Report No. 1445
November 19, 2020

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1445 – Report on Section 304 in Public M&A Transactions*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1445 commenting on the application of Section 304 of the Code to public merger and acquisition transactions.

In M&A transactions involving publicly held corporations, it is often difficult to determine whether the control requirement of Section 304 is met. Even in situations in which stock ownership is widely dispersed, there can be substantial overlap on account of the presence of index and other mutual funds and exchange traded funds, hedge funds, and arbitrageurs. The issue is exacerbated by the broad ownership attribution rules applicable to Section 304. As a result, it is often difficult or impossible for taxpayers and the government to determine with any certainty whether Section 304 applies, even in siutations where there is little likelihood that there is an intent to achieve an inappropriate bail-out of corporate earnings which Section 304 is intended to prevent. In addition, potential uncertainty about the possibility of dividend treatment poses a serious issue for foreign shareholders and withholding agents. Our report suggests possible counting conventions that generally look solely to the holdings of 5 perecnt or greater shareholders and officers and directors for purposes of the control requirement in order to enhance administrability without contravening what we understand to be the policy behind Section 304.

We appreciate your consideration of our report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Andrew H. Braiterman
Chair

Enclosure

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Report No. 1445

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON SECTION 304 IN PUBLIC M&A TRANSACTIONS

November 19, 2020

TABLE OF CONTENTS

Page

I. Introduction

This Report[1] discusses the application of Section 304[2] in the context of public mergers and acquisitions ("**M&A**"). Section 304 was originally enacted as an anti-abuse provision intended to prevent the inappropriate bailout of corporate earnings and profits ("**E&P**") as either capital gain or return of capital by extending the reach of Section 302 to stock sales between related corporations under common "control." The "control" test is relatively mechanical and is based in relevant part on identifying overlapping ownership (taking into account attribution rules) between shareholders of the corporations party to the transaction.[3]

In light of the growing presence of broad-based index mutual funds and industry-specific exchange-traded funds as well as hedge funds, merger arbitrageurs and other traders, two publicly traded corporations in the same industry are likely to have significant overlap in shareholder bases even where the ownership of each corporation is relatively dispersed. Thus, there is a meaningful risk that Section 304 "control" exists in an M&A transaction involving a public company even where the stock is widely held. Leaving aside whether the application of Section 304 in these circumstances is consistent with its original Congressional intent, this application of Section 304 presents a number of practical concerns for the various stakeholders in a public M&A transaction, including shareholders, withholding agents, and the corporations party to the transaction.

This Report recommends to the Treasury Department and the Internal Revenue Service (collectively, "**Treasury**") potential counting conventions that could be adopted to address these issues in public M&A transactions with the goals of (i) furthering the administrability of Section 304 and (ii) aligning the application of Section 304 in public M&A transactions with Congress's original policy intent. Part II of this Report provides a summary of our recommendations. Part III provides an overview of the original policy rationale underpinning Section 304, key aspects of the statute relevant to public M&A transactions (particularly, the "control" requirement) and the practical issues resulting from its uncertain application. Part IV contains a detailed discussion of our recommendations.

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1 The principal authors of this Report are Sara Zablotney and Adam Kool, with substantial drafting from Simon Kwong. Helpful comments were received from William D. Alexander, Kimberly S. Blanchard, Andy Braiterman, Tim Devetski, Tijana J. Dvornic, Edward Gonzalez, Corey M. Goodman, Shane Kiggen, Michael Kliegman, Stephen B. Land, Michael Mollerus, Richard Nugent, Deborah L. Paul, Yaron Reich, Amit M. Sachdeva, Michael Schler, Eric Sloan, Karen G. Sowell, Joseph Toce, Shun Tosaka, and Gordon E. Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the Executive Committee or the House of Delegates of the New York State Bar Association.

2 Unless otherwise stated, all "Section" references are to the Internal Revenue Code of 1986, as amended (the "**Code**").

3 As described in further detail below, under Section 304(a)(1), a sale of stock by a controlling shareholder in one controlled corporation to another controlled corporation (i.e., a brother-sister sale) is generally recharacterized as a redemption. Section 304(a)(2) similarly recharacterizes a purchase of parent corporation by its controlled subsidiary corporation as a redemption.

II. Summary of Recommendations

We recommend that Treasury consider a set of potential Counting Conventions in which certain shareholders would be excluded from the calculation of "control" under Section 304(c), with the goal of ameliorating certain administrative and policy issues that arise as a result of the application of Section 304 in public M&A transactions.

1. **Counting Convention #1: Only Count "Large" Shareholders.** Under our first Counting Convention, only shareholders who own a specified threshold percentage of the stock of the acquiring corporation or the issuing corporation would be taken into account in measuring Section 304(c) control (subject to exceptions under Counting Convention #2 and Counting Convention #3). We suggest this threshold be set at 5%.

2. **Counting Convention #2: Directors and Officers**. As an exception to Counting Convention #1, our second Counting Convention would include in the Section 304(c) "control" analysis any stock owned by directors and officers of the acquiring corporation or the issuing corporation (in addition to stock described in Counting Convention #1) on the theory that these persons are potentially in a position to facilitate a bailout transaction even if they own a relatively small amount of stock of either corporation.

3. **Counting Convention #3: Limitations Based on Available Information** Our final Counting Convention addresses how stakeholders' actual knowledge and practical limitations on available information might be taken into account in measuring Section 304(c) "control," and proposes techniques for standardizing and dispersing relevant information to all stakeholders in a public M&A transaction.

4. **Reliance on Conventions in Advance of Closing**. We further recommend that Treasury consider allowing taxpayers to apply the Counting Conventions to determine the applicability of Section 304 at a time reasonably in advance of the closing of an M&A transaction, with the goal of easing administrability by providing greater clarity as to the application of Section 304 at the time proceeds from a public M&A are disbursed.

III. Background

Section 304(a)(1) generally provides that, for Section 302 purposes, "if one or more persons are in control of each of two corporations, and in return for property, one of the corporations acquires stock in the other corporation from the person (or persons) so in control, then… such property shall be treated as a distribution in redemption of the stock of the corporation acquiring such stock." Additionally, Section 304(a)(2) generally provides that, for Section 302 purposes, "if in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and the issuing corporation controls the acquiring corporation, then such property shall be treated as a distribution in redemption of the stock of the issuing corporation."

A. **Policy Rationale for Section 304**

From a policy perspective, Section 304 is intended to act as a backstop to Section 302. In particular, Section 304 is designed to deter transactions by which a shareholder could use controlled corporations to extract E&P from corporate solution as a capital gain (rather than a dividend) by structuring the transaction as a sale of the stock of one controlled corporation to another.

Congress enacted the predecessor to Section 304[4] in response to the Tax Court's decision in *Wanamaker Trust v. Commissioner*.[5] The Senate Report accompanying the Revenue Act of 1950 explained that:

> [*Wanamaker Trust*] has revealed a loophole through which [a shareholder can extract corporate E&P from a controlled corporation] without coming within the scope of section 115(g)[6]… Therefore, section 209 of your committee's bill amends section 115(g) of the code, so as to cover indirect redemption of shares in a parent corporation through purchases by its subsidiaries… [t]he House bill also extended the application of section 115(g) to cases in which both the issuing corporation and the acquiring corporation are controlled directly or indirectly by the same interests.[7]

Additionally, in connection with the enactment of the Internal Revenue Code of 1954, which included versions of Section 304(a)(1) and Section 304(a)(2) substantially similar to the current versions, the Senate again summarized the purposes of these provisions:

> Your committee follows the House bill in its retention of the provision of existing law which prevents tax avoidance where a subsidiary corporation purchases stock in its parent from the shareholders of the parent and also extends the provision to include sales of stock between corporations owned by the same interests although the corporations are not in a parent-subsidiary relationship. Under these circumstances it is provided that where the effect of the sale is in reality the distribution of a dividend, it will be taxed as such.[8]

The report issued by the House Committee on Ways and Means accompanying the enactment of the Internal Revenue Code of 1954 provides further color on the Congressional intent

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4 Internal Revenue Code of 1939, Section 112(g)(2).

5 *Wanamaker Trust v. Comm'r*, 11 T.C. 365 (1948), *aff'd per curiam*, 178 F.2d 10 (3d Cir. 1949) (sale proceeds from a shareholder's sale of its controlled parent corporation stock to the parent corporation's wholly-owned subsidiary corporation did not constitute a distribution to the shareholder substantially equivalent to a taxable dividend under former Section 115(g), the predecessor to current Section 302(b)(1)).

