Y, the increase to its earnings and profits could be limited to any appreciation in the Y stock. Such limitation should be avoided, however, if X retains any Y stock to which otherwise disappearing basis could be added.

[40] Since P directly owns X, it would be entitled at least to an 80 percent deduction. Moreover, P arguably would be entitled to a 100 percent deduction even if X were recently acquired. Since X's current earnings would have been increased by the deemed dividend from Z, and thus would likely be the source of the dividend to P, the dividend would to that extent appear to be attributable to earnings of a year in which X and Z were affiliated for purposes of the qualifying dividend definition.

[41] The Zenz issues discussed above with respect to consolidated groups would also affect the viability of the cousin-of-mirror transaction in a nonconsolidated context. Thus, X's sale of Y could be characterized as a section 302(a) redemption if it was followed closely by a sale of X.

[42] Freeman, Response to Loss Disallowance: Partial Deconsolidation, 47 Tax Notes 1349, 1362-1365 (1990), discusses these issues at length.

creates a deferred gain account that must be recognized upon a "disposition" of the stock.

Section 1059 potentially applies at two points in the above transaction, i.e., either with respect to the deemed redemption of Z stock or to X's subsequent distribution to P. The application of section 1059 to X's actual distribution to P would be straightforward. Provided that P has owned the X stock for over two years, section 1059 would not apply. Section 1059(a). Thus, in the case of a long- held X, basis reduction in X's stock would be avoided. In the bust-up situation, where X is recently acquired, P would be required to "age" its ownership of X before taking out a dividend. Although this would, of course, also delay the time at which X could be sold,[43] such delay could well be an acceptable condition where the tax advantages were significant.

The difficult issues concerning section 1059's application relate to the deemed redemption of Z stock. On its face, application of section 1059 to that distribution would not affect the benefits of the transaction to P, since P's basis in X would not be reduced on account of a distribution to X. The deferred gain rules of section 1059, however, could require X to recognize gain that would more than offset gain avoided by P on its sale of X stock.

Although the matter is anything but certain, there is some basis for treating the deemed redemption of Z stock as an extraordinary dividend subject to section 1059. The distribution would plainly satisfy the quantitative test of section 1059(c). In addition, since X does not own Z stock before the transaction,

[43] As discussed above, some delay in the sale of X could be necessary to prevent the risk that a sale of X closely following the section 304 transaction would cause the deemed redemption to be treated as a sale or exchange under Zenz v. Quinlivan principles.

it arguably would not meet the exception for stock held more than two years. Moreover, even if X were deemed to satisfy the required two year holding period,[44] the distribution would arguably be a nonpro rata redemption, which is treated as an extraordinary dividend without regard to the holding period of the stock.[45] Section 1059(e)(1).

If the deemed redemption of Z stock were treated as an extraordinary dividend, causing basis reduction under section 1059, the consequences to X could be onerous. Returning again to Rev. Rul. 70-496, X might be treated by the Service as having no basis in the Z stock redeemed, so that the reduction would generate a deferred gain account equal to the entire amount of the distribution treated as a nontaxable dividend. Since X's deemed stock ownership of Z does not survive the transaction, a “disposition” would arguably occur for purposes of section 1059(a)(2), causing prompt recognition of the deferred income. As a consequence, the benefit to P of the overall transaction would be more than fully offset, since X would recognize taxable dividend income and gain equal in total to the full value of the Y stock, and not simply the excess of its value over basis. Had X

---

[44] As noted above, Rev. Rul. 91-5 supports treating X as having a holding period for purposes of the dividend received deduction in the Z stock treated as redeemed. This conclusion rests at least in part on legislative history directly addressing availability of the deduction for a deemed distribution under section 304. Although there is no similarly explicit evidence concerning section 1059, the logic of the ruling's approach would support a holding period for X's fictional Z stock based either on the period X held the transferred Y stock or on P's holding period in z.

[45] The deemed redemption of Z stock would avoid section 1059 under the exception for “qualifying dividends” if it were attributable to earnings from the period during which X and Z were in the same affiliated group. Section 1059(e)(2). That exception would be of little value where X was recently acquired, however, and even in the case of a long-held X, the exception could be unavailable if there were any significant period in which X and Z were not affiliated. See H.R. Rep. No. 795, 100th Cong., 2d Sess. 42 (1988), stating that section 1059(e)(2) should be applied consistently with section 1059(d)(6), which excepts from section 1059 dividends with respect to stock held during the entire existence of the distributing corporation.

simply distributed the Y stock to P in a taxable spin-off,[46] X's gain would, of course, have been limited to the appreciation in Y. Moreover, if X had significant pre-existing earnings, a distribution of Y to P would have achieved the same shelter under the dividend received deduction as would a distribution of sale proceeds to P in the cousin-of-mirror transaction. In such circumstances, application of section 1059 as described above makes treatment under section 304 a good deal harsher than an alternative of near equivalent economic substance.

