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## **New U.S. Guidance on Tax-Free Spin-Offs**

by Lewis J. Greenwald and Robert J. LeDuc

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# New U.S. Guidance on Tax-Free Spin-Offs

by Lewis J. Greenwald and Robert J. LeDuc

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When a controlled foreign corporation (CFC)<sup>1</sup> makes a pro rata distribution of the stock of a subsidiary under section 355 of the U.S. Internal Revenue Code (IRC) of 1986, as amended, Treas. reg. section 1.367(b)-5(c) operates to preserve the potential application of section 1248. Specifically, if the “postdistribution amount” is different than the “predistribution amount” (each as defined below) for the distributing and/or controlled corporations, then Treas. reg. section 1.367(b)-5(c) requires the distributee to reduce the basis of distributing and/or controlled, and potentially include amounts in income as deemed dividends.<sup>2</sup> Slightly different rules apply if a CFC makes a non-pro rata distribution.<sup>3</sup>

A private letter ruling released on 3 July 2003, PLR 200327054, discussed an otherwise tax-free spin-off under section 355 that implicated the basis reduction/income inclusion provisions of Treas. reg. section 1.367(b)-5(c). That ruling is one of only a handful of primary authorities that discusses those provisions.<sup>4</sup> (For the full text of PLR 200327054, see *2003 WTD 130-16* or *Doc 2003-15944* (8 original pages).)

## Section 367(b)

Except to the extent described in section 367(a), section 367(b) governs the treatment of corporate restructurings under sections 332, 351, 354, 355, 356, and 361 (the subchapter C provisions), where the status of a foreign business entity as a “corporation” is necessary for application of the relevant nonrecognition provisions.<sup>5</sup> Unlike section 367(a), section 367(b) provides that a foreign corporation that is a party to one of those nonrecognition transactions generally will be respected as a corporation. Therefore, the parties will obtain the benefits of the applicable nonrecognition exchange provisions, except as otherwise provided in regulations.<sup>6</sup>

The principal purpose of section 367(b) is to prevent the avoidance of U.S. federal income tax that can arise when the subchapter C provisions apply to transactions involving foreign corporations.<sup>7</sup> The section 367(b) regulations recognize that the subchapter C provisions have been drafted to apply to domestic corporations and U.S. stockholders, and do not fully take into account the cross-border aspects of U.S. federal income taxation (for example, deferral, foreign tax credits, and section 1248).<sup>8</sup> Because determining the proper interaction of the IRC’s international provisions and the subchapter C provisions is “necessarily highly technical,” Congress granted the IRS broad regulatory authority to provide the “necessary or appropriate” rules, rather than enacting a complex statutory regime.<sup>9</sup>

<sup>1</sup>Section 957; Treas. reg. section 1.367(b)-2(a). All section references are to the Internal Revenue Code.

<sup>2</sup>For purposes of Treas. reg. section 1.367(b)-5, the terms “distributing corporation,” “controlled corporation,” and “distributee” have the same meaning as used in section 355 and the regulations thereunder, and all distributees are treated as exchanging shareholders. See Treas. reg. sections 1.367(b)-5(a)(1) and (2).

<sup>3</sup>See Treas. reg. section 1.367(b)-5(d).

<sup>4</sup>See also, PLR 200234064 (15 May 2002); PLR 200202047 (9 Oct. 2001); PLR 200129029 (23 July 2001); PLR 200048008 (4 Dec. 2000).

<sup>5</sup>T.D. 8862, 2000-1 C.B. 466. See also Treas. reg. section 1.367(b)-1(a).