6 Internal Revenue Code of 1939. This is the predecessor statute to current Section 302.

7 S. Rep. No. 81-2375, at 3096 (1950).

8 S. Rep. No. 83-1622, at 4673 (1954).

underlying Section 304. In particular, this report identifies that shareholders of closely held corporations, as opposed to shareholders of publicly held corporations, are most likely to engage in the abusive transactions that Section 304 is intended to target. The House version of the statute in fact included a carve-out from Section 304 for transactions in which the relevant corporations were publicly held, although the final version of the legislation did not include this exception.[9] As stated in the House report issued in 1954:

> Publicly held corporations usually have a corporate existence separate from that of their shareholders and as a rule do not merge or consolidate with a view to the tax advantages which may result therefrom at the shareholder level. There is ample evidence, however, that closely held corporations may undertake these transactions solely in the hope of distributing earnings to shareholders at capital gains rates.[10]

Following the enactment of the Internal Revenue Code of 1954, Congress again reiterated the general policy goal underlying Section 304 both in 1982[11] and 1997,[12] in each instance stating that Section 304 is intended to function as an anti-abuse provision aimed at preventing the bailout of corporate E&P as capital gain through the use of stock sales between a shareholder (or a group of shareholders) and affiliated corporations under common control. However, as the 1954 House Report had presciently identified, distinctions between closely held corporations and publicly traded corporations have resulted in the practical application of Section 304 in the public M&A context in a manner inconsistent with, or at the least not compelled by, its policy rationale. This result has been driven, in large part, by the application of the "control" requirement under Section 304(c) as described in the discussion that follows.

B. <u>Key Aspects of Section 304 Relevant to Public M&A</u>

In the context of an M&A transaction between two publicly traded corporations, the risk of Section 304 potentially applying to recharacterize a stock-for-property exchange as a

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[9] In rejecting the House position with respect to the application of Section 304 publicly traded corporations, the Senate cited concerns that (1) it may be difficult to appropriately differentiate publicly held corporations from privately held corporations and (2) rules that completely exempted publicly traded corporations would unfairly favor large corporations over small corporations. S. Rep. No. 83-1622, at 4674 (1954).

As discussed in greater detail below, we agree with the Senate's conclusion that full-scale exemption of public companies and their shareholders from Section 304 is inappropriate for the reasons discussed in Part IV, below. However, we believe that some degree of relief is appropriate in the context of public M&A transactions, and thus our position represents a compromise between the House and Senate positions that we believe appropriately reflects the policies and concerns underlying Section 304 as elucidated by the legislative history.

[10] H. Rep. No. 83-1337, at 4065 (1954).

[11] H.R. Conf. Rep. No. 97-760, at 542 (1982) ("Where the same shareholder or a group commonly controls two or more corporations, they may attempt to avoid the dividend consequences that would result from a pro rata redemption of stock by selling the stock in one controlled corporation to another.").

[12] S. Rep. No. 105-33, at 143 (1997) ("Section 304 is directed primarily at preventing a controlling shareholder from claiming basis recovery and capital gain treatment on transactions that result in a withdrawal of earnings from corporate solution").

distribution of such property in redemption of the stock will largely turn on whether the two publicly traded corporations are under common "control" for Section 304 purposes.

1. Definition of "Control"

Section 304(c) states that for purposes of Section 304 generally, "control means the ownership of stock possessing at least 50 percent of the total combined voting power of all classes of stock entitled to vote, or at least 50 percent of the total value of shares of all classes of stock..." Thus, for purposes of determining whether a group of persons are in "control" of a corporation, Section 304(c) effectively looks to whether those persons collectively own 50% of the vote or value of that corporation.

No formal coordination among stockholders is required to create "control" for Section 304 purposes. Rather, the "control" analysis takes into account stock owned by any shareholder who (1) owns an interest in a target corporation (or "**issuing corporation**") whose stock is being sold in the transaction, (2) receives non-stock consideration in the transaction and (3) owns an interest in the purchasing corporation (or "**acquiring corporation**") after the transaction.[13] Additionally, in measuring the ownership percentage of the acquiring corporation for a particular shareholder of the acquiring corporation, any acquiring corporation stock received by the shareholder as consideration in the transaction is taken into account in addition to any acquiring corporation stock owned by such shareholder prior to the transaction.[14] Furthermore, a shareholder counts towards the control test even if it owns different percentages of the acquiring corporation and issuing corporation, such that if such shareholder owns one share in the issuing corporation and 25% of the outstanding shares in the acquiring corporation, the shareholder's entire 25% ownership counts towards the 50% requirement of control of the acquiring corporation. Since the shareholders of the issuing corporation by definition own 100% of the stock of the issuing corporation, the control analysis is effectively reduced to the question of whether issuing corporation shareholders own in the aggregate 50% or more of acquiring corporation's stock after transaction (again, taking into account any acquiring corporation stock received in the transaction).

As a practical matter, a publicly-traded corporation generally cannot reliably identify its beneficial stockholders apart from those beneficial owners that are required to provide ownership information under applicable securities laws (e.g., on Securities and Exchange Commission ("**SEC**") Schedule 13D or Schedule 13G). While some sophisticated services exist that can provide more information, the reliability of such information is limited to a moment in time and availability of information to that service.

In reality, the respective shareholder bases of two publicly traded corporations party to an M&A transaction can involve significant overlap.[15] Often, this overlapping ownership is

[13] Treas. Reg. § 1.304-5(b)(1).

[14] Section 304(c)(2)(A).

[15] See, e.g., Maria Goranova, Ravi Dharwadkar and Pamela Brandes, *Owners on Both Sides of the Deal: Mergers and Acquisitions and Overlapping Institutional Ownership*, 31 Strategic Management Journal 1114, https://doi.org/10.1002/smj.849 (February 16, 2010) ("… owners are not always independently affiliated with only one party to an M&A; in many cases, the acquiring and target firms include some 'overlapping' owners who simultaneously hold stakes in both the acquirer and the target firms. A cursory analysis of the 2,688 M&A deals

attributable in part to brokers holding the stock of either corporation in "street name," and may not represent beneficial ownership from a tax perspective.[16] Even where large holders are the beneficial owners of the stock of a corporation, often these holders are passive investors exercising no meaningful influence over the governance of either corporation.[17]

Compounding these difficulties in measuring "control," Section 318 attribution rules apply with reduced thresholds for attribution to and from corporations.[18] The rules under Section 318(a)(3)(A), which require downward attribution from partners to partnerships, are especially burdensome in this context. These downward attribution rules effectively require a large investment partnership to take into account every interest in a relevant corporation owned by each of its partners, even if these partners own relatively small interests in the investment partnership and/or a relevant corporation. Because many of the investors in large investment partnerships are themselves partnerships, the relevant persons to be taken into account under Section 318(a)(3)(A) can expand exponentially as one moves up through the chain of ownership, and as a practical matter Section 318(a)(3)(A) represents a nearly impossible fact-gathering obligation. As a result, attribution under Section 318(a)(3)(A) results in an extremely high likelihood that shareholders of publicly traded corporations overlap even where those shareholders are not able to identify one another, and it is exceedingly difficult (and indeed, often impossible) for the parties to a public M&A transaction or for their respective shareholders to determine whether Section 318 attribution would cause otherwise unrelated shareholders of the issuing corporation to be attributed ownership of the acquiring corporation stock.

2. Consequences When Section 304 Applies to Public M&A Transactions

To the extent Section 304 applies to a public M&A transaction, the transaction must be analyzed under Section 302. For these purposes the Section 302 rules look solely at the ownership

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involving publicly traded companies during 1998–2004 from the Bloomberg database reveals that in 41.7 percent of the deals, the acquiring and target firms shared some of the same owners. Furthermore, in M&As with overlapping ownership, overlapping owners held 18.9 percent of the acquiring firm, the investment stakes of 44 owners." at 1114-1115).

16 See John C. Wilcox, John J. Purcell III and Hye-Won Choi, *"Street Name" Registration & The Proxy Solicitation Process*, A Practical Guide To SEC Proxy And Compensation Rules, (2006) ("The vast majority of publicly traded shares in the United States are registered on companies' books not in the name of beneficial owners—*i.e.*, those investors who paid for, and have the right to vote and dispose of, the shares—but rather in the name of "Cede & Co.," the name used by The Depository Trust Company… Street name shares may also be registered in the name of an investor's bank or broker on a company's share register.").

17 See, e.g., Kenechukwu Anadu et al., *The Shift from Active to Passive Investing: Risks to Financial Stability?*, Working Paper SRA 18-04, Federal Reserve Bank of Boston, https://www.bostonfed.org/-/media/Documents/Workingpapers/PDF/2018/rpa1804.pdf (May 15, 2020) ("The shift to passive investing is a global phenomenon. In the U.S., . . . the shift has been especially evident among open-end mutual funds (MFs) and in the growth of exchange-traded funds (ETFs), which are largely passive investment vehicles. As of March 2020, passive funds accounted for 41 percent of combined U.S. MF and ETF assets under management (AUM), up from three percent in 1995 and 14 percent in 2005." at 2).

