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NOVEMBER 16, 2020

Letter Ruling Conjures Ghost of Section 958(b)(4) Past

In Private Letter Ruling 202045007, dated May 22 but released November 6, 2020, the IRS invokes the principle of now-repealed Section 958(b)(4), concluding that the downward attribution rule of Section 318(a)(3) would not apply to treat a U.S. person as owning stock owned by a non-U.S. person in determining whether a taxpayer met an exception to Section 367(a)(1) gain recognition.

Of course, private letter rulings carry little value for anyone other than the taxpayer involved. Fortunately for the rest of us, proposed regulations under Section 367(a), issued in September, would extend the determination under the ruling to everyone.

Background

Section 318(a)(3) provides rules for attributing to a partnership, estate, trust, or corporation stock owned by a person who is a partner, beneficiary, trustee, or shareholder, respectively ("downward attribution"). Before its repeal by the Tax Cuts and Jobs Act (TCJA), Section 958(b)(4) prevented downward attribution of stock from a foreign person to a U.S. person. Under prior law, the wholly owned U.S. subsidiary of a foreign corporation would not be treated as owning the stock of the foreign parent's wholly owned foreign subsidiary. Post-TCJA, the U.S. subsidiary would be treated as owning the stock of the foreign subsidiary, making the foreign subsidiary a "controlled foreign corporation" (CFC).

Aside from increasing the number of "U.S. shareholders" and CFCs under the Subpart F rules, the repeal of Section 958(b)(4) has had collateral effects due to statutory and regulatory cross-references. Final and proposed regulations, issued in September, attempted to rein in some of the consequences. Specifically, the proposed rules included changes meant to ensure that certain rules under Section 367(a) would apply the same way they did before the repeal of Section 958(b)(4).

LTR 202045007

Per the redacted facts of the ruling, a foreign parent directly and indirectly owned a foreign subsidiary and a U.S. subsidiary. The foreign and U.S. subsidiaries indirectly owned some amount of stock in a public U.S. company, which underwent an F reorganization by merging into a new U.S. target, with the new target surviving and the shareholders of the U.S. company receiving stock of the new target. Subsequently, a foreign partnership held through the parent's foreign subsidiary formed and contributed assets to a new foreign subsidiary, and public shareholders of the U.S. target transferred their U.S. target stock to the new subsidiary in a Section 351 exchange.

Section 367(a)(1) provides that when a U.S. person transfers appreciated property to a foreign corporation in a transaction that would otherwise qualify as a nonrecognition exchange, the U.S. transferor will generally recognize gain on the transfer. However, under Section 1.367(a)-3(c)(1), a U.S. transferor of stock of a domestic corporation ("U.S. target") to a foreign corporation in an outbound nonrecognition transaction will not recognize gain if the U.S. target complies with certain reporting requirements and meets the following four criteria:

1. Fifty percent or less of both the total value and voting power of the stock in the transferee foreign corporation is received, in the aggregate, by U.S. transferors.
2. Fifty percent or less of both the total value and voting power of the stock in the transferee foreign corporation is owned, in the aggregate, immediately after the transfer, by U.S. persons that are officers or directors of U.S. target or five-percent shareholders of U.S. target. (For purposes of this criterion, a five-percent shareholder is a person who owns at least 5 percent, by value or vote, of stock of the U.S. target immediately *before* the transfer.)
3. Either the U.S. transferor is not a five-percent shareholder of the transferee foreign corporation or enters into a five-year gain recognition agreement. (For purposes of this criterion, a five-percent transferee shareholder is a person who owns at least 5 percent, by value or vote, of the transferee foreign corporation immediately *after* the transfer.)
4. The active trade or business test described in the regulations is met.

Pursuant to Section 1.367(a)-3(c)(4)(iv), the constructive ownership rules of Section 318, as modified by Section 958(b), apply in determining stock ownership for purposes of the above criteria.

The taxpayer represented that, but for downward attribution from a non-U.S. person to a U.S. person, the taxpayer would have met the second criterion. Under Section 1.367(a)-3(c)(9)(ii), the IRS may issue a private letter ruling to allow a taxpayer to qualify for the exception to Section 367(a)(1) if the taxpayer fails to satisfy any of the above requirements due to the constructive ownership rules. In the ruling, the IRS basically allows the taxpayer to ignore the repeal of Section 958(b)(4) for the limited purpose of applying the second criterion of Section 1.367(a)-3(c)(1).

September's proposed regulations would amend Section 1.367(a)-3(c)(4)(iv) to apply the attribution rules of Section 318, as modified by Section 958(b)—but turning off downward attribution from a foreign person to a U.S. person for all purposes of Section 1.367(a)-3(c), other than determining whether a U.S. person is a five-percent transferee shareholder. Whether the specter of downward attribution in the ruling inspired the proposed rules or the taxpayer unwittingly timed their request as the IRS was already considering formal relief, taxpayers should appreciate that the IRS is continuing to address unintended yet material side effects of the Section 958(b)(4) repeal.

For more information, please contact Edward Tanenbaum at 212.210.9425 or Heather Ripley at 212.210.9549.

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