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Report No. 1463
June 28, 2022

The Honorable Lily Batchelder
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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 William M. Paul
Principal Deputy Chief Counsel
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(Technical)
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Report No. 1463 - An Analysis of Potential Design Changes to the Section 1.367-3(b) Regulations in Light of the Tax Cuts and Jobs Act.

Dear Ms. Batchelder and Messrs. Rettig and Paul:

I am pleased to submit Report No. 1463 of the Tax Section of the New York State Bar Association discussing potential design changes to the Section 1.367-3(b) regulations in light of the Tax Cuts and Jobs Act.

We appreciate your consideration of our Report. If you have any questions, please feel free to contact us and we would be happy to assist.

Respectfully Submitted,

Robert Cassanos
Chair

Enclosure

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Report No. 1463

New York State Bar Association Tax Section

AN ANALYSIS OF POTENTIAL DESIGN CHANGES TO REGULATION SECTION 1.367(b)-3 IN LIGHT OF THE TAX CUTS AND JOBS ACT

June 28, 2022

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New York State Bar Association Tax Section

An Analysis of Potential Design Changes to Regulation Section 1.367(b)-3 in Light of the Tax Cuts and Jobs Act[1]

I. Introduction

This Report comments on potential design changes to Reg. §1.367(b)-3[2] that may be appropriate in light of the enactment of the 100-percent dividends received deduction under Section 245A for qualifying dividends from foreign corporations (the "**Section 245A DRD**") and the other substantial changes to the international tax provisions of the Code pursuant to legislation informally known as the Tax Cuts and Jobs Act of 2017 (the "**TCJA**").[3]

Reg. §1.367(b)-3 addresses the tax consequences of inbound asset reorganizations under Section 368(a) and inbound liquidations under Sections 332 and 337 (collectively, "**inbound nonrecognition transactions**").[4] The preamble to final regulations issued in 2000 (the "**2000 Final Regulations**") states that the principal Section 367(b) policy consideration with respect to inbound nonrecognition transactions is the appropriate carryover of tax attributes from foreign acquired corporations to domestic acquiring corporations.[5] This policy consideration is comprised of "interrelated shareholder-level

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1 The principal authors of this Report are Stephen Massed and Peter Schuur, with substantial contributions by Samuel Krawiecz, Chiemeka Onwuanaegbule, and Ian Simmons. This Report reflects comments and contributions from Kimberly S. Blanchard, Robert Cassanos, Peter J. Connors, Andrew Herman, Shane Kiggen, Vadim Mahmoudov, William L. McRae, Richard M. Nugent, Deborah L. Paul, Gary Scanlon, Michael L. Schler, Joseph Toce, Shun Tosaka, Philip Wagman, and Gordon E. Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of the NYSBA Executive Committee or the House of Delegates.

2 Except as otherwise indicated, all "**Section**" and "**Reg. §**" refer, respectively, to the Internal Revenue Code of 1986, as amended (the "**Code**"), and the Treasury Regulations promulgated thereunder.

3 The TCJA is formally known as "*An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018*." Pub. L. No. 115-97.

4 An "**inbound**" transaction is a transaction or series of transactions through which a domestic corporation acquires the assets of a foreign corporation. For purposes of this Report, (i) a "**foreign acquired corporation**" is the target corporation in an inbound asset reorganization or the liquidating corporation in an inbound liquidation; (ii) a "**domestic acquiring corporation**" is the acquiring corporation in an inbound asset reorganization or the 80-percent distributee corporation in an inbound liquidation; and (iii) an "**exchanging shareholder**" is a person that exchanges (or is deemed for U.S. tax purposes to exchange) foreign acquired corporation stock in an inbound nonrecognition transaction.

5 T.D. 8862 (Jan. 24, 2000).

and corporate-level components."[6] The shareholder-level component is the taxation of previously deferred earnings and profits ("**E&P**") of foreign acquired corporations, and the corporate-level component is the extent and manner in which tax attributes of foreign acquired corporations should carry over to domestic acquiring corporations.[7]

Reg. §1.367(b)-3 seeks to address the shareholder-level and corporate-level concerns regarding inbound nonrecognition transactions by requiring an exchanging shareholder that is either a United States shareholder[8] ("**U.S. Shareholder**") or a foreign corporation with a U.S. Shareholder to recognize as a deemed dividend the all earnings and profits amount ("**AEPA**") with respect to its stock in the foreign acquired corporation.[9] The AEPA with respect to a share of foreign acquired corporation stock is the net positive E&P of the foreign acquired corporation attributable to such share under the principles of Section 1248, determined without regard to the requirements therein that are irrelevant to determining the exchanging shareholder's pro rata portion of the foreign acquired corporation's E&P.[10] However, unlike Section 1248, the AEPA is not limited by the built-in gain of foreign acquired corporation shares owned by Section 1248 shareholders. As an exception to the general rule, exchanging shareholders that are United States persons that are not U.S. Shareholders ("**Small U.S. Shareholders**") recognize gain, but not loss, with respect to their shares of the foreign acquired corporation, unless they elect to include the AEPA with respect to their shares or a *de minimis* exception applies.[11] Reg. §1.367(b)-3 does not tax other shareholders (*e.g.*, foreign individuals and foreign corporations that do not have U.S. Shareholders) or the E&P attributable to such other shareholders.

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6 *Id.*

7 *Id.*

8 A "United States shareholder" means a shareholder described in Section 951(b) (without regard to whether the foreign corporation is a controlled foreign corporation). Reg. §1.367(b)-3(b)(2).

9 Reg. §1.367(b)-3(b)(3)(i). An AEPA dividend recognized by an exchanging shareholder that is a foreign corporation is not eligible for the same-country exception or the look-through exception to subpart F income under section 954(c)(3)(A)(i) and 954(c)(6), respectively. *Id*.; I.R.S. Notice 2007-9, §3, 2007-1 C.B. 401. This Report does not separately discuss the Reg. §1.367(b)-3 considerations as regards exchanging shareholders that are foreign corporations with U.S. Shareholders.

10 *See* Reg. §1.367(b)-3(d).

11 Reg. §1.367(b)-3(c). A Small U.S. Shareholder can only elect to recognize an AEPA dividend instead of recognizing gain if the foreign acquired corporation (or its successor in interest) provides the shareholder with the information to substantiate its AEPA and the shareholder satisfies certain procedural requirements. Reg. §1.367(b)-3(c)(3).

The TCJA's changes to the international provisions of the Code fundamentally altered the taxation of the foreign earnings of foreign corporations. The global intangible low-taxed income ("**GILTI**") rules expanded substantially the current taxation of foreign earnings of controlled foreign corporations ("**CFCs**") by requiring U.S. Shareholders to include in income currently the GILTI with respect to their CFCs.[12] Section 965 imposed a "transition" tax on U.S. Shareholders of deferred foreign income corporations by treating as subpart F income the accumulated post-1986 deferred foreign income of these corporations. At the same time, the TCJA introduced the Section 245A DRD. These changes were designed to end the "lock-out" effect that incentivized U.S. Shareholders to keep untaxed foreign earnings of their CFCs offshore, and to allow foreign earnings to be distributed to corporate U.S. shareholders without residual tax.[13] As a result, U.S. Shareholders are taxed currently on a broader range of CFC earnings. However, corporate U.S. Shareholders benefit from the Section 245A DRD for dividends of foreign earnings not subject to current taxation under the subpart F income or GILTI rules.[14]

This Report addresses how Section 245A and the related TCJA changes impact Reg. §1.367(b)-3 and have created meaningful disparities regarding the taxation of repatriations of foreign E&P through distributions of property as compared to different forms of inbound nonrecognition transactions. This Report discusses potential design changes we believe are appropriate for the Treasury Department and the Internal Revenue Service (collectively, "**Treasury**") to consider in relation to Reg. §1.367(b)-3 to address these disparities. The changes we discuss seek to update the Section 367(b) policy considerations regarding inbound nonrecognition transactions in light of the TCJA changes and to align the tax treatment of similar inbound transactions.

Part II of this Report contains a summary of the potential design changes to Reg. §1.367(b)-3 in light of the TCJA that we discuss in this Report. Part III discusses the development and underlying policy of Reg. §1.367(b)-3. Part IV discusses the relevant changes made to the international provisions of the Code by the TCJA. Part V discusses the application of Reg. §1.367(b)-3 to common corporate acquisition paradigms after the TCJA.

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[12] Section 951A(a).

[13] *See* Senate Committee Print to Accompany H.R. 1, S. Prt. 20, 115th Cong., 1st Sess. (Dec. 2017), at 358.

[14] CFC E&P taxed currently under the subpart F income rules (including amounts subject to the Section 965 transition tax) or GILTI rules ("**PTEP**") are not taxed again when distributed to the U.S. Shareholder that originally included such amounts. Section 959(a).

II. Summary of Potential Design Changes

A. Treatment of U.S. Corporate Acquirer ("**USB**") of Foreign Acquired Corporation ("**FT**") in an Inbound Nonrecognition Transaction.

- If USB liquidates FT under Section 332, the concerns behind Section 1059 are not present because USB's FT stock is eliminated in the liquidation. Therefore, we recommend that Reg. §1.367(b)-3 be amended to provide that Section 1059 does not apply to an AEPA dividend resulting from an inbound Section 332 liquidation.

- If USB domesticates FT in an inbound asset reorganization (*e.g.*, if FT continues to the United States in a reorganization under Section 368(a)(1)(F) (an "**F reorganization**")), Section 1059 concerns also should not apply because there is no economic reduction to the value of the stock of the successor domestic corporation ("**UST**"). However, we recognize that the basis increase arising under Reg. §1.367(b)-2(e)(2)(ii) from the AEPA dividend implicates Section 1059 policy because it can produce a tax-advantaged capital loss or gain reduction. We recommend that Reg. §1.367(b)-2(e)(2)(ii) be revisited to address this issue.

    - One approach would be to provide that to the extent an AEPA dividend gives rise to a Section 245A DRD-eligible dividend that would otherwise be subject to Section 1059, neither Section 1059 nor the basis adjustment rules in Reg. §1.367(b)-2(e)(2)(ii) apply in respect of the dividend.

- The Section 246 Holding Period Requirement (as defined below) also may be implicated for an AEPA dividend resulting from an inbound nonrecognition transaction with respect to FT.

    - If the Section 246 Holding Period Requirement applies, to benefit from a Section 245A DRD, USB must hold the shares of FT one year before undertaking the inbound nonrecognition transaction (as compared to an actual dividend from FT, where the Section 246 Holding Period Requirement could be satisfied if USB retains the shares of FT following the dividend).

    - An alternative, proxy approach would permit USB to satisfy the Section 246 Holding Period Requirement by holding for the remainder of the necessary period either (i) substantially all of the assets of FT received in an inbound Section 332 liquidation; or (ii) substantially all of the stock in the successor entity received in an inbound asset reorganization.

B. Treatment of Historical FT Shareholders in an Inbound Asset Reorganization of FT.

- Many of the considerations discussed in this Report regarding the application of Sections 1059 and 246 to USB also apply to corporate U.S. Shareholders of FT, if USB acquires the assets of FT in an inbound asset reorganization. However, these considerations are not relevant to non-corporate U.S. Shareholders or Small U.S. Shareholders of FT. Thus, design choices must be made regarding the treatment of the historical FT shareholders in light of the recommendations and design choices described above in Part II.A.

    - In view of the TCJA's fundamental changes to the taxation of foreign earnings and the importation of foreign asset basis into the U.S. tax net and the fact that Small U.S. Shareholders generally cannot influence the structuring of USB's acquisition of FT, one approach would be to revise Reg. §1.367(b)-3 so that FT's Small U.S. Shareholders are not subject to tax with respect to the exchange of their FT stock, preserving such gain under the Subchapter C nonrecognition rules. Under this approach, Reg. §1.367(b)-3 would continue to apply as currently drafted to FT's U.S. Shareholders of FT. Thus, corporate U.S. Shareholders would benefit from the Section 245A DRD with respect to the AEPA dividend if they satisfy the applicable requirements, and non-corporate U.S. Shareholders would include the AEPA dividend in income without the benefit of the Section 245A DRD.