18 Section 304(c)(3); Treas. Reg. § 1.304-5(a).

interests in the issuing corporation before and after the transaction.[19] Section 318 attribution applies without limitation on attribution to and/or from corporations in measuring shareholders' interests in the issuing corporation before and after the transaction.[20]

> **Example 1a**. Shareholder beneficially owns twenty shares of the stock of P Corporation, a widely-held publicly traded company ("**P**"), and ten shares of the stock of T Corporation, another widely-held publicly traded company ("**T**"). Each of P and T has 10,000 common shares outstanding. Shareholders of T collectively own 3,000 shares of the stock of P prior to the transactions described in this Example.
>
> P and T and their affiliates enter into a merger agreement by which P will acquire 100% of the stock of T in exchange for both cash and P stock. Pursuant to the terms of the merger agreement, each of T's shareholders receives $1.00 cash and 0.5 shares of P stock for each share of T stock, such that P will pay $10,000 and issue 5,000 total shares in the transaction. After the close of the transaction, T will continue to exist as a wholly-owned subsidiary of P. Assume the transaction does not qualify as a "reorganization" within the meaning of Section 368(c) of the Code.
>
> After the transaction, T's shareholders collectively own 8,000 shares of P's stock a (i.e., 3,000 shares owned prior to the merger, plus 5,000 shares acquired in the merger), representing 53.33% of P's 15,000 shares outstanding post-merger. As a result, Section 304(a) by its terms applies to the transaction.[21]
>
> Shareholder's receipt of cash consideration in the transaction will be tested under Section 302 for dividend equivalency. Under Section 302 (and applying Section 318 attribution), Shareholder's proportionate ownership in T increases as a result of the merger since Shareholder owns ten shares of T (i.e., 0.10% of 10,000 T shares) prior to the transaction and twenty five shares of P (i.e., 0.17% of 15,000 P shares) after the transaction, and therefore by attribution Shareholder is

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19 Section 304(b)(1); Treas. Reg. § 1.304-2(a).

20 Section 304(b)(1). In contrast, Section 318 by default only attributes stock ownership to or from a shareholder that owns at least 50% of the corporation (by value).

21 *See* Section 304(c)(2)(A) ("Where 1 or more persons in control of the issuing corporation transfer stock of such corporation in exchange for stock of the acquiring corporation, the stock of the acquiring corporation received shall be taken into account in determining whether such person or persons are in control of the acquiring corporation.")

> treated as owning 0.17% of the stock of T by virtue of its ownership of P. Because Shareholder's interest in T increases from 0.10% to 0.17% as a result of the transaction, the cash portion of Shareholder's merger consideration will be treated as a dividend for U.S. federal income tax purposes, assuming T or P has sufficient E&P.

For non-U.S. holders of U.S. issuing corporation stock, cash proceeds treated as a dividend under Section 304 are generally subject to withholding at a rate of 30% or such lower rate as may be provided under an applicable income tax treaty.[22]

> **Example 1b**. The facts are the same as in Example 1a, but Shareholder is a non-U.S. person, and both P and T are Delaware corporations.
>
> P or the applicable withholding agent must withhold upon the cash portion of Shareholder's merger consideration at a rate of 30% or any lower rate pursuant to an applicable income tax treaty.

Furthermore, although Section 304 by its terms is focused on the tax treatment of property received by shareholders, the corporate parties to an M&A transaction may also suffer directly from the lack of clarity as to whether Section 304 applies to a transaction. In particular, where the issuing corporation is a foreign corporation, the application of Section 304 to a public M&A transaction (to the extent such application results in a deemed dividend via the application of Section 302) could prevent the transaction from qualifying as a "qualified stock purchase" within the meaning of Section 338(h)(3) since Section 304 recasts the M&A transaction as a Section 351 contribution followed by a redemption subject to Section 302. Additionally, the lack of certainty regarding the application of Section 304(c) may also impact whether a transaction qualifies as a "reorganization" within the meaning of Section 368(a)(1)(D) (which requires common "control" within the meaning of Section 304(c)), and "control" within the meaning of Section 304(c) also implicates certain reporting requirements under Section 6043. In each case, uncertainty regarding the scope of Section 304 imposes unnecessary compliance burdens on taxpayers (as well as Treasury in the event of an audit or other enforcement action).

3. Policy Concerns Motivating Section 304 as Applied in Public M&A Context

As discussed above, Section 304 is fundamentally an anti-bailout provision designed to limit taxpayers' ability to extract the E&P of a corporation using cross-chain acquisitions of stock of corporations under common control or downward stock sales between a parent corporation and its controlled subsidiary corporation. In the context of a closely held corporation, Section 304 generally operates as Congress intended—taxpayers who in fact exercise control over each of two corporations (whether brother-sister corporations or parent-subsidiary corporations) cannot sell stock in one corporation to the other corporation and extract corporate E&P without dividend

[22] Section 1441; Section 1442.

taxation unless the transaction results in a meaningful reduction in ownership of the acquired corporation applying the test of Section 302(b).

From a corporate governance and regulatory perspective, there are substantial differences in the ability of a shareholder or group of shareholders to influence economic decision making in closely held corporations as opposed to publicly traded corporations. Such differences warrant different treatment in the application of Section 304. For example, applicable state corporate law statutes generally require the board of directors of each corporation to approve M&A and similar transactions. In closely held corporations, the boards of directors may consist of shareholders, officers and other company insiders who may have the ability to directly influence the corporations to engage in the abusive transactions that Section 304 is intended to address. In contrast, shareholders of a widely-held publicly traded corporation have much less ability to cause corporations to engage in dividend-avoidance behavior. U.S. securities exchange rules generally require the boards of directors of U.S. publicly-listed corporations to have a majority of independent directors.[23] Such independent directors are nominated by a governance committee of the board of directors and further approved by a vote of the shareholders, must follow certain independence criteria pursuant to the applicable exchange listing rules, and owe fiduciary duties to the corporation and its shareholders in the aggregate (as opposed to one shareholder or a particular group of shareholders). Accordingly, the possibility that a shareholder or a particular group of shareholders could cause a majority of an independent board of directors to approve of the corporation engaging in the abusive transactions Section 304 is intended to prevent is exceedingly low, given the independence requirements and fiduciary obligations of the independent directors.

Therefore, the application of Section 304 to public M&A transactions involving corporations with widely held stock ownership and no large shareholders is difficult to reconcile with the Congressional intent motivating the enactment of Section 304. As discussed above, it is extraordinarily unlikely that a shareholder or group of shareholders of a widely held, publicly traded corporation without a large shareholder would be able to cause the corporation to acquire another corporation as a means for avoiding dividend taxation on corporate E&P. It is especially unlikely that such tax-avoidance behavior would occur where such shareholders beneficially own their stockholdings through a layer of brokers, mutual funds, ETFs and/or other intermediaries who hold such stock on a passive, institutional basis.[24] The real-world implications of this inconsistency between the application of Section 304 and its policy underpinnings are further magnified with the substantial shift from active to passive investment strategies over recent

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[23] *See, e.g.,* New York Stock Exchange Rule 2009-89, § 303A.01 (2009).

[24] *See, e.g.*, supra, note 17; *see also*, John C. Bogle, *The Index Mutual Fund: 40 Years of Growth, Change, and Challenge*, 72 Financial Analysts Journal 1, https://doi.org/10.2469/faj.v72.n1.5 (2016) ("Assets of index funds have risen dramatically over the years—from $11 million in 1975 to $511 million in 1985 to $55 billion in 1995, leaping to $868 billion in 2005 and now standing at $4 trillion. From 4% of equity mutual fund assets in 1995, the market share of index fund assets grew fourfold to 16% in 2005 and then more than doubled to a record high of 34% in 2015." at 9).

decades.[25] As a result, parties to a public M&A transaction currently face material practical difficulties as a result of the uncertain application of Section 304.

C. Practical Issues Resulting from Uncertainty

In light of the uncertainties resulting from substantial shareholder overlap and the potential for expansive application of Section 304, parties to a public M&A transaction often determine that they must disclose the risk of Section 304 applying to the transaction.[26] In some cases, parties to a public M&A transaction affirmatively determine that they will conservatively assume Section 304 applies to the transaction for purposes of withholding and information reporting. And even where parties to a public M&A transaction do not affirmatively determine to apply Section 304 to transaction, withholding agents will customarily assume Section 304 applies if the issue has been disclosed as a risk in public SEC filings regarding the transaction.

Additionally, for non-U.S. holders of issuing corporation stock who are subject to withholding as described above, filing a U.S. tax return and attempting to claim a refund of withheld amounts may not be an adequate remedy, since those non-U.S. holders will have limited knowledge (or ability to obtain knowledge) of the shareholder base of either the issuing corporation or the acquiring corporation in order to determine whether Section 304 in fact applied to the transaction.

Thus, in practice, Section 304 presents significant challenges to parties to public M&A transactions in ways that were never intended or contemplated by Congress when enacting the statute in 1954. As one treatise has observed, "What started out as a modest anti-dividend avoidance rule has grown into a considerable monster."[27] These difficulties serve no purpose in furthering the policy rationale of Section 304 and have yet to be addressed through federal legislation or Treasury guidance. With the goal of remedying the issues described above, the remainder of this Report proposes several alternatives intended to promote a more workable application of Section 304 that is in greater alignment with its policy underpinnings in the context of public M&A.

