May 8, 2008

Hon. Douglas H. Shulman
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Concerning Example 4 of Regulation Section 1.367(b)-4(b)(1)(iii)

Dear Commissioner Shulman:

Enclosed are comments concerning example 4 of regulations section 1.367(b)-4(b)(1)(iii). These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association, and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Stanley L. Blend
Chair, Section of Taxation

Enclosures

cc: Hon. Donald L. Korb, Chief Counsel, Internal Revenue Service
Hon. Eric Solomon, Assistant Secretary (Tax Policy), Department of the Treasury
COMMENTS CONCERNING EXAMPLE 4 OF REGULATION SECTION 1.367(b)-4(b)(1)(iii)

The following comments ("Comments") concerning example 4 of Regulation section 1.367(b)-4(b)(1)(iii) are submitted on behalf of the American Bar Association Section of Taxation (the "Section") and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Joseph Calianno, Chair of the Task Force on International Aspects of Subchapter C. Substantive contributions also were made by Jeff Korenblatt, Mark Melten and Kagney Petersen. The Comments were reviewed by Mark Harris, Vice-Chair of the Section’s Foreign Activities of U.S. Taxpayers Committee ("FAUST") and Giovanna Sparagna, a former Chair of FAUST. The Comments were further reviewed by Peter Blessing of the Section’s Committee on Government Submissions and Stephen Shay, Council Director for FAUST.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who might be affected by the federal income tax principles addressed by these Comments, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 8, 2008
Executive Summary

In the preamble ("Preamble") to the proposed regulations under section 367 that were issued on January 5, 2005, in tandem with the release of the cross-border “A” reorganization regulations proposed on the same day, the Internal Revenue Service (the “Service”) and the Department of the Treasury ("Treasury") requested comments concerning ways in which the principles of sections 367(a)(5) and 1248(f)(1), in conjunction with the new basis and holding period rules of Proposed Regulation section 1.367(b)-13, could be used to preserve the section 1248 amounts in certain reorganizations. More specifically, the Preamble set forth the following statement and request for comments relating to Example 4 of Regulation section 1.367(b)-4(b)(1)(iii) ("Example 4"):

If a domestic corporation is a section 1248 shareholder with respect to a foreign corporation and transfers the stock in such foreign corporation to another foreign corporation in a section 361 transfer, the domestic corporation must include in income the section 1248 amount, if any, with respect to the stock of the transferred foreign corporation. See section 1248(f)(1) and section 1.367(b)-4(b)(2)(ii) [sic], Example 4.

Taxpayers have commented that this rule may result in income inclusions in some cases where the section 1248 amount could be preserved, such that a current inclusion may not be necessary or appropriate. The Service and Treasury are considering the application of section 367(a)(5) and section 1248(f)(1) to such transactions, in conjunction with section 1.367(b)-13 of these regulations, to preserve section 1248 amounts, and comments are requested in this regard. The Service and Treasury also are considering, and request comments, on situations in which there are multiple shareholders (including minority shareholders) of the domestic corporation; multiple assets (including appreciated and depreciated assets being transferred as part of the section 361 transfer); and liabilities being assumed in connection with the transaction.

The Service and Treasury finalized the section 367 regulations, including the regulations under 1.367(b)-13 (the “-13 regulations”), with certain modifications. Additionally, the Service and Treasury finalized certain regulations under section 358 (the “Section 358 Regulations”) relating to determining the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain nonrecognition transactions.

These Comments provide an overview and analysis of (i) section 367(a)(5), (ii) sections 1248 and 367(b), and (iii) the -13 Regulations and Section 358 Regulations, and recommend applying the above provisions to preserve section 1248 amounts in transactions the same as, or similar to,

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1 All references to sections herein are references to sections of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise expressly stated herein, and references to regulations are to the Treasury Regulations issued under the Code.
Example 4 along with several examples illustrating the application of the new rules. Specifically, we recommend a reduction or an elimination of the immediate income inclusion required under Regulation section 1.367(b)-4(b)(1)(iii) Example 4 by applying the language currently in sections 367(a)(5), (b) (and the regulations thereunder), and 1248(f) in a manner to preserve the section 1248 amount through:

1) Appropriate basis adjustments in the foreign stock received in the transaction under section 367(a)(5); and

2) Adjusting the attribute (holding period and earnings and profits) attributable to such stock through the application of rules similar to those in Regulation section 1.367(b)-13.
I. BACKGROUND

A. Section 367(a)(5)

1. General Background

Section 367(a)(1) provides that a U.S. person generally must recognize gain (but not loss) when it transfers property to a foreign corporation in certain types of exchanges, including an exchange described in section 361. However, if certain conditions are satisfied, the Code and regulations provide for certain exceptions to this general gain recognition rule.6 For instance, section 367(a)(3) and the regulations thereunder provide an exception to the general gain recognition rule for certain property used in the active conduct of a trade or business of a foreign corporation outside the United States.7 Additionally, in the case of transfers of stock or securities, section 367(a)(2) and the regulations thereunder provide exceptions to the general gain recognition rule for the outbound transfer of stock or securities of domestic and foreign corporations.8 One of the conditions imposed by the regulations for such transfers is that section 367(a)(5) must not prevent the relevant exception to gain recognition from applying.9

Section 367(a)(5) provides:

Section 367(a)(2) and (3) shall not apply in the case of an exchange described in (a) or (b) of section 361. Subject to such basis adjustments and such other conditions as shall be provided in regulations, the preceding sentence shall not apply if the transferor corporation is controlled (within the meaning of section 368(c)), by 5 or fewer domestic corporations. For purposes of the preceding sentence, all members of the same affiliated group (within the meaning of section 1504) shall be treated as 1 corporation.

Therefore, in the case of an outbound section 361(a) or (b) transfer of assets, the domestic corporation transferring its assets to a foreign corporation must overcome the hurdle of section 367(a)(5) in order to qualify for an exception to section 367(a)(1). The first sentence of section 367(a)(5) generally turns off the exceptions to section 367(a)(1) and, therefore, requires the domestic corporation to recognize gain (but not loss) on the transfer of assets (including stock or securities) to the foreign corporation.10 However, the second sentence of section 367(a)(5)

6 Other provisions also may apply to a domestic corporation’s transfer of assets to a foreign corporation (e.g., sections 987, 904(f)(3) and 1503(d)). Additionally, certain reporting requirements generally will apply to the transfer.

7 See Reg. §§ 1.367(a)-1T-6T.

8 See generally, Reg. § 1.367(a)-3(b) (transfers of foreign stock or securities) and -3(c) (transfers of domestic stock or securities) for the requirements that must be satisfied to qualify for an exception to the general gain recognition rule of section 367(a)(1).

9 Id.

10 For illustrations of the application of section 367(a)(5) to prevent an exception to section 367(a)(1) from applying, see Reg. § 1.367(a)-3(d)(3), Examples 8B, 8C and 12. Portions of the discussion in this letter are taken from,
provides relief if certain ownership requirements, basis adjustments and such other conditions as provided (in as yet unpublished) regulations are satisfied.\textsuperscript{11} One of the underlying purposes reflected in the second sentence of section 367(a)(5) is the preservation of U.S. corporate level tax. In order to ensure that this purpose is carried out, the stock of the foreign corporation received by domestic corporate shareholders of the domestic transferor corporation may need to be adjusted.