    - Treasury could also consider extending the proposal described above for Small U.S. Shareholders to FT's non-corporate U.S. Shareholders, so they also do not recognize AEPA dividends with respect to their FT stock, preserving their FT stock gain under the Subchapter C nonrecognition rules. Like Small U.S. Shareholders, non-corporate U.S. Shareholders do not benefit from the Section 245A DRD. However, non-corporate U.S. Shareholders are likely to have a greater degree of control over the affairs of FT, making such a change less compelling than providing relief to Small U.S. Shareholders.

    - In the case of corporate U.S. Shareholders, Reg. §1.367(b)-3 could be revised. One approach would be, in the case of a corporate U.S. Shareholder that satisfies the ownership requirements of Section 1504(a)(2) with respect to USB upon completion of the reorganization, to provide the following treatment: (i) to the extent an AEPA dividend received by such corporate U.S. Shareholder gives rise to a Section 245A DRD-eligible dividend that would otherwise be subject to Section 1059, neither Section 1059 nor the basis adjustment rules in Reg. §1.367(b)-

2(e)(2)(ii) apply in respect of the dividend; and (ii) the corporate U.S. Shareholder would be allowed to satisfy the Section 246 Holding Period by retaining the USB stock received in the inbound reorganization for the remainder of the necessary period. Alternatively, a broader approach could be pursued whereby the recommendations in the preceding sentence are applied to all corporate U.S. Shareholders of FT.

III. Discussion of Reg. §1.367(b)-3

In 1976, Congress revised Section 367, separating outbound transfers of property in Section 367(a) from all other transfers in Section 367(b).[15] The legislative history to this change sets out the core Section 367(b) policy concerns regarding inbound nonrecognition transactions:

> [T]he availability of non-recognition treatment for distributions or exchanges of stock of controlled foreign corporations in situations not presently covered under section 367 or 1248 detracts substantially from the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation.[16]

We summarize below how Treasury implemented these policy concerns in Reg. §1.367(b)-3.

A. Development of Reg. §1.367(b)-3

Reg. §1.367(b)-3 has evolved from proposed regulations issued in 1991 (the "**1991 Proposed Regulations**"). The 1991 Proposed Regulations established the basic framework for the taxation of exchanging shareholders in connection with inbound nonrecognition transactions, including the AEPA rules. The 2000 Final Regulations finalized the 1991 Proposed Regulations with significant modifications. The 2000 Final Regulations retained the basic framework of the 1991 Proposed Regulations, but simplified the rules.

Treasury issued additional proposed regulations in 2000 (the "**2000 Proposed Regulations**") addressing the carryover of net operating loss carryforwards, capital loss carryforwards, and E&P in inbound nonrecognition transactions. The 2000 Proposed

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15 Tax Reform Act of 1976, P.L. 94-455.

16 H.R. Rep. No. 94-658, 94th Cong., 1 Sess., at 242 (1976).

Regulations were finalized in 2006 with minor modifications (the "**2006 Final Regulations**").

1. 1991 Proposed Regulations

The preamble to the 1991 Proposed Regulations sets out four main principles underlying the regulations: (i) the repatriation of a United States person's share of the E&P of a foreign acquired corporation through an inbound nonrecognition transaction generally should cause the United States person to recognize income and, relatedly, the domestic acquiring corporation should not succeed to the basis or other attributes of the foreign acquired corporation except to the extent that the United States person's share of the E&P that gave rise to those tax attributes has been subject to tax; (ii) the regulations should prevent material distortions of income, including in relation to the source, character, timing or amount of income items that could affect the tax liability of any person for any year; (iii) the regulations should minimize complexity to the extent not inconsistent with the first two principles; and (iv) income realized in a transaction that otherwise qualifies for nonrecognition treatment under the Code should not be accelerated to the extent such deferral is not inconsistent with the other three principles.[17]

Under the 1991 Proposed Regulations, exchanging U.S. Shareholders were subject to one of two rules: (i) they could include in income as a dividend the AEPA with respect to their shares in the foreign acquired corporation, or (ii) they could elect to recognize gain (but not loss) on their exchange of shares in the foreign acquired corporation. The 1991 Proposed Regulations required exchanging Small U.S. Shareholders to recognize gain (but not loss) with respect to their share in the foreign acquired corporation. The different treatment of Small U.S. Shareholders was a rule of convenience meant to alleviate administrative concerns should these shareholders not have the information necessary to determine their AEPA.[18]

The 1991 Proposed Regulations also included an attribute reduction rule, which applied if a U.S. Shareholder's realized gain was less than its AEPA. This rule reduced the foreign acquired corporation's tax attributes by the shortfall in the following order: (i) net operating loss carryforwards; (ii) capital loss carryforwards; and (iii) asset basis (first to depreciable tangible assets, then to inventory, and then to amortizable intangible assets).[19]

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[17] 56 Fed. Reg. 41995-96 (Aug. 26, 1991).

[18] 56 Fed. Reg. 41997.

[19] The 1991 Proposed Regulations also required exchanging shareholders that were U.S. Shareholders to recognize foreign currency gain or loss on their share of a foreign acquired corporation's capital account. Treasury recognized these foreign currency rules were complex and did not include the rules

2. 2000 Final Regulations

By 2000, Treasury had refined the principles of Section 367(b) regarding inbound nonrecognition transactions. The preamble to the 2000 Final Regulations reaffirms that Reg. §1.367(b)-3 requires adjustments or inclusions to prevent the material distortion of income that can arise in inbound nonrecognition transactions. The preamble elaborates that:

> [T]he principal policy consideration of section 367(b) with respect to inbound nonrecognition transactions is the appropriate carryover of attributes from foreign to domestic corporations. This consideration has interrelated shareholder-level and corporate-level components. At the shareholder level, the section 367(b) regulations are concerned with the proper taxation of previously deferred earnings and profits. At the corporate level, the section 367(b) regulations are concerned with both the extent and manner in which tax attributes carry over in light of the variations between the Code's taxation of foreign and domestic corporations.[20]

The preamble to the 2000 Final Regulation affirms Treasury's conclusion that inclusion of the AEPA is the appropriate means of satisfying the interrelated shareholder-level and corporate-level components of Reg. §1.367(b)-3, because the deemed dividend ends the deferral of untaxed earnings and generally ensures that the Section 381 carryover basis reflects an after-tax amount.[21] In doing so, the preamble recognizes that the AEPA regime "does not consider tax attributes that accrue during a non-U.S. person's holding period."[22] Treasury, however, requested comments whether future Section 367(b) regulations should require attribute reduction in lieu of AEPA income inclusion and on

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in the 2000 Final Regulations. T.D. 8862. Reg. §1.367(b)-3(b)(3)(iii) reserves on the recognition of exchange gain or loss with respect to capital.

20 T.D. 8862.

21 *Id*. Congress enacted Section 362(e) after Treasury issued the 2000 Final Regulations. Section 362(e)(1) prevents the importation of a net built-in loss in an inbound reorganization under Section 368(a) and thus is an additional safeguard regarding the tax-free importation of basis into the U.S. tax net.

22 *Id*. The 2000 Final Regulations clarified this point in response to commenters who raised concerns that the regulations' use of Section 1248 attribution principles might be read to require the carryover of non-U.S. persons' earnings under Section 1223(2). T.D. 8862 (Jan. 24, 2000).

possible approaches to address tax attributes related to the holding periods of non-U.S. persons.[23]

The 2000 Final Regulations also made simplifying changes to the 1991 Proposed Regulations. The final regulations require U.S. Shareholders to include their AEPA as a dividend, eliminating the option to recognize gain and the associated attribute reduction rules.[24] The 2000 Final Regulations also provide more flexibility for Small U.S. Shareholders, who recognize gain realized on the exchange unless they elect to include the AEPA dividend, subject to a $50,000 *de minimis* exception.

3. 2000 Proposed Regulations and 2006 Final Regulations

The 2000 Proposed Regulations addressed the carryover of net operating loss and capital loss carryforwards, E&P not included in the AEPA, and E&P deficits. The proposed regulations generally provided that these tax attributes do not carry over from the foreign acquired corporation to the domestic acquiring corporation in an inbound nonrecognition transaction unless the attributes are effectively connected to a U.S. trade or business (or attributable to a permanent establishment, in the context of a relevant U.S. income tax treaty).[25] The 2006 Final Regulations adopted the 2000 Proposed Regulations without change, except for reserving on the carryover of PTEP in inbound nonrecognition transactions.

B. Current Rules: AEPA Structure

The AEPA with respect to a share of foreign acquired corporation stock is the net positive E&P of the foreign acquired corporation attributable to such share.[26] A foreign acquired corporation's E&P generally are determined using principles that are substantially similar to those used to compute the E&P of domestic corporations.[27] However, in determining an exchanging shareholder's AEPA, a foreign acquired corporation's E&P do not include amounts specified in Section 1248(d), such as PTEP and E&P attributable to income effectively connected with a U.S. trade or business.[28] The

23 *Id*.

24 Treasury issued temporary regulations that included a more limited taxable exchange election; however, these regulations were not finalized. T.D. 8863 (January 24, 2000).

25 T.D. 8862 (Jan. 24, 2000).

26 Reg. §1.367(b)-2(d)(1).

27 Reg. §1.367(b)-2(d)(2)(i).

28 Reg. §1.367(b)-2(d)(2)(ii).

amount of E&P attributable to a share of foreign acquired corporation stock is determined under the principles of Section 1248, but without regard to the Section 1248 requirements that are irrelevant to determining the exchanging shareholder's pro rata portion of the E&P.[29] Thus, the principles of Section 1248 apply without regard to whether the foreign acquired corporation is, or has been, a CFC, or whether the exchanging shareholder is a Section 1248 shareholder with respect to the foreign acquired corporation.[30]

An AEPA dividend is treated as a dividend for all purposes of the Code and is considered paid out of the E&P to which it is attributable (*e.g.*, an AEPA dividend is not paid out of PTEP).[31] The following ordering rules apply with respect to an AEPA dividend:

1. an exchanging shareholder first determines its gain realized with respect to an inbound nonrecognition transaction;

2. the exchanging shareholder is then deemed to receive the AEPA dividend immediately before the inbound nonrecognition transaction and increases the basis of its foreign acquired corporation stock by the amount of the AEPA dividend, which is taken into account in determining the basis of the property it receives in an inbound reorganization under Section 358; and

3. the foreign acquired corporation's E&P are reduced by the amount of the AEPA dividend before the exchanging shareholder determines its consequences of recognizing gain in excess of the AEPA dividend.[32]

As discussed above, the AEPA does not take into account amounts attributable to the holding period of non-U.S. persons.[33]

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[29] Reg. §1.367(b)-2(d)(3)(i).

[30] Id.

[31] Reg. §1.367(b)-2(e)(2).

[32] Reg. §1.367(b)-2(e)(2).

[33] *See* discussion corresponding to fn [21], above.

IV. TCJA Changes

A. The Section 245A DRD

1. In General

Section 245A allows a domestic corporation that is a U.S. Shareholder, with respect to a specified 10-percent owned foreign corporation (an "**SFC**") a 100 percent dividends received deduction for the foreign-source portion of dividends received from the SFC.[34] Generally, an "SFC" is a foreign corporation that has at least one corporate U.S. Shareholder.[35] The "foreign-source portion" of a dividend is the amount of the dividend attributable to the SFC's undistributed foreign earnings—*i.e.*, the SFC's E&P that have not been taxed in the United States.[36]

A Section 245A DRD is available for a dividend paid with respect to a share of SFC stock only if the corporate U.S. Shareholder held the share for more than 365 days during the 731-day period beginning on the date which is 365 days before the date the share becomes ex-dividend (the "**Section 246 Holding Period Requirement**").[37] A corporate U.S. Shareholder, however, is treated as holding a share of SFC stock for any period only if: (i) the SFC was an "SFC" at all times during the period; and (ii) the corporate U.S. Shareholder was a "U.S. Shareholder" of the SFC at all times during the period.[38]

A Section 245A DRD-eligible dividend can produce benefits for corporate U.S. Shareholders beyond the deduction itself because the dividend is a tax-exempt reduction of the value of SFC stock that does not affect the basis of the SFC stock. Thus, a Section

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[34] Section 245A(a). A Section 245A DRD is not allowed for a hybrid dividend. Section 245A(e)(1). Generally stated, a "hybrid dividend" is an amount received from a CFC for which the CFC received a deduction or other tax benefit related to taxes imposed by a foreign country. Section 245A(e)(4).