IV. Discussion

A. Framework for Analyzing Proposed Counting Conventions

The details of our proposed Counting Conventions are framed by the following principles: First, we identify key policy considerations. Second, we address definitional issues with respect to

25 *Id*.

26 *See, e.g.*, Wesco International, Inc., Amendment No. 2 to Form S-4 (Form S-4/A) at 125 (March 9, 2020); Xerox Holdings Corporation, Amendment No. 1 to Form S-4 (Form S-4/A) at 54 (March 6, 2020); Hillenbrand, Inc., Amendment No. 1 to Form S-4 (Form S-4/A) at 99 (October 11, 2019); Eldorado Resorts, Inc., Amendment No. 1 to Form S-4 (Form S-4/A) at 228 (October 4, 2019); New Media Investment Group Inc., Amendment No. 2 to Form S-4 (Form S-4/A) at 174 (October 3, 2019).

27 Boris I. Bittker and James S. Eustice, Federal Income Taxation of Corporations & Shareholders, ¶9.09[1] (WG&L).

the term "publicly traded." Third, we discuss whether qualification for any proposed guidance should require the issuing corporation to be publicly traded, the acquiring corporation to be publicly traded, or both corporations to be publicly traded. Fourth, we discuss the need to harmonize any potential guidance on this topic with the statutory text of Section 304 and the legislative history.

1. Key Policy Considerations

Any potential guidance must carefully balance a number of policy considerations:

- First, it is critical that any potential guidance provide greater certainty to taxpayers as to the application of Section 304. The law as it exists and is applied today requires taxpayers to make guesses (which are more or less educated, depending on the circumstances) as to whether Section 304 applies to any particular public M&A transaction. Any guidance should permit all relevant parties, including shareholders, withholding agents, and the corporate parties to a public M&A transaction to determine with a reasonable degree of certainty the practical consequences of the transaction under Section 304.

- Second, any proposed guidance should be administrable, both from the perspective of taxpayer compliance and from the perspective of government enforcement. In some cases a certain degree of fact-finding may be appropriate to more accurately match the application of Section 304 to facts that present particularly significant bailout potential. However, the reality of information available to all parties should be a common principle.

- Third, it is important that the policies underlying Section 304 continue to be defended, even in the case of public M&A transactions. While our proposal below narrows the circumstances to which Section 304 may apply, we do not believe that Section 304 should be abandoned wholesale in the context of public M&A transactions. Although in many cases shareholders will have limited ability to influence the decision to engage in an M&A transaction, we readily acknowledge that some publicly traded corporations have large shareholders that in fact do present bailout risk. The proposed guidance should not serve as a shield for transactions that legitimately present the bailout potential that led to the enactment of Section 304.

2. Meaning of "Publicly Traded"

A threshold question with respect to any potential guidance regarding public M&A transactions is how to identify corporations that are "publicly traded." We believe that an appropriate definition of "publicly traded" can be drawn from existing Regulations addressing analogous concepts. For example, Regulations Section 1.897-1(g) effectively defines a publicly traded corporation as an entity "any class of stock of [which] is regularly traded on an established securities market." Similarly, a partnership qualifies as a "publicly traded partnership" under Section 7704(b)(1) if "interests in such partnership are traded on an established securities market." In each case, Regulations provide guidance on the meaning of "established securities market," and we believe these regulatory definitions could generally be imported into the Section 304 context without meaningful substantive modification.[28]

Notwithstanding the appropriateness of these definitions as a general matter, we are wary of taxpayers inappropriately taking advantage of any potential relief under Section 304. In particular, we believe that it would be inappropriate to permit taxpayers seeking to avoid Section 304 to list securities on an exchange (perhaps, for example, a small non-U.S. exchange or a

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[28] Specifically, Treas. Reg. § 1.897-1(m) defines "established securities market" as:

(1) A national securities exchange which is registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f),

(2) A foreign national securities exchange which is officially recognized, sanctioned, or supervised by governmental authority, and

(3) Any over-the-counter market. An over-the-counter market is any market reflected by the existence of an interdealer quotation system. An interdealer quotation system is any system of general circulation to brokers and dealers which regularly disseminates quotations of stocks and securities by identified brokers or dealers, other than by quotation sheets which are prepared and distributed by a broker or dealer in the regular course of business and which contain only quotations of such broker or dealer.

Treas. Reg. § 1.7704-1 defines "established securities market" as:

(1) A national securities exchange registered under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f);

(2) A national securities exchange exempt from registration under section 6 of the Securities Exchange Act of 1934 (15 U.S.C. 78f) because of the limited volume of transactions;

(3) A foreign securities exchange that, under the law of the jurisdiction where it is organized, satisfies regulatory requirements that are analogous to the regulatory requirements under the Securities Exchange Act of 1934 described in paragraph (b) (1) or (2) of this section (such as the London International Financial Futures Exchange; the Marche a Terme International de France; the International Stock Exchange of the United Kingdom and the Republic of Ireland, Limited; the Frankfurt Stock Exchange; and the Tokyo Stock Exchange);

(4) A regional or local exchange; and

(5) An interdealer quotation system that regularly disseminates firm buy or sell quotations by identified brokers or dealers by electronic means or otherwise.

See also, Treas. Reg. § 1.884-5(d)(2)(i) which defines "established securities market" as, for any taxable year:

(1) A foreign securities exchange that is officially recognized, sanctioned, or supervised by a governmental authority of the country in which the market is located, is the principal exchange in that country, and has an annual value of shares traded on the exchange exceeding $1 billion during each of the three calendar years immediately preceding the beginning of the taxable year;

(2) A national securities exchange that is registered under section 6 of the Securities Act of 1934 (15 U.S.C. 78f); and

(3) A domestic over-the-counter market (as defined in paragraph (d)(2)(iv) of this section).

regional or local exchange) for the purpose of qualifying for relief from the application of Section 304. Accordingly, we recommend excluding from any definition of "publicly traded" any corporation the shares of which were listed on an established securities market for a principal purpose of qualification for relief under the proposed guidance.[29]

Additionally, we believe that the definition of a "publicly traded" corporation should also include a requirement that the shares of such corporation be both actively traded and widely held. This is intended so that taxpayers may not seek to inappropriately avoid the application of Section 304 by listing securities (regardless of any principal purpose or intent motivating the listing) where such securities are either (i) illiquid and do not trade in any meaningful way, but are held among a relatively dispersed group of shareholders or (ii) liquid and trade in a meaningful way, but only trade among a relatively concentrated group of shareholders (possibly acting in concert). In both of the previously described scenarios, the practical difficulties in determining whether Section 304 applies are less acute, and the risk that the M&A transaction is motivated by an inappropriate bailout intent is heightened.

In terms of a technical foundation for an actively traded or widely held requirement, Regulations issued under Section 884 (which generally apply for U.S. income tax treaty purposes as well) offer a number of principles that can be considered. Under Regulations Section 1.884-5(d)(4), in particular, Treasury has constructed a fairly elaborate regime for measuring whether a specific class of stock that is listed on an exchange is treated as "regularly traded." These rules generally require public listing with respect to classes of stock representing at least 80% of the aggregate vote and value of a corporation, with separate trading requirements depending on the location of the securities exchange. These rules also include appropriate anti-abuse provisions for related party transfers and exclusions for closely held classes of stock. Treasury may consider adopting this regime under Section 884 wholesale, or may consider adopting only portions of it, but in any event these Regulations represent a thoughtful starting place for addressing these definitional issues.[30]

3. Whose Stock Must Be Publicly Traded?

We believe that any guidance under Section 304 generally should be limited to situations where both the stock of the acquiring corporation and the stock of the issuing corporation are publicly traded. While it would clearly be appropriate to modestly extend this requirement to capture subsidiaries and affiliates of publicly traded corporations (for example, persons controlled by a publicly traded corporation within the meaning of Section 304(c)),[31] we believe that proposed

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29 We note, however, that any such "principal purpose" test could diminish any objective certainty, which we aim to be a key component of any proposed guidance. As an alternative, Treasury could consider relying on the actively traded and widely held concepts described below.

30 As an alternative, Treas. Reg. § 1.1296-2(b) includes a simplified rule for measuring whether stock is "regularly traded." The regime proposed in Treas. Reg. § 1.1296-2(b) is less administratively burdensome than the regime under Section 884, but as a result it may be less likely to properly address potentially abusive cases.

31 This extension is intended cover M&A transactions whereby a publicly traded acquiring corporation utilizes a subsidiary to acquire the publicly traded issuing corporation. We believe that it would be reasonable to modestly extend proposed guidance to such transactions.

guidance should not provide relief from Section 304 where only one of the two relevant corporations is publicly traded.