<sup>6</sup>*Id.*

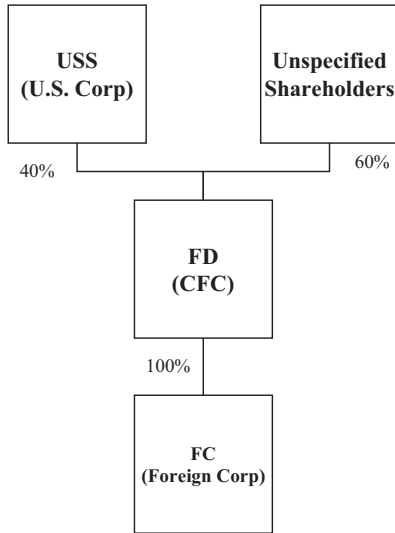
<sup>7</sup>*Id.*

<sup>8</sup>*Id.* See also, Bernard T. Bress, “New Section 367(b) Regulations,” 11 *J. of International Tax’n* 6 (June 2000) (Section 367(b) historically viewed as essentially “a backstop to Section 1248”).

<sup>9</sup>T.D. 8862, 2000-1 C.B. 466, citing H.R. Rep. No. 658, 94<sup>th</sup> Cong., 1<sup>st</sup> Sess. 241 (1975).

Figure 1

Treas. reg. section 1.367(b)-5(g)  
Example 1



- USS, a domestic corporation, owns 40 percent of the outstanding stock of FD, a CFC. USS has a basis of \$80 in its FD stock, which has a fair market value of \$200.
- FD owns 100 percent of the outstanding stock of FC, a foreign corporation.
- FD has no E&P and a fair market value of \$250 (not considering its ownership of FC); FC has \$300 of E&P and a fair market value of \$250. Thus, USS's section 1248 amount (computed immediately before the distribution) is \$120, all of which is attributable to FC; USS's predistribution amount with respect to FD is zero.

## The Section 367(b) Regulations

Final section 367(b) regulations were issued on 21 January 2000.<sup>10</sup> Treas. reg. section 1.367(b)-1(b)(1)(i) provides the general rule that a foreign corporation in a section 367(b) exchange is considered to be a corporation and, as a result, all of the related provisions (for example, section 381) will apply, except to the extent provided in the section 367(b) regulations. Treas. reg. section 1.367(b)-1(c) provides rules as to when a section 367(b) notice must be filed by an exchanging shareholder.

Treas. reg. section 1.367(b)-2 provides the following core definitions for the section 367(b) regulations:

- *section 1248 shareholder* means any United States person that satisfies the ownership requirements of section 1248(a)(2) or (c)(2) with respect to a foreign corporation;<sup>11</sup>
- *section 1248 amount* means, with respect to stock in a foreign corporation, the net positive earnings and profits (if any) that would have been attributable to that stock and includible in income as a dividend under section 1248 and the regulations thereunder, if the stock were sold by the shareholder;<sup>12</sup> and
- *all-earnings-and-profits amount* means the net positive earnings and profits (if any) with respect to the stock in a foreign corpo-

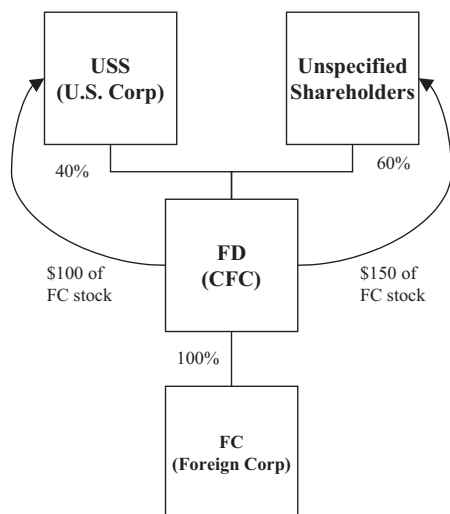
<sup>10</sup>T.D. 8862, 2000-1 C.B. 466. On 27 December 1977, proposed and temporary regulations were issued under section 367(b) (T.D. 7530, amended by T.D. 8243 (3 Mar. 1989) and by T.D. 8397 (25 Feb. 1992)). On 26 August 1991, proposed regulations were issued and on 18 June 1998, final regulations were issued (T.D. 8770). The 1998 final regulations addressed transactions under section 367(b) only to the extent the transactions also were subject to the stock transfer rules of section 367(a). Therefore, the 1977 temporary regulations remained in effect until February 2000 to the extent not superseded by the 1998 final regulations.

