

**THE APPLICATION OF SECTION 304 TO A DISPOSITION OF
SHARES IN A U.S. REAL PROPERTY HOLDING CORPORATION**

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With increasing frequency, foreign multinationals are acquiring domestic companies, and, as these domestic operations grow and change, the foreign parent often reorganizes its U.S. corporate structure. Such reorganizations may take the form of a transaction described in section 304. Tax advisors traditionally think that such transactions create a U.S.-source distribution to the foreign parent and that the U.S. tax on the dividend component of such distribution may be reduced by a U.S. income tax treaty.

This article examines the tax consequences to the foreign parent when the transaction is described in section 304 and involves the transfer of the shares in a U.S. real property holding corporation. While this area of the tax law is not entirely clear, we believe that in certain of these transactions section 304 and the regulations (and subsequent notices), issued under section 897 addressing nonrecognition transactions, provide a surprising result: the foreign parent must recognize any and all gain on the transferred shares of the U.S. real property holding corporation and pay tax on that gain under section 897.

I. Overview

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Generally, the disposition of stock in a domestic corporation that is held by a foreign corporation is not subject to U.S. tax unless the gain or loss resulting from the disposition is effectively connected with the conduct of a trade or business within the United States.² There are, however, at least two exceptions to this general rule that could subject a foreign corporation disposing of shares of a domestic corporation to U.S. tax, notwithstanding that the foreign corporation does not conduct a U.S. trade or business.

Under the first exception, if the disposition is made to a corporation that is related to the selling foreign corporation, section 304(a) may apply to convert the sales proceeds into a distribution that is potentially treated as a U.S. source dividend.³ A U.S. source dividend is generally subject to a 30-percent gross basis tax unless reduced or eliminated by an income tax treaty between the United States and the country of residence of the selling foreign corporation.⁴

Under the second exception, as a result of the Foreign Investment in Real Property Tax Act of 1980 (“FIRPTA”), a disposition of the stock of a domestic corporation that is a “United States

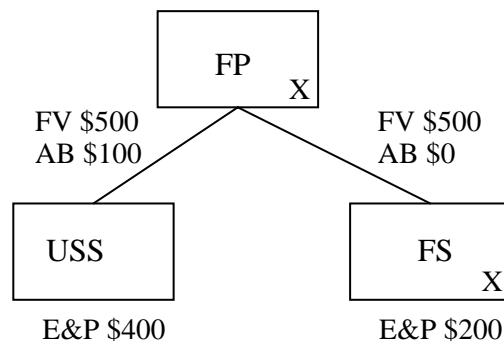
² Under section 882(a), a foreign corporation engaged in a trade or business within the United States during the taxable year is taxed as provided in sections 11, 55, 59A, or 1201(a) on its taxable income which is effectively connected with the conduct of a trade or business within the United States.

³ Section 304(a) generally treats the related-party sale of stock in the domestic corporation as a redemption of the stock of the acquiring corporation. If the redemption is treated as a distribution to which section 302(d) applies, the determination of the amount that is a dividend under section 301(c) is made as if the property were distributed first by the acquiring corporation, to the extent of its earnings and profits, and limited as provided in section 304(b)(5), and then by the issuing corporation (i.e., the corporation that is sold), to the extent of its earnings and profits. Section 304(b)(2).

⁴ Section 881(a).

real property holding corporation” (“USRPHC”)⁵ is taken into account as if the foreign corporation were engaged in a trade or business within the United States during the taxable year and as if such gain were effectively connected to such trade or business.⁶ If the FIRPTA provisions⁷ are otherwise applicable, a foreign corporation may be subject to U.S. net basis taxation as a result of the disposition of stock of a USRPHC.

This article examines how the FIRPTA provisions and section 304 operate contemporaneously when the domestic corporation that is disposed of is a USRPHC, and the USRPHC is sold to a related corporation in a transaction that is otherwise described in section 304(a). The issues under consideration are illustrated in the following fact pattern:



⁵ Section 897(c)(2) generally defines a USRPHC as any corporation if the fair market value of the U.S. real property interests (“USRPIs”) held by such corporation equals or exceeds 50 percent of the fair market value of the sum of the corporation’s USRPIs, all interests in real property located outside of the United States, and any other assets of the corporation which are used or held for use in a trade or business.