We acknowledge that a separate form of relief from Section 304 where only one of the acquiring corporation or the issuing corporation is publicly traded and the other corporation is privately held may indeed be appropriate in some cases.[32] However, we generally believe that where one of the two relevant corporations is privately held, the need for relief is less acute. In particular, so long as at least one of the two corporations that are party to the relevant M&A transaction is privately held, it is more likely that the shareholders of the privately held corporation are able to structure the transaction in a manner that has inappropriate bailout potential, as well as to coordinate and share information in a manner that at least in part ameliorates the potential over-breadth of Section 304 and difficulty in ascertaining its applicability.[33]

4. <u>Harmonizing Proposed Guidance and Statutory Construct</u>

The proposal described in this Report would not be complete without a discussion of how proposed guidance should be harmonized with the statutory history and legislative text of Section 304. In this Section, we discuss why we believe that the legislative history regarding the decision not to exempt public M&A transactions from the rules of Section 304 does not preclude the guidance we propose in Section IV.B, and we discuss how Treasury should take into account the statutory text of Section 304 in crafting proposed guidance.

a. *Legislative History and the Proposed Public Trading Guidance*

As noted above, in 1954 the House of Representatives proposed an exception to Section 304 for publicly traded corporations, but this proposal was ultimately rejected by the Senate. In rejecting the proposal, the Senate cited concerns that (1) it may be difficult to appropriately differentiate publicly held corporations from privately held corporations and (2) rules that completely exempted publicly traded corporations would unfairly favor large corporations over small corporations.[34] The fact that Congress specifically considered an exception to Section 304 for publicly traded corporations and ultimately declined to adopt such an exception naturally

32 For example, where privately held corporations are owned by investment funds, determining overlap of ownership presents an administrative obligation that is in practice impossible to satisfy.

33 We note that this is the case even if a privately held corporation lists its stock immediately following an M&A transaction, since shareholders would generally have an opportunity to coordinate while the corporation is privately held.

Further consideration could be given to exceptions where corporations in question become publicly traded in connection with a transaction. For example, in a so-called "double-dummy" structure, a newly formed holding corporation (which is not publicly traded prior to the transaction) acquires the stock of both parties to a combination transaction, both of whom may be publicly and actively traded and widely held. It may be appropriate to offer an exception for this type of structure. However, this exception should be narrowly circumscribed such that if taxpayers fund a newly formed corporation exclusively with cash or other property as a means to extract proceeds from corporate solution while avoiding Section 304, the relief proposed in this Report would not be available.

34 S. Rep. No. 83-1622, at 4674 (1954).

invites the question as to whether proposed guidance would be contrary Congressional intent underlying Section 304 as enacted in 1954.

We believe that Congress's decision not to adopt a complete exception to Section 304 in the context of public M&A transactions does not preclude the adoption of the guidance we propose in this Report. The proposal in this Report would not go so far as to exempt all public M&A transactions from the application of Section 304. Rather, the proposed guidance simply seeks to narrow the application of Section 304 where the risk of anti-bailout concerns are particularly low and the administrative burden on taxpayers and the government to determine the applicability of Section 304 is relatively high. Accordingly, our proposal does not attempt to specifically override the Senate's view that complete exemption from Section 304 in the context of public M&A transactions is inappropriate, and we do not believe that the legislative history precludes the relief we propose.

b. *Proposed Guidance and Conformity to Statutory Text*

In addition to considering legislative history, we must also consider the text of Section 304 as it was enacted. In our discussion above, we have identified two core justifications for proposed guidance that should drive how to think about the relationship between the proposed guidance and the statutory text. First, as a practical matter, determining whether Section 304 applies in the context of many public M&A transactions is extremely difficult. Second, application of Section 304 in the context of public M&A transactions does little to further the anti-bailout policy considerations that led to the enactment of Section 304. Whether future guidance in this area is motivated by one or both of these justifications drives both the form of the guidance and how closely the guidance must hew to the statutory text of Section 304.

In particular, if future guidance is based solely on the evidentiary difficulties that taxpayers encounter in applying Section 304 in the public M&A context, the proposed guidance could be a simple procedural rule that clarifies certain presumptions shareholders may use in measuring whether a 50% overlap exists. This type of guidance would be analogous to private letter rulings that have been issued with respect to the application of Section 355(e) permitting certain simplified counting conventions not specifically contained in the statute (for example, taxpayers have been permitted to treat regulated investment companies and domestic tax-exempt pension trusts described in Section 401(a) as the "ultimate owners" of shares of distributing or controlled corporations for purposes of Section 355(e)).[35] This approach does not require interpretive guidance that interacts with the statutory text of Section 304. Instead, this approach represents a purely procedural mechanism based on practical difficulties in applying Section 304 to public M&A transactions.

In contrast, where future guidance is based not just on evidentiary or procedural concerns but also on the view that broad application of Section 304 to public M&A transactions goes beyond what Congress intended in enacting Section 304, more substantive guidance may be considered. In this case, we would expect that any such guidance would be accomplished through an interpretation of the concept of "control" under Section 304(c).

[35] *See, e.g.,* Private Letter Ruling 201740015 (Feb. 14, 2017).

Notably, Treasury has already taken some steps to interpret aspects of the "control" requirement under Section 304(c) in a way that avoids overly broad application of Section 304. Based on Treasury's general interpretive authority under Section 7805(a),[36] Regulations Section 1.304-5(b)(2) in particular narrows the measurement of "control" under Section 304(c)(2)(B) based on Treasury's view of the purpose of Section 304(c)(2)(B). Section 304(c)(2)(B) by its terms requires that each of the transferors of issuing corporation stock be taken into account in measuring "control" of two corporations. Thus, under the statute even a holder of the issuing corporation that only received cash in an M&A transaction and owned no interest in the acquiring corporation before or after the transaction would be included in measuring "control," as illustrated in the following example:

> **Example 2**. Individual A, the owner of 20% of Corporation T's only class of stock, transfers that stock to newly created Corporation P solely in exchange for all of the stock of Corporation P. Pursuant to a single, integrated plan, Corporation P, solely in exchange for cash, acquires the remaining 80% of the Corporation T stock from Corporation T's other shareholder, Individual B, who is unrelated to Individual A and Corporation P.
>
> Section 304(c)(2)(B) by its terms would result in the application of Section 304 to the transaction since the group of persons who control Corporation T before the transaction (Individual A and Individual B) are also in "control" of Corporation P by virtue of Individual A's 100% ownership of Corporation P.

However, Regulations Section 1.304-5(b)(2) excludes Individual B in Example 2 from the "control" test. In revising the "control" test, the Regulations explain that "[b]ecause the purpose of section 304(c)(2)(B) is to include in the relevant control group the person or persons that retain or acquire acquiring corporation stock in the transaction, only the person or persons transferring stock of the issuing corporation that retain or acquire any proprietary interest in the acquiring corporation are taken into account for purposes of applying section 304(c)(2)(B)."

Furthermore, Treasury has exercised its regulatory authority in the past to address issues of administrative practicality and to implement Treasury's view of the policy motivating statutory text in areas unrelated to Section 304. For example, Regulations issued under Section 382 substantially simplify the complex analysis of "owner shift" that would otherwise be required by the statute.[37] While we readily acknowledge that certain aspects of the proposal we describe below may represent a more expansive interpretation (or limited scope) of the definition of "control" than what is contemplated by Regulations Section 1.304-5(b)(2), we nonetheless believe that Treasury's willingness to limit the application of Section 304(c) "control" concepts in the past and Treasury's willingness to interpret and implement guidance in other similar areas each justify any similar

[36] *See* Treasury Decision 8515 (January 20, 1994).

[37] Temp. Treas. Reg. § 1.382-2T(k)(1)(i).

decision in future proposed guidance under Section 304. In any case, in the event that Treasury wishes to advance the proposal described in this Report but does not believe it has regulatory authority to do so, we encourage Treasury to seek a statutory amendment providing appropriate regulatory authority.

B. Details of Proposed Counting Conventions

Below we describe a set of proposed counting conventions that Treasury may consider to alleviate the overly broad application of Section 304 in public M&A transactions. We employ the framework laid out above to explain why we believe the counting conventions together provide appropriate relief from the application of Section 304, and we note potential challenges for both Treasury and taxpayers that should be considered in connection with the conventions.

As noted above, Section 304 applies only where one or more persons are in "control" of each of two corporations. Accordingly, one set of potential solutions to the overbreadth of Section 304 in public M&A transactions involves a modification of the manner in which "control" is measured for purposes of Section 304(c) (each a "**Counting Convention**"). Section 304 by its terms requires every single shareholder of a corporation to be considered in determining whether "control" applies, a practical impossibility in the context of widely held and actively traded public corporations. A natural starting point for potential guidance is therefore a simplification of the manner in which "control" is measured through the adoption of a series of Counting Conventions. In particular, Treasury may consider measuring the "control" requirement in the public M&A context by eliminating certain stockholders from consideration and focusing the relevant determination on larger shareholders or other shareholders who are more likely to present the bailout concerns Section 304 is designed to address.