<sup>11</sup>Treas. reg. section 1.367(b)-2(b). Under section 1248(a), if (1) a U.S. person sells or exchanges stock in a foreign corporation, and (2) that person owns (within the meaning of section 958(a) or (b)) 10 percent or more of the vote of that foreign corporation at any time during the five-year period ending on the date of the sale or exchange when that foreign corporation was a CFC, then the gain recognized on the sale or exchange is treated as a dividend to the extent of the earnings and profits attributable to that stock.

<sup>12</sup>Treas. reg. section 1.367(b)-2(c)(1).

Figure 2

Treas. reg. section 1.367(b)-5(g)  
Example 1 (Cont.)



- In a pro rata distribution described in section 355, FD distributes stock in FC worth \$100 to USS; thereafter, USS's FD stock is worth \$100 as well.
- USS's postdistribution amounts with respect to FD and FC are zero and \$60, respectively.
- Under Treas. reg. section 1.367(b)-5(c), USS must reduce its basis in its FC stock from \$40 to zero, and include \$20 in income as a deemed dividend. USS increases its basis in FD by the amount by which it decreases its basis in FC, as well as by the amount of the deemed dividend.

ration. The all-earnings-and-profits amount is determined without regard to the amount of gain that would be realized on a sale or exchange of the stock of the foreign corporation.<sup>13</sup>

If, under the section 367(b) regulations, an exchanging shareholder is required to include an amount in income as a deemed dividend, that amount is treated as a dividend for all purposes of the IRC including, for example, the deemed paid foreign tax credit of section 902.<sup>14</sup> The deemed dividend is considered to be received immediately before the exchanging shareholder's receipt of

consideration for its stock in the foreign corporation.<sup>15</sup>

Treas. reg. section 1.367(b)-3 provides rules for inbound asset transfers — that is, where a foreign corporation transfers assets to a U.S. corporation in either a section 332 liquidation or a “C,” “D,” or “F” reorganization under section 368(a)(1).<sup>16</sup>

Treas. reg. section 1.367(b)-4 provides rules for foreign-to-foreign transfers, that is, where a foreign corporation transfers stock or assets to another foreign corporation in either a section 351

<sup>13</sup>Treas. reg. section 1.367(b)-2(d)(1). Treas. reg. section 1.367(b)-2(d)(3) provides that the all-earnings-and-profits amount, with respect to stock of a foreign corporation, is determined according to the attribution principles of section 1248 and the regulations thereunder. Those attribution principles apply without regard to the requirements of section 1248 that are not relevant to the determination of a shareholder's pro rata portion of earnings and profits. For example, the all-earnings-and-profits amount is determined without regard to whether the foreign corporation was a CFC at any time during the five years preceding the section 367(b) exchange, without regard to whether the shareholder owned 10 percent or greater interest in the stock, and without regard to whether the earnings and profits of the foreign corporation were accumulated in post-1962 taxable years, or while the corporation was a CFC.

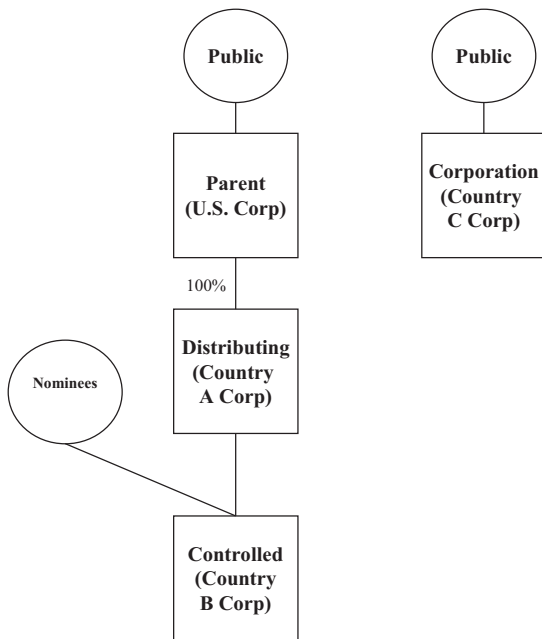
<sup>14</sup>Treas. reg. section 1.367(b)-2(e)(2) and (4), *Example 1*.