The application of section 1059 as described above is, however, far from clear. At the threshold, it is unclear that X's deemed and transient ownership of Z stock should be accorded significance for purposes of section 1059. Although, denying X basis in the redeemed Z stock makes section 1059’s application quite onerous, it also weakens the case that it should apply at all. The arguably implicit holding of Rev. Rul. 70-496 is that the transferor is never actually a shareholder of the acquiring corporation. This arguably would preclude application of section 1059, which requires a distribution “with respect to any share of stock” and causes a reduction in “the basis of such stock”.[47]

A more plausible case for section 1059's application might exist if, contrary to Rev. Rul. 70-496, X were given basis in the Z stock on account of its deemed contribution to Z. On

---

[46] A spin-off of Y to X would be taxable in any case where P had purchased X within five years of the spin-off. Section 355(b)(2)(D).

[47] Additional support for the nonapplication of section 1059 might arguably be drawn from Broadview Lumber, 561 F.2d 698 (7th Cir. 1977), and a line of similar cases, which have generally limited the collateral effect of fictional events under section 304. See Webb v. CIR, 67 T.C. 293 (1976), aff'd per curiam, 572 F.2d 135 (5th Cir. 1978); cf. Continental Bankers Life Ins, v. CIR, 93 T.C. 52 (1989). Broadview Lumber, however, addressed the consequences of a taxpayer other than the transferor, and its rationale in important part was that section 304 was generally intended to address the tax treatment of the transferor. Section 1059's application in this context concerns only the transferor.

this model, however, section 1059 leaves the earnings and basis shifting advantages of the cousin-of-mirror transaction unaddressed. By allowing X credit for its basis in Y, basis reduction under section 1059 produces a deferred gain account limited to the appreciation in the stock of Y (less any taxable portion of the dividend). Although this would be a sounder result as to X's amount of gain recognition, it would permit X, to the extent of its basis in Y, to increase its earnings and profits without regard to any recognized gain or change in economic position. Thus, where a taxable spin-off of Y would have increased X's earnings only to the extent of its recognized gain, the cousin-of-mirror transaction permits an increase, depending on the earnings and profits of Z, up to the full value of Y.

This aspect of the transaction is illustrated most plainly in the case where Y is unappreciated. If X had distributed unappreciated Y to P, the X earnings and profits available for such distribution would not have been increased. Since any excess of Y's value (i.e., the amount of the distribution to P) over X's earnings and profits would reduce P's basis in X or produce a gain, the net benefit to P on a subsequent sale would be limited to X's pre-distribution earnings and profits. The cousin-of-mirror transaction increases that limit by the earnings and profits of Z up to the full value of the Y stock, in effect allowing X to pay a dividend to P drawing not only on its own but also on Z's earnings and profits.[48]

---

[48] Since the distribution to X would be treated as a dividend to the extent of the acquiring or acquired corporation's earnings and profits, the transaction actually permits P to draw a dividend from X, Y or Z. Since Y is X's wholly-owned subsidiary, however, the expansion of X's earnings to include those of Y may be less troubling.

IV. Future Regulations

1. Need for Issuance

The preamble to the Regulations states that affiliated group section 304 transactions not subject to the Regulations remain subject to the "proper adjustments" requirement of section 304(b)(4). Given that the Service took a number of years before issuing the rather simply stated rule of the Regulations, and that the rationale for its issuance rested significantly on the complexity of specific rules under section 304(b)(4), it would seem a fair surmise that regulations under section 304(b)(4) are not imminent. Since the great majority of affiliated groups currently elect the privilege of a consolidated return and thus would be subject to the Regulations, it would be understandable if the Service has not attached a high priority to rules addressing transactions not covered by the Regulations. It is worth noting, however, that recent actions of the Service, particularly the loss disallowance regulations, have added significant costs to the consolidated return election. In due course, the election may no longer be a routine matter for affiliated groups, and the population not covered by the Regulations could accordingly expand.[49]

---

[49] We note as well that consolidated group section 304 transactions occurring before July 24, 1991 are not addressed by the Regulations, although such transactions occurring after March 31, 1988 remain subject to section 304(b)(4). This body of additional cases does not make issuance of regulations under section 304(b)(4) a matter of urgency, but is further reason that the Service will in due course be required to address the topic.