1. Counting Conventions

Below we outline a number of Counting Conventions that Treasury may consider in restricting the types of shareholders that "count" for purposes of measuring Section 304(c) control in the context of public M&A transactions. We propose that Treasury adopt each of these Counting Conventions as a set of rules governing the measurement of "control" under Section 304. We begin with a simple distinction between large shareholders and small shareholders, and then discuss more targeted means for identifying shareholders who are likely to exercise formal or informal control over the participants in a public M&A transaction. We also discuss the role (if any) that actual knowledge of shareholder overlap should play as part of the Counting Conventions.

We also recommend that these Counting Conventions aggregate taxpayers acting in coordination with one another. This type of aggregation rule is common where there is a meaningful risk that large shareholders may attempt to disaggregate their holdings to fall below a 5% threshold, or where small shareholders may seek to band together in an effort to exercise the influence of a 5% shareholder without risking application of the relevant rules. As such, we recommend that rules analogous to Section 355(d)(7)(B) and Regulations Section 1.382-3(a)(1)(i) be employed to treat two or more persons acting pursuant to a plan or arrangement as a single shareholder under any Counting Convention.

a. *Counting Convention #1: Only Count "Large" Shareholders.*

In our first Counting Convention, only large shareholders would be taken into account in measuring Section 304(c) "control." Under this Counting Convention, there is no inquiry into the ability of any large shareholder to actually exercise control or otherwise influence corporate action—rather, any shareholder of sufficient size is taken into account.

The most important question to answer when applying this Counting Convention is where to draw the boundary line between "small" shareholders who could generally be ignored and "large" shareholders who must be taken into account. We believe that the 5% ownership threshold is appropriate for three reasons.[38]

First, a 5% threshold is consistent with a number of other rules found in the Code and Regulations that differentiate between smaller holders and larger holders. For example, Regulations Section 1.355-7(h)(3) applies a 5% ownership requirement in measuring whether a shareholder is a "controlling shareholder." Similarly, Section 382(g) applies a 5% threshold in identifying large shareholders for purposes of determining whether a loss corporation has undergone an "ownership change." Regulations Section 1.367(a)-3(b) also generally permits less than 5% shareholders of transferee foreign corporations to avoid the application of Section 367(a)(1) without a gain recognition agreement. Section 897(h)(5)(B)(iv) and Regulations Section 1.897-1(c)(2)(iii)(A), in turn, exclude from Section 897 only holders of 5% or less of the total fair market value of a class of shares of a publicly traded corporation.

Second, a 5% threshold is consistent with the modification of Section 318 rules under Section 304(c)(3)(B) for purposes of determining whether stock of a subsidiary should be attributed to an owner of the stock of an issuing corporation or an acquiring corporation when measuring Section 304(c) control. Implicit in this determination is the notion that a holder of less than 5% of the stock of a corporation owns a sufficiently small interest that an attribution requirement would be inappropriate and unnecessary to safeguard the policy concerns driving Section 304. If it is not appropriate to attribute the assets of a corporation to a holder of less than 5% of the stock of that corporation, it seems similarly sensible (at least in the context of a public M&A transaction) to exclude these small shareholders from the calculation of "control" under Section 304(c).

Third, a 5% threshold is consistent with lines drawn in the U.S. securities law context, potentially affording a degree of easing of compliance concerns for both Treasury and taxpayers. Specifically, owners of 5% or more of the stock of publicly traded corporations are generally required to file periodic statements with the SEC identifying and detailing their ownership interest in the corporation.[39] Assuming a 5% threshold is applied, then consideration could be given to permitting taxpayers to rely on Schedule 13D and Schedule 13G filings to identify shareholders

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38 When determining whether the 5% ownership threshold is met, constructive ownership under Section 318 necessarily must apply or else, a significant loophole would exist. Admittedly, however, this would result in additional complexity and reduce some of the certainty for which any proposed guidance strives for.

39 15 U.S.C. § 78m(d), (g).

who have an ownership interest of five percent or more (as is the case in the Section 382 context).[40] Admittedly, these Schedule 13D and Schedule 13G filings do not always conclusively establish tax ownership due to differences in measurements of ownership for federal income tax purposes, on the one hand, and SEC purposes, on the other hand (for example, SEC rules may require multiple taxpayers to be aggregated for filing purposes).[41] However, we believe that in any case the ability to rely on these forms is likely to prove useful to taxpayers.

The following Example highlights how this basic Counting Convention could operate in practice:

> **Example 3**. The shares of Corporation X and Corporation Y are publicly traded on the New York Stock Exchange.
>
> Eight mutual funds (A, B, C, D, E, F, G and H) (collectively, the "**Mutual Funds**") each owns 5% of the stock of both Corporation X and Corporation Y. Each of the Mutual Funds files statements with the SEC reflecting its ownership in the two corporations.
>
> Activist Investor I also owns 8% of the stock of each of Corporation X and Y. Activist Investor I files statements with the SEC reflecting its ownership in the two corporations.
>
> The remaining 52% of the stock of Corporation X and Corporation Y is beneficially owned by 10,000 unrelated shareholders, none of whom owns more than 0.1% of the stock of either corporation. These 10,000 unrelated shareholders have no publicly disclosed relationship to one another and none of Corporation X, Corporation Y, the Mutual Funds, or Activist Investor I have any means by which to identify these 10,000 unrelated shareholders. Accordingly, while it is possible that these 10,000 unrelated shareholders may supply the remaining 2% overlap sufficient to reach 50% overlap among Corporation X and

40 *See* Temp. Treas. Reg. § 1.382-2T(k)(1)(i). Although we cite Regulations issued under Section 382 as an example of guidance that may be considered in crafting proposed guidance under Section 304, we note that the precise operation of Temp. Treas. Reg. § 1.382-2T(k)(1)(i) is imperfect. In particular, Temp. Treas. Reg. § 1.382-2T(k)(1)(i) only permits reliance on Schedule 13D or Schedule 13G filings to establish ownership as of the date of the filing. This creates uncertainty in the Section 382 context as to how these reliance rules operate between annual filing dates and would create similar uncertainty regarding the application of these rules on the date of an M&A transaction if these concepts are imported without modification into the Section 304 regime.

41 In the Section 382 context, it is not uncommon for publicly traded corporations to engage in some form of limited diligence to determine the extent to which Schedule 13D or Schedule 13G filings in fact represent 5% beneficial ownership by a single taxpayer. A similar exercise may be appropriate in the Section 304 context if reliance on these filings is permitted.

> Corporation Y, as a practical matter whether this 50% overlap exists is not knowable.
>
> Using the Counting Convention described above with a 5% threshold, it is clear that Section 304 does not apply to an acquisition of Corporation X by Corporation Y. Because 5% shareholders collectively own only 48% of the two corporations (and would own 48% of the combined corporation on these facts assuming that the transaction consideration is paid pro rata to target shareholders), the Counting Convention prevents any group of persons from having "control" of both corporations.

Once the specific ownership threshold employed to differentiate large and small shareholders is settled, this form of Counting Convention must also address situations in which a person is a large shareholder of either the issuing corporation or the acquiring corporation, but not both. We believe that in all cases a person who is a large shareholder in only one of the two corporations should be taken into account under the Counting Convention, but we see two potential alternatives for measuring these large shareholders' contribution to the "control" test under Section 304(c). Under the first alternative, a large shareholder's entire stake in both corporations would be taken into account even if there was no public record of the taxpayer's ownership in one of the corporations. Under a second alternative, Treasury could still take into account all large shareholders in either corporation, but only the ownership interests that are equal to or greater than the specified threshold would be taken into account in measuring a contribution to Section 304(c) control (subject to Counting Convention #3, discussed below).

> **Example 4.** The facts are the same as in Example 3, except that Activist Investor I only owns 2% of the outstanding common stock of Corporation Y (the acquiring corporation). If the first alternative described above is adopted, then both Activist Investor I's 8% interest in Corporation X and Activist Investor I's 2% interest in Corporation Y is taken into account when applying the Counting Convention. If the second alternative is adopted, then only stock of Corporation Y (if any) received with respect to Activist Investor's 8% interest in Corporation X is taken into account, and Activist Investor's 2% pre-transaction interest in Corporation Y is ignored for purposes of measuring Section 304(c) control.

The difference between these two alternatives is particularly pronounced where a large shareholder of the acquiring corporation owns a small interest in the issuing corporation, as illustrated by the following Example:

> **Example 5**. The facts are the same as Example 3, except that Activist Investor I owns a single share of Corporation X. If the first alternative described above is adopted, then all of Activist Investor I's stock in Corporation Y is included in

measuring Section 304(c) control. If the second alternative described above is adopted, then Activist Investor I's 8% ownership of Corporation Y is effectively ignored for purposes of measuring Section 304(c) control, since Activist Investor I would not be included in the "control" measurement if it is not treated as receiving property with respect to its Corporation X stock in the M&A transaction.