<sup>15</sup>Treas. reg. section 1.367(b)-2(e)(3)(ii).

<sup>16</sup>In general, under Treas. reg. section 1.367(b)-3, an exchanging shareholder is required to include in income (as a deemed dividend) the all-earnings-and-profit amount with respect to its stock in the foreign acquired corporation. For example, where DC, a domestic corporation, owns all of the stock of FC, a foreign corporation, and the all-earnings-and-profits amount attributable to the FC stock is \$20, DC is required to include the \$20 in income as a deemed dividend under Treas. reg. section 1.367(b)-3(b)(3)(i) when FC liquidates into DC in a section 332 liquidation. Treas. reg. section 1.367(b)-3T provided that an exchanging shareholder could elect to recognize gain (but not loss) that it realized in the exchange (the taxable exchange election) for exchanges occurring between 23 February 2000 and 23 February 2001.

Figure 3

PLR 200327054  
Structure Before Proposed Transaction



- Parent, a publicly traded State “A” corporation, owns 100 percent of the shares of Distributing, a Country “A” corporation.
- Distributing owns most of the shares of Controlled, a Country “B” corporation; the balance of the shares are held by Nominees.
- Corporation, a publicly traded Country “C” corporation, is unrelated to Parent.

exchange, or a “B,” “C,” “D,” “E,” “F,” or “G” reorganization under section 368(a)(1).<sup>17</sup>

Finally, Treas. reg. section 1.367(b)-5 provides rules for section 355 distributions:

- Treas. reg. section 1.367(b)-5(b) applies to a section 355 distribution if the distributing corporation is a domestic corporation and the controlled corporation is a foreign corporation;
- Treas. reg. section 1.367(b)-5(c) applies to a section 355 distribution where the distributing corporation is a CFC and the stock of the controlled corporation (domestic or foreign) is distributed pro rata to the distributing corporation’s shareholders; and
- Treas. reg. section 1.367(b)-5(d) applies to a section 355 distribution where the distributing corporation is a CFC and the stock of the controlled corporation (domestic or for-

ign) is not distributed pro rata to the distributing corporation’s shareholders.

### Treas. Reg. Section 1.367(b)-5(b)

As noted above, Treas. reg. section 1.367(b)-5(b) applies if the distributing corporation is a domestic corporation and the controlled corporation is a foreign corporation:

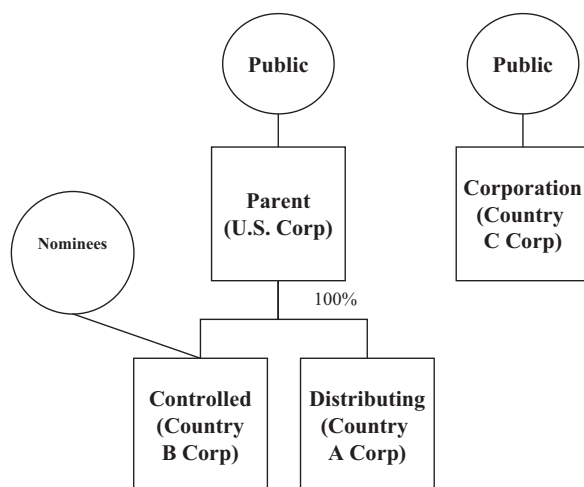
- If the distributee is a corporation, the controlled corporation is considered to be a corporation — that is, no gain or loss is recognized by the distributing corporation or the corporate distributee; and
- If the distributee is an individual, the controlled corporation is not considered to be a corporation and the distributing corporation (but not the individual distributee) must recognize gain (but not loss) realized on the distribution.<sup>18</sup>

<sup>17</sup>In general, under Treas. reg. section 1.367(b)-4, the exchanging shareholder must include in income, as a deemed dividend, the section 1248 amount attributable to the stock that it exchanges if the exchanging shareholder loses its status as a section 1248 shareholder as a result of the exchange.