2. Legislative History of Section 367(a)(5)

The reports on section 367(a)(5) from the Senate Finance Committee and the House Ways and Means Committee,\textsuperscript{12} which are nearly identical, indicate an expectation that any regulatory exception to the general rule of section 367(a)(5) will provide relief only if the U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (1) the U.S. corporate shareholders’ basis in such stock received pursuant to the section 358, or (2) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation.

According to the House and Senate reports, relief only would be granted to the extent that the domestic corporate transferor is owned by persons subject to U.S. taxing jurisdiction. The following excerpt from the reports provides some insight:

The requirement that five or fewer domestic corporations own at least 80 percent of the U.S. transferor corporation’s stock assures that the bulk of the built in gain will remain subject to U.S. taxing jurisdiction. In addition, it also is expected that regulations will require the U.S. corporate transferor to recognize immediately any built-in gain that does not remain subject to U.S. taxing jurisdiction by virtue of a substituted stock basis. This would occur, for example, where 20 percent or less of the U.S. corporate transferor is owned by foreign shareholders who receive substituted basis stock in the transferee corporation, which stock would not be subject to U.S. taxing jurisdiction on disposition.

Thus, according to the above excerpt, any portion of the domestic corporate transferor’s built-in gain that is allocable to a foreign shareholder would be immediately taxable to the transferor corporation. However, even though the overall intent of section 367(a)(5) is to disallow nonrecognition transactions that would cause built-in gain to escape corporate-level taxation, the House and Senate reports appear to leave open the possibility that relief still could be granted to the extent of minority ownership by U.S. persons (assuming that the domestic

\textsuperscript{11} To date, no regulations under section 367(a)(5) have been issued addressing the basis adjustments. However, several PLRs have required adjustments pursuant to section 367(a)(5) to avoid gain recognition under section 367(a)(1). \textsuperscript{12} See e.g., PLR 9533005 (August 18, 1995). Additionally, as discussed below, the Service and Treasury recently issued some guidance relating to certain issues under section 367(a)(5).

An explanation of the proposed legislation prepared by the staff of the Joint Committee on Taxation ("JCT"), which was issued several months prior to the House and Senate reports, contemplates the same basis adjustments to the stock held by the corporate shareholders of the domestic corporate transferor. However, there are some important differences:

It is expected that regulations will provide this relief only if the U.S. corporate shareholder agrees to take a basis in the stock it receives in a foreign corporation that is a party to reorganization equal to the lesser of (a) the U.S. corporation’s basis in such stock received pursuant to section 358, or (b) its proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation. U.S. taxing jurisdiction over the built-in gain in such cases of U.S. corporate control is indirectly retained through the provisions of the Code relating to controlled foreign corporations. The requirement that certain U.S. corporate shareholders own at least 80 percent of the controlled foreign corporation stock assures that the bulk of the built-in gain will remain subject to U.S. taxing jurisdiction and justifies not imposing a partial tax on the portion of the gain not attributable to U.S. corporate shareholders. (Such a partial tax could present administrative difficulties in adjusting the basis of property in the hands of the transferee foreign corporation).

The JCT explanation appears to rationalize the relief based upon the continued status of the transferee corporation as a controlled foreign corporation. The most significant variation in the JCT approach, as contrasted with the House and Senate approach, is the lack of a requirement that the transferor corporation recognize gain attributable to foreign shareholders. In fact, the JCT explanation specifically allows nonrecognition in such circumstances, despite the permanent loss of U.S. taxing jurisdiction over the allocable portion of the domestic corporate transferor’s built-in gain. As the above excerpt indicates, the JCT justified this result based upon the fact that the bulk of the built-in gain will remain subject to U.S. taxing jurisdiction and the administrative difficulties associated with imposing a partial tax on the domestic corporate transferor. While there may be some differences between the House and Senate reports and the JCT explanation, the common thread of both is the preservation of the bulk of the built-in gain at the U.S. corporate level.

3. The Service’s Section 367(a)(5) Ruling Position

While no regulations have been issued under section 367(a)(5), the Service has issued rulings that offer some guidance relating to the adjustments required pursuant to section 367(a)(5). These rulings have addressed section 361 transfers in the context of outbound asset

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13 It should be noted, however, that in a similar situation, the section 367 regulations try to preserve domestic corporate level gain in section 355 distributions by a domestic corporation of stock of a CFC by requiring gain to be recognized by a domestic corporation distributing stock of a CFC unless the distributee is a domestic corporation. See Reg. §§ 1.367(b)-5(b) and 1.367(e)-1(b).


15 Id.
In addressing the adjustments required under section 367(a)(5), the Service has required that the basis of the foreign corporation’s stock in the hands of the domestic corporate shareholder equal the lesser of the adjusted basis of the stock of the domestic corporate transferor in the hands of domestic corporate shareholder immediately prior to the proposed transaction, or the net basis of the transferred assets in the hands of domestic transferor immediately prior to the proposed transaction.

As previously observed, the legislative history requires a basis equal to the lesser of the basis that would arise under the section 358 basis rules or the transferor’s pre-transfer basis in its assets. The section 367(a)(5) rulings use slightly modified language that looks to the lesser of the section 358 basis, or the “net basis” of the transferred assets in the hands of the domestic corporate transferor immediately prior to the transaction. The term net basis is not specifically defined in the rulings, but presumably is equal to the basis of the transferred property in the hands of the domestic corporate transferor less any transferred liabilities.

The net basis approach seems to be the more appropriate result. The language suggested by the legislative history (i.e., “the basis in the assets of the transferor corporation transferred to the foreign corporation) is not entirely clear whether such language is referring to net basis. However, a different reading of that language could lead to inconsistent results between transfers encumbered by liabilities and those transfers not so encumbered where the net basis is less than the section 358 basis. For example, if the domestic corporate transferor transfers trade or business assets to FC, a foreign corporation, with a fair market value of $100 and a basis of $75 in an asset reorganization, the domestic corporate transferor shareholder will take a basis in the FC stock of $75 (assuming the section 358 basis is higher). Because the fair market value of the FC stock is $100 (the value of the transferred property), the domestic corporate shareholder will have a built-in gain in the stock of $25, which is equal to the transferred built-in gain. This appears to be the intended result of the basis adjustments of section 367(a)(5).

If the facts in the preceding paragraph are changed such that the transferred assets are encumbered by a liability of $50, the adjusted basis of the assets to the domestic corporate transferor would not change. However, the value of FC stock only would be $50 (the value of the transferred property less the liability). If the domestic corporate shareholder would take a $75 adjusted basis in the foreign corporation shares, it would result in a built-in loss of $25. However, if the domestic corporate transferor were to sell such assets for $50 and such liabilities

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16 See e.g., PLRs 9731039 (August 1, 1997), 9533005 (August 18, 1995) and 9344009 (November 5, 1993).
18 Because the rulings involved a transferor with a single corporate shareholder, the rulings offer no guidance on how to deal with minority shareholders that are either foreign or non-corporate domestic taxpayers. Thus, in the absence of other authority, recourse can only be made to the legislative history described above.
19 The term “net basis” is defined in Reg. § 1.312-10(a). While this definition does not directly apply to section 367(a)(5), it seems likely that the rulings intended for this definition to apply when using the term “net basis”.
20 The fair market value of the FC stock is $100 less the $75 basis that domestic corporate shareholder has in the FC stock.
were assumed by the acquirer, the domestic corporate transferor would have $25 of gain ($100 amount recognized ($50 of cash plus $50 liability relief) - $75 basis). It is unlikely that this is the intended result of the basis adjustments of section 367(a)(5). Under the "net basis" approach, the domestic corporate transferor would take a $25 adjusted basis in the foreign corporation shares and on a sale would recognize a gain of $25.