2. General Paramaters

Before discussing the specific nature of regulations under section 304(b)(4), two general observations are in order. The first is that not all of the mischief achievable under the cousin-of-mirror technique is a product of section 304. In particular, the transaction in certain circumstances takes advantage of the fact that, by virtue of the dividend received deduction, even as limited by section 1059, a corporation may draw earnings from an affiliated subsidiary without either recognizing income or reducing its basis. In the paradigm case of a long-held subsidiary, this ability serves only to prevent double taxation of the same income within an affiliated group. Where the subsidiary is more recently acquired, however, such that its earnings are already reflected in the parent's cost basis for the stock, the dividend received deduction, assuming section 1059 is avoided, may enable the parent to shelter gain or create a noneconomic loss on a subsequent sale.[50] Section 304 expands this potential by permitting additional earnings to be shifted to the subsidiary.

The second general point is that the issues raised by the cousin-of-mirror technique are not confined to affiliated groups. Although the tax efficiency of the transaction could be enhanced by the 100 percent deduction available for certain

---

[50] On the same basis, the “son-of-mirror” technique remains available in the nonconsolidated group context. Thus, assuming P has purchased X which owns appreciated subsidiary Y, distribution of Y to P will cause gain recognition to X under section 311(b), but will also increase X's earnings and profits. To the extent the distribution (assuming it occurs more than 2 years after the purchase) is treated as a dividend and sheltered under section 243, P will have diminished the value of X without reducing its cost basis in X stock. A loss recognized on a subsequent sale of X by P may thus serve to “offset” (albeit not through consolidation) gain recognized to X on the distribution.

dividends between affiliated group members, transactions between nonaffiliates might still generate significant advantages relying on an 80 percent or 70 percent deduction. Recent years have illustrated, moreover, that a group may be willing to disaffiliate a group member, given that disaffiliation can be achieved without substantial sacrifice of economic interest or control, in order to achieve a particular tax objective. If the advantages were perceived as substantial, similar restructuring could be undertaken to avoid the application of section 304(b)(4).

3. Section 1059

A threshhold issue in determining the content of regulations under section 304(b)(4) is what application section 1059 has to intra-group section 304 transactions. As discussed above, requiring basis reduction under section 1059 would ensure that the transferor in a cousin-of-mirror transaction recognizes income in respect of the appreciation in the acquired corporation's stock. Assuming that X were allowed credit for its basis in the stock of Y,[51] reduction of its basis in the stock of Z treated as redeemed would produce a deferred gain account which, together with any taxable dividend amount, would equal the appreciation in the Y stock. Thus, X would have eventual income recognition equal in amount to the gain it would have recognized on a sale or other taxable disposition of Y.

---

[51] This, of course, would require that the Service abandon one aspect of the holding in Rev. Rul. 70-496, a result we believe is appropriate.

Although section 1059 could provide a basis for rational tax treatment, it would be a technical stretch to apply its provisions consistently to cousin-of-mirror transactions.[52] In particular, given the general two year holding period test of section 1059, it would appear difficult to require basis reduction in intra-group section 304 transactions where X, Y and Z had been affiliated for over two years. Although the effect of the holding period test is not certain where, as in a cousin-of-mirror transaction, the dividend recipient has no actual ownership in the paying corporation, X's holding period in the fictional Z stock, for reasons noted above, should take account either of the period Y stock has been owned by X or the period Z has been owned by P.[53]

In addition, we believe it would be inappropriate to attempt to apply section 1059 to cousin-of-mirror transactions on the basis that the deemed redemption of Z stock is a nonpro rata redemption, which is subject to section 1059 without regard to holding period. The rationale for the nonpro rata redemption rule is not clear from the statute or its legislative history. Nothing suggests, however, that it would have been intended to routinely bring inter-corporate section 304 transactions within section 1059. Moreover, if, as suggested above, the consequences of a section 304 deemed dividend are determined by reference to affiliated group ownership where the recipient has no direct ownership in the paying corporation, application of the nonpro

---

[52] In order to produce a fully rational scheme, the basis reduction effects of section 1059 would have to be supplemented with other basis and earnings and profits adjustments. Such adjustments could be authorized under section 304(b)(4) and should include adjustments to the earnings and profits of X and Z that would approximate the results of a taxable disposition of Y by X.