⁶ Section 897(a)(1). Because section 897(a)(1) deems the foreign corporation to be engaged in a trade or business within the United States, and gain or loss recognized with respect to the disposition of a USRPI as being effectively connected to such trade or business, the disposition of a USRPI will be taxable under section 882(a), unless an exception otherwise applies.

⁷ In 1984 the Congress added section 1445 to the Code to facilitate the collection of the tax imposed by section 897. We refer to section 987, section 1445 and section 6039C as the “FIRPTA provisions.”

FP, a corporation that is a resident of Country X, owns the shares of USS, a domestic corporation that is a USRPHC. FP also owns the stock of FS, a corporation that is resident of Country X. USS has a fair market value of \$500 and earnings and profits of \$400. FP has a tax basis of \$100 in the shares of USS. FS has earnings and profits of \$200. FP has a tax basis of \$0 in the shares of FS. Neither FP nor FS is, or has been, a controlled foreign corporation as defined in section 957(a). FP sells the shares of USS to FS in exchange for \$500.

II. Application of Section 304

A. Overview of Section 304

Generally, a taxpayer recognizes gain or loss on the sale of stock equal to the difference between the fair market value of the consideration received over the adjusted tax basis in the shares that are sold.⁸ However a sale of stock between related parties can alter this general treatment if the provisions of section 304(a) apply to the sale.

Section 304(a)(1) applies if one or more persons are in control of two corporations and, in return for property, one of the corporations (the “acquiring corporation”) acquires stock in the other corporation (the “issuing corporation”) from the person or persons so in control.⁹ For this purpose, control means the ownership of at least 50 percent of all voting stock or at least 50 percent of the value of all classes of stock in the corporation, applying modified attribution rules under section

⁸ Section 1001(a).

⁹ Section 317(a) defines the term “property” as money, securities, and any other property except stock in the issuing corporation. The “issuing corporation” (for purposes of section 317) is the corporation whose stock is issued in the transaction. In the context of a section 304 transaction, the section 317 issuing corporation is the section 304 acquiring corporation.

318.¹⁰ If section 304(a)(1) applies, the property received by the selling shareholder is treated as a distribution in redemption of the stock of the acquiring corporation, rather than as consideration received in exchange for stock of the issuing corporation.

In the instant case, FP's sale to FS of the stock of USS is described in section 304(a)(1). Immediately prior to the sale, FP controlled both USS and FS by virtue of owning, directly, all of the outstanding shares in both entities. FS purchased the stock of USS from FP for consideration other than stock of FS. Accordingly, the \$500 sales proceeds, in the hands of FP, are treated as received in redemption of stock in FS, rather than as proceeds from the sale of the stock of USS.

B. Treatment of the Deemed Redemption of FS Stock

The deemed redemption of FS stock is tested under the redemption provisions of section 302(b) to determine whether FP is accorded sale or exchange treatment, or, alternatively, whether FP is deemed to receive a \$500 distribution, the characterization of which is made under section 301(c).¹¹ Section 302(b) is applied by reference to FP's ownership of the stock of USS.¹² Under 302(b), if the redemption either is (i) not essentially equivalent to a dividend, (ii) is a substantially disproportionate redemption of the shareholder's stock, (iii) results in a complete termination of the shareholder's interest in the corporation, or (iv) is a redemption from a non-corporate shareholder in a partial liquidation, the redemption is treated as a sale or exchange. If the deemed redemption does not satisfy any of these four conditions FP is treated, pursuant to section 302(d), as receiving a distribution that is described in section 301.

The deemed redemption of the stock of FS does not qualify under any of the four conditions in section 302(b). The fourth condition does not describe the transaction because FP is a corporate

¹⁰ Section 304(c)(3) modifies the attribution rules in two important ways. First, the application of section 318(a)(2)(C) is applied by reference to a 5 percent ownership threshold, rather than the 50 percent ownership threshold that is set forth in section 318. Second, the application of section 318(a)(3)(C) is also applied by reference to a 5 percent threshold. However, for this purpose, if section 318(a)(3)(C) would not apply absent the modified threshold percentage, the stock is attributed to the corporation in that proportion to the shareholder's ownership percentage, by value, in such corporation.