4. Recent Guidance

The Service and Treasury recently have shed some additional light with respect to the application of section 367(a)(5) to outbound section 361 transfers by domestic corporations. For instance, Regulation section 1.367(a)-3T(e)(1) requires as a condition to avoiding the application of section 367(a)(1) in an outbound section 361 transfer that not only the conditions set forth in the second sentence of section 367(a)(5) and any regulations thereunder be satisfied, but also that:

all domestic corporate shareholders of the U.S. transferor immediately before the transaction that own 5 percent or more (applying the attribution rules of section 318, as modified by section 958(b)) of the total voting power or the total fair market value of the stock of the transferee foreign corporation immediately after the transaction enter into gain recognition agreements as provided in Regulation section 1.367(a)-8T with respect to their pro rata share (determined by the relative fair market value of the U.S. transferor stock or securities owned) of the gain that was realized but not recognized on the transfer of the stock or securities of the transferred corporation that, in addition to the terms of Regulation section 1.367(a)-8T(b), designate such domestic corporate shareholders as U.S. transferors for purposes of paragraphs (b) and (c) of this section and Regulation section 1.367(a)-8T; and all domestic corporate shareholders that enter into gain recognition agreements pursuant to paragraph (e)(1)(iii) of this section make the election described in §1.367(a)-8T(b)(1)(vii).21

Additionally, in Notice 2008-10,22 the Service and Treasury clarified the application of section 367(a)(5) in the context of the coordination rule of Regulation section 1.367(a)-3(d)(2)(vi) as follows:

The IRS and Treasury will issue regulations under section 367(a) to clarify how the two exceptions to the general coordination rule of Regulation section 1.367(a)-3(d)(2)(vi)(A) are to be applied. The rule of Exception One contained in Regulation section 1.367(a)-3(d)(2)(vi)(B)(1 )i(i) will be modified to clarify that the basis adjustment required as provided in section 367(a)(5) must be made to the stock of the foreign acquiring corporation received by domestic corporate shareholders of the U.S. transferor in the reorganization such that the appropriate amount of unrecognized gain in the U.S. transferor's property is reflected in such stock. Thus, the basis adjustment requirement cannot be satisfied by adjusting the basis in stock of the foreign acquiring corporation held by such shareholders prior to the reorganization. The regulations will clarify that to

21 For further guidance including its application to certain triangular reorganizations and an example illustrating this rule, see Reg. § 1.367(a)-3T(e)(1)-(3).
the extent the appropriate amount of unrecognized gain in the U.S. transferor's property cannot be preserved in the stock of the foreign acquiring corporation received in the reorganization, then the U.S. transferor's transfer of property to the foreign acquiring corporation shall be subject to sections 367(a) and (d). Regulation section 1.367(a)-3(d)(2)(vi)(B)(2) will be modified to clarify that Exception Two shall not apply to a section 351 transfer that is also a section 361 exchange. Thus, a section 351 transfer that is also a section 361 exchange may only qualify, if at all, for Exception One.

B. Section 1248 and Section 367(b)

1. Application of Section 1248

When section 1248(a) applies to a transaction, some or all of the gain recognized by certain U.S. persons on the sale or exchange of the stock of a foreign corporation is recharacterized as ordinary dividend income. This rule complements the general rules of subpart F, by assuring that these U.S. persons cannot convert what otherwise would be ordinary income, the taxation of which has been deferred, into capital gains eligible for preferable tax rates.

The amount recharacterized under section 1248(a) is limited by the amount of gain recognized in the transaction. Further, the amount recharacterized under section 1248 is limited to the amount of the earnings and profits (“e&p”) attributable to the stock sold or exchanged. Generally speaking, the e&p taken into account is the e&p of the foreign corporation (and, in certain cases, e&p of lower tier foreign corporations) attributable to such stock which were accumulated in tax years of the foreign corporation beginning after December 31, 1962 and during the period or periods the stock sold or exchanged was held by such person while the foreign corporation was a controlled foreign corporation or “CFC” (as defined in section 957). Certain e&p under section 1248(d) are excluded (e.g., previously taxed e&p).

In order for section 1248(a) to apply to a sale or exchange of a foreign corporation, a U.S. person must own (directly, indirectly or constructively applying the ownership rules of sections 958(a) and (b)) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation at any time during the 5-year period ending on the date of the sale or exchange of the stock when the foreign corporation was a CFC. An analogous provision is section 964(e), which provides that, if a CFC sells or exchanges stock in any other foreign corporation, gain recognized on such sale or exchange will be included in

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23 As a result of the deemed dividend, a domestic corporation may be eligible to claim a foreign tax credit under section 902.

24 See section 1248(c)(2) and the regulations thereunder.

25 See generally, Reg. §§1.1248-2, -3 and -8

26 For a special rule when section 1248 may apply to the sale or exchange of domestic stock, see section 1248(e).
Generally, in order for section 1248(a) to apply to a transaction, gain must be recognized in the transaction. However, section 1248(f) provides special rules in the case of certain nonrecognition transactions, including certain section 361(c)(1) distributions:

Except as provided in regulations prescribed by the Secretary if- (i) a domestic corporation satisfies the stock ownership requirements of subsection (a)(2) with respect to a foreign corporation, and (ii) such domestic corporation distributes stock of such foreign corporation in a distribution to which section 311(a), 337, 355(c)(1), or 361(c)(1) applies, then, notwithstanding any other provision of this subtitle, an amount equal to the excess of the fair market value of such stock over its adjusted basis in the hands of the domestic corporation shall be included in the gross income of the domestic corporation as a dividend to the extent of the earnings and profits of the foreign corporation attributable (under regulations prescribed by the Secretary) to such stock which were accumulated in taxable years of such foreign corporation beginning after December 31, 1962, and during the period or periods the stock was held by such domestic corporation while such foreign corporation was a controlled foreign corporation. For purposes of subsections (c)(2), (d), and (h), a distribution of stock to which this subsection applies shall be treated as a sale of stock to which subsection (a) applies.

However, section 1248(f)(2) provides an exception to the income inclusion rule of section 1248(f)(1) for certain distributions:

In the case of any distribution of stock of a foreign corporation, paragraph (1) shall not apply if such distribution is to a domestic corporation (i) which is treated under this section as holding such stock for the period for which the stock was held by the distributing corporation, and (ii) which, immediately after the distribution, satisfies the stock ownership requirements of subsection (a)(2) with respect to such foreign corporation.