[53] See notes 39 and 44, supra.

rata redemption rule of section 1059 would be questionable in cases in which ownership of Z was entirely within the group.

4. Alternative Approaches

Although a technical analysis does not support routine section 1059 basis reduction for cousin-of-mirror transactions, we believe roughly parallel results are independently authorized under section 304(b)(4). Indeed, we believe section 304(b)(4) provides the Service with clearer authority, and greater flexibility, in providing for gain recognition that is appropriate both in amount and timing. Although section 304(b)(4), unlike section 1059, is limited in its application to transactions within an affiliated group, we believe that in that context the adjustments it authorizes provide a better targeted and ultimately sounder response to cousin-of-mirror transactions.

The Service should also consider, however, whether section 304(b)(4) should be employed simply to layer a gain recognition rule upon the already cumbersome mechanical fictions of section 304. Although this approach is plainly faithful to the statute and its legislative history, we believe the Service's authority under section 304(b)(4) would enable it to move the tax consequences of affiliated group cousin-of-mirror transactions even closer to actual sale treatment. Although such use of its authority might be viewed as aggressive, we believe it is defensible both as a technical and policy matter.

Distribution/Deferred Gain. The most straightforward approach to section 304(b)(4) would require basis and earnings and profits adjustments to ensure eventual gain recognition in respect of the Y stock, while retaining the tax consequences of the redemption and capital contribution deemed to occur under the basic statutory framework. Although the point is not addressed in the legislative history, gain in respect of the Y stock ought properly to be recognized by X rather than Z or another member of the group, since it would have accrued economically at the time of Y's transfer. Although this result conflicts with the fiction of X having contributed Y to the capital of Z, we believe the Service's authority under section 304(b)(4) permits it to require eventual gain recognition by X. The vehicle for such recognition would be the fictional stock in Z which section 304 deems to have been redeemed from X. In order to generate a deferred gain for X, basis in the fictional Z stock could be "adjusted" so as to produce a "negative basis" equal to any appreciation in the stock of Y.[54] Such account would be taken into income upon any subsequent event which would result in X and Y not being members of the same affiliated group.[55] In order that this not produce a duplication of gain, Z's basis in the stock of Y would be increased to its fair market value at the time of the transfer.[56]

[54] The basis adjustment required would depend on X's basis in the fictional Z stock, the issue addressed in Rev. Rul. 70-496. In addition, although X's gain recognition on its transfer of the Y stock is arguably independent of the consequences of the deemed distribution from Z, it would seem appropriate that the amount of the adjustment be reduced to the extent of any gain recognized by X under section 301(c)(3).

[55] The legislative history refers to gain recognition at the time X, Z or members above them in the group are sold. We believe the somewhat different trigger of disaffiliation would be easier to administer where there is a partial disposition and is equally sound as a policy matter.

[56] In the case where X and Z are affiliated with each other but not with Y, section 304(b)(4) would apply to the transaction but would not literally authorize basis adjustment for the stock of Y, a non-group member. This would seem a glitch, perhaps traceable to the fact that section 304(b)(4) as originally enacted applied only to transfers of stock of a group member to another group member. A 1987 technical correction expanded section 304(b)(4) to cover any sale of stock between group members that was subject to section 304, but did not expand the authority to adjust basis to include stock of non-group members.

In any event, where X is not affiliated with Y at the time of the transfer, recognition of its deferred gain ought to be triggered by disaffiliation from Z. To limit gain duplication in such cases, any gain recognized by Z on a sale of the Y stock (which in such cases would continue to have a carryover basis) should reduce X's deferred gain.

Requiring X to recognize gain in respect of Y stock appreciation addresses the specific concern identified in the legislative history. As discussed above, however, the cousin-of-mirror transaction also serves to shift earnings and profits from Z to X, without regard to whether the transferred Y stock is appreciated. Since section 304(b)(4) also authorizes earnings and profits adjustments, we believe it would be appropriate to require that the earnings and profits of X be reduced to the extent of its basis in the Y stock. This reflects the fact that X receives no credit for such basis,[57] and leaves X, taking account of the deemed distribution from Z, with a net increase in its earnings only to the extent of appreciation in the Y stock. A distribution by X to P would thus draw on earnings of Z only to the extent of appreciation in the Y stock, which appreciation would be recognized by X if its stock were subsequently sold by P.[58]

In sum, the above approach generally preserves the current operation of section 304 insofar as it deems a distribution to occur from Z to X that is potentially taxable as a dividend. The treatment of the transfer as a contribution to Z is also substantially preserved, in that no gain is currently recognized. Basis “adjustments” are provided, however, to ensure that any gain in the Y stock will be recognized by X if X ceases to be affiliated with Z. Finally, the transaction's effects on

[57] AS discussed above at note 24, a reduction in earnings and profits is appropriate where a corporation contributes an asset and receives no basis increase in any retained asset. Although this effect has perhaps been avoidable in a cousin-of-mirror transaction by X's retention of some amount of Y stock, we believe regulations should require X to reduce its earnings by its basis in the Y stock transferred regardless of whether Y stock is retained.