¹¹ Sections 304(a)(1) and 304(b)(1).

¹² Section 304(b)(1).

shareholder and a partial liquidation can only apply to a non-corporate shareholder.¹³ Each of the other three conditions generally requires either a termination or a meaningful reduction in FP's actual or constructive ownership in USS. In the instant case, FP owns all of the stock of USS before the transaction and, immediately after the transaction, FP continues to own all of the stock of USS through attribution from FS.¹⁴ Because there is no termination or reduction in FP's ownership interest in the stock of USS, the deemed redemption does not satisfy any of the other conditions in section 302(b). Accordingly, the redemption is treated as a distribution of property to which section 301 applies.¹⁵

C. Consequences of Section 301 Treatment

Pursuant to section 304(a)(1), because the redemption is treated as a distribution to which section 301 applies, FP and FS are treated as if FP had transferred the stock of USS to FS, in exchange for hypothetical stock in FS, in a transaction to which section 351(a) applies, followed by the immediate redemption of the hypothetical FS stock that was deemed issued.¹⁶ As a result of these fictional steps, which appear to apply for all purposes of the Code, FP takes a basis in the hypothetical FS stock equal to its basis in the stock of USS, or \$100.¹⁷ As determined above, the deemed redemption of the hypothetical FS stock is treated as a \$500 distribution under section 301(c).

As a general matter, section 301(c)(1) treats the distribution first as constituting a dividend to the extent of the available current and accumulated earnings and profits (E&P) of the corporation. Section 304(b)(2) provides that the determination of the amount that is a dividend, and source

¹³ Section 302(b)(4).

¹⁴ Section 318(a)(2)(C), as modified by section 304(b)(1), provides that a shareholder of a corporation is treated as owning the stock owned, directly or indirectly, by such corporation. In the instant case, section 318(a)(2)(C) will treat FP as owning the stock of USS that is owned by FS. Thus, FP's ownership of USS will, for this purpose, not be diluted as a result of the transaction.

¹⁵ Section 302(d).

¹⁶ Section 304(a)(1).

¹⁷ Section 358(a).

thereof, is made as if the property were distributed first by the acquiring corporation, to the extent of its available E&P, and, if necessary, by the issuing corporation, to the extent of its available E&P. In the case of a foreign acquiring corporation, however, a limitation is placed on the amount of E&P that can be used for this purpose. Generally, if the acquiring corporation has never been a controlled foreign corporation, none of its E&P is available for purposes of sourcing the dividend under section 304(b)(2).¹⁸ In the instant case, because FS has never been a controlled foreign corporation, none of its E&P is available to source the \$500 distribution. However, because USS has available E&P, FP is treated as receiving a U.S. source dividend in the amount of \$400.¹⁹

Because only \$400 of the \$500 distribution is sourced as a dividend, the remaining \$100 of the distribution constitutes a tax-free return of basis under section 301(c)(2) and, if the basis amount is not sufficient to offset the remaining distribution, any excess amount is treated as gain from the sale or exchange of property under section 301(c)(3). In the instant case, FP has a \$100 basis in the hypothetical FS shares that are redeemed. FP therefore is treated as receiving the remaining \$100 of the total distribution as a return of its equity investment in the hypothetical FS stock, reducing its basis in such stock to \$0. Because the entire distribution is characterized under sections 301(c)(1) and (c)(2) there is no remaining amount to characterize as gain from the sale or exchange of property under section 301(c)(3).²⁰

¹⁸ Under section 304(b)(5), the only earnings and profits taken into account are the earnings and profits attributable to stock of the foreign acquiring corporation that is owned by certain U.S. shareholders (i.e., a U.S. person who owns, applying the attribution rules of section 958, 10 percent or more of the total combined voting power of all classes of stock entitled to vote) of the foreign corporation, and that were accumulated during the period or periods the stock was owned by such shareholders while the corporation was a controlled foreign corporation.

A controlled foreign corporation is any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock in the corporation entitled to vote, or the total value of such corporation is owned (actually or by applying the attribution rules of section 958) by U.S. shareholders on any day during the taxable year of such foreign corporation. Section 957(a).