The 1976 legislative history to section 1248(f) states that, where “the corporate distribute[e] does not receive a stepped up basis as a result of the distribution and … the potential for the future application of section 1248 still exists, it is not necessary to [apply section 1248(f)(1) to] override the nonrecognition provisions which otherwise apply to a corporate distribution.”28 Thus, the legislative history envisions permitting nonrecognition treatment in situations in which the section 1248 amount can be preserved.

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27 In determining the amount that is recharacterized, the determination of whether such other foreign corporation was a CFC is made without regard to the preceding sentence. Further, the same country exception to foreign personal holding company income is not applicable to such dividend. See section 964(e)(2).

2. Section 1248(f) Guidance

The Service and Treasury have not issued any regulations under section 1248(f). However, they did provide some guidance in Notice 87-64,29 which elaborated on section 1248(f) by providing that, pursuant to section 1248(f)(2), section 1248(f)(1) will not apply to certain distributions of CFC stock to a domestic corporation in which no gain is recognized under section 337. Additionally, in the case of certain section 355 distributions of CFC stock, the Service and Treasury indicated that they may limit the application of section 1248(f)(1) to situations in which the CFC is no longer a CFC immediately after the distribution or in which one or more of the distributees of the CFC stock are not “United States shareholders” (within the meaning of section 951(b)) after the distribution. They also indicated that the regulations would contain provisions to ensure that the section 1248 amount would be preserved and stated that such regulations may require appropriate adjustments to the basis and holding period of the stock of the CFC in the hands of the distributee. Therefore, consistent with the legislative history of section 1248(f), the Notice envisioned relief from section 1248(f)(1) in situations in which the section 1248 amount could be preserved.

The Service also has issued several rulings addressing the application of section 1248(f) in the context of asset reorganizations30 and section 355 distributions. These rulings generally provide relief from the application of section 1248(f)(1) in situations in which the section 1248 amount can be preserved through various adjustments. For instance, in PLR 9533005, the taxpayer (“Taxpayer”), a domestic corporation, owned all the stock of Oldco, a domestic corporation that was a dual resident corporation under section 1503(d). Oldco’s sole asset was the stock of FS, a foreign corporation. The Taxpayer proposed a restructuring that would result in Oldco becoming a foreign corporation for federal tax purposes. As a result of the restructuring, Oldco was treated for federal tax purposes as transferring all of its assets (the FS stock) to Newco, a foreign corporation, in an asset reorganization and Taxpayer was treated as exchanging its stock in Oldco for stock in Newco. The Service first ruled that the transfer of the FS stock would not be subject to section 367(a)(1) as long as a gain recognition agreement (“GRA”) was filed. After providing a section 367(a)(5) ruling that the basis of the Newco stock in the hands of Taxpayer would be the lesser of the adjusted basis of the Oldco stock in the hands of Oldco immediately prior to the proposed transaction or the net basis of the transferred assets in the hands of Oldco, the Service provided the following section 1248(f) ruling:

For purposes of section 1248 of the Code, the holding period of the stock of Newco received by Taxpayer will be the greater of the holding period of the stock of Oldco in the hands of Taxpayer or the holding period of the stock of FS in the hands of Oldco. Section 1248(f)(1) does not apply to the deemed section 361(c) distribution of the stock of Newco by Oldco to Taxpayer (section 1248(f)(2)).

In PLR 9344009, the Service ruled on a substantially similar transaction to the transaction described above except that the Oldco in the ruling instead of just owning a single asset (the

30 See e.g., PLRs 9533005 (August 18, 1995), 9344009 (November 5, 1993), 9111033 and 9010070 (March 9, 1990).
stock of a foreign subsidiary) owned stock of three foreign subsidiaries (X, Y and Z), cash and receivables. The Service issued the same section 367(a)(5) ruling as the ruling in PLR 9533005. However, the section 1248(f) ruling was slightly modified as follows:

For purposes of section 1248 of the Code, the holding period of the stock of Newco received by Parent will be the greater of the holding period of the stock of Oldco in the hands of Parent or the holding periods of the stock of X, Y or Z, respectively, in the hands of Oldco. Section 1248(f)(1) does not apply to the deemed section 361(c) distribution of the stock of Newco by Oldco to Parent (section 1248(f)(2)).

The section 1248(f) ruling does not specifically address the treatment of the other assets held by Oldco or whether the Newco stock held by Parent would be divided or segmented to replicate the section 1248 amounts relating to the stock of X, Y and Z.

The Service also has issued numerous private letter rulings that have applied Notice 87-64 in the section 355 context. In these rulings, the Service has established that it will not apply section 1248(f)(1) to require current income recognition where (i) the basis of the CFC’s stock in the hands of the transferee is the lesser of the adjusted basis of such stock in the hands of the United States shareholder transferor or the substituted basis allocated to such stock in accordance with Regulation section 1.358-2(a)(2); (ii) the holding period of the CFC’s stock in the hands of the transferee is the greater of the holding period of such stock in the hands of the United States shareholder transferor or the holding period of the transferor’s stock in the hands of the transferee; and (iii) the e&p of the CFC, to the extent attributable to such stock under Regulation sections 1.1248-2 or 1.1248-3, that were accumulated in taxable years of the CFC beginning after December 31, 1962, and during the period in which the appropriate entity held (or was considered to hold the stock under section 1223) the stock of the CFC while it was a CFC is preserved with respect to the CFC’s stock.31

3. Application of Section 367(b)

In addition to section 1248(f), section 367(b) and the regulations thereunder provide a backstop to section 1248 in certain nonrecognition transactions that would not be covered by section 1248(a). Congress recognized that the subchapter C provisions of the Code could permit a section 1248 shareholder32 to effectively circumvent the application of section 1248 through the use of the nonrecognition provisions of the Code. Therefore, section 367(b) was introduced into the Code as a backstop to section 1248. One of the underlying policies of section 367(b) is the preservation of the potential application of section 1248. In situations in which the section 1248 amount33 will not be preserved after the exchange because the requisite section 1248 shareholder or CFC status is not preserved, section 367(b) and the regulations thereunder require

31 See, e.g., PLRs 200327057 (July 3, 2003), 200104024 (January 26, 2001) and 9848010 (November 27, 1998).

32 The term section 1248 shareholder refers to any United States person that satisfies the ownership requirements of section 1248(a)(2) or (c)(2) with respect to a foreign corporation. See Reg. § 1.367(b)-2(b).

33 The term section 1248 amount generally refers to the net positive e&p (if any) that would have been attributable to such stock and includible in income as a dividend under section 1248 and the regulations thereunder. See Reg. section 1.367(b)-2(b). Special rules may apply in the case of certain foreign shareholders. Id.
an income inclusion by the exchanging shareholder. The exchanging shareholder generally must include in income its section 1248 amount. However, to the extent that the section 1248 shareholder or CFC status is preserved, the regulations do not require a current income inclusion by the exchanging shareholder.34

Specifically, under Regulation section 1.367(b)-4(b)(1)(i), a section 1248 shareholder (or, in certain cases, a foreign corporate shareholder that has a section 1248 shareholder) generally must include in income its section 1248 amount as a result of a section 367(b) exchange,35 if immediately after the exchange (i) the stock received in the exchange is not stock in a corporation that is a CFC as to which the section 1248 shareholder described above is a section 1248 shareholder, or (ii) the foreign acquiring corporation or the foreign acquired corporation (if any, such as in a transaction described in section 368(a)(1)(B) or 351), is not a CFC as to which the section 1248 shareholder described above is a section 1248 shareholder.