[35] Section 245A(b). An SFC does not include a corporation that is a passive foreign investment company (a "**PFIC**") with respect to the corporate U.S. Shareholder in question and which is not a CFC. Section 245A(b)(2).

[36] *See* Section 245A(c). The "foreign source portion" of a dividend is determined by multiplying the amount of the dividend by the ratio of the SFC's undistributed foreign earnings to its undistributed earnings. Section 245A(c)(1). An SFC's "undistributed foreign earnings" are its undistributed earnings that are not attributable to effectively connected income or dividends received from 80 percent-owned domestic corporations. Sections 245A(c)(3) and 245(a)(5). An SFC's "undistributed earnings" are its E&P determined as of the close of its taxable year without regard to distributions during the year. Section 245A(c)(2).

[37] Section 246(c)(1)(A) and (5)(A).

[38] Section 246(c)(5)(B).

245A DRD-eligible dividend can either reduce the capital gain or create or increase the capital loss recognized from a subsequent disposition of SFC stock. As discussed below, Sections 1059 and 961(d) address concerns with this result.

2. Section 1059

Prior to the enactment of the TCJA, Section 1059 was primarily a domestic provision because dividends of foreign E&P were not allowed a dividends received deduction ("**DRD**"), and thus were subject to tax in full when paid. The Section 245A DRD, however, increased the role and importance of Section 1059 by extending its application to SFC dividends of undistributed foreign earnings.

Under Section 1059, if a corporate U.S. Shareholder receives an extraordinary dividend with respect to a share of SFC stock and the shareholder has not held the share for more than two years before the dividend announcement date (the "**Section 1059 Holding Period Requirement**"), then the basis of the share is reduced (but not below zero) as of the beginning of the ex-dividend date by the nontaxed portion of the extraordinary dividend.[39] If the nontaxed portion of the extraordinary dividend exceeds the basis of the share of stock with respect to which the dividend is paid, the corporate U.S. Shareholder recognizes gain equal to the amount of such excess.[40] In general, an SFC dividend is an "extraordinary dividend" if the amount of the dividend is equal to or exceeds the threshold percentage (five percent for stock with preferred dividend rights and ten percent for all other stock) of the corporate U.S. Shareholder's basis in the share of SFC stock with respect to which the dividend is paid.[41] The "nontaxed portion" of an extraordinary dividend is the amount by which the amount of the dividend exceeds the taxable portion of the dividend.[42] Thus, Section 1059 essentially treats the nontaxable portion of an extraordinary dividend as a distribution of property subject to Sections 301(c)(2) and (3), notwithstanding the fact that the distributing corporation has E&P.

Section 1059 is an anti-abuse rule that was enacted to curtail the benefits of transactions that took advantage of the Code's DRD rules to create non-economic stock

[39] Section 1059(a)(2). Rules similar to those in Section 246(c)(3) and (4) apply for purposes of determining whether the Section 1059 Holding Period Requirement is satisfied. Section 1059(d)(3). Thus, the Section 1059 Holding Period can be satisfied by taking into account carryover and tacked holding periods under Section 1223(1) and (2), respectively.

[40] Section 1059(a)(2).

[41] Section 1059(c)(1) and (2). Certain distributions are treated as extraordinary dividends, irrespective of whether the distributions otherwise satisfy the applicable threshold percentage or whether the corporate U.S. Shareholder satisfies the Section 1059 Holding Period Requirement. *See* Section 1059(e)(1)(A).

[42] Section 1059(b)(1). As regards the Section 245A DRD, the "taxable portion" of an extraordinary dividend is the portion of the dividend includible in gross income, reduced by the amount of the Section 245A DRD allowed for the dividend. Section 1059(b)(2).

losses for tax purposes. The paradigm transactions that were intended to be subject to Section 1059 were so-called "dividend-strip" transactions.[43] A typical dividend-strip transaction had two parts. First, a domestic corporation would make a portfolio investment in stock of another corporation shortly before the stock became ex-dividend (*e.g.*, stock of a corporation with an established dividend-paying history or that announced its intention to pay a dividend) by purchasing a minority stock interest in such corporation.[44] Second, after the dividend was paid, the purchaser would sell the stock at a loss because the dividend reduced the fair market value, but not the basis, of the purchased stock.[45] The purchaser would (i) recognize ordinary income for the dividend paid with respect to the purchased stock and, if it satisfied the applicable holding period requirement, claim an 85-percent DRD for the dividend; and (ii) claim a capital loss on the subsequent stock sale.[46]

Congress thought the results of dividend-strip (and similar) transactions were inappropriate, viewing the purchase of extraordinary dividend-paying stock as the acquisition of two assets: the right to receive the dividend and the stock itself.[47] Congress concluded it was appropriate to reduce the basis of the stock to reflect the portion of the extraordinary dividend that was not subject to tax.[48] As originally enacted, Section 1059 only applied if a corporation both (i) received an extraordinary dividend with respect to a share of stock, *and* (ii) disposed of the stock before it held the share for more than one year.[49] Thus, as enacted, Section 1059 applied only to the extent a corporation engaged in both parts of a dividend-strip transaction.

Two years after enactment, Congress determined that Section 1059 was an inadequate deterrent because taxpayers could obtain the inappropriate tax benefits of dividend-strip transactions by merely waiting one year to sell extraordinary dividend-

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43 Certain straddle-like transactions were used by taxpayers to achieve results that were similar to dividend-strip transactions. In these transactions, taxpayers would purchase dividend-paying stock and sell short similar securities (*e.g.*, convertible bonds) that were not "substantially identical" to the dividend-paying stock. H. Rep. No. 432(II), 98th Cong. 2d Sess., at 1185-86 (1984) ("**1984 House Report**").

44 *See id.*, at 1184.

45 *Id*.

46 *Id.*

47 *Id*., at 1186.

48 *Id*.

49 Section 1059(a) (1984).

paying stock.[50] In particular, Congress noted that the one-year holding period originally included in Section 1059, which apparently was intended to deter the proscribed transactions by subjecting taxpayers to market risk during the period, was an insufficient restriction in light of the substantial tax arbitrage benefits that could be obtained.[51] In response to this concern, Congress amended Section 1059 by replacing the condition that the taxpayer hold extraordinary dividend-paying stock for more than one year at the time of disposition with a condition that the taxpayer hold extraordinary dividend-paying stock for more than two years as of the dividend announcement date.[52] Consistent with Section 1059 as originally enacted, Congress deferred gain recognition for the amount by which the nontaxable portion of an extraordinary dividend exceeded the basis of the stock in question until the taxpayer disposed of the stock.[53] Congress also added a category of transactions that give rise to *per se* extraordinary dividends, irrespective of whether the applicable threshold percentage is exceeded or whether the shareholder Section 1059 Holding Period Requirement is satisfied.

Congress ended Section 1059 gain deferral in 1997 in connection with amendments that responded to positions taken by taxpayers regarding the application of the Code's DRD rules to transactions intended to be dividend-equivalent redemptions, in some cases on account of the Section 318 option rules.[54] The legislative history to Section 1059 does not describe why Congress chose to end deferral for Section 1059 gain. Presumably Congress, at least in part, wanted to prevent taxpayers from indefinitely deferring gain recognition for the Section 302 redemptions in question by retaining a small amount of shares in the redeeming corporation.[55] However, there is no indication that the decision to end deferral was based on a fundamental change to the congressional intent that motivated the original enactment of Section 1059.

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[50] S. Rep. No. 313, 99th Cong. 2d Sess., at 249 (1986).

[51] *Id*. at 249, n. 12.

[52] H Rep. No. 841, 99th Cong. 2d Sess., at 164 (1986) (Conf. Rep.).

[53] Section 1059(a)(2) (1986).

[54] H. Rep. No. 220, 105th Cong. 1st Sess., at 525-56 (1997) (Conf. Rep.).

[55] *See* H. Rep. No. 148, 105th Cong. 1st Sess., at 459-60, fn. 17 (1997) (noting the Seagram Corporation's intent to rely on the Section 318 option rules to treat a stock redemption by the DuPont Corporation as a dividend-equivalent redemption); *see also* Sheppard, "Can Seagram Bail Out of DuPont without Capital Gain Tax," 95 TNT 75–4 (Apr. 10, 1995) (discussing the DRD and basis consequences of the DuPont-Seagram transaction).

The version of the Build Back Better Act passed by the House of Representatives in November 2021[56] (the "**House Bill**") includes a proposal to add new Section 1059(g) to treat disqualified CFC dividends as *per se* extraordinary dividends. A "disqualified CFC dividend" is a dividend paid by a CFC to a U.S. Shareholder that is attributable to E&P either earned during any period the CFC was not a "CFC" or that is attributable to disqualified CFC dividends received from other CFCs.[57] For these purposes, (i) the determination of whether a foreign corporation is a CFC is made without regard to Section 958(b)(4) repeal, and (ii) E&P properly attributable to stock owned by non-U.S. Shareholders is considered earned during a period a foreign corporation was not a CFC.[58]

3. Section 961(d)

Section 961(d) generally provides that if a domestic corporation receives a dividend from an SFC, then, solely for purposes of determining loss on a disposition of stock of the SFC, the domestic corporation's basis in the stock of the SFC is reduced (but not below zero) by the amount of any Section 245A DRD allowed with respect to the stock.[59] Thus, unlike Section 1059, Section 961(d) only applies to prevent loss recognition and does not apply where gain is recognized or no gain or loss is recognized. Congress thought this approach was appropriate because it was consistent with Section 1248 policy, since Section 1248(a) dividends are eligible for the Section 245A DRD.[60] Section 961(d) includes a coordination rule that provides the general basis reduction rule

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56 H.R. 5376 (Nov. 18, 2021). The same proposal was also included in the draft legislative text released on December 11, 2021, by U.S. Senate Finance Committee Chairman Ron Wyden (D-OR).

57 H.R. 5376, § 138148(a).

58 *Id.*

59 *See also* Section 964(e)(4)(B) (providing "[f]or purposes of this title, in the case of a sale or exchange by a controlled foreign corporation of stock in another foreign corporation in a taxable year of the selling controlled foreign corporation beginning after December 31, 2017, rules similar to the rules of section 961(d) shall apply").

60 The legislative history to Section 961(d) provides the following explanation:

> A participation exemption system could provide double tax benefits in certain circumstances. In particular, a distribution from a foreign subsidiary that is eligible for a DRD would reduce the value of the foreign subsidiary, reducing any built-in gain or increasing any built-in loss in the shareholder's stock of the subsidiary. *Reducing gain in this manner is consistent with the application of section 1248(a) (or section 964(e)) to recharacterize gain as a dividend for which a DRD may be allowed. Increasing loss in this manner, however, creates a double U.S. tax benefit for receiving a tax-free distribution from a foreign subsidiary*.

Committee on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, 115th Cong. 1st Sess. at 360 (S. Prt. No. 115-20) (emphasis added).

does not apply to the extent the domestic corporation reduced the basis in its SFC stock under Section 1059. Thus, the Code prioritizes Section 1059 over Section 961(d).

B. Asset Basis Provisions of the GILTI Rules

CFC asset basis is relevant in determining a U.S. Shareholder's current GILTI inclusion in two ways. First, the depreciation and amortization deductions properly allocable to a CFC's gross tested income are taken into account in determining the CFC's tested income.[61] Second, a U.S. Shareholder's exempt routine return is based on its pro rata shares of its CFCs' basis in tangible assets that produce or are held for the production of gross tested income.[62] Thus, after the TCJA, if a U.S. Shareholder acquires stock of a non-CFC foreign target corporation and such corporation becomes a CFC as a result of the acquisition, the U.S. Shareholder in effect imports the foreign corporation's asset basis into the current U.S. tax net (albeit at an effective tax rate that takes into account the Section 250 deduction) without taxation of the foreign corporation's pre-CFC E&P.

V. Discussion of Paradigms

When considering the tax consequences and policy considerations involving inbound nonrecognition transactions, we believe it is helpful to review the application of the relevant rules to different transaction structures for bringing assets of foreign corporations into the United States, both from the lens of a pre-TCJA world and under the current TCJA regime. We summarize three paradigms below, which are described in detail in the Annex. Each of the paradigms has its distinct tax consequences, however, we believe that comparing the paradigms is a helpful construct for evaluating changes to Reg. §1.367(b)-3 that may be appropriate in light of the enactment of the TCJA.