<sup>18</sup>Treas. reg. sections 1.367(b)-5(b)(1)(i) and (ii).

Figure 4

PLR 200327054  
Step 1 – the Distribution



- Distributing distributes its entire interest in Controlled to Parent (the Distribution).

### Treas. Reg. Section 1.367(b)-5(c)

In a pro rata spin-off by a CFC, if the distributee's "postdistribution amount" with respect to the distributing and/or controlled corporation is less than the distributee's "predistribution amount" with respect to distributing and/or controlled, respectively, then the distributee's basis in that stock immediately after the distribution<sup>19</sup> is reduced (but not below zero) by the amount of that difference.<sup>20</sup> To the extent that the difference would have reduced the basis below zero, the distributee is required to include that difference in income, as a deemed dividend.<sup>21</sup> For that purpose:

- the *postdistribution amount* for a distributing or controlled corporation is the distributee's section 1248 amount computed immediately after the distribution;<sup>22</sup> and

- the *predistribution amount* for a distributing or controlled corporation is the distributee's section 1248 amount computed immediately before the distribution.<sup>23</sup>

If a distributee reduces the basis in the stock of the distributing or controlled corporation (or has an income inclusion with respect to that stock), the distributee increases its basis in the stock of the other corporation by the amount of the basis decrease (or deemed dividend inclusion).<sup>24</sup> However, the distributee's basis in that stock cannot be increased above the fair market value of that stock, and cannot be increased to the extent the increase diminishes the distributee's postdistribution amount with respect to that corporation.<sup>25</sup>

The following example (see Figures 1 and 2) illustrates the provisions of Treas. reg. section 1.367(b)-5(c):

**Facts.** USS, a domestic corporation, owns 40 percent of the outstanding stock of FD, a CFC. USS has a basis of \$80 in its FD stock, which has a fair market value of \$200. FD owns 100 percent of the stock of FC, a foreign corporation. FD has earnings and profits of zero and a fair market value

<sup>19</sup>Determined in accordance with the "normal principles" of section 358.

<sup>20</sup>Treas. reg. section 1.367(b)-5(c)(2). Treas. reg. section 1.367(b)-5(c)(3) provides that the basis increase provided in Treas. reg. section 1.367(b)-2(e)(3)(ii) will not apply to a deemed dividend that is included in income pursuant to Treas. reg. section 1.367(b)-5(c)(2).

<sup>21</sup>*Id.* Under Treas. reg. section 1.367(b)-5(f), that deemed dividend is not treated as foreign personal holding company income under section 954(c).

<sup>22</sup>Treas. reg. section 1.367(b)-5(e)(2).

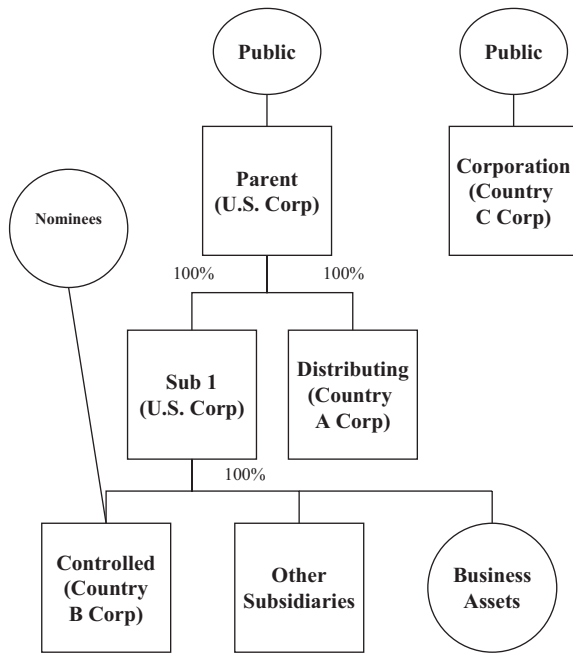
<sup>23</sup>Treas. reg. section 1.367(b)-5(e)(1).

<sup>24</sup>Treas. reg. section 1.367(b)-5(c)(4).