Regulation section 1.367(b)-4(b)(1)(ii) provides that in the case of a triangular reorganization described in Regulation section 1.358-6(b)(2), or a reorganization described in sections 368(a)(1)(G) and (a)(2)(D), an exchange is not described in Regulation section 1.367(b)-4(b)(1)(i) if the stock received in the exchange is stock of a domestic corporation and, immediately after the exchange, such domestic C corporation is a section 1248 shareholder of the acquired corporation in the case of a triangular B reorganization or the surviving corporation in the case of a triangular C reorganization, a forward triangular merger, a reorganization described in sections 368(a)(1)(G) and (a)(2)(D), or a reverse triangular merger and such acquired or surviving corporation is a CFC.

The regulations also provide detailed rules designed to preserve the section 1248 amount. For instance, the current regulations provide specific rules for purposes of sections 1248 and 367(b) for attributing e&p of the requisite entities to the stock of certain shareholders as well as rules relating to the subsequent exchanges of stock.36

4. Application of Sections 1248 and 367(b) to Example 4

This general policy of deferring a current income inclusion in cases in which the section 1248 amount can be preserved seemingly was abandoned when Example 4 was promulgated along with the rest of the final section 367(b) regulations in 2000:

Example 4 – (1) Facts. DC1, a domestic corporation, owns all of the outstanding stock of DC2, a domestic corporation. DC2 owns various assets including all of the outstanding stock of FC2, a foreign corporation. The stock of FC2 has a value of $100, and DC2 has a basis of $30 in such stock. The section 1248 amount attributable to the FC2 stock held by DC2 is $20. DC2 does not own any other stock in a foreign corporation. FC1 is a

34 See also, Reg. §§ 1.367(b)-4(b)(1)(ii) and (iii). For the application of section 367(b) in the context of section 355 distributions, see Reg. §1.367(b)-5.

35 Reg. § 1.367(b)-4(a) generally addresses the acquisitions by a foreign corporation (the foreign acquiring corporation) of stock or assets of another foreign corporation (the foreign acquired corporation) in an exchange described in section 351 or a reorganization described in sections 368(a)(1).

36 See e.g., Reg. §§ 1.367(b)-4(d) and 1.1248-8.
foreign corporation that is unrelated to DC1, DC2 and FC2. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets and liabilities of DC2 in exchange for FC1 voting stock that represents 20 percent of the outstanding voting stock of FC1. DC2 distributes the FC1 stock to DC1, and the DC2 stock held by DC1 is canceled. DC1 properly files a gain recognition agreement under Regulation section 1.367(a)-8 to qualify for nonrecognition treatment under section 367(a) with respect to DC2's transfer of the FC2 stock to FC1. See Regulation section 1.367(a)-3T(e).

(2) Result. Pursuant to paragraph (b)(1)(i)(A) of this section, DC2 is the exchanging shareholder that is a section 1248 shareholder with respect to FC2, the foreign acquired corporation. Immediately after the exchange, DC2 is not a section 1248 shareholder with respect to FC1, the corporation whose stock is received in the exchange (because the DC2 stock is canceled). Thus, paragraph (b)(1)(i)(B) of this section is satisfied and, as a result, paragraph (b)(1)(i) of this section applies to DC2's section 361 exchange of FC2 stock. Accordingly, under paragraph (b) of this section, DC2 must include in income, as a deemed dividend from FC2, the section 1248 amount ($20) attributable to the FC2 stock that DC2 exchanges. This result arises without regard to whether FC1 and FC2 are controlled foreign corporations immediately after the exchange. For the tax treatment of DC2's transfer of assets (other than stock) to FC1, see sections 367(a)(1) and (a)(3), and the regulations thereunder. Because the exchange is also described in section 361(a) or (b), see section 367(a)(5) and any regulations thereunder. If any of the assets transferred are intangible assets, see section 367(d) and the regulations thereunder.

Notably, Example 4 contains the statement that “[current inclusion of the section 1248 amount into income of the transferring domestic corporation, or DC2] arises without regard to whether FC1 and FC2 are controlled foreign corporations immediately after the exchange.” Thus, we believe that Example 4 adopted a position at odds with general policy of sections 367(b) and 1248(f) of permitting deferral when the section 1248 amount can be preserved through basis and holding period adjustments.

C. -13 Regulations and Section 358 Regulations

1. Background

The -13 Regulations provide new basis and holding period rules that are designed to preserve relevant section 1248 or 964(e) amounts in certain section 354 or 356 exchanges and certain triangular reorganizations. As discussed above, the basis and holding period (and the e&p attributable to such holding periods) are essential to preserving section 1248 or 964(e) amounts. In order to preserve these amounts, the -13 Regulations provide a cross-reference to the Section 358 Regulations to determine the basis and holding period of stock in a foreign corporation received by certain shareholders in a section 354 or 356 exchange by employing certain tracing and identification principles. The -13 Regulations also provide different rules for determining basis and holding period for certain triangular reorganizations (triangular “C”, forward triangular, reverse triangular reorganizations and triangular G reorganizations described in Regulation section 1.358-6(b)(2)(i), (ii), (iii) and section 368(a)(1)(G) and (a)(2)(D)) involving

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37 Reg. § 1.367(b)-13(b).
foreign corporations.\textsuperscript{38} These rules generally override the normal over-the-top basis rules under Regulation section 1.358-6(c). The -13 Regulations apply to determine the basis and holding period of stock of certain foreign surviving corporations held by a controlling shareholder whose stock is issued in an exchange under section 354 or 356 in a triangular reorganization.\textsuperscript{39} One of the mechanisms used to preserve the relevant section 1248 amounts is to divide the basis and holding period in each share of the stock of the surviving corporation.

2. Section 354 or 356 Exchanges

In the case of a section 354 or 356 exchange, the Section 358 Regulations contain a tracing approach such that the basis of each share of stock received by the exchanging shareholder has the same basis of the allocable portion of the share or shares of stock exchanged, as adjusted under Regulation section 1.358-1. The Section 358 Regulations also provide that if more than one share of stock is received in exchange for one share of stock, the basis of the share of stock surrendered is allocated to the shares of stock received in the exchange in proportion to the fair market value of the shares of stock received. If one share of stock is received in respect of more than one share of stock or a fraction of a share of stock is received, the basis of the shares of stock surrendered is allocated to the share of stock received, or a fraction thereof received, in a manner that reflects, to the greatest extent possible, that a share of stock is received in respect of shares of stock acquired on the same date and at the same price.\textsuperscript{40}

The Section 358 Regulations contain a designation procedure for situations in which the exchanging shareholder that purchased or acquired shares of stock in a corporation on different dates or at different prices exchanges such shares of stock in a section 354 or 356 exchange, and the shareholder is not able to identify which particular share or shares of stock (or portion of a share of stock) is received in exchange for a particular share or shares of stock.\textsuperscript{41} The designation must be consistent with the terms of the exchange or distribution, and the other rules provided under the Section 358 Regulations. However, if the exchanging shareholder cannot establish and does not designate the particular shares received, the shareholder is treated as selling or otherwise exchanging shares received in a nonrecognition exchange for a share that was purchased or acquired at the earliest time (\textit{i.e.}, a first-in first-out approach).\textsuperscript{42}

3. Triangular Reorganizations Involving Section 1248 or 964(e) Shareholders

Absent special rules, preserving the section 1248 amounts would be difficult if not impossible in triangular reorganizations where the merging or surviving corporation (S or T, \textsuperscript{38} Reg. § 1.367(b)-13(a)(1) and (2)(ii).