¹⁹ The \$400 dividend is subject to a 30 percent withholding tax, unless reduced or eliminated by an income tax treaty between the United States and Country X.

²⁰ FP has a \$0 basis in the actual FS shares that it owns. If FP had basis in these shares, it is uncertain whether this basis would be available for reduction under section 301(c)(2), if necessary. We are aware of no

III. Application of Section 897

A. Overview of FIRPTA Provisions

Generally, FP's sale of USS to FS is a disposition subject to section 897(a). FP therefore takes it into account the \$400 of gain realized on the disposition of the USS shares as if FP were engaged in a trade or business within the United States during the taxable year, and as if such gain were effectively connected with such trade or business.²¹ However, because the transaction is also subject to section 304, the transaction is "recast" for U.S. tax purposes, resulting in a different set of transactional steps that must be analyzed for purposes of section 897(a).

As described above, under the recast, FP is treated as if it transferred the stock of USS to FS, in exchange for hypothetical FS stock, in a transaction that is described in section 351(a), rather

formal guidance that addresses whether the basis reduction in this context is limited to the basis in the hypothetical shares that are redeemed, or rather, can also include basis in any actual shares of the acquiring corporation that are owned. The Service appears to have an evolving position on this issue. In FSA 200111004, the Service concluded that the modifications made to section 304, which resulted in the section 351 / redemption fictions that are described above, did not intimate a Congressional intention to limit basis recovery to only the basis in the hypothetical shares that are redeemed. The Service and Treasury then issued REG-150313-01 (proposed regulations) dealing with the treatment of basis in stock redemptions, including redemptions resulting from the application of section 304. In those proposed regulations, which were withdrawn in Announcement 2006-30, 2006-1 C.B. 879, the Service took the position that only the basis in the hypothetical shares, and not basis in actual shares owned, was available for reduction under section 301(c)(2). See Prop. Treas. Reg. §1.304-2(c) Example 3. In the preamble to T.D. 9250, dealing with the application of section 367(a) to the fictions created under section 304, the Service reiterated its position by stating that "current law does not provide for the recovery of the basis of any shares other than the basis of the...stock deemed to be received...in the section 351(a) exchange." However, in Announcement 2006-30, the Service stated that the IRS and Treasury was studying whether it is appropriate to reduce the basis of both the retained and redeemed shares prior to applying section 301(c)(3).

On January 16, 2009, the Service issued proposed regulations (REG-143686-07) detailing a single model for recovery of stock basis in distributions under section 301 and transactions that are treated as dividends to which section 301 applies (e.g., as a result of the application of section 304). Under the proposed regulations, the redemption proceeds are required to be allocated between the hypothetical shares and any actual shares owned, in the same class, based on relative fair market values. Gain recognition is determined on a share-by-share basis, thus allowing the use of basis in any actual shares owned for reduction under section 301(c)(2).

²¹ Section 897(a)(1).

than selling the stock of USS to FS in a transaction that would otherwise be taxable under section 1001(a), and thus be subject to tax under section 897(a). The hypothetical FS stock is then treated as immediately redeemed by FS in exchange for the sales proceeds. As discussed above, the redemption of the hypothetical FS shares results in FP receiving a \$400 U.S. source dividend that is subject to a gross basis 30 percent U.S. withholding tax (unless such tax is reduced by an income tax treaty) and a \$100 tax-free return of basis. Because of the recast, there are two transactions to be analyzed under the FIRPTA provisions: (i) the transfer of USS by FP to FS, in exchange for hypothetical FS shares, in a transaction that qualifies under section 351(a), and (ii) the immediate redemption of the hypothetical FS shares issued to FP, in exchange for the stock of USS, by FS.

B. Treatment of Nonrecognition Transactions under the FIRPTA Provisions

Generally, any nonrecognition provision of the Code applies to a transfer by a foreign person of a U.S. Real Property Interest (“USRPI”), including the stock of a USRPHC, on which gain is realized, but only to the extent that the transferred USRPI is exchanged for a USRPI which, immediately following the exchange, would be subject to U.S. tax on a subsequent exchange.²²

In the instant case, this general nonrecognition rule does not apply because FP is not receiving, in exchange for the stock of USS, stock in another corporation that constitutes a USRPHC, because FS is a foreign corporation. However, Treas. Reg. §1.897-6T(b)(1) provides an additional exception for certain foreign-to-foreign exchanges (the “Foreign-Foreign Exception”).²³

²² Treas. Reg. §1.897-6T(a)(1).