In comparing the two alternatives, we note that the first alternative provides a more expansive "control" analysis that takes into account even small interests in one of the two relevant corporations. This first alternative reproduces many of the uncertainties that the Counting Conventions are designed to minimize since interests in the two corporations that are not publicly disclosed or easily identified must be taken into account. At the same time, the first alternative provides results that are more consistent with the literal text of Section 304, which takes into account ownership interests regardless of size.

The second alternative provides greater administrative relief and greater certainty in outcome since only large interests in the two corporations are taken into account in applying Section 304. In particular, if the second alternative is adopted, then taxpayers continue to be spared the administrative burden that Counting Convention #1 is designed to mitigate, since the alternative only takes into account larger shareholder interests in both corporations. The information regarding larger interests in relevant corporations should generally be readily available and verifiable. Furthermore, in applying this second alternative, Treasury could still require that certain public information regarding stock ownership be taken into account in accordance with Counting Convention #3, with the result that certain small interests in the issuing corporation and the acquiring corporation may still be taken into account under this second alternative to the extent these small interests are within the ambit of available information that Treasury requires taxpayers to take into account. We do not take a view on which of these alternatives is more appropriate.

b. *Counting Convention #2: Directors and Officers.*

Our second Counting Convention represents a minor exception to our first Counting Convention and takes into account stock owned by officers and directors of the relevant corporation (in addition to the stock described in Counting Convention #1) without regard to the amount of stock these persons own. This Counting Convention is analogous to standards set out in Regulations Section 1.367(a)-3(c)(1)(ii), which is designed to determine whether U.S. owners of a target corporation have control of a foreign acquiring corporation immediately after the transfer of stock of the U.S. corporation to the foreign corporation. Under the standard contemplated by Regulations Section 1.367(a)-3(c)(1)(ii), both officers and directors of the target corporation and 5% shareholders are taken into account in measuring whether a "control group" exists. Applied in the Section 304 context, this Counting Convention could take into account stock of the acquiring corporation and the issuing corporation owned by the officers and directors of either the acquiring corporation or the issuing corporation.

Example 6. The facts are the same as Example 3, except that Director M is a member of the board of both Corporation X and Corporation Y. Director M owns 0.5% of the stock of

> both Corporation X and Corporation Y, and the 10,000 unrelated shareholders described in Example 3 own 51.5% of Corporation X and Corporation Y rather than 52%.
>
> Applying this Counting Convention, Director M is taken into account in measuring whether Section 304(c) "control" exists notwithstanding that Director M owns a relatively small amount of stock in both corporations.

c. *Counting Convention #3: Relevance of Available Information.*

i. The Difficult Issue of Actual Knowledge

Perhaps the most challenging issue in adopting Counting Conventions is whether and to what extent actual knowledge must be taken into account (and if so, whose actual knowledge is relevant), as highlighted by the following Example:

> **Example 7.** The facts are the same as Example 3, except that Corporation X and Corporation Y are actually aware that one of the 10,000 unrelated individuals (Individual P) in fact owns 2% of each of Corporation X and Corporation Y. Individual P is not a director or officer of either corporation, invests on her own behalf and does not exercise any meaningful influence over corporate activity.

On the facts of Example 7, Section 304 by its terms appears to apply to a combination of Corporation X and Corporation Y. Taking into account the eight Mutual Funds each owning 5% of both corporations (a total of 40% overlap), the 8% interest in both corporations owned by Activist Investor I, and the 2% interest in both corporations owned by Individual P, a group of persons owns 50% of both corporations and therefore is in "control" of both Corporation X and Corporation Y.

If the Counting Conventions described above are adopted, should the result in Example 7 change such that Section 304 does not apply? In each of the Counting Conventions described above Individual P would be excluded from measuring Section 304(c) "control" unless actual knowledge is taken into account—Individual P owns a relatively small percentage of each corporation, and Individual P is neither a director nor an officer of either corporation.

Suppose the facts in Example 7 were slightly different and neither Corporation X nor Corporation Y had actual knowledge of Individual P's ownership, but Individual P is a foreign person and its brokerage firm did have actual knowledge of the overlap. In this case, should Individual P's brokerage firm be required to apply Section 304 in its capacity as a withholding agent and should Individual P be subject to Section 304 more generally, while other stakeholders may continue to rely on the relevant Counting Convention?

The answer to these questions depends on the scope and purpose of any proposed guidance. To the extent that Treasury adopts these Counting Conventions solely as a means of resolving difficult evidentiary issues, then arguably Section 304 should apply to any person who has actual knowledge of sufficient shareholder ownership for Section 304 to apply. Where actual knowledge exists, a shareholder or corporate party to a public M&A transaction cannot complain that the evidentiary burden of Section 304 is insurmountable since one way or another that taxpayer has come upon the requisite information to make a determination. In contrast, guidance that ignores a person's actual knowledge arguably must be grounded in the view that the concept of "control" under Section 304(c) should be interpreted more narrowly in the public M&A context as a result of the low likelihood that a public M&A transaction is motivated by an inappropriate bailout intention. As discussed above, this form of guidance would be analogous to Regulations Section 1.304-5(b)(2) interpreting the Section 304 meaning of "control," though we readily admit that such an interpretation would represent a more expansive exercise of regulatory authority than Regulations Section 1.304-5(b)(2). Under this approach, actual knowledge could (at least in some cases) be ignored and Section 304 potentially would not apply to a transaction that the statute by its terms would capture because Treasury has narrowed the meaning of "control" for Section 304(c) purposes.

Taking into account actual knowledge also presents a number of additional evidentiary and administrative issues. For example, Regulations issued under Section 382 take into account a taxpayer's "actual knowledge" in measuring whether a loss corporation has undergone an ownership change and include a somewhat complex patchwork of rules regarding "actual knowledge." Sometimes Regulations issued under Section 382 require actual knowledge to be taken into account,[42] and sometimes these Regulations offer the taxpayer the option as to whether actual knowledge is taken into account.[43] These types of complexities compound in the Section 304 context where, rather than a single loss corporation, the actual knowledge of the relevant corporations, withholding agents, and shareholders of both corporations can potentially be relevant. An actual knowledge concept also presents administrative challenges for Treasury on audit, where Treasury may be required to engage with taxpayers in a complex fact-finding exercise about who had what actual knowledge and at what time.

ii. Proposals to Address Limits of Available Information

Acknowledging that a perfect answer to this problem is likely to prove elusive, we believe that an appropriate balancing of these considerations justifies an additional Counting Convention requiring the parties to the public M&A transaction (perhaps with the assistance of certain large shareholders) to engage in a specified level of fact-finding regarding the application of Section 304 to a given transaction. Once this specified fact-finding obligation is satisfied, no further obligation would be imposed on the stakeholders to a public M&A transaction.

We propose two different approaches to this issue for Treasury's consideration. A majority of our Executive Committee favors our first approach, in which taxpayers are required to consider only publicly filed statements of ownership reflected on SEC Schedule 13D and Schedule 13G,

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[42] Treas. Reg. § 1.382-2T(k)(2) (requiring certain actual knowledge to be taken into account if that actual knowledge is acquired on any testing debt or before the due date of the income tax return for the taxable year in which the testing date occurs).

[43] *Id.* (permitting but not requiring, actual knowledge regarding ownership interests by members of overlapping "public groups")

other than for purposes of Counting Convention #2. However, a significant minority of our Executive Committee favors a second approach in which actual knowledge following a broader canvassing of publicly available information is required. We discuss each approach in detail below. In each case, Treasury may also require the parties to a public M&A transaction to report the conclusions or the contents of their fact-finding to shareholders and withholding agents reasonably in advance of the closing of a transaction in order to eliminate confusion regarding the potential application of Section 304.[44]

Approach #1: Only Schedule 13D and Schedule 13G Taken Into Account

Under our first approach, the only relevant information to be taken into account would be SEC filings on Schedule 13D and Schedule 13G, analogous to the requirements imposed on loss corporations under Regulations Section 1.382-2T(k)(3). Regulations Section 1.382-2T(k)(3) in particular contemplates an inquiry with respect to the ownership of the loss corporation by specific persons (generally, persons directly or indirectly owning 5% or more of the loss corporation)—after this analysis is complete, the loss corporation is generally under no further obligation to engage in a diligence exercise or otherwise make determinations with respect to the ownership of its stock. As is the case in the Section 382 context, we would expect that where taxpayers can show that the person filing a Schedule 13D or Schedule 13G is not in fact the beneficial owner of shares from a tax perspective, then the ownership reflected on the Schedule 13D or Schedule 13G generally need not be taken into account in measuring Section 304(c) control unless the actual beneficial owner itself owns 5% or more of the corporation in question.[45]

Treasury may consider requiring a similar exercise in the Section 304 context, with either a conclusion or the contents of the analysis being made available to persons who are required to determine whether Section 304 applies to a public M&A transaction. While this alternative does not necessarily result in all available information being taken into account since the approach ignores any ownership not reflected in a Schedule 13D or Schedule 13G, the approach will capture much of the publicly available information regarding ownership in the relevant corporations. This approach also has the benefit of offering a discrete and specific set of tasks that are required of taxpayers, which allows taxpayers to be confident they have complied with the applicable requirements without imposing an overwhelming administrative burden. A more circumscribed diligence requirement may further be justified by the relatively low likelihood that a public M&A transaction presents significant bailout risk. A majority of our Executive Committee supports this approach.