\textsuperscript{39} Reg. § 1.367(b)-13(a)(1). These changes apply to transactions that are subject to section 367(b) as well as section 367(a), including transactions concurrently subject to sections 367(a) and (b).

\textsuperscript{40} Reg. § 1.358-2(a)(2)(i).

\textsuperscript{41} In the case of an exchange under section 354 or 356, the designation must be made on or before the first date on which the basis of a share of stock received is relevant. The basis of the shares received in an exchange under section 354 or 356, is relevant when such shares are sold or otherwise transferred.

\textsuperscript{42} Reg. § 1.358-2(a)(2)(vii).
depending on the type of reorganization) is a foreign corporation with a section 1248 shareholder. The application of section 1248 relies on the tracking of basis and holding periods (and the corresponding e&p attributable to the stock) in order to operate. The application of the over-the-top basis rules contained in Regulation section 1.358-6(c) can distort these amounts. For instance, in the context of a forward triangular reorganization or triangular “C” reorganization, the basis that the controlling corporation (P) has in its S stock is adjusted as if P had acquired the T assets directly from T in a section 362(b) exchange and then transferred the T assets to S in a transaction in which P’s basis in the S stock is determined under section 358. The application of the over-the-top rules would not work well to preserve section 1248 amounts if P is a domestic corporation, S is a foreign corporation and T is a foreign corporation with a section 1248 shareholder.

Therefore, the -13 Regulations apply a different regime in these situations to facilitate the policy of preserving section 1248 amounts. They achieve this objective by taking a stock-based approach in determining the basis and holding period of the controlling corporation (P) in the surviving corporation (S or T, depending on the type of reorganization). This is accomplished by providing for a divided basis and holding period in each share of the stock of the surviving corporation to reflect the relevant section 1248 amounts.

In the case of a reverse triangular reorganization, the -13 Regulations apply if P is a section 1248 shareholder (or, in certain cases in which P has a U.S. person that is a section 1248 shareholder) and P’s exchange of S stock is not described in Regulation sections 1.367(b)-3(a) and (b) or in Regulation sections 1.367(b)-4(b)(1)(i), (2)(i), or (3). The -13 Regulations also apply in the case of the other triangular reorganizations if a T shareholder is a section 1248 shareholder or a foreign corporation with a U.S. person that is a section 1248 shareholder with respect to such foreign corporation and T and one of the described exchanging shareholder’s exchange of T stock is not described in Regulation sections 1.367(b)-3(a) and (b) or in Regulation sections 1.367(b)-4(b)(1)(i), (2)(i), or (3).43

When these conditions are satisfied, each share of stock of the surviving corporation (S or T) held by P generally must be divided into portions attributable to the S stock and the T stock immediately before the exchange.44 The -13 Regulations provide very detailed rules on how to divide such shares to preserve the relevant section 1248 amounts, including certain exceptions to this general approach.45

The following example from the regulations illustrates some of these concepts.

Example. (i) Facts. (A) US1, a domestic corporation, owns all the stock of F1, a foreign corporation. F1 owns all the stock of FT, a foreign corporation, with 100 shares of stock outstanding. Each share of FT stock is valued at $10x. Because F1 acquired the stock of FT at two different dates, F1 owns two blocks of FT stock for purposes of section 1248. The first block consists of 60 shares. The shares in

43 Reg. § 1.367(b)-13(c)(1)(i) and (ii).
44 Reg. §§ 1.367(b)-13(c)(2).
45 See generally, Reg. § 1.367(b)-13(c) and (d).
the first block have a basis of $300x ($5x per share), a holding period of 10 years, and $240x ($4x per share) of earnings and profits attributable to the shares for purposes of section 1248. The second block consists of 40 shares. The shares in the second block have a basis of $600x ($15x per share), a holding period of 2 years, and $80x ($2x per share) of earnings and profits attributable to the shares for purposes of section 1248.

(B) US2, a domestic corporation, owns all of the stock of FP, a foreign corporation, which owns all of the stock of FS, a foreign corporation. FP owns two blocks of FS stock. Each block consists of 10 shares with a value of $200x ($20x per share). The shares in the first block have a basis of $50x ($5x per share), a holding period of 10 years, and $50x ($5x per share) of earnings and profits attributable to such shares for purposes of section 1248. The shares in the second block had a basis of $100x ($10x per share), a holding period of 5 years, and $20x ($2x per share) of earnings and profits attributable to such shares for purposes of section 1248.

(C) FT merges into FS, with FS surviving, and F1 receives 50 shares of FP stock with a value of $1,000x in exchange for its FT stock. The merger of FT into FS qualifies as forward triangular merger, and immediately after the exchange US1 is a section 1248 shareholder with respect to F1, the exchanging shareholder, FP and FS, all of which are controlled foreign corporations.

(ii) Basis and holding period determination. (1) US1 is a section 1248 shareholder of F1, the exchanging shareholder, and FT (both of which are controlled foreign corporations) immediately before the transaction. Moreover, F1 is not required to include amounts in income under §1.367(b)-3(b) or 1.367(b)-4(b) as described in paragraph (c)(1)(ii)(B) of this section. Accordingly, the basis and holding period of the FS stock held by FP immediately after the triangular reorganization is determined pursuant to paragraph (c) of this section.

(2) Pursuant to paragraph (c) of this section, each share of FS stock is divided into portions attributable to the basis and holding period of the FS stock held by FP immediately before the exchange (the FS portion) and the FT stock held by F1 immediately before the exchange (the FT portion). The basis and holding period of the FS portion is the basis and holding period of the FS stock held by FP immediately before the exchange. Thus, each share of FS stock in the first block has a portion with a basis of $5x, a value of $20x, a holding period of 10 years, and $5x of earnings and profits attributable to such portion for purposes of section 1248. Each share of FS stock in the second block has a portion with a basis of $10x, a value of $20x, a holding period of 5 years, and $2x of earnings and profits attributable to such portion for purposes of section 1248.

(3) Because the exchanging shareholder of FT stock (F1) has a section 1248 shareholder (US1), the holding period and basis of the FT portion is the holding period and the proportionate amount of the basis of the FT stock immediately before the exchange to which such portion relates. Further, because F1 exchanged
two blocks of FT stock, the FT portion must be divided into two separate portions attributable to the two blocks of FT stock. Thus, each share of FS stock will have a second portion with a basis of $15x ($300x basis / 20 shares), a value of $30x ($600x value / 20 shares), a holding period of 10 years, and $12x of earnings and profits ($240x / 20 shares) attributable to such portion for purposes of section 1248. Each share of FS stock will have a third portion with a basis of $30x ($600x basis / 20 shares), a value of $20x ($400x value / 20 shares), a holding period of 2 years, and $4x of earnings and profits ($80x / 20 shares) attributable to such portion for purposes of section 1248.