²³ Treas. Reg. §1.897-6T(b)(1) requires the following conditions to be satisfied in order for the Foreign-Foreign Exception to apply: (i) the transferee’s subsequent disposition of the USRPI must be subject to U.S. tax, as determined under Treas. Reg. §1.897-5T(d)(1), (ii) the filing requirements of Treas. Reg. §1.897-5T(d)(1)(iii) must be satisfied, (iii) one of the five conditions set forth in Treas. Reg. §1.897-6T(b)(2) must be satisfied, and (iv) one of three forms of exchange take place, as outlined in Treas. Reg. §1.897-6T(b)(1)(i) through (iii). Several of these conditions, however, have been modified or eliminated by the IRS through Notices. In Notice 89-57, 1989-1 C.B. 698, the filing requirement outlined in (ii) above was suspended in cases in which the transfer qualifies in its entirety for nonrecognition, the transferor does not have any other income that is effectively connected with a U.S. trade or business during the taxable year that includes the transfer, and either (a) a withholding certificate is obtained pursuant to Treas. Reg. §1.1445-3(a), or (b) a notice of nonrecognition is submitted to the IRS pursuant to Treas. Reg. §1.1445-2(d)(2). In Notice 2006-46, 2006-1 C.B. 1044, the IRS eliminated requirement (iii) above, requiring the transaction satisfy one of five stated conditions. In addition, Notice 2006-46 provides additional forms of exchanges that may

One of the conditions that must be satisfied if a transaction is to satisfy the Foreign-to-Foreign Exception is that the exchange take the form of a permitted exchange, as outlined in the regulations as modified by Notice 2006-46. One of the permitted exchanges is an exchange of stock of a USRPHC in a transfer that qualifies under section 351, if, immediately after the exchange, “substantially all” of the outstanding stock of the transferee foreign corporation is owned by the same nonresident alien individuals and foreign corporations that, immediately before the exchange, owned the stock of the USRPHC.²⁴ In the instant case, the transfer of USS to FS should qualify as a permitted exchange, and therefore be subject to the Foreign-Foreign Exception, because FP is treated as transferring the stock of USS to FS in an exchange that qualifies under section 351(a), and FP, the owner of all of the stock of USS immediately prior to the transfer, owns all of the stock of FS immediately after the transfer.

We note that prior to the Taxpayer Relief Act of 1997 (the “1997 Act”),²⁵ section 304(a)(1) treated FP as contributing the stock of USS to FS as a contribution to the capital of FS, rather than as transferring the stock of USS to FS in a transaction that qualifies under section 351.²⁶ Section

qualify for purposes of condition (iv) above. We assume that all of these conditions, unless otherwise stated, will be satisfied in the example under consideration.

²⁴ This exception also applies to transfers of the USRPHC pursuant to a reorganization under section 368(a)(1)(B), as well as other exchanges enumerated in Treas. Reg. §1.897-6T(b)(1)(i), (ii) and Notice 2006-46.

The actual requirements for the Foreign-Foreign Exception, as it relates to section 351 exchanges and reorganizations under section 368(a)(1)(B), have been modified by Notice 2006-46. Prior to the issuance of the notice, the exchange must have been of the stock of a USRPHC in an exchange that qualified under section 351 (or section 368(a)(1)(B)), and, immediately after the exchange, all of the outstanding stock of the transferee corporation (or the stock of the transferee corporation’s parent in the case of a parenthetical section 368(a)(1)(B) reorganization) must have been owned in the same proportions by the same nonresident alien individuals and foreign corporations that, immediately before the exchange, owned the stock of the USRPHC.