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[44] See Section IV.B.2 for a discussion of a specific rule permitting reliance on information as of some time reasonably in advance of the closing of a transaction.

[45] *See, e.g.,* Private Letter Ruling 200713015 (Mar. 30, 2007) (holding that investment advisors filing Schedule 13G with respect to stock were not themselves owners of the stock for purposes of Section 382 where clients retained the right to receive both dividends and the proceeds from sales of the stock, and as a result permitting taxpayer to ignore the ownership reported by the investment advisors in calculating whether an ownership change had occurred); *see also* Private Letter Ruling 200747016 (Nov. 23, 2007) (providing a set of rulings relating to the identification of 5% shareholders for Section 382 purposes based on a variety of Schedule 13D and Schedule 13G filing practices).

Approach #2: "Publicly Available" Information Taken Into Account

A second approach, favored by a significant minority of the Executive Committee, would require the parties to a public M&A transaction to take into account actual knowledge, with a requirement to engage in a diligence exercise that reaches beyond what is reflected in Schedule 13D or Schedule 13G, and would include information that is publicly available. For these purposes, we would expect that Treasury could utilize certain conventions applied in the Section 355(e) context where taxpayers look to affirmatively demonstrate that sufficient overlap in ownership exists between two corporations to prevent the application of Section 355(e) to a public M&A transaction.[46] These private letter rulings generally permit taxpayer to utilize either "publicly filed" or "publicly available" information. Although certain private letter rulings have been more descriptive than others, it appears that Treasury is generally amenable in the Section 355(e) context to permitting taxpayers to take into account not just Schedule 13D and Schedule 13G filings, but also publicly available filings on Schedule 13F (filed by certain large investment managers), voluntary disclosures to investment research companies, and voluntary postings on the investors' or investment advisors' websites.[47]

Under our second approach, all "publicly available" information (however specifically defined) would be taken into account. This approach imposes a more significant administrative burden upon taxpayers to actively seek publicly available information, but will also improve the accuracy of determinations under the Counting Conventions as compared to the first approach. We believe this second approach is likely to be most effective if Treasury is able to articulate with clarity the sources from which taxpayers are expected to seek "publicly available" information such that even with a broader and more thorough diligence requirement, taxpayers will be able to determine with confidence whether the required amount of review of publicly available information has been completed.

2. <u>When to Count?</u>

The adoption of our proposed Counting Conventions may be particularly helpful if taxpayers are allowed to apply the Counting Conventions reasonably in advance of the closing of a transaction. This type of measurement in advance of closing is somewhat analogous to the rules in Regulations Section 1.368-1(e)(2), which generally permit taxpayers to measure whether the non-statutory "continuity of shareholder interest" requirement under Section 368 is satisfied based on the value of stock consideration as of the signing date rather than the closing date of a transaction.[48] This approach is also consistent with the private letter rulings issued under Section 355(e) that are discussed above, which permit taxpayers to rely on the most recently filed publicly available documents where the closing of a transaction does not coincide with a date for which a

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[46] *See, e.g.*, Private Letter Ruling 201740015 (Feb. 14, 2017); Private Letter Ruling 201817001 (Jan. 26, 2018); Private Letter Ruling 201910004 (Dec. 6, 2018).

[47] *Id.*

[48] As is the case under Regulations Section 1.368-1(e)(2), we would expect that modifications to a binding contract would limit taxpayers' ability to rely on any sort of rule permitting reliance on information in advance of a closing.

monthly or quarterly filer has provided ownership information.[49] While we acknowledge that Section 304 by its terms requires testing for "control" as of the closing of a transaction,[50] we believe that permitting information to be relied upon reasonably in advance of the closing of a transaction does little to offend the policy of Section 304—in the event that an inappropriate bailout intent does not exist as of the time of a public filing reasonably in advance of a transaction, it is highly unlikely that such a bailout intention will develop prior to closing.

Applying the Counting Conventions reasonably in advance of the closing of a transaction also prevents arbitrary shifts in the parties' shareholder base that naturally arise over time (including as a result of passive algorithmic trading) from affecting the result under Section 304. For example, it is not uncommon for investors engaging in merger arbitrage investment strategies to build positions in one or both of the parties to a public M&A transaction in the period between signing and closing. Additionally, where a material risk that Section 304 may apply to a public M&A transaction exists, well-advised non-U.S. shareholders of the issuing corporation may reasonably seek to dispose of their shares prior to the M&A transaction to avoid the adverse U.S. federal income tax consequences described above, further shifting the shareholder base and potentially shifting outcomes under Section 304. Admittedly, ignoring fluctuations in ownership of the relevant corporations for some period in advance of closing does invite the possibility that a transaction could escape the reach of Section 304 even if, for example, a single shareholder acquired 50% of both corporations prior to the closing of a transaction. However, we view this as a low likelihood occurrence, and in any case, this type of concern may be best solved by an anti-abuse rule rather than by abandoning the concept of a measurement in advance of closing altogether.

In the event Treasury worries that a broadly applicable rule permitting measurement of Section 304(c) control reasonably in advance of closing is overly generous to taxpayers, consideration could be given to limiting the application of such a rule to a more circumscribed group of stakeholders (for example, withholding agents and small shareholders). Withholding agents in particular present a sympathetic case for a rule that permits Section 304 "control" to be determined in advance of closing—given the possibility of significant shifts in shareholder bases up until the moment before the closing of the M&A transaction, withholding agents will not necessarily be able to rely on the Counting Conventions in making withholding decisions at or immediately after the closing of the transaction (unless a rule applies permitting reliance reasonably in advance of closing), and as a result, in practice Section 304 would effectively apply to many public M&A transactions from the perspective of withholding agents and the shareholders to whom they pay transaction proceeds, even if the Counting Conventions we propose were adopted. Accordingly, we recommend that at a minimum Treasury consider such a rule for

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[49] *See, e.g.*, Private Letter Ruling 201740015 (Feb. 14, 2017); Private Letter Ruling 201817001 (Jan. 26, 2018); Private Letter Ruling 201910004 (Dec. 6, 2018).

[50] In light of the statutory language of Section 304, the proposal to implement a measurement date rule would require an interpretation of "control" in the form of substantive guidance holding that for certain purposes "control" can be measured as of a date prior to the closing date of a transaction notwithstanding the statutory text. In the event that Treasury determines it lacks regulatory authority to implement this type of substantive guidance and wishes to implement a pre-closing measurement date rule, we recommend seeking statutory authorization.

withholding agents who must disburse transaction proceeds at (or shortly following) the time of the closing of a transaction.

3. Key Benefits and Drawbacks of Counting Conventions

We believe that the chief virtue of our Counting Conventions lies in both the certainty of outcome and administrative simplicity. Particularly where the IRS and taxpayers are entitled to rely on statements filed with the SEC to establish the existence or absence of "control," compliance with Section 304 is far less likely to present a practical impossibility. Rather, results should generally be knowable based on information that is publicly available and relatively simple to verify in the case of an audit (subject to our discussion above regarding actual knowledge, which may require some level of fact-finding and uncertainty in outcome to the extent actual knowledge is taken into account).

The imperfections of our Counting Conventions arise from the relative imprecision with which the Counting Conventions defend the policies underlying Section 304. In this respect, the Counting Conventions suffer from some of the same defects as the statute itself—an objective test based solely on stock ownership is naturally limited in its ability to precisely target transactions with an inappropriate bailout motivation. In some cases Section 304 may continue to apply under the Counting Conventions even where no bailout concerns present themselves (e.g., two corporations are owned by the same 11 unrelated 5% shareholders but in fact no bailout intent exists). In other cases, the Counting Conventions may fail to reach fact patterns Section 304 was arguably designed to address (e.g., a 40% shareholder with practical control of two corporations forces an M&A transaction with an explicit bailout intent). This lack of accuracy is the natural corollary to the greater certainty in application of the Counting Conventions as compared to the statute as it operates today. However, taking into account these shortcomings, we nonetheless believe that the adoption of the Counting Conventions described in this Report would represent an appropriate balancing of the Section 304(c) policy considerations at issue in the context of public M&A transactions.

C. Conclusion

This Report has described a number of opportunities for Treasury to resolve and limit the overbroad application of Section 304 in public M&A transactions. Because the government has not issued specific guidance on this topic, we welcome the opportunity to elaborate and further comment in the event Treasury ultimately decides to adopt any of the proposals described herein.