A. Common Fact Pattern

The basic facts underlying each of the examples are as follows (see diagram 1 below). USB, a domestic corporation, acquires all the stock of FT. FT is a foreign corporation that is not, and has never been, a CFC or a PFIC. FT is owned by USSH (a domestic corporation), a group of U.S. citizens (collectively, the "**US Individuals**"), and a group of non-U.S. citizens (collectively, the "**Foreign Individuals**"). USSH is a U.S. Shareholder with respect to FT and FT is an SFC with respect to USSH. USSH satisfies the Section 246 Holding Period Requirement and the Section 1059 Holding Period Requirement with respect to its shares in FT. None of the US Individuals is a U.S.

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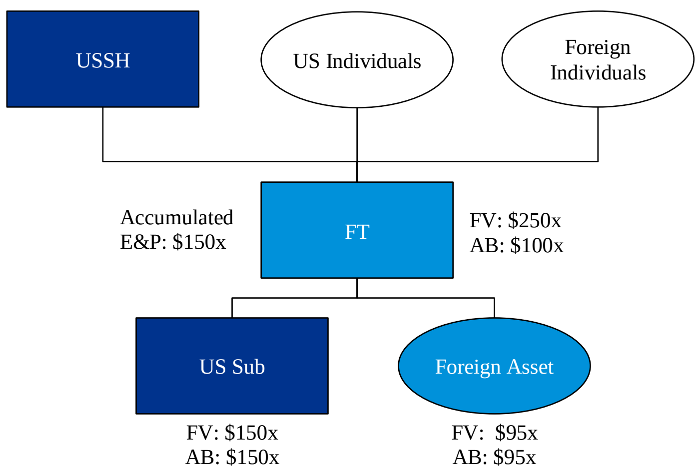
61 Section 951A(c)(2)(A)(ii).

62 *See* Section 951A(b)(2)(A).

Shareholder with respect to FT. The outstanding FT stock has an aggregate value of $250x and uniform basis of $100x.

FT owns all the stock of US Sub (a domestic corporation), Foreign Asset, and other non-de minimis assets (not shown). For purposes of illustration, assume that the values of US Sub and Foreign Asset are $150x and $95x, respectively; FT has a fair market value basis in its US Sub stock and Foreign Asset; and FT's non-de minimis assets have a fair market value and basis of $5x. Further assume that FT has accumulated E&P of $150x and no current year E&P. FT's accumulated E&P are not from dividends paid by US Sub or PTEP and are attributable evenly among its three groups of shareholders.



B. Paradigm 1: Tax-free Stock Acquisition Followed by Separate Dividend

In the first example, USB acquires FT in a tax-free stock acquisition and then FT distributes US Sub and Foreign Asset as a separate, post-closing dividend.[63] Before the TCJA, USB would have a taxable dividend of $150x (due to accumulated non-PTEP E&P of $150x) and $95x of return of basis (reducing the basis in FT stock by $95x). All of the E&P of FT are taken into account in determining the amount of USB's dividend. The historical shareholders of FT would not be taxed on the acquisition, and the basis in their USB shares would equal the basis in their exchanged FT shares.

Under current rules, if USB continues to hold the FT stock for one year so that it satisfies the Section 246 Holding Period Requirement, USB should benefit from the

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63 Assume FT (i) retains its non-*de minimis* assets so the distribution is not a *de facto* liquidation, (ii) the distribution is not a partial liquidation for purposes of Section 1059, and (iii) the distribution is not a hybrid dividend for purposes of Section 245A.

Section 245A DRD. Whether there would be a basis adjustment under Section 1059 would depend on whether USB satisfies the Section 1059 Holding Period Requirement, taking into account the Section 1223 tacked holding period from the historical FT shareholders.[64] The consequences to the historical FT shareholders are the same as before TCJA.

In Paradigm 1, if either the US Sub stock or Foreign Asset has a fair value in excess of basis, FT would recognize the gain under Section 311(b). Prior to the TCJA, USB would take any resulting subpart F income into account and non-subpart F income would be included in the AEPA. Post-TCJA, Section 311(b) gains may also be taken into account in determining GILTI, and the corresponding earnings would be treated as PTEP.

C. Paradigm 2A/B: Tax-free Stock Acquisition Followed by Separate Section 332 Liquidation or F Reorganization

In the second example, USB acquires FT in a tax-free stock acquisition and then either (A) liquidates FT in a separate Section 332 liquidation ("**Paradigm 2A**") or (B) migrates FT to the United States in an F reorganization ("**Paradigm 2B**"). Before the TCJA, under Reg. §1.367(b)-3, USB would have recognized a taxable AEPA dividend, comprised of the E&P attributable to USSH's FT shares (shares owned by USSH (a U.S. Shareholder)) and perhaps the US Individuals (Small U.S. Shareholders).[65] USB's basis in its FT shares would increase by the same amount, but this increase would only be relevant for Paradigm 2B (in 2A, FT liquidates). The consequences to the historical FT shareholders would be the same as in Paradigm 1.

Post-TCJA, the AEPA dividend to USB would benefit from the Section 245A DRD. However, in contrast to Paradigm 1, it appears that USB must wait one year before undertaking the Section 332 liquidation or F reorganization of FT, to satisfy the Section 246 Holding Period Requirement. USB's basis in its FT shares will be potentially reduced if Section 1059 applies (same holding period analysis as Paradigm 1). USB's basis in its FT shares will be increased by the AEPA dividend. As noted above, however, the increase will likely be irrelevant in Paradigm 2A since FT shares cease to exist after

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64 See fn. 38, supra.

65 USB's AEPA dividend includes the portion of FT's E&P attributable to FT stock acquired from USSH, but it does not include the portion of FT's E&P attributable to FT stock acquired from the Foreign Individuals. It is not entirely clear whether USB's AEPA dividend includes the portion of FT's E&P attributable to the FT stock acquired from the US Individuals because the individuals are not Section 1248 shareholders. *Compare* Reg. §1.367(b)-2(d) (applying Section 1248 attribution principles without regard to the Section 1248 requirements that are irrelevant to the determination of a shareholder's pro rata portion of E&P) *with* Reg. §1.1248-8 (only attributing E&P in acquisitive restructuring transactions to the extent foreign corporate stock is exchanged by a Section 1248 shareholder).

the liquidation.[66] The consequences to the historical FT shareholders would be the same as prior to TCJA.

Unlike Paradigm 1, if either the US Sub stock or Foreign Asset has a fair value in excess of basis, FT would not recognize gain in connection with the Section 332 liquidation or F reorganization and the historical basis of the shares of US Sub or Foreign Asset would carry over to USB or to UST. Earnings attributable to FT's effectively connected income would carry over to USB or UST, respectively.

D. Paradigm 3: Inbound Asset Reorganization

In the last fact pattern USB acquires the assets of FT in a reorganization described in Section 368(a)(1)(A) (an "**A reorganization**"). In a pre-TCJA world, there would be no tax to USB. Similar to Paradigm 2, USB would have a carryover basis in FT's assets (including the asset basis associated with the FT's E&P attributable to the Foreign Individuals), and earnings attributable to FT's effectively connected income would carry over to USB. For the historical FT shareholders, there would be an AEPA dividend for USSH (a U.S. Shareholder), and, subject to the de minimis exception, the US Individuals (Small U.S. Shareholders) would recognize gain on their FT shares unless they elected to include their AEPA dividends. The AEPA dividend and FT stock gain recognized by the historical FT shareholders would increase their basis in their FT stock and therefore in their USB stock received in the reorganization under Section 358.

Post-TCJA, USB will have the same consequences as in the pre-TCJA world. Historical shareholders also will have the same consequences as the prior regime, except that USSH (as a corporate U.S. Shareholder) will get the benefit of Section 245A DRD on its AEPA dividend.

E. Observations

1. Prior to Enactment of TCJA

In all three paradigms, FT's earnings are taxed as dividends (either as an actual divided or as an AEPA dividend) when repatriated to the United States. However, there are differences in the taxation of the dividends in the three paradigms. In Paradigm 1, the distribution is treated a dividend to USB to the extent of the full E&P of FT, and so includes earnings that are attributable to the Foreign Individuals. In contrast, in Paradigm 2, the AEPA dividends do not include earnings that are attributable to the Foreign

[66] Although there is some uncertainty regarding the ordering, if the Section 1059 adjustment was deemed to occur prior to the basis increase under Section 367, and there was not sufficient basis to be reduced (which would be the case in Paradigms 2A and 2B), then gain would be triggered pursuant to Section 1059.

Individuals or (potentially) the US Individuals.[67] In Paradigm 3, USB is not subject to the AEPA regime at all; rather only FT's E&P attributable to USSH are subject to the AEPA regime, unless the US Individuals elect to include their AEPA dividends instead of recognizing stock gain.

These differences reflect the policy and design choices underpinning the 2000 Final Regulations. As discussed earlier, Reg. §1.367(b)-3 ended tax deferral, for U.S. Shareholders of foreign acquired corporation stock, of E&P that arose during their ownership period that were not previously taxed under Section 951. Also, to increase administrability and reduce complexity, Reg. §1.367(b)-3 required Small U.S. Shareholders to recognize stock gain as a proxy for taxing the foreign acquired corporation's E&P attributable to such shares. However, Reg. §1.367(b)-3 did not seek to tax legacy foreign shareholder earnings, and assets corresponding to those earnings could come into the U.S. tax system tax-free with full basis in connection with an inbound nonrecognition transaction.[68]

An important distinction between Paradigm 1, on the one hand, and Paradigms 2 and 3, on the other, involves the repatriation of appreciated assets. In Paradigm 1, if the distribution includes appreciated assets, USB generally will take into account the gain in determining subpart F income, and any gain that USB does not take into account under these rules will create additional AEPA. In contrast, in Paradigms 2 and 3, if the inbound nonrecognition transaction involves appreciated assets, the historic basis carries over into the U.S. successor entity, the built-in gain would be deferred and subject to U.S. corporate tax only when the successor entity disposes of the assets in a taxable transaction.[69]

2. Post-TCJA Differences

Section 245A fundamentally changes the picture. In Paradigm 1, USB can access the Section 245A DRD immediately following the acquisition of FT, so long as USB continues to hold FT stock for the period necessary to satisfy the Section 246 Holding Period Requirement. This reflects the approach of the TCJA and Section 245A not to tax untaxed foreign earnings when brought into the United States. As a result, following the TCJA, legacy untaxed foreign earnings (whether attributable to U.S. or foreign persons) and the associated legacy asset basis can come into the U.S. tax system tax-free following

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[67] Excluded earnings carry over to the domestic acquiring corporation (USB in Paradigm 2A and UST in Paradigm 2B) only to the extent they are effectively connected with a U.S. trade or business of FT.

[68] The historical approach to not taxing legacy foreign shareholder earnings makes sense from a policy perspective because the foreign shareholders are not subject to U.S. tax on the inbound transaction, regardless of the form of the transaction.

[69] Section 362(e) prevents importation of built-in losses in these situations.

a tax-free stock acquisition. Under this approach, the backstops to Section 245A (in addition to the Section 246 Holding Period Requirement and the hybrid rules in Reg. §1.245A(e)-1) are the Section 961(d) and Section 1059 basis adjustments to prevent corporate U.S. Shareholders from obtaining additional arbitrage benefits from the Section 245A DRD (in the case of Section 961(d), prevention of stock losses, and in the case of Section 1059, prevention of stock losses and reduction of stock gain).

In Paradigm 2A and 2B, the Section 245A DRD is also available, but only if USB holds the FT shares for one year before effectuating the second step liquidation/migration. The Section 1059 implications of Paradigm 2A and 2B are the same as those in Paradigm 1.[70]

In contrast, in Paradigm 3 Section 245A will only apply to the AEPA dividend recognized by USSH. The Section 1059 implications of Paradigm 3 as to USSH are largely the same as those of Paradigm 2B to USB. Also, if FT were to have non-corporate U.S. Shareholders, such shareholders would recognize a taxable AEPA dividend. Unless the *de minimis* exception applies, the US Individuals will have taxable gain (or a taxable AEPA dividend if an election is made). In effect, the Reg. §1.367-3(b) approach puts Small U.S. Shareholders and non-corporate U.S. Shareholders at a disadvantage in an asset reorganization, as compared to the stock acquisitions and post-acquisition transactions in Paradigms 1 and 2.