²⁵ P.L. 105-34

²⁶ See, e.g., Treas. Reg. §1.304-2(a) (“The stock received by the acquiring corporation shall be treated as a contribution to the capital of such corporation. See section 362(a) for determination of the basis of such stock. The transferor’s basis for his stock in the acquiring corporation shall be increased by the basis of the stock surrendered by him.”). These regulations have not been modified to take into account the changes made by the 1997 Act.

897(j) requires any built-in-gain in a USRPI (including stock in a USRPHC) to be recognized if the USRPI is transferred to a foreign corporation as a contribution to capital. Treasury Reg. §1.897-6T(b)(5) specifically referenced capital contributions resulting from the application of section 304 as being included within this rule.²⁷ Section 897(j) was enacted because Congress was aware that some taxpayers were taking the position that FIRPTA provisions could be avoided if a USRPI were transferred to a foreign corporation as a contribution to capital in which the taxpayer was a shareholder.²⁸ Although Treas. Reg. §1.897-6T(b)(5) has not been modified to remove the cross-reference to capital contributions resulting from the application of 304, we believe that section 897(j) should no longer apply to the transfer of a USRPHC that is otherwise subject to section 304. As a result of the 1997 Act, section 304 deems the stock of USS to be transferred by FP to FS in a transaction to which section 351(a) applies. The regulations under section 897 have specific rules governing the transfer of stock in a USRPHC in a transaction that is subject to section 351. These rules, and not the rules governing capital contributions, should now govern the transfer because section 304 no longer provides the capital-contribution fiction. Accordingly, the Foreign-Foreign Exception should apply to the transfer of the shares of USS by FP to FS in exchange for the hypothetical FS stock.

C. The Subsequent Disposition Rule

The Foreign-Foreign Exception dealing with section 351 exchanges includes an exception that, if applicable, causes the initial section 351 exchange to be taxable under section 897(a). The flush language of Treas. Reg. §1.897-6T(b)(1), which applies to the Foreign-Foreign Exception with respect to transfers described in sections 351 and 368(a)(1)(B), provides that if the nonresident alien individual or foreign corporation that received stock in the transaction, in exchange for the stock of the USRPHC, *disposes* of any such foreign stock within one year from the date of its

²⁷ Treas. Reg. §1.897-6T(b)(1) provided that “A foreign person that contributes a U.S. real property interest to a foreign corporation as paid in surplus or as a contribution to capital (including a contribution provided in section 304(a)) shall be treated, for purposes of section 897(j), as exchanging the U.S. real property interest for stock in the foreign corporation.”

²⁸ H.R. Conf. Rep. No 97-215, 278, 97th Cong., 1st Sess. (1981), 1981-2 C.B. 481.

receipt, the individual or foreign corporation is required to recognize that portion of the gain realized with respect to the stock of the USRPHC for which the foreign stock disposed of was received (the “Subsequent Disposition Rule”).²⁹

In the instant case, one must consider whether the redemption of the hypothetical FS shares is a “disposition” that causes the Subsequent Disposition Rule to apply.³⁰ The term “disposition” has a specific meaning under section 897, because the general rule under section 897(a) applies only when there is a “disposition” of a USRPI (which includes the stock of a USRPHC). Treasury Reg. §1.897-1(g) provides that, for purposes of sections 897, 1445, and 6039(C), the term “disposition” means “any transfer that would constitute a disposition by the transferor *for any purpose* of the Internal Revenue Code or regulations thereunder.”

As discussed above, the redemption of the hypothetical FS stock is treated as a distribution under section 301(c). The characterization of the distribution is a \$400 U.S. source dividend under section 301(c)(1), and a \$100 tax-free return of basis under section 301(c)(2). There is no gain from the sale or exchange of property under section 301(c)(3).³¹

We are aware of no authorities that address whether the deemed redemption of the hypothetical FS stock causes the Subsequent Disposition Rule to apply. However, we believe that Treas. Reg. §1.897-5T(b)(2) provides analogous authority that supports the view that a redemption to which sections 301(c)(1) or (2), but not section 301(c)(3), applies does not constitute a disposition for this purpose. This regulation section applies to a USRPHC that distributes property with respect to its stock to a foreign shareholder. If applicable, the foreign shareholder is treated as

²⁹ This language was modified by Notice 2006-46. Prior to the notice, dispositions within 3-years from the date of its receipt were covered. No reason for the reduction to one-year, or the policy reason for this rule, was stated.