(iii) Subsequent disposition – first block. Assume, immediately after the transaction, FP disposes of a share of FS stock from the first block. When FP disposes of any share of its FS stock, it is treated as disposing of each divided portion of such share. With respect to the first portion (attributable to the FS stock), FP recognizes a gain of $15x ($20x value-$5x basis), $5x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value-$15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value-$30x basis).

(iv) Subsequent disposition – second block. Assume further, immediately after the transaction, FP also disposes of a share of stock from the second block of FS stock. With respect to the first portion (attributable to the FS stock), FP recognizes a gain of $10x ($20x value-$10x basis), $2x of which is treated as a dividend under section 1248. With respect to the second portion (attributable to the first block of FT stock), FP recognizes a gain of $15x ($30x value-$15x basis), $12x of which is treated as a dividend under section 1248. With respect to the third portion (attributable to the second block of FT stock), FP recognizes a capital loss of $10x ($20x value-$30x basis).”

II. RECOMMENDATIONS AND EXAMPLES

A. General Methodology

As described above, sections 367(a)(5), 1248(f), and 367(b), in conjunction with the Regulations, can be applied in a manner to prevent or reduce an immediate inclusion in transactions the same as, or similar to, Example 4 by preserving some or all of the section 1248 amount.

As a preliminary matter, section 367(a)(5) will need to be applied to determine whether any exceptions (such as the exception for foreign stock transfers) to section 367(a)(1) are available. This will require the requisite 80 percent domestic corporate ownership of the domestic corporate transferor as required by section 367(a)(5). This domestic corporate ownership may exist but there may be minority shareholders of the domestic corporate transferor

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46 Reg. §§ 1.367(b)-13(e), Example 1.
(e.g., a U.S. individual or a foreign shareholder). Although, as discussed above, the House and Senate Reports differ from the JCT explanation on the issue of gain recognition by the domestic corporate transferor, the approach of the House and Senate Reports appears to have a stronger policy basis (i.e., preservation of the U.S. corporate level tax). This would require the domestic corporate transferor to recognize a proportionate amount of gain on its assets (including stock of CFCs)\(^47\) with corresponding adjustments, including a basis adjustment in such assets in the hands of the foreign acquiring corporation.

Additionally, assuming that the requisite domestic corporate ownership condition is satisfied, appropriate basis adjustments may need to be made to ensure that the corporate level tax is preserved. The legislative history indicates that this basis adjustment will require that a domestic corporate shareholder agree to take a basis in the stock it receives in a foreign corporation equal to the lesser of (a) the corporate shareholder’s basis in such stock as determined under section 358, or (b) its proportionate share of the basis in the assets of the domestic corporate transferor transferred to the foreign corporation. The Service’s ruling position has been that the basis of the foreign corporation’s stock in the hands of the domestic corporate shareholder should equal the lesser of (a) the adjusted basis of the stock of the domestic corporate transferor in the hands of domestic corporate shareholder immediately prior to the proposed transaction, or (b) its proportionate share of the net basis of the transferred assets in the hands of domestic transferor immediately prior to the proposed transaction. As discussed above, this terminology difference may be relevant in the case of liabilities of the domestic corporate transferor. The Service’s ruling position would appear to treat the liabilities as a reduction of the domestic corporate transferor’s inside basis in its assets for purposes of determining the outside basis in the stock. This position seems to be a logical approach for dealing with liabilities and should be adopted.

Assuming that section 367(a)(5) does not require full gain recognition by the domestic corporate transferor, the other rules can be applied to preserve the relevant section 1248 amounts of the domestic corporate transferor in the hands of the domestic corporate shareholder(s). This will require that the appropriate basis, holding period and e&p be attributed to the relevant stock of the foreign acquiring corporation through a modified version of the -13 Regulations. Those regulations generally apply to a shareholder that is exchanging stock of a CFC to preserve the relevant section 1248 amounts. However, in an Example 4 type transaction, the exchanging shareholder will be exchanging stock of another domestic corporation and not stock of a CFC. Therefore, the assets being transferred by the domestic corporate transferor will need to be treated for purposes of section 1248 as the assets of the domestic corporate shareholder. Essentially, this approach would require that the domestic corporate shareholders of the domestic corporate transferor step into the shoes of the domestic corporate transferor on a proportionate basis to preserve the relevant section 1248 amounts. After determining the domestic corporate shareholder’s basis in the stock of the foreign acquiring corporation after applying section 367(a)(5), the principles of the -13 Regulations would need to be applied and, depending on the assets transferred by the domestic corporate transferor, each share of stock of the foreign acquiring corporation may need to be divided to preserve the section 1248 amounts.

\(^{47}\)Correspondingly, section 1248(a) would apply to recharacterize some or all of the gain as ordinary dividend income.
For instance, if the domestic corporate transferor has two CFCs (CFC1 and CFC2) as well as other assets being transferred in an Example 4 type of transfer and the domestic corporate shareholder exchanges 1 share of stock in the domestic corporate transferor for 1 share of stock in the foreign acquiring corporation, the domestic corporate shareholder would divide the basis in that share of stock of the foreign acquiring corporation (as determined after applying section 367(a)(5)) into 3 separate segments-one for CFC1, one for CFC2 and a final segment for all of the other assets. Aggregating the other assets held by the domestic corporate transferor seems to make sense because those assets do not have section 1248 amounts. With regard to each CFC, the holding period would reflect the holding period that the domestic corporate transferor had in such CFC and the e&p would be allocated under the principles of the 13 Regulations. With regard to the third segment of stock relating to the other assets, the holding period for that segment would be determined based on the domestic corporate shareholder’s holding period in the stock of the domestic corporate transferor.

B. Examples

The following examples illustrate this approach to preserving the section 1248 amounts.

1. Example 1 (Base Case)

   a. Facts. DC1, a domestic corporation, owns 10 shares of stock which represents all of the outstanding stock of DC2, a domestic corporation. The stock of DC2 has a value of $100 and DC1 has a basis of $40 in such stock. DC1’s holding period with respect to such stock is 5 years. DC2 owns only one asset, consisting of all 100 of the outstanding shares of FC2, a foreign corporation, and has no liabilities. The stock of FC2 has a value of $100, and DC2 has a basis of $30 in such stock. DC2’s holding period with respect to such stock is 10 years. DC2 is a section 1248 shareholder with respect to FC2, a CFC, and the section 1248 amount attributable to the FC2 stock held by DC2 is $20 (.2 of e&p per share). FC1, a foreign corporation and a CFC, is unrelated to DC1, DC2 and FC2. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets of DC2 in exchange for 10 shares of FC1 voting stock that represents 20 percent of the outstanding voting stock of FC1. DC2 distributes the FC1 stock to DC1, and the DC2 stock held by DC1 is canceled. DC1 properly files a GRA under Regulation section 1.367(a)-8/8T to qualify for nonrecognition treatment under section 367(a) with respect to DC2’s transfer of the FC2 stock to FC1. See Regulation section 1.367(a)-3T(e). After the transaction, DC1 is a section 1248 shareholder with respect to FC1, a CFC.

