Achieving a Smooth Stock Basis

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In a helpful recent private letter ruling, the Internal Revenue Service illustrated a method allowing multinational corporations seeking tax-efficient ways to repatriate offshore cash to avoid the obstacle posed by *Johnson v. United States*.

Multinational corporations often seek tax-efficient ways to repatriate offshore cash. However, the U.S. Court of Appeals for the Fourth Circuit decision in *Johnson v. United States*, 435 F.2d 1257 (4th Cir. 1971), often presents a significant obstacle to these efforts by applying section 301(c)(2) to distributions in excess of earnings and profits (E&P) by reducing stock basis share-by-share, rather than in the aggregate. But the Internal Revenue Service (IRS), in a helpful recent private letter ruling, PLR 201043021 (June 29, 2010), has illustrated a method to get around the *Johnson* issue.

Some background is in order. Section 301 provides rules regarding the treatment of distributions of property from a corporation to its shareholders. Specifically, section 301(c)(1) provides that the portion of a distribution that constitutes a dividend is included in the gross income of the recipient shareholder. Under section 316, the term "dividend" means any distribution of property out of the accumulated or current E&P of the distributing corporation. Thus, a recipient shareholder will recognize taxable dividend income upon receipt of a distribution from a corporation to the extent of the distributing corporation's E&P.

Next, to the extent that the distribution exceeds the E&P of the distributing corporation, section 301(c)(2) provides that the distribution is applied against the basis of the stock the recipient has in the distributing corporation.

Finally, to the extent the distribution exceeds the basis the recipient shareholder has in the shares of the distributing corporation, section 301(c)(3) provides that the distribution is treated as a sale or exchange of property by the recipient shareholder, in most instances resulting in taxable capital gain for the recipient shareholder.

In *Johnson*, the sole shareholder of a corporation owned two blocks of shares, one with a high basis and one with a low basis, in the same class of stock. The corporation made a distribution in excess of E&P, and the shareholder claimed that under section 301(c)(2) he was entitled to recover his basis in all of his stock prior to recognizing any gain (*i.e.*, basis recovery on an aggregate basis). Rejecting this argument, the court stated that the distribution is treated as made *pro rata* across all shares, such that the taxpayer must recover basis share-by-share. As a result, the taxpayer recognized gain under section 301(c)(3) on the low basis block of shares, even though he still had

unrecovered basis in his high-basis block of shares. In proposed regulations issued on January 21, 2009 (Proposed Regulations), the IRS and the U.S. Treasury proposed to add the *Johnson* rule to the regulations under section 301.

The taxpayer in PLR 201043021 seems to have had a *Johnson* problem. Its U.S. holding company (Holdings) owned the stock of three controlled foreign corporations (Target CFCs) within the meaning of section 957(a). The Target CFCs were acquired at different times and at different prices. The Target CFC shares, thus, had various bases and holding periods.

For certain stated business reasons, the taxpayer proposed to form a non-U.S. holding company (Transferee) and transfer the stock of the Target CFCs in exchange for voting and non-voting common stock of Transferee. Among the stated reasons for forming the new non-U.S. holding company structure was to "permit Parent Group to reduce Country B withholding tax on potential future distributions of share premium." It would not be surprising if an unstated reason was to avoid the U.S. tax disadvantages of the *Johnson* rule.

The IRS ruled that Holdings would not recognize gain or loss on the transfer of the Target CFCs in exchange for Transferee stock. With respect to the basis in the Transferee stock, the IRS ruled:

The aggregate basis of the Transferee Stock received by Holdings shall be the same as the aggregate basis of the Target CFCs Stock surrendered in exchange therefor and shall be allocated between the class of voting common shares of Transferee Stock and the class of nonvoting common shares of Transferee Stock received in the exchange in proportion to the fair market values of the classes, *such that each voting common share shall have an identical, averaged basis and each nonvoting common share shall have an identical, averaged basis*. (Section 358; Treas. Reg. § 1.358-2(b)(2)). (Emphasis added.)

Thus, after this transaction, the share-by-share approach of the *Johnson* rule would no longer stand in the way of tax-free distributions in excess of Transferee's E&P to the extent of Holdings' basis in the Transferee stock.

In reaching this result, the IRS followed its longstanding position. Under section 358(a)(1), the basis of property permitted to be received under section 351 without the recognition of gain or loss is the same as that of the property exchanged. Section 358(b) provides that, under regulations prescribed by the Secretary, the basis determined under section 358(a)(1) shall be allocated among the properties permitted to be received without the recognition of gain.

The regulations under Treas. Reg. § 1.358-2(a)(2) provide a "tracing regime" for reorganization exchanges governed by sections 354 or 356, under which the basis of each share of stock received must match the basis of the stock exchanged therefor. In applying these rules, the shareholder may designate which share is received in exchange for a particular share, provided the designation is consistent with the terms of the exchange and is economically

reasonable. Treas. Reg. § 1.358-2(a)(2)(vii). Although this regime provides taxpayers with a great deal of flexibility in determining stock basis, it generally preserves the bases in blocks of stock acquired at different times and for different prices. Tracing does not apply, however, to stock received in an exchange described in both section 351 and in section 354 or section 356 "if, in connection with the exchange, the shareholder . . . exchanges property for stock . . . in an exchange to which neither section 354 nor section 356 applies or liabilities of the shareholder . . . are assumed." Treas. Reg. § 1.358-2(a)(2)(viii).

Treas. Reg. § 1.358-2(b)(2) provides that, in a section 351 exchange in which the transferor of property receives stock or securities of more than one class or receives both stock and securities, the basis of the property transferred is allocated among all of the stock and securities received in proportion to the fair market values of the stock of each class and the securities of each class. Neither the Code nor the regulations specify, however, how the basis of stock is determined where only one class of stock is received in a section 351 exchange to which neither section 354 nor section 356 apply. (The Proposed Regulations expand the tracing regime to certain section 351 transactions.)

The IRS, however, has long held that the average basis method applies to section 351 exchanges. *See* Rev. Rul. 85-164, 1985-2 C.B. 117; Rev. Rul. 68-55, 1968-1 C.B. 140. PLR 201043021 simply applied this well-established rule. Nonetheless, the ruling illustrates a significant planning opportunity. In the ruling, the taxpayer apparently structured the transaction specifically to achieve an average basis by causing Transferee to issue both voting and nonvoting common stock to its sole shareholder. Because nonvoting stock was issued, the acquisitions of the Target CFCs did not constitute reorganizations under section 368(a)(1)(B), and the taxpayer, therefore, was not required to specifically trace the separate blocks of Target CFC stock to the shares of Transferee stock received in the exchange. Thus, the IRS in effect "blessed" a transaction structured to put the taxpayer in position to make future tax-free distributions merely by forming a first-tier foreign holding company to hold the stock of the taxpayer's CFCs.

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