If appreciated assets are involved, in Paradigm 1 USB will take into account the gain in determining subpart F income or GILTI, and any gain that USB does not take into account under these rules will be included in AEPA. In effect, GILTI replaces gain that, prior to the TCJA, would have given rise to earnings and profits and resulted in dividend income. As was the case prior to the TCJA, in Paradigms 2 and 3, the historic basis carries over into the U.S. successor entity, the built-in gain would be deferred and subject to U.S. corporate tax only when the successor entity disposes of the assets in a taxable transaction.

F. Potential Design Changes to Reg. §1.367(b)-3

The U.S. international tax system in place when Treasury promulgated Reg. §1.367(b)-3 was very different than the current system. In particular, prior to the TCJA, (i) foreign earnings of a foreign corporation generally were not subject to tax until distributed to U.S. persons that owned stock of the foreign corporation, and (ii) the basis of foreign assets owned by a foreign corporation generally was not relevant in computing the current tax liability of a U.S. person that owned stock of the foreign corporation,

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70 If the stock basis adjustment under the Section 367(b) regulations were to occur prior to the deemed receipt of the AEPA dividend, the adjustments would counteract the application of Section 1059, as discussed further below.

except where the foreign corporation's E&P were distributed to a U.S. person in the form of a dividend. The subpart F regime provided exceptions to these general rules, but the subpart F exceptions were limited in scope, and taxpayers were able to structure their offshore operations to minimize subpart F income and maintain deferral.

The TCJA fundamentally changed the taxation of foreign corporate earnings by enacting the Section 245A DRD, the GILTI rules, and Section 965. These rules replaced the historical deferral regime with a current inclusion regime that is subject to a limited participation exemption for foreign E&P arising in periods before a foreign corporation was a CFC and an equity-based routine return on certain tangible assets. As a result, for corporate U.S. Shareholders, (i) foreign earnings are either currently subject to tax or exempt from tax when distributed, and (ii) the basis of foreign assets owned by a CFC is relevant in computing the shareholder's current tax liability. The enactment of Section 362(e)(1), which prevents the importation of a net built-in loss in an inbound reorganization, prevents the tax-free importation of basis into the U.S. tax system is also relevant to Section 367(b) policy.

It is appropriate to revisit the role of Section 367(b) as regards inbound nonrecognition transactions in light of the significant changes made by the TCJA, most notably the impact that the Section 245A DRD and the GILTI rules have on the taxation of deferred CFC E&P and the current relevance of CFC asset basis, respectively. In particular, a domestic corporation is now able to repatriate CFC earnings and onshore foreign asset basis without residual U.S. tax cost. We believe it is significant that the current tax system does not limit the Section 245A DRD to E&P generated while a foreign corporation is a CFC.[71] Thus, a domestic corporation's ability to repatriate foreign earnings and to onshore foreign asset basis is not conditioned on the earnings and basis having been first subject to the subpart F income or GILTI regime.[72] As discussed in Paradigm 1, a domestic corporation can acquire the stock of a non-CFC foreign target corporation and repatriate the target corporation's pre-acquisition E&P and asset basis through a dividend distribution without paying tax.[73] Moreover, as discussed above,

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71 As discussed above, the House Bill would expand Section 1059 so that any "disqualified dividend" from a CFC is treated as an extraordinary dividend, even if the shareholder has owned the shares of the foreign corporation for two or more years. *See* fn. 55-57, above, and the related discussion. *Cf.* Sections 304(b)(5)(A) and (B) (takes into account acquiring corporation earnings only to the extent attributable to a transferor that is a U.S. Shareholder and that were accumulated during periods while the acquiring corporation was a CFC); Section 1248 (takes into account only earnings attributable to periods when the selling shareholder held the shares and the foreign corporation was a CFC).

72 *See, e.g.,* the legislative history of Section 245A cited in fn. 13, *supra* (Section 245A was motivated by a congressional desire to eliminate the U.S. tax costs of bringing foreign earnings back to the United States).

73 Although Paradigm 1 addresses a tax-free stock acquisition followed by a distribution, the same results would also occur if the stock acquisition was a taxable transaction.

because a CFC's asset basis is relevant in determining the GILTI inclusions of its U.S. Shareholders, a U.S. Shareholder's acquisition of foreign corporation stock effectively imports CFC asset basis into the current U.S. tax net without such assets being onshored through a distribution or inbound nonrecognition transaction.

1. Consistency of Tax Treatment for Different Forms of Inbound Transactions

We believe that the first step in assessing the role of Section 367(b) with respect to inbound nonrecognition transactions after the TCJA is to determine whether and to what extent the tax consequences of bringing foreign earnings into the United States in Paradigms 1 through 3 should be aligned. For the reasons described above relating to subsequent distributions of appreciated assets, we believe there is greater alignment between Paradigms 2 and 3. Given the economic similarities between the transactions described in Paradigms 2 and 3, we believe some degree of parity would be beneficial, as substantial inconsistencies unnecessarily prioritize certain forms of transactions over others and may lead to traps for the unwary. Prioritizing one form of an inbound reorganization may also have non-tax consequences, if a favorable tax structure is more difficult to implement from a U.S. or foreign legal or regulatory perspective. We discuss these considerations below, first from the perspective of the acquiring U.S. corporation, USB, and then from the perspective of the U.S. Shareholders and Small U.S. Shareholders of the foreign corporation, FT.

2. USB Considerations

a) Section 1059 Considerations

A key difference between Paradigms 1 and 2A/2B is the relevance of Section 1059 policy. As noted above, Section 1059 is an anti-abuse rule intended to prevent domestic corporate taxpayers from using the Code's DRD rules to create non-economic losses for tax purposes. We recognize this concern is relevant to Paradigm 1, but we believe it is not relevant to Paradigm 2. Section 1059 policy is not relevant to Paradigm 2A because USB's FT stock is eliminated in the inbound Section 332 liquidation of FT. Thus, USB cannot sell the FT stock at a loss as a result of the AEPA dividend after the inbound Section 332 liquidation. Accordingly, we believe that Reg. §1.367(b)-3 should be amended to provide that Section 1059 does not apply to an AEPA dividend that results from an inbound Section 332 liquidation.[74]

It could be argued that because Section 1059 requires gain recognition without regard to a disposition of extraordinary dividend-paying stock, gain recognition is

[74] An alternative would be to revise the regulations to provide specifically that the basis increase in Reg § 1.367-2(e)(2)(ii) applies immediately before taking into account the Section 1059 basis reduction.

appropriate for the inbound Section 332 liquidation notwithstanding that USB's FT stock ceases to exist as a result of the liquidation. That is, the general rule under Section 1059 does not condition gain recognition upon completing the second part of a dividend-strip transaction, so the fact the USB's FT stock ceases to exist is irrelevant to determining whether Section 1059 should apply to an AEPA dividend resulting from an inbound Section 332 liquidation.

As discussed above, the 1997 legislative history contains no indication that the decision to end deferral was based on a fundamental change to the congressional intent that motivated the enactment of Section 1059. Rather, the 1997 legislative history creates an inference that after 13 years of a cat-and-mouse game with taxpayers, culminating with the *Seagrams-DuPont* transaction, Congress enhanced the scope of the rule to more effectively deter dividend-strip transactions by eliminating Section 1059 gain deferral.[75] Accordingly, the 1997 amendment can be viewed as shifting Section 1059 to a model that presumes that taxpayers will eventually dispose of extraordinary dividend-paying stock in taxable transactions. This presumption is not relevant to inbound Section 332 liquidations because the transaction that would give rise to the extraordinary dividend also results in a tax-free disposition of the associated stock.

Section 1059 policy also is not relevant to Paradigm 2B, because the value of USB's UST stock after the inbound migration has not been reduced by the AEPA dividend. Thus, as an economic matter, FT does not have a reduction in fair market value as a result of the AEPA dividend after the inbound migration. We recognize, however, that Reg. §1.367(b)-2(e)(2)(ii), which increases the basis in USB's FT stock immediately before the F reorganization, implicates Section 1059 policy because it effectively produces the tax-advantaged capital loss Section 1059 is intended to prevent—albeit through a tax-free basis step up as opposed to a tax-free value reduction. Accordingly, we believe that Reg. §1.367(b)-2(e)(2)(ii) should be revisited.

One approach would be to provide that to the extent an AEPA dividend received by USB gives rise to a Section 245A DRD-eligible dividend that would otherwise be subject to Section 1059, neither Section 1059 nor the basis adjustment rules in Reg. §1.367(b)-2(e)(2)(ii) apply in respect of the dividend. Although this approach would address Section 1059 concerns by preventing the creation of artificial stock losses (or artificial reductions of stock gains), it may produce latent adverse consequences for USB in Paradigm 2B. In particular, if UST were to subsequently distribute property with respect to its stock to USB, such distributions would be more likely to produce stock gain (or an excess loss account with respect to UST if UST and USB elected to file a

[75] See fn. 55, *supra*.

consolidated tax return), because the E&P supporting the AEPA dividend would not be capitalized into USB's UST stock basis.[76]

Another approach to revising Reg. §1.367(b)-2(e)(2)(ii) would be to use a method similar to that used to determine the Section 956 consequences of United States property investments by CFCs with corporate U.S. Shareholders.[77] Under this method, (i) USB would not recognize an AEPA dividend from FT to the extent it would receive a Section 245A DRD with respect to the dividend; and (ii) USB would not adjust the basis of its FT stock under Reg. §1.367(b)-2(e)(2)(ii). This approach would produce an E&P result that would not be aligned with the E&P consequences of the inbound dividend described in Paradigm 1 and would have the same potential for a subsequent distribution by UST to result in stock gain (or an excess loss account in cases where UST joins a U.S. consolidated group).[78]

The enactment of the House Bill proposal to amend Section 1059(g) would not make Section 1059 policy relevant to Reg. §1.367(b)-3 for the reasons stated above—non-economic stock losses are not at issue in Paradigm 2A because USB's FT stock basis is eliminated as a result of the liquidation, and Paradigm 2B does not include a tax-advantaged reduction of value in USB's UST stock.[79] Moreover, Section 1059(g) would apply to dividends sourced to all of FT's E&P, whereas an AEPA dividend would be sourced to FT E&P attributable to USSH and, depending on how one interprets the application of Section 1248 attribution principles, may be sourced to FT E&P attributable to the US Individuals.[80] Therefore, consistent with the historical policy objectives of

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76 Similar to Paradigm 2A, an alternative would be to revise the regulations to provide specifically that the basis increase in Reg § 1.367-2(e)(2)(ii) applies immediately before taking into account the Section 1059 basis reduction.

77 *See* Reg. §1.956-1(a)(2).

78 The FT's E&P would not carry over to UST under Reg. §1.367(b)-3(f)(1). Additionally, even if FT's E&P were to carry over to UST, such E&P would become separate return limitation year ("**SRLY**") E&P with respect to UST if UST became a member of USB's U.S. consolidated group. A distribution of property sourced to UST's SRLY E&P would be eliminated from USB's taxable income, not increase the E&P of the USB U.S. consolidated group, and result in a downward adjustment to USB's UST stock basis. *See* Reg. §1.1502-13(f)(2)(ii); Reg. §1.1502-33(b)(3), Example 1(d) (with respect to separate return limitation year E&P, S's E&P reduction from a dividend tiers up to P and offsets P's increase in E&P from the dividend).

79 As noted above, Reg. §1.367(b)-2(e)(2)(ii) would have to be revisited to prevent basis adjustments from creating non-economic stock losses without value reduction.

80 The measurement of FT's disqualified dividends for purposes of the House Bill's Section 1059(g) proposal and USB's AEPA dividend with respect to FT would also be different if FT were a CFC prior to the acquisition by USB. For example, if USSH, the Foreign Individuals, and the US Individuals owned 51 percent, 30 percent, and 19 percent, respectively, of FT prior to the acquisition,

Section 1059 and Reg. §1.367(b)-3, Section 1059(g) and the AEPA regime should be viewed as serving different purposes.