[58] X's earnings would not be increased by such gain recognition, since the economic value relating to the appreciation is transferred to Z with no corresponding credit to the basis of any asset retained by X.

the earnings and profits of X are limited so as to prevent artificial sheltering of gain on a subsequent sale of its stock.

Sale Treatment. Although the approach outlined above is faithful to section 304(b)(4) and its legislative history, it produces a plainly hybrid characterization of a brother-sister section 304 transaction. The fiction of a redemption distribution and capital contribution is largely retained, but the adjustments necessary to prevent the cousin-of-mirror abuses add results akin to deferred sale treatment.

In lieu of this hybrid model, we believe the Service should consider adjustments that would largely avoid the dividend and earnings and profits effects that section 304 normally produces and move the transaction's tax treatment closer still to its actual form, i.e., a sale between affiliates. To achieve these results within the technical constraints of section 304(b)(4), the earnings and profits of Z would be "adjusted" so that the deemed redemptive distribution to X does not attract earnings, but would instead be treated as a return of capital. Assuming X's basis in the fictional Z stock equals its basis in the Y stock,[59] return of capital treatment would generate current gain to X under section 301(c)(3) equal to the appreciation in the stock of Y. Moreover, since the distribution would not be out of earnings, the earnings of Z would not be depleted and those of X would be increased only to the extent of its gain recognition. In addition, in order to prevent gain duplication, the basis of

[59] We recognize that this is inconsistent with the holding of Rev. Rul. 70-496. If the Service continues to believe Rev. Rul. 70-496 was correct on this issue, it could easily reverse the result in this limited context by virtue of its authority under Section 304(b)(4) to adjust the stock basis of group members.

the transferred Y stock would be adjusted to equal its value at the time of the transfer.[60]

It should be recognized that the above approach may be favorable to the taxpayer where the stock of Y is not significantly appreciated. In such cases, little or no gain would be recognized while current dividend consequences would be avoided. The fact, however, that recharacterization under section 304 may in certain cases disadvantage corporate taxpayers should not distract from the larger fact that its predominant effect is to the contrary. In any event, the Service would seem to give up very little by permitting affiliated groups to exchange unappreciated subsidiaries for cash within the group free of dividend consequences.

In sum, the above approach largely approximates sale treatment for an affiliated group cousin-of-mirror transaction.[61] Although this was not directly contemplated in the statute's legislative history, it is achieved within the statute's technical constraints and is consistent with its basic objectives. Moreover, given the dubious rationale for applying section 304 to corporate transferors, we think an approach that

[60] As noted above, such adjustment would be outside the Service's literal authority where Y was not affiliated with X and Z. Although inappropriate, the resulting possibility for gain duplication would seem unavoidable given that any implementation of section 304(b)(4) would involve possible gain recognition by group members other than Z and prior to a sale of Y by Z.

[61] In the case where the Y stock was depreciated in value, the above approach would depart from sale treatment in permitting Z to retain a carryover basis in the Y stock. Although deferred loss treatment under section 267(f) would arguably be more appropriate, there is no easy mechanism for preserving the deferred loss in X. Since transfer of the loss basis in Z is the same result that occurs under the ordinary section 304 mechanics, we think that permitting transfer of the built-in loss to Z does not detract from the alternative approach suggested.

largely blunts its application to such transferors is consistent with broader policy considerations.

3. Technical Scope.

In general, we think it appropriate that regulations under section 304(b)(4) be limited in application to cases of cross-chain transfers, in which the acquiring corporation is not a first or lower-tier subsidiary of the transferor. Thus, we believe the statute's purposes do not require adjustments for parent-subsidiary sales. In such cases, the transaction does not facilitate a future sale of the transferor separate from the acquired corporation. Moreover, treatment of the sale proceeds as a distribution from the acquiring or acquired corporation does not generally permit an earnings and profits result that could not have been achieved by providing for actual distributions from those corporations.