367 Rules Applicable to Spin-offs Under Attack

Long after the comment period for the proposed section 367 rules issued in January 1990 has expired, various portions of the rules have come under renewed attack. A recent report to Commissioner Shirley Peterson submitted by ABA Tax Section members has rekindled ire over the proposed rules, although it is unclear whether the comments will be taken to heart.

The temporary regulations generally require that a domestic corporation making a section 355 distribution of stock or securities of a domestic or foreign corporation to a foreign distributee must recognize gain, but not loss, with respect to the distributed stock or securities. Apart from relatively narrow exceptions from this treatment, the result upon a section 355 distribution to a foreign shareholder will be corporate-level gain recognition to the distributing entity.

The report criticized this approach, among other reasons, for its focus on the corporation. The potential for tax avoidance on the distribution, according to the report, is at the shareholder-distributee level. Because the *shareholders* enjoy any anticipated benefit of this opportunity for tax avoidance, the report argues that the shareholders should bear the burden of taxation on the distribution rather than the corporation. Another related point made by the report is that the difference between the corporate and individual tax rates results in an incorrect tax rate being applied in cases where the foreign shareholder-distributee is not a corporation.

The report also argues that the amount of tax (in addition to the tax rate) should be measured by reference to the particulars of the shareholder's situation. Thus, the difference between the fair market value of the stock and the foreign distributee's substituted basis in the stock should be the measure of the gain to be recognized on the distribution.

New Approach?

The suggestion by ABA members is that nonrecognition treatment for such section 355 distributions be allowed as long as the foreign distributee, the domestic distributing corporation, and the controlled corporation all agree to treat the distributee's stock and securities in the distributing and controlled corporations as a U.S. real property interest for the ensuing five years, and therefore subject to tax on a subsequent disposition within this period.

According to the report, the election for U.S. real property holding corporation status would result in the distributee taking a substituted basis in the distributed stock and securities under section 358. The result would be that the transaction would be subject to the same tax treatment as a U.S. person with respect to timing, amount and the level at which the tax is imposed.

To close the circle, the foreign distributee would have to agree to waive any claim to exemption from tax on the gain under an applicable income tax treaty. The distributing and the controlled corporations would also agree to be jointly and severally liable for the distributee's tax upon a subsequent disposition. They would be required to pay a tax at the time of any transfer of record ownership of stock or securities held by the distributee, or to establish that an exemption is warranted.

Shareholder Level Tax Election Instead

If the Service chooses not to adopt the USRPHC approach argued for in the report–as almost certainly will be the case given the various administrative problems this approach suggests–the report suggests an alternative. Under it, a foreign shareholder-distributee would be able to elect to be taxed at the time of distribution as if it were a U.S. person that immediately sold the distributed stock on the difference between the fair market value of the stock and its substituted basis in the hands of the shareholder.

Foregone Conclusion?

From the Treasury's viewpoint, it seems highly unlikely that the first alternative involving the USRPHC election would be seriously considered. Even the shareholder-level tax election would not be likely to be attractive to the Service. ■