Finally, it bears mention that Section 1059 is an anti-abuse provision intended to prevent non-economic stock losses that typically resulted from portfolio investments in dividend-paying stock. We believe these concerns do not extend to an AEPA dividend in a situation where the foreign subsidiary stock (and the associated basis) ceases to exist.

b) Section 246 Holding Period Considerations

An important difference between Paradigms 1 and 2A/2B is that in Paradigm 1 USB can satisfy the Section 246 Holding Period Requirement by reference to its post-distribution ownership of FT, whereas in Paradigm 2 USB cannot do so because FT ceases to exist as an SFC as a result of the inbound nonrecognition transaction. As a result, in Paradigm 2, USB must wait one year before completing the liquidation or migration to satisfy the Section 246 Holding Period Requirement.

The Section 246 Holding Period Requirement is one of several holding period requirements in Section 246 applicable to DRDs. The general holding period is for 45 days during the 91-day period beginning on the date that is 45 days before the ex-dividend date.[81] One purpose of these holding periods is to ensure that the holder actually owns the shares for the requisite period of time (taking into account the carryover holding period rules), and bears the risk of the performance of the company during that time period (as seen from the rules that toll the holding period where the taxpayer has reduced their risk of loss through various derivatives or other positions).[82] These rules were also intended to discourage dividend-strip transactions.[83]

(1) Strict Section 246 Holding Period Approach

Based on a plain reading of the Section 246 Holding Period Requirement, the difference in the form of the transactions in Paradigm 2 prevents USB from satisfying the holding period with respect to the AEPA dividend, unless USB waits one year to effectuate the second step liquidation or F reorganization. During this period, the operations of FT would be taken into account in determining USB's GILTI and subpart F

Section 1059(g) would only apply to dividends sourced to the FT E&P attributable to the Foreign Individuals and the US Individuals.

81 Section 246(c) (longer holding periods apply with respect to for dividends from preferred stock in certain circumstances and for qualified dividend income).

82 Section 246(c)(4).

83 *See* Bittker & Eustice, *Federal Income Taxation of Corporations and Shareholders*, ¶5.05[7][c].

inclusions. What is at stake, therefore, is the taxation of E&P that USB inherits from predecessor U.S. Shareholders and possibly predecessor Small U.S. Shareholders.

(2) Successor Shares/Assets Approach

Since the AEPA dividend is a construct of Reg. §1.367(b)-3 and not an actual dividend, we believe Treasury should consider allowing USB to satisfy the Section 246 Holding Period Requirement retroactively, if it retains substantially all of the assets of FT, in Paradigm 2A, or the stock of UST (the successor entity) in Paradigm 2B. For example, under a contractual arrangement between USB and Treasury akin to gain recognition agreements used in the context of Section 367(a), USB could be allowed the Section 245A DRD with respect to an AEPA dividend from FT within the first year of the stock acquisition, which would be recaptured if USB does not ultimately satisfy the one-year holding period.

Allowing the Section 246 Holding Period Requirement to be satisfied by reference to successor assets or shares would be consistent with Section 246 policy aimed at continuing to hold the investment for the requisite period. During the applicable period, USB would bear the risks and losses with respect to FT's former operations and any items of income, gain, deduction, and loss will be subject to full U.S. tax in the hands of USB or UST. As a result, USB would retain meaningful economic ownership of the former FT operations in a manner that is consistent with ongoing ownership of the shares. We believe this approach also is consistent with the policy goals of the international provisions of the TCJA. In light of the current taxation of FT's earnings and current relevance of FT's asset basis under the GILTI and CFC rules, there is no longer any reason to create a taxable AEPA dividend to USB where an actual dividend of the same amount would qualify for a Section 245A DRD, and requiring USB to continue to own an interest in the CFC's successor (*i.e.*, the US acquirer in the inbound reorganization) or all the CFC's assets (in the case of a liquidation) for more than a year after the inbound transaction would satisfy Section 246 concerns.

3. FT Shareholder Considerations

As regards corporate U.S. Shareholders such as USSH, Paradigm 3 presents similar design considerations for Sections 246 and 1059 as those discussed above with respect to USB in Paradigm 2B. These considerations are not relevant to non-corporate U.S. Shareholders of FT or Small U.S. Shareholders, such as the US Individuals. We believe it is appropriate to reconsider the tax treatment of the historical FT shareholders in Paradigm 3 in light of any changes to the tax treatment of USB in Paradigm 2.

One approach would be to revise Reg. §1.367(b)-3 so that FT's Small U.S. Shareholders are not subject to tax with respect to the exchange of their FT stock, preserving such gain under the Subchapter C nonrecognition rules.[84] Although the TCJA did not change how Small U.S. Shareholder investments in FT were taxed, we support providing gain recognition relief to Small U.S. Shareholders in light of the TCJA's changes to the taxation of foreign earnings and the importation of foreign asset basis into the U.S. tax system and the fact that Small U.S. Shareholders generally cannot influence the structuring of USB's acquisition of FT. Affording this relief would also create parity with respect to the treatment of Small U.S. Shareholders in Paradigms 2 and 3, eliminating the fairly arbitrary results that occur under current law, and provide U.S.-parented multinationals greater flexibility in structuring acquisitions of foreign-parented groups. Moreover, Section 362(e) would prevent loss importation transactions, providing an additional guardrail against improper erosion of the U.S. tax base.

Under this approach, Reg. §1.367(b)-3 would continue to apply as currently drafted to FT's U.S. Shareholders of FT. Thus, Sections 245A and 1059 would apply to AEPA dividends deemed received by a corporate U.S. Shareholder of FT based on such shareholder's existing holding period in its FT shares. Non-corporate U.S. Shareholders would include an AEPA dividend in income without the benefit of the Section 245A DRD.

Treasury could also consider extending the proposal described above for Small U.S. Shareholders to FT's non-corporate U.S. Shareholders, so non-corporate U.S. shareholders also do not recognize AEPA dividends with respect to their FT stock, preserving their FT stock gain under the Subchapter C nonrecognition rules. Like Small U.S. Shareholders, non-corporate U.S. Shareholders do not benefit from the Section 245A DRD. These shareholders, however, are likely to have a greater degree of control over the affairs of FT, making such a change less compelling than providing relief to Small U.S. Shareholders.

In the case of corporate U.S. Shareholders, Reg. §1.367(b)-3 could be revised to align the application of Sections 246 and 1059 in Paradigm 3 with the recommendations for Paradigm 2B discussed above, because the considerations with respect to these Sections are relevant to both paradigms.

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84 We recognize that preserving the stock gain of Small U.S. Shareholders gain does not tax them on their shares of deferred foreign E&P, and that these shareholders may benefit from an improvement in the tax rates applicable to dividends and gain, if FT dividends would not have been taxed as qualified dividend income under Section 1(h)(11) ("**QDI**"). This is the result under the current operation of Reg. §1.367(b)-3, as such Small U.S. Shareholders are subject to tax on their foreign acquired corporation stock gain without regard to whether the foreign acquired corporation's E&P would produce QDI-eligible dividends to the Small U.S. Shareholders. The TCJA changes to the Code that are discussed above do not implicate this design choice and thus it should not be controlling on whether Small U.S. Shareholders should be permitted gain deferral for inbound reorganizations.

One approach could be, in the case of a corporate U.S. Shareholder that satisfies the ownership requirements of Section 1504(a)(2) with respect to USB upon completion of the reorganization, to provide the following treatment: (i) to the extent an AEPA dividend received by such corporate U.S. Shareholder gives rise to a Section 245A DRD-eligible dividend that would otherwise be subject to Section 1059, neither Section 1059 nor the basis adjustment rules in Reg. §1.367(b)-2(e)(2)(ii) apply in respect of the dividend; and (ii) the corporate U.S. Shareholder would be allowed to satisfy the Section 246 Holding Period by retaining the USB stock received in the inbound reorganization for the remainder of the necessary period.

This approach would provide relief for a corporate U.S. Shareholder in a situation where that shareholder has ownership of USB in Paradigm 3, that is aligned with USB's ownership of FT in Paradigm 2.

Alternatively, under a broader approach, Treasury could extend the immediately preceding recommendations to all corporate U.S. Shareholders of FT in Paradigm 3. These corporate U.S. Shareholders all could be seen as in an analogous position to USB in Paradigm 2, although the analogy is not as close as in the narrower approach described above.

VI. Annex

A. Overview

The following paradigms discuss the application of Treas. Reg. § 1.367(b)-3 to common transactions after the enactment of the TCJA. As these examples illustrate, the interaction of Reg. §1.367(b)-3 and the current U.S. tax regime can produce disparate results for substantially similar transactions. Unless otherwise noted, each of the examples below has the following facts:

(i) USB is a domestic corporation.

(ii) FT is a foreign corporation with one class of stock outstanding. The total fair market value of the outstanding FT stock is $250x.

(iii) The FT shareholders are as follows:

(a) USSH, a domestic corporation, owns 40 percent of FT. USSH's FT stock has a fair market value of $100x and uniform basis of $40x. USSH satisfies the Section 246 Holding Period Requirement and the Section 1059 Holding Period Requirement with respect to its FT stock.

(b) US Individuals, all of which are U.S. citizens, own, in the aggregate, 30 percent of FT. The US Individuals' FT stock has an aggregate fair market value of $75x and uniform basis of $30x.

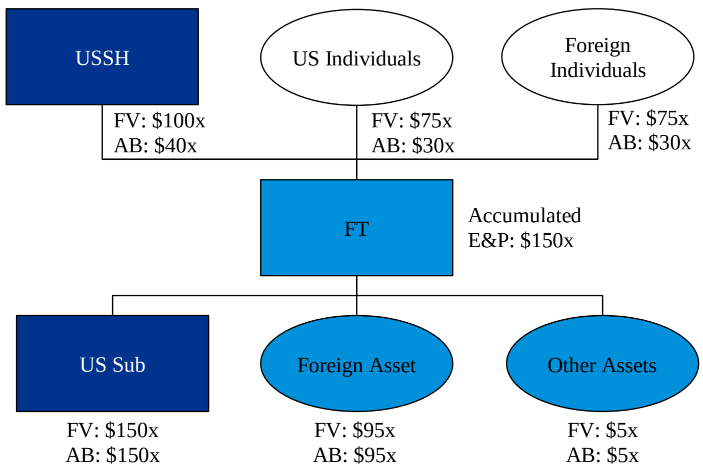
(c) Foreign Individuals, all of which are non-U.S. citizens, own, in the aggregate, 30 percent of FT. The Foreign Individuals' FT stock has an aggregate fair market value of $75x and uniform basis of $30x.

(iv) FT is not, and has never been, a CFC or a PFIC.

(v) USSH is the only U.S. Shareholder of FT.

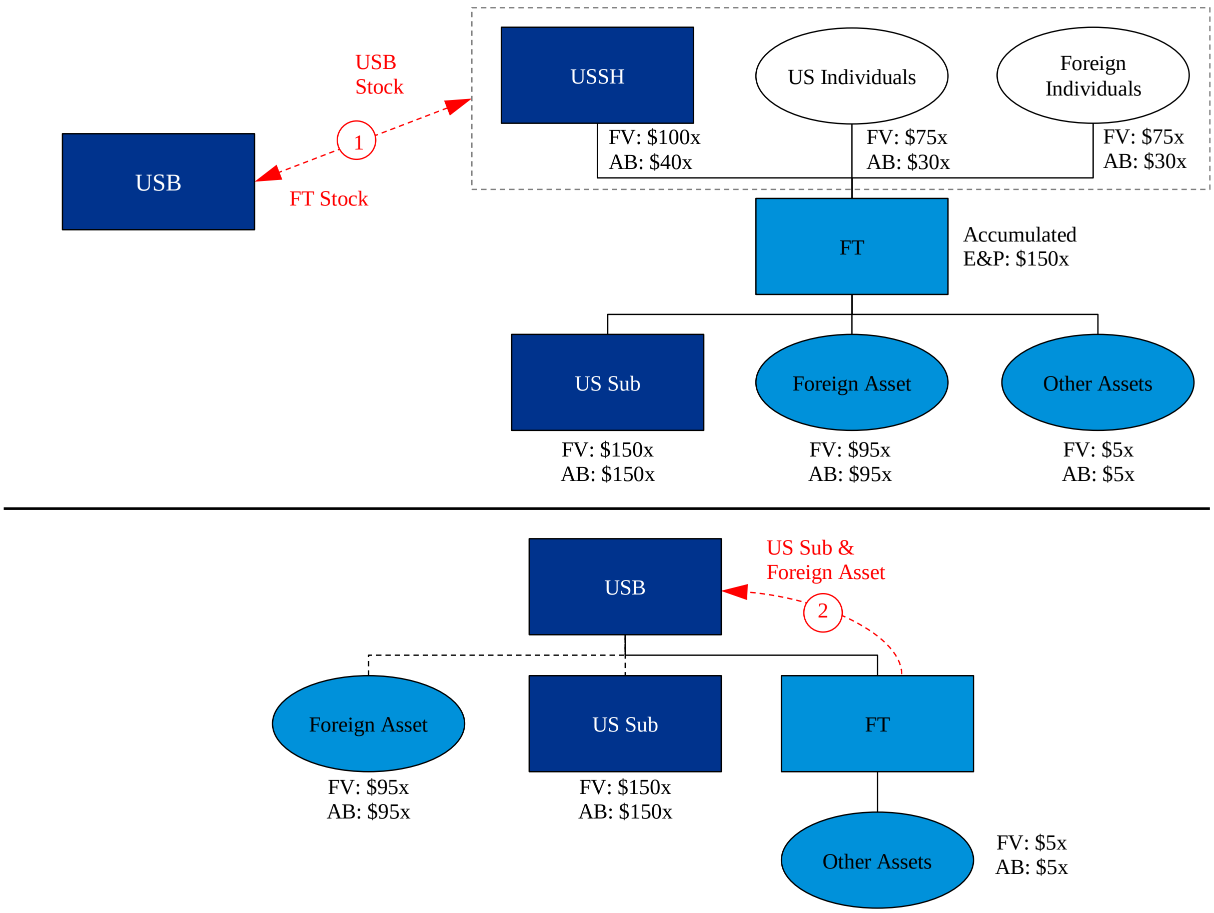
(vi) FT owns the following assets: (a) 100 percent of the outstanding shares of US Sub, a domestic corporation, which have a total fair market value and basis of $150x; (b) Foreign Asset, which is an asset used by FT in a foreign business that has a fair market value and basis of $95x; and (c) other non-*de minimis* assets that have a total fair market value and basis of $5x.