<sup>25</sup>*Id.*

Figure 5

PLR 200327054  
Step 2 – Contribution 1



- Parent transfers all of its shares in Controlled, shares in certain other subsidiaries, and certain business assets to a newly formed domestic subsidiary (Sub 1) in exchange for all of the shares of Sub 1 (Contribution 1).

of \$250 (not considering its ownership of FC). FC has earnings and profits of \$300 and a fair market value of \$250. In a pro rata distribution described in section 355, FD distributes FC stock to USS worth \$100; thereafter, USS's FD stock is worth \$100 as well.

USS's section 1248 amount (computed immediately before the distribution) is \$120, all of which is attributable to FC. Therefore, USS's predistribution amount with respect to FD is zero.

**Results.** USS's postdistribution amounts with respect to FD and FC are zero and \$60, respectively. Those amounts are computed as follows: Under section 358, USS allocates its \$80 basis in FD between FD and FC according to relative values, yielding a \$40 basis in each block of stock. If USS sold its FC stock immediately after the distribution, it would have a \$60 gain (\$100 fair market value — \$40 basis), all of which would be treated as a dividend under section 1248.

The basis adjustment and income inclusion rules of Treas. reg. section 1.367(b)-5(c) apply to the extent of any difference between USS's postdistribution and predistribution amounts. In the case of FD, there is no difference between the

two amounts and, as a result, no basis adjustment or income inclusion is required. In the case of FC, USS's postdistribution amount is \$60 less than its predistribution amount. As such, USS is required to reduce its basis in its FC stock from \$40 to zero and include \$20 in income as a deemed dividend. USS increases its basis in FD by the amount by which it decreased its basis in FC, as well as by the amount of the deemed dividend (\$40 + \$40 + \$20 = \$100).<sup>26</sup>

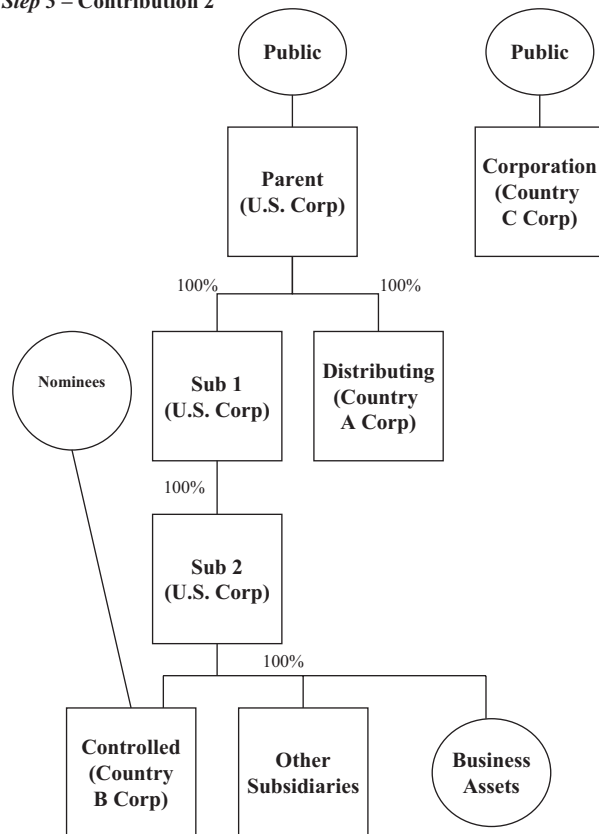
### Treas. Reg. Section 1.367(b)-5(d)

In a non-pro rata distribution by a CFC, if a distributee's postdistribution amount with respect to the distributing and/or controlled corporation is

<sup>26</sup>Treas. reg. section 1.367(b)-5(g), *Example 1*. Additionally, under Treas. reg. section 1.367(b)-2(e), the \$20 deemed dividend is considered as having been paid by FC to FD, and by FD to USS, immediately prior to the distribution. Under Treas. reg. section 1.367(b)-5(f), the deemed dividend is not included as foreign personal holding company income under section 954(c). Further, under Treas. reg. section 1.367(b)-5(c)(3), the basis increase of Treas. reg. section 1.367(b)-2(e)(3)(ii) does not apply with respect to the \$20 deemed dividend.