³⁰ Although the Subsequent Disposition Rule uses the term “disposes” instead of the term “disposition,” no difference in meaning should apply. The definition of disposition in Treas. Reg. §1.897-1(g) should apply for purposes of applying the Subsequent Disposition Rule.

³¹ It would seem appropriate to treat gain recognition under section 301(c)(3) as a disposition for this purpose. If any section 301(c)(3) gain was recognized on a share of hypothetical FS shares, it appears that the entire realized gain in that share on the date of the section 351 transfer, and not limited to the gain recognized under section 301(c)(3), would be taxable under section 897(a).

having disposed of a USRPI and is required to recognize gain or loss on the stock of the USRPHC to the extent that part or all of the distribution is treated under section 301(c)(3) as a sale or exchange of stock, part or all of the distribution is treated pursuant to section 302(a) as made in part or full payment in exchange for stock, or part or all of the distribution is treated pursuant to section 331 as made in full payment in exchange for stock.³² Thus, with respect to distributions under section 301(c), including redemptions which are treated as distributions under section 301(c) as a result of the application of section 302(d), gain or loss occurs only if the distribution is sourced in full or in part by reference to section 301(c)(3).

Exempting distributions characterized as a dividend under section 301(c)(1), or a tax-free return of basis under section 301(c)(2), also is consistent with the mechanical approach of computing the amount of gain or loss that arises from the disposition of a USRPI. Treasury Reg. §1.897-1(h) provides that the amount of gain or loss arising from the disposition of a USRPI is to be determined as provided in sections 1001(a) and (b), which generally applies to transactions that constitute a sale or exchange under the Code. A dividend distribution under section 301(c)(1) is generally not viewed as a sale or exchange under the Code.³³ Likewise, a distribution characterized as a tax-free return of basis should also not constitute a disposition because section 301(c)(2), unlike

³² We note that one could read the language in Treas. Reg. §1.897-5T(b)(2) as providing that any distribution of property, regardless of its characterization under section 301, constitutes a “disposition” but that gain or loss is only recognized to the extent the distribution constitutes a sale or exchange under sections 301(c)(3), 302(a), or 331(a). In the preamble to T.D. 8198, the IRS, in discussing this provision, stated “If a corporation that is a United States real property holding corporation distributes property to a foreign shareholder with respect to its stock, the foreign shareholder is treated as having disposed of a United States real property interest.” Although we acknowledge that the language could be read in this manner, we believe the better view is that a disposition occurs only to the extent that a distribution under section 301(c) results in a deemed sale or exchange for U.S. tax purposes. Because a dividend distribution under section 301(c)(1), or a tax-free return of basis distribution under section 301(c)(2), does not constitute a sale or exchange under their operative provisions, distributions characterized under these sections should not constitute a disposition for purposes of the Subsequent Disposition Rule.

³³ Cf. Treas. Reg. §1.367(a)-8T(a)(1)(iv) (the term “disposition” means any transfer that would constitute a disposition for any purpose of the Code and regulations thereunder, but does not include a redemption of stock under section 302(d) to the extent the redemption is treated as a distribution to which section 301(c)(1) applies).

section 301(c)(3), does not result in a constructive sale or exchange of the underlying shares.³⁴ The definition of disposition for section 897 purposes requires a “transfer” that would constitute a disposition for any purpose of the Code. A shareholder in receipt of a dividend distribution under section 301(c)(1), or tax-free return of basis distribution under section 301(c)(2), does not actually, and should not be deemed to, transfer any property to the foreign distributing corporation. By contrast, a distribution characterized under section 301(c)(3) is treated as gain from the sale or exchange of property and, thus, is treated as a transfer of property due to the sale or exchange that is deemed to occur. Accordingly, we believe that, in the instant case, FP has not disposed of the hypothetical FS shares, which were received in exchange for the stock of USS, for purposes of applying the Subsequent Disposition Rule to the deemed redemption.³⁵ FP should not recognize the \$400 built-in-gain in the shares of USRPHC under section 897. Rather, the \$400 built-in-gain

³⁴ Section 301(c)(2) provides that the portion of the distribution which is not a dividend is to be applied against and reduce the adjusted basis of the stock. In contrast, section 301(c)(3) provides that portion of the distribution which is not a dividend, to the extent it exceed the adjusted basis of the stock, shall be treated as gain from the sale or exchange of property.