(vii) FT has $150x of accumulated E&P and no current E&P. All of FT's E&P are undistributed foreign earnings.



B. Paradigm 1: Tax-free Stock Acquisition Followed by Separate Dividend

(i) *Facts*. USB acquires 100 percent of the outstanding shares of FT solely in exchange for issuing shares of its own common stock to the FT shareholders in a transaction treated as a plan of reorganization described in Section 368(a)(1)(B) (a "***B reorganization***"). In a separate transaction, FT distributes the stock of US Sub and Foreign Asset to USB. The distribution by FT is not a partial liquidation for purposes of Section 1059, and is not a hybrid dividend for purposes of Section 245A.



(ii) *Analysis*.

(A) *FT Stock Acquisition*. USB does not recognize gain or loss on its issuance of stock in exchange for FT stock,[85] and takes a transferred basis and carryover holding

85 Section 1032(a).

period in the FT stock.[86] The historical FT shareholders do not recognize gain or loss on their exchange of FT stock for USB stock,[87] and take an exchanged basis and tacked holding period in their USB stock.[88]

(B) *FT Distribution*. The distribution by FT is characterized as a $150x dividend and, subject to the application of Section 1059 (discussed below), a $95x return of FT stock basis.[89] USB takes a fair market value basis in the US Sub stock and Foreign Asset.[90]

If USB satisfies the Section 246 Holding Period Requirement with respect to FT, USB is allowed a Section 245A DRD for the FT dividend.[91] Since FT remains in existence after the distribution, USB can satisfy this requirement through its post-distribution ownership of FT. Thus, FT does not have to wait a year before making the distribution to qualify for a Section 245A DRD.

If USB claims a Section 245A DRD with respect to the FT dividend, USB must reduce its FT stock basis for the non-taxed portion of the dividend, unless USB satisfies the Section 1059 Holding Period Requirement with respect to its FT stock. For this purpose, USB includes the carryover holding periods that result from the FT stock acquisition, but not its post-distribution ownership of FT. If USB does not satisfy the Section 1059 Holding Period Requirement with respect to a share of FT stock, then as of the beginning of the ex-dividend date for the FT dividend, USB must reduce the basis of the share by the amount of the FT dividend paid with respect the share and recognize gain to the extent of any shortfall.[92] Thus, if USB were required to reduce its FT stock basis under Section 1059(a), USB could recognize stock gain up to $145x.

If USB were to subsequently dispose of its FT stock, loss with respect to the disposition would be determined by reducing USB's FT stock basis for any Section 245A

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86 Sections 362(b) and 1223(2).

87 Section 354(a).

88 Sections 358(a) and 1223(1).

89 Section 301(c)(1) and (2).

90 Section 301(d).

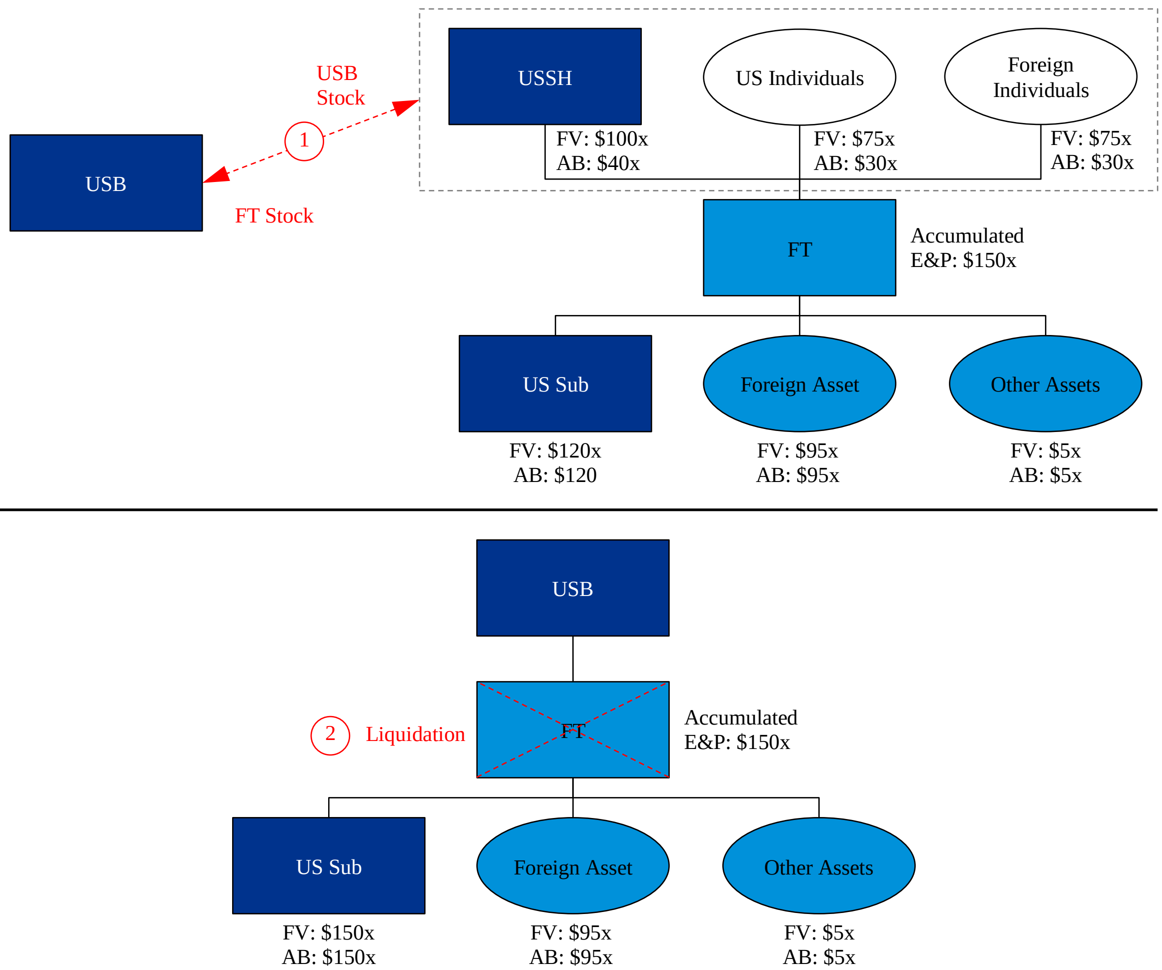
91 Section 245A(a).

92 Section 1059(a). The Section 1059(g) proposal in the House Bill would treat the entire amount of the FT dividend as an extraordinary dividend regardless of USB's holding period for its FT stock. Thus, USB would recognize gain of $145x as a result of the FT distribution.

DRD-eligible dividends paid with respect to the stock that did not already reduce USB's FT stock basis under Section 1059.[93]

C. Paradigm 2A: Tax-free Stock Acquisition Followed by Separate Section 332 Liquidation

(i) *Facts*. USB acquires 100 percent of the outstanding shares of FT solely in exchange for issuing shares of its own common stock to the FT shareholders in a B reorganization. In a separate transaction, FT completely liquidates under Sections 332 and 337, distributing the stock of US Sub, Foreign Asset, and the other assets to USB.



93 Section 961(d).

(ii) _Analysis_.

(A) _FT Stock Acquisition_. Same as Paradigm 1.

(B) _FT Liquidation_. FT does not recognize gain or loss on the liquidating distribution of its assets to USB.[94] USB does not recognize gain or loss on its receipt of FT's assets,[95] and takes a transferred basis and carryover holding period in FT's assets.[96] Since, however, the liquidation is an inbound Section 332 liquidation, USB includes in income the AEPA dividend attributable to its FT stock.[97] The FT AEPA dividend is treated as a dividend for all purposes of the Code.[98] Immediately prior to the inbound liquidation, USB is deemed to receive the AEPA dividend and increase the basis of its FT stock by the amount of the AEPA dividend.[99] The FT E&P that are not included in the AEPA dividend is eliminated and does not carry over to USB.[100]

If USB satisfies the Section 246 Holding Period Requirement with respect to FT, USB is allowed a Section 245A DRD for the AEPA dividend.[101] Unlike Paradigm 1, however, FT does not remain in existence after the liquidation and thus USB cannot satisfy this requirement through post-transaction ownership of FT. Accordingly, USB will only be able to claim a Section 245A DRD with respect to the FT AEPA dividend if the liquidation occurs at least a one year after the FT stock acquisition.

The Section 1059 analysis for Paradigm 2A is the same as that for Paradigm 1. Thus, if USB claims a Section 245A DRD with respect to the AEPA dividend, USB must reduce its FT stock basis for the non-taxed portion of the dividend and recognize gain to the extent of any basis shortfall, unless it can satisfy the Section 1059 Holding Period

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94 Section 337(a).

95 Section 332(a).

96 Sections 334(b)(1) and 1223(2).

97 Reg. §1.367(b)-3(b)(3)(i). USB's AEPA dividend includes the portion of FT's E&P attributable to FT stock acquired from USSH, but it does not include the portion of FT's E&P attributable to FT stock acquired from the Foreign Individuals. It is not entirely clear whether USB's AEPA dividend includes the portion of FT's E&P attributable to the FT stock acquired from the U.S. Individuals because the individuals are not Section 1248 shareholders. *Compare* Reg. §1.367(b)-2(d) (applying Section 1248 attribution principles without regard to the Section 1248 requirements that irrelevant to the determination of a shareholder's pro rata portion of E&P) *with* Reg. §1.1248-8 (only attributing E&P in acquisitive restructuring transactions to the extent foreign corporate stock is exchanged by a Section 1248 shareholder).