Figure 6

PLR 200327054  
Step 3 – Contribution 2



- Sub 1 contributes all of the shares and assets it receives in Contribution 1 to a newly formed domestic subsidiary (Sub 2) in exchange for all of the shares of Sub 2 (Contribution 2).

less than the distributee's predistribution amount with respect to those corporations, then the distributee includes in income the amount of the difference(s) as a deemed dividend.<sup>27</sup> Where a distributee owns no stock in the distributing or controlled corporation immediately after the distribution, the distributee's postdistribution amount with respect to that corporation is zero.<sup>28</sup>

### PLR 200327054

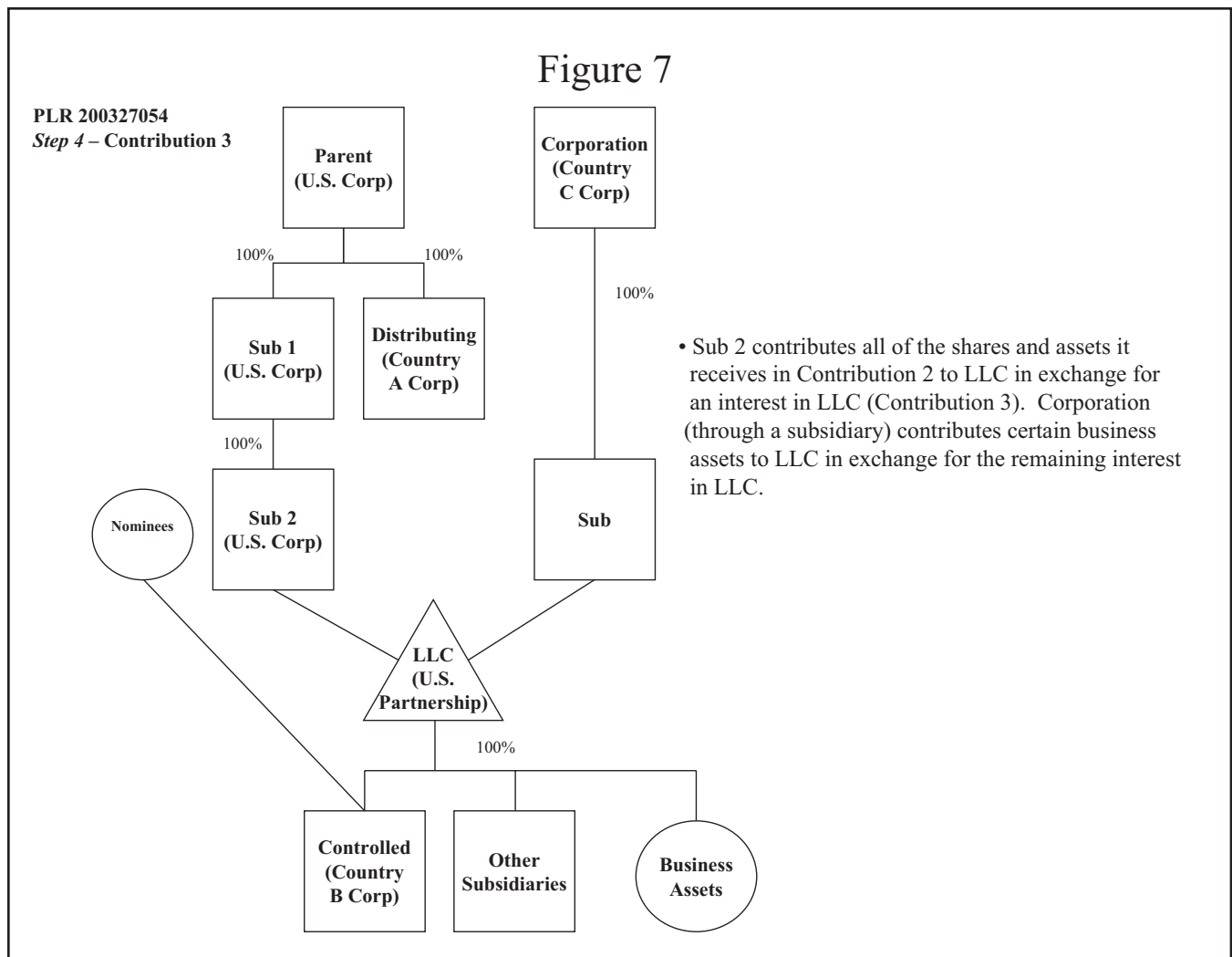
PLR 200327054 implicated Treas. reg. section 1.367(b)-5(c) in the context of a joint venture formation. As noted above, that ruling is one of only a handful of authorities that discuss the basis reduction/income inclusion provisions of Treas. reg. section 1.367(b)-5(c).