³⁵ If the facts are changed such that the stock of USS is owned by FS1, a corporation that is wholly-owned by FP, and FS1, rather than FP, sells the stock of USS to FS (i.e., a cross-chain sale), the Foreign-Foreign Exception would not apply because, in this case, substantially all of the outstanding stock of FS, the transferee corporation, would not be owned by the same foreign corporation that, immediately before the exchange, owned the stock of USS. FS1 is the owner of USS stock prior to the exchange but does not own any of the outstanding FS stock, other than the hypothetical FS stock that is issued as a result of the section 304 fictions (described above). There appear to be no attribution rules applicable for this purpose which would treat FS1 as owning the FS stock that is owned by FP. Under these alternative facts, FS1 should have the same section 304 consequences (i.e., \$400 U.S. source dividend from USS and a \$100 tax-free return of basis) in addition to a \$400 capital gain that is taxable under section 897(a). Because FS1 is treated as recognizing \$400 of gain on the transfer of USS to FS, under section 897(a), it would be reasonable for FS to increase its basis in USS by the \$400 of gain that is recognized by FS1. Under section 362(a), property acquired by FS in connection with a transaction to which section 351 applies, has a basis equal to the basis such property had in the hands of FS1, increased in the amount of gain recognized to FS1 on such transfer. In order to avoid double taxation in the future, FS should increase its basis in USS, which is initially \$100 (the basis such stock had in the hands of FS1) by the gain recognized by FS1 under section 897, which is recognized in connection with the section 351 transfer. Because the entire \$400 built-in-gain in the stock of USS was taxed to FS1 under section 897, there is no policy reason to replicate the built-in-gain in the hands of FS for a subsequent section 897(a) tax in the future. See generally section 304(b)(6).

should be preserved in the hands of FS and should be taxed under section 897(a) if, and when, FS disposes of these shares in the future.³⁶

IV. Conclusion

A sale of stock in a USRPHC to a related party in an acquisition that is also described in section 304 can result in U.S. tax under both section 304, in the form of a U.S. source dividend that can be subject to a 30 percent U.S. withholding tax, and under section 897(a), with respect to the built-in-gain inherent in the shares of the USRPHC. Neither the statute nor the regulations under section 897 have been modified to take into account the 1997 change to the tax fictions that are created under section 304. The deemed transfer of the stock of the USRPHC to the foreign acquiring corporation, in a transaction that is described in section 351(a), should be exempt from tax under section 897(a) provided the Foreign-Foreign Exception is otherwise satisfied. We believe the better view is that the redemption of the hypothetical shares issued in exchange for the stock of the USRPHC should cause the Subsequent Disposition Rule to apply only in those cases in which the redemption of the hypothetical shares results in gain being recognized under section 301(c)(3). Otherwise, to the extent the redemption results in a dividend under section 301(c)(1), or a tax-free return of basis under section 301(c)(2), the redemption should not constitute a “disposition” for purposes of applying section 897(a). In order to bring clarity to this issue, we recommend that the IRS and Treasury provide guidance on the proper application of section 897 to dispositions that are also governed by section 304.

³⁶ Under section 362(a), property acquired by FS in connection with a transaction to which section 351 applies has a basis equal to the basis such property had in the hands of FP, increased in the amount of gain recognized to FP on such transfer. FP had a basis of \$100 in the stock of USS. Because FP recognizes no gain or loss as a result of its transfer of USS to FS, FS should take a \$100 basis in the stock of USS. Although FP is treated as receiving a \$400 dividend from USS, the dividend should not result in an increase to FP’s basis in the stock of USS, and hence, in the basis of the stock of USS in the hands of FS. In addition, because there is not an actual distribution of property by USS, the deemed dividend does not result in a reduction in the fair market value of USS. Thus, FS will own the stock of USS which has a \$500 fair market value and a \$100 adjusted tax basis, preserving the \$400 of built-in-gain for purposes of applying section 897 to future dispositions.

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