98 Reg. §1.367(b)-2(e)(2).

99 Reg. §1.367(b)-2(e)(3).

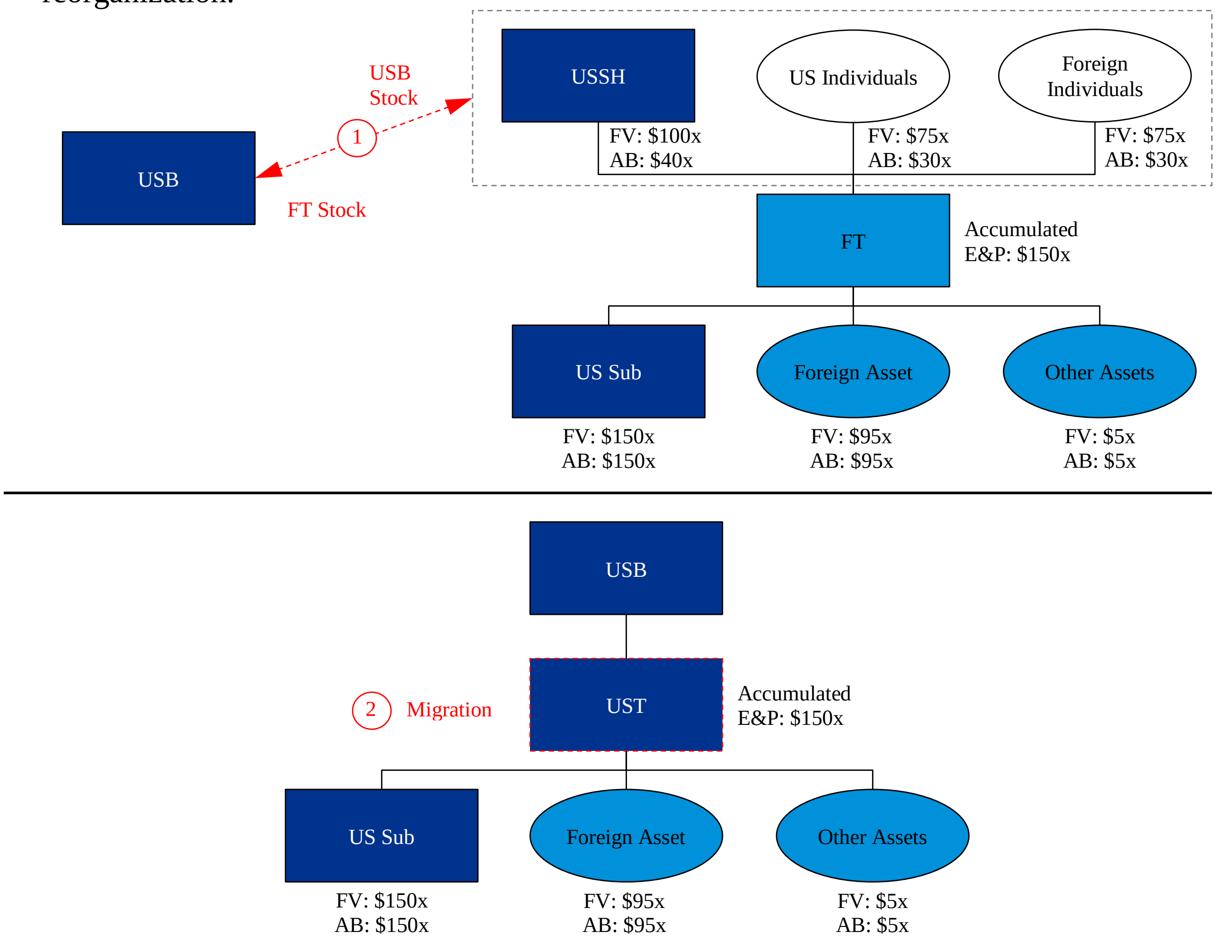
100 Reg. §1.367(b)-3(f)(1).

101 Section 245A(a).

Requirement with respect to FT.[102] Importantly, it appears that any Section 1059 basis reduction occurs prior to the basis increase under Reg. §1.367(b)-2(e)(3). Thus, the Section 367(b) basis increase is effectively irrelevant to USB because the FT stock is eliminated as a result of the liquidation.

D. Paradigm 2B: Tax-free Stock Acquisition Followed by F Reorganization

(i) _Facts_. USB acquires 100 percent of the outstanding shares of FT solely in exchange for issuing shares of its own common stock to the FT shareholders in a B reorganization. In a separate transaction, FT migrates to the United States and becomes a domestic corporation (FT after the migration, "***UST***") in transaction treated as an F reorganization.



[102] It is not entirely clear if the basis increase under this rule is intended to apply before or after the Section 1059 basis reduction. *Compare* Section 1059(d)(1) (stating the Section 1059 basis reduction is "treated as occurring at the beginning of the ex-dividend date of the extraordinary dividend to which the reduction relates") *with* Reg. §1.367(b)-2(e)(3)(ii) (stating the Section 367(b) basis increase is taken into account for purposes of determining the amount of gain otherwise recognized with respect to a Section 367(b) exchange).

(ii) *Analysis*.

(A) *FT Stock Acquisition*. Same as Examples 1 and 2.

(B) *FT Migration*. The migration of FT to UST consists of the following transfers for tax purposes: (i) FT is deemed to transfer all of its assets to UST in exchange for the issuance of stock and the assumption of liabilities by UST; and (ii) FT is deemed to distribute the UST stock to USB in exchange for USB's FT stock.[103] FT's tax year ends as a result of the continuation.[104] The FT E&P that are not included in the AEPA dividend (discussed below) are eliminated and do not carry over to UST.[105]

UST does not recognize gain or loss on its issuance of stock in exchange for FT's assets,[106] and takes a transferred basis and carryover holding period in FT's assets.[107] FT does not recognize gain or loss on the transfer of its assets to UST in exchange for UST stock or UST's assumption of liabilities, or on the distribution of UST stock to USB.[108]

USB does not recognize gain or loss on its exchange of FT stock for UST stock,[109] and takes an exchanged basis and tacked holding period in the UST stock.[110] However, since the migration is an inbound F reorganization, USB includes in income the AEPA dividend attributable to its FT stock.[111] The Sections 245A and 1059 analyses for Paradigm 2B are the same as those for Paradigm 2A. Thus, (i) USB can claim a Section 245A DRD with respect to the AEPA dividend in Paradigm 2B only if the migration occurs at least a year after the FT stock acquisition; and (ii) USB must reduce its FT stock basis for the non-taxed portion of the AEPA dividend and recognize gain to the extent of any basis shortfall, unless it can satisfy the Section 1059 Holding Period Requirement with respect to its FT stock.

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103 *See TBL Licensing LLC v. Comm'r*, 158 T.C. No. 1 (2022).

104 Reg. §1.367(b)-2(f)(4).

105 Reg. §1.367(b)-3(f)(1).

106 Section 1032(a).

107 Sections 362(b) and 1223(2).

108 Sections 357(a) and 361(a) and (c).

109 Section 354(a).

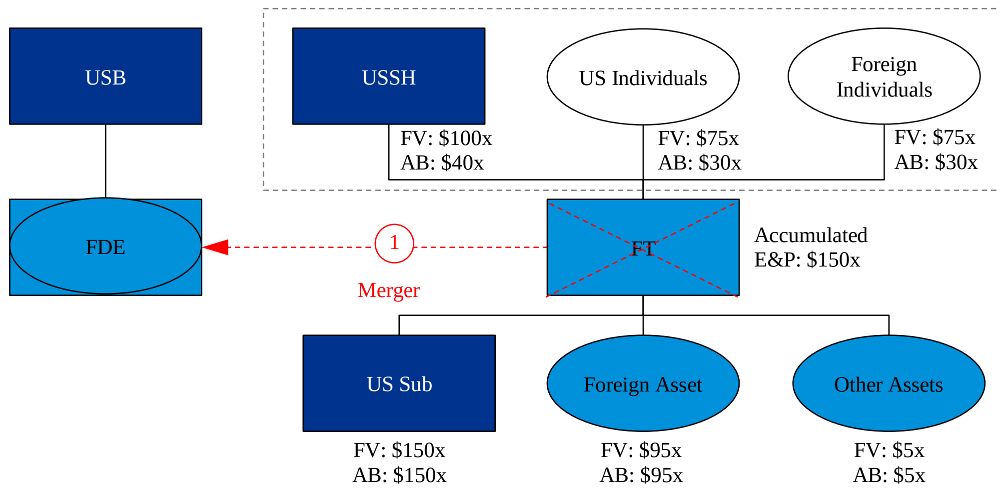
110 Sections 358(a) and 1223(1).

111 Reg. §1.367(b)-3(b)(3)(i).

A key difference between Paradigms 2A and 2B is that in Paradigm 2B USB's FT stock basis is reflected in the exchanged basis in its UST stock under Section 358. Thus, any adverse consequences of the Section 1059 basis reduction and gain recognition are substantially mitigated by the basis increase rules of Reg. §1.367(b)-2(e)(3)(ii).[112] Further, Section 961(d) does not appear to limit USB's ability to claim a loss with respect to a subsequent disposition of UST because UST is not an SFC.

E. Paradigm 3: Inbound Asset Reorganization

(i) *Facts*. FT merges with and into FDE, a disregarded entity of USB, with FDE surviving in an A reorganization. The FT shareholders receive USB common stock in exchange for their FT stock in the merger.



(ii) *Analysis*. The merger of FT with and into FDE consists of the following transfers for tax purposes: (i) FT is deemed to transfer all of its assets to USB in exchange for the issuance of common stock and the assumption of liabilities by USB; and (ii) FT is deemed to distribute the USB stock to the FT shareholders in exchange for their FT stock. FT's tax year ends as a result of the merger.[113] The FT E&P that are not included in the AEPA dividend included by USSH (discussed below) are eliminated and thus do not carry over to USB.[114]

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112 The sum of the Section 1059 basis reduction and gain recognition should be equal to the Reg. §1.367(b)-2(e)(3)(ii) basis increase. Thus, the adjustments largely offset each other with the obvious difference that the Section 1059 adjustments produce an adverse timing result to USB.

113 Section 381(b)(1).

114 Reg. §1.367(b)-3(f)(1).

USB does not recognize gain or loss on its issuance of common stock in exchange for FT's assets,[115] and takes a transferred basis and carryover holding period in FT's assets.[116] FT does not recognize gain or loss on the transfer of its assets to USB in exchange for USB stock and USB liability assumption, or on the distribution of such stock to the FT shareholders.[117]

USSH does not recognize gain or loss on its exchange of FT stock for USB stock,[118] and takes an exchanged basis and tacked holding period in the USB stock.[119] Since, however, the merger is an inbound A reorganization, USSH includes in income the AEPA dividend attributable to its FT stock. USSH satisfies the Section 246 Holding Period Requirement and the Section 1059 Holding Period Requirement with respect to its FT stock. Thus, USSH is allowed a Section 245A DRD with respect to its AEPA dividend and does not have basis reduction or gain recognition under Section 1059 as a result of the AEPA dividend. Similar to Paradigm 2B, Section 961(d) does not appear to limit USSH's ability to claim a loss with respect to a subsequent disposition of its USB stock because USB is not an SFC. Additionally, USSH increases the basis of its USB stock for the amount of its AEPA dividend.[120]

The US Individuals are generally required to recognize gain (but not loss) with respect to their FT stock.[121] There are two exceptions to this general rule. First, if FT (or its successor) provides a US Individual with information to substantiate its AEPA dividend and the US Individual satisfies certain reporting procedures, then the US Individual can elect to include its AEPA deemed dividend in lieu of recognizing its FT stock gain; the US Individuals would not be eligible for a Section 245A DRD with respect to their AEPA dividends. Second, a US Individual does not recognize gain or include in income an AEPA dividend if the total value of its FT stock is less than $50,000 on the date of the merger.[122]

The Foreign Individuals are not subject to tax with respect to their exchanges of FT stock for USB stock in the merger.

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115 Section 1032(a).

116 Sections 362(b) and 1223(2).

117 Sections 357(a) and 361(a) and (c).

118 Section 354(a).

119 Sections 358(a) and 1223(1).

120 Reg. §1.367(b)-2(e)(3)(ii).

121 Reg. §1.367(b)-3(c)(2).

122 Reg. §1.367(b)-3(c)(4).

F. Summary

The transactions described in the preceding examples produce substantially similar economic results, but very different tax results. In Paradigm 1, the onshoring of US Sub stock and Foreign Asset, FT's primary assets, is effectively exempt from tax if USB satisfies the Section 1059 Holding Period with respect to its FT stock. In Paradigms 2A and 2B, the onshoring of FT's assets will generate taxable dividend income to USB unless the onshoring transactions occur at least one year after the FT stock acquisition and USB satisfies the Section 1059 Holding Period with respect to its FT stock. Finally, in Paradigm 3 the onshoring of FT's assets will generate taxable income (either capital gain or ordinary dividend income) only to the US Individuals. For the reasons discussed in Part V of this Report, we believe the tax consequences of the Paradigms 2 and 3 as regards the onshoring of basis and taxation of undistributed foreign earnings should be revisited in light of the TCJA.