   b. Basis and Holding Period Results. DC1’s section 358 basis in the FC1 stock that it received would be $40 (i.e., its adjusted basis in the DC2 stock that it surrendered in the exchange) or $4 of basis per share. However, based upon the section 367(a)(5) authorities discussed above, DC1 should take the lower $30 basis that DC2 had in its assets (i.e., the FC2 stock) immediately prior to the transaction. Therefore, each share of stock of FC1 will have a basis equal to $3 per share. For purposes of section 1248, applying the principles of the 13 Regulations would require DC1 to take a holding period in the stock of FC1 of 10 years with $2 of e&p attributable to each share of stock. Because the section 1248 amount that otherwise would have been includible by DC2 has been preserved in the hands of DC1 with respect to the FC1 stock that it received in the exchange, DC2 should not be required to recognize any income as a result of the transaction under section 1248 or section 367(b).
2. Example 2 (Base Case with liabilities)

a. **Facts.** The same facts as in Example 1, except that DC2 has $20 of liabilities.

b. **Basis and Holding Period Results.** DC1’s section 358 basis in the FC1 stock that it received would be $40 (i.e., its adjusted basis in the DC2 stock that it surrendered in the exchange) or $4 of basis per share. However, based upon the section 367(a)(5) authorities discussed above, DC1 should take the lower $20 net basis that DC2 had in its assets immediately prior to the transaction. Therefore, each share of stock of FC1 will have a basis equal to $2 per share. For purposes of section 1248, applying the principles of the -13 Regulations would require DC1 to take a holding period in the stock of FC1 of 10 years with $2 of e&p attributable to each share of stock. Because the section 1248 amount otherwise includible by DC2 has been preserved in the hands of DC1 with respect to the FC1 stock that it received in the exchange, DC2 should not be required to recognize any income as a result of the transaction under section 1248 or section 367(b).

3. Example 3 (Base Case with CFC and Non-CFC Assets).

a. **Facts.** Same facts as in Example 1, except that DC2 owns two assets, one consisting of all 100 of the outstanding shares of FC2, a foreign corporation. The stock of FC2 has a value of $50, and DC2 has a basis of $10 in such stock. DC2’s holding period with respect to such stock is 10 years. DC2 is a section 1248 shareholder with respect to FC2, a CFC, and the section 1248 amount attributable to the FC2 stock held by DC2 is $20. The other asset, Asset 1, is an asset to which section 367(a)(2) normally would apply. The fair market value of this asset is $50 and DC2 has a basis in this asset of $15. As in Example 1, FC1 is a CFC that is unrelated to DC1, DC2 and FC2. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets of DC2 in exchange for 10 shares of FC1 voting stock that represents 20 percent of the outstanding voting stock of FC1. DC2 distributes the FC1 stock to DC1, and the DC2 stock held by DC1 is canceled. DC1 properly files a GRA under Regulation section 1.367(a)-8/8T to qualify for nonrecognition treatment under section 367(a) with respect to DC2's transfer of the FC2 stock to FC1. See Regulation section 1.367(a)-3T(e). After the transaction, DC1 is a section 1248 shareholder with respect to FC1, a CFC.

b. **Basis and Holding Period Results.** DC1’s section 358 basis in the FC1 stock that it received would be $40 (i.e., its adjusted basis in the DC2 stock that it surrendered in the exchange). However, based upon the section 367(a)(5) authorities discussed above, DC1 should take the lower inside basis that DC2 had in the stock of FC2 and Asset 1 immediately prior to the transaction. Because DC2’s section 1248 amount was only attributable to the FC2 stock, however, each share of the FC1 stock received by DC1 should be divided into two separate portions, one attributable to the stock of FC2, the other attributable to Asset 1. The basis of this allocation should be the fair market value of FC2 and Asset 1, which in the example are equal ($50 each). Accordingly, the portion of each share attributable to the FS stock would have a fair market value of $5, an adjusted basis of $1, a holding period of 10 years with $2 of e&p attributable to each share. The portion of each share attributable to Asset 1 will have a fair market value of 5, and adjusted basis of $1.5, and a holding period equal to 5 years (the holding period that DC1 had in DC2). Again, because the section 1248 amount that otherwise would have been includible by DC2 has been preserved in the hands of DC1 with respect to the FC1
stock that it received in the exchange, DC2 should not be required to recognize any income as a result of the transaction under section 1248 or section 367(b).

4. Example 4 (Base Case with More Than One Owner).

a. Facts. DC1, a domestic corporation, owns 9 shares of stock which represents 90 percent of all of the outstanding stock of DC2, a domestic corporation. The stock of DC2 has a value of $90 and DC1 has a basis of $40 in such stock. DC1’s holding period with respect to such stock is 5 years. The remaining 10 percent of the outstanding stock of DC2 is owned by FI, a foreign individual. DC2 owns only one asset, consisting of all 100 of the outstanding shares of FC2, a foreign corporation, and has no liabilities. The stock of FC2 has a value of $100, and DC2 has a basis of $30 in such stock. DC2’s holding period with respect to such stock is 10 years. DC2 is a section 1248 shareholder with respect to FC2, a CFC, and the section 1248 amount attributable to the FC2 stock held by DC2 is $20 (.2 of e&p per share). FC1, a foreign corporation and a CFC, is unrelated to DC1, DC2, FC2 and FI. In a reorganization described in section 368(a)(1)(C), FC1 acquires all of the assets of DC2 in exchange for 10 shares of FC1 voting stock that represents 20 percent of the outstanding voting stock of FC1. DC2 distributes 9 shares of the FC1 stock to DC1 and 1 share to FI, and the DC2 stock held by DC1 and FI is canceled. DC1 properly files a GRA under Regulation section 1.367(a)-8T to qualify for nonrecognition treatment under section 367(a) with respect to DC2's transfer of the FC2 stock to FC1. See Regulation section 1.367(a)-3T(e). After the transaction, DC1 is a section 1248 shareholder with respect to FC1, a CFC.

b. Basis and Holding Period Results. Applying the approach of the House and Senate Reports to 367(a)(5), DC2 would be required to recognize 10 percent of its gain in the stock of FC2 (the portion of the assets attributable to FI) which would be $7 ($2 of which would be recharacterized under section 1248(a) as ordinary dividend income). Appropriate adjustments would need to be made to reflect the gain recognized, including increasing the basis that FC1 would take in the stock of FC2. The next step would be to apply section 367(a)(5) basis adjustments. DC1’s section 358 basis in the FC1 stock that it received would be $40 (i.e., its adjusted basis in the DC2 stock that it surrendered in the exchange) or $4 of basis per share. However, based upon the section 367(a)(5) authorities discussed above, DC1 should take its proportionate share (90 percent) of the lower $30 basis that DC2 had in its assets (i.e., the FC2 stock) immediately prior to the transaction. Therefore, each share of stock of FC1 will have a basis equal to $3 per share (a total of $27). For purposes of section 1248, applying the principles of the -13 Regulations would require DC1 to take a holding period in the stock of FC1 of 10 years with $1.8 of e&p attributable to each share of stock ($2 of the section 1248 amount already has been recognized in the transaction). Because the section 1248 amount (other than the $2 already recognized) can be preserved in the hands of DC1 with respect to the FC1 stock that it received in the exchange, DC2 should not be required to recognize $18 of its section 1248 amount under section 1248 or section 367(b).