In PLR 200327054, the IRS ruled that a distribution qualifying under section 355 generally was tax-free, except to the extent the transaction triggered an income inclusion under Treas. reg. section 1.367(b)-5(c). In that ruling, Parent, a publicly traded state "A" corporation, owns 100 percent of the shares of Distributing, a country "A" corporation. Distributing apparently owns most of the issued and outstanding shares of Controlled, a country "B" corporation; nominees (the Nominees) hold the balance of the shares of Controlled. Parent and "Corporation," a publicly traded country "C" corporation unrelated to Parent, agreed to form "LLC," a newly formed U.S. limited liability company that will be treated as a partnership for U.S. federal tax purposes. Both Parent and Corporation will contribute assets to LLC as part of the Proposed Transaction as defined below. See Figure 3.

To facilitate formation of the joint venture, Parent proposed the following series of steps comprising an integrated transaction (collectively, the Proposed Transaction):

<sup>27</sup>Treas. reg. section 1.367(b)-5(d)(3).

<sup>28</sup>*Id.*



- *Step 1* — Distributing distributes its entire interest in Controlled to Parent (the Distribution) (Figure 4).
- *Step 2* — Parent transfers all of its shares in Controlled, shares in certain other subsidiaries, and certain business assets (including certain intellectual property) to a newly formed domestic subsidiary (Sub 1), in exchange for all of the shares of Sub 1 (Contribution 1) (Figure 5).
- *Step 3* — Sub 1 contributes all of the shares and assets it receives in Contribution 1 to a newly formed domestic subsidiary (Sub 2), in exchange for all of the shares of Sub 2 (Contribution 2) (Figure 6).
- *Step 4* — Sub 2 contributes all of the shares and assets it receives in Contribution 2 to LLC in exchange for an interest in the profits and losses and all other tax items of LLC (Contribution 3). Corporation (through a subsidiary) will contribute certain business assets to LLC in exchange for the remaining

interest in profits and losses and all other tax items of LLC (Figure 7).

The Proposed Transaction results in LLC owning the majority of Controlled, with the Nominees owning the remaining shares of Controlled. On these facts, the IRS ruled that:

- Treas. reg. section 1.367(b)-5(c) will apply to Distributing's transfer of the stock of Controlled to Parent;
- except for any income inclusion resulting from the application of Treas. reg. sections 1.367(b)-5(a) and (c), no income, gain, or loss will be recognized by Parent on its receipt of the stock of Controlled in the Distribution;
- no income, gain, or loss will be recognized by Distributing on the distribution of all of its stock of Controlled to Parent pursuant to the Distribution;
- the basis of the stock of Distributing and Controlled in the hands of Parent immediately after the distribution will be the same

as the aggregate basis of the Distributing stock held immediately before the distribution, allocated in proportion to the fair market value of each in accordance with Treas. reg. section 1.358-2(a), as adjusted, if necessary, pursuant to the provisions of Treas. reg. section 1.367(b)-5(c); and

- the holding period of the Controlled stock received by Parent will include the holding period of the stock of Distributing, provided that the stock of Distributing is held as a capital asset on the date of the Distribution.

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