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TAX DEEMING RULES: A METHOD TO THE MADNESS

By Jonathan Zhu

Jonathan Zhu is an attorney in the Tax Practice Group, Heller Ehrman White & McAuliffe LLP.

This article has three objectives. First, Zhu suggests a first principles analytical approach for structuring and analyzing the myriad of problems that arise in the context of ''deeming rules'' — the broad array of tax rules that deem, for a specified purpose, one transaction to be another. Second, he illustrates the utility of the approach through an examination of a prototypical deeming rule that treats some purchases by a subsidiary of the parent's stock from the parent's shareholders as a corporate redemption. Third, Zhu proposes the adoption of a default rule that some ancillary transactions resulting solely from the deeming be disregarded for tax purposes.

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I. Introduction

Many statutory tax provisions[1] ''deem,'' for a specified tax purpose, one transaction or one set of transactions to be another transaction or another set of transactions. Such deeming rules are common,[2] and can lead to unique tax problems. This article sorts through those problems and proposes how they should be addressed. Their prevalence notwithstanding, many of these problems can be systematically identified, both for taxpayers in planning the transactions and for Congress and the Treasury in designing the deeming rules that are made to apply to the transactions. The foreseeability, and thus avoidability, of the many problems makes it especially lamentable that an inordinate amount of confusion and litigation has taken place regarding these rules.

Part II of this article begins by describing a first principles typology for the many problems that arise from the deeming rules. Part III turns to examine these problems, and the typology, in the context of a prototypical deeming rule, section 304(a)(2).[3] Part IV calls for modest reform by Congress and Treasury that could yield substantial dividends in easing taxpayers', and therefore the IRS's, lives. Until the time of that reform, however, the typology set forth here should be helpful to taxpayers in navigating the alternate universe that are the deeming rules.

II. The Typology

Given any deeming rule, it is easy enough to enumerate at least some of the problems for the taxpayers involved. Such an enumeration generates, however, not just a list of problems, but also substantial anxiety and

[1]Unless otherwise indicated, all references to the ''code'' are to the Internal Revenue Code of 1986, as amended. ''Regulations'' refers to the Treasury regulations promulgated under the code. ''Sections'' refers to sections of the code or the regulations. By ''statutory tax provisions,'' I mean both the code and the regulations.

[2]Examples are legion. Under section 367(d), a person who transfers intangible property to a foreign corporation in a transaction that meets the requirements of section 351 is ''treated as,'' that is, deemed to be receiving annual payments from the transferee, whether or not the person actually receives any such payments. Section 367(d); Treas. reg. section 1.367(d)-1T. Section 338, under which some stock purchases are deemed to be asset acquisitions, is an example of an elective, rather than mandatory, deeming rule. Section 338; Treas. reg. sections 1.338-0 through 1.338-10 (also an example of an exceedingly complex deeming rule). Finally, as an example in the gift tax area, a gift to or by a corporation is deemed for gift tax purposes as a gift to or by that corporation's shareholders. Treas. reg. section 25.2511-1(h)(1).

[3]Section 304(a)(2) deems a subsidiary's purchase of its parent corporation's stock from any shareholder of the parent corporation as a redemption of the parent's stock by the parent corporation. Section 304(a)(2). *See infra* Part III.A.

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hand-wringing, both because any such list is likely to be long, and because many of those problems are not addressed by the deeming rule.

Fundamentally, these problems derive from three sources. First, as opposed to the original transaction that comes with the flesh and blood,[4] the deemed transaction is skeletal. To complete the skeleton is tricky, because it requires attention, not to what is there, but to what is missing.[5] So, the Type I issues are about how to give "flesh and blood" to the deemed transaction, that is, about the mechanics of implementing the deeming rule for the stated purpose.

Second, the deeming often takes the taxpayers to an alternate end state, and additional imaginary steps[6] are needed to connect the alternate to the original. Whether, and to what extent, the taxpayers need to deal with the attendant tax consequences of these additional imaginary steps is almost never addressed by the deeming rules. Herein lie the Type II issues, as to how to deal with the "imaginary steps" or the "ancillary steps."

Third and finally, it is never certain whether the deeming should be respected beyond its stated purpose. When the deeming rule codifies a substance-over-form doctrine,[7] the intuition behind the doctrine and the motivation for its codification ineluctably exert pressure on related contexts, which in turn may spill over further. Those are the Type III, or "transplantation," issues, concerning to what other situations the deeming may be transported.

III. A Case Study: Section 304(a)(2)

A. The Deeming

When a subsidiary acquires stock in its parent corporation from a shareholder of the parent corporation, the stock acquisition will not be treated automatically as a sale or exchange between the subsidiary and the parent's shareholder.[8] Instead, section 304(a)(2) deems the transaction as a section 302 redemption of the parent's stock by the parent corporation.[9]

Under section 302, a redemption is treated as an exchange only if at least one of the four prescribed sets of conditions is met.[10] Otherwise, section 302(d) treats the redemption as a distribution of property under section 301.

Distributions of property under section 301 are first treated as dividends under section 316 to the extent of the distributing corporation's available earnings and profits, then as a reduction of basis of the stock held by the distributee; and finally, if the nondividend portion of the fair market value of the distributed property exceeds the adjusted basis of the stock, any such excess is treated as gain from the sale or exchange of the stock.[11]

The deeming rule of section 304(a)(2) was designed to target shareholder bailouts, as capital gains, of the earnings and profits of a subsidiary.[12] The rule might be viewed as codification of the "constructive dividend" doctrine[13] when what amounts to a redemption is effectuated as a sale or exchange through a subsidiary. As compared with the common-law doctrine that is more flexible, that has a broader target, and that has less well-defined contours,[14] section 304(a)(2) installs an explicit, specific, and mechanical statutory scheme for treating — deeming — a sale of stock as a corporate redemption.

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[4]That is, the reams of documentation for the transaction.

[5]It is tricky also because, early on in the life of the alternate universe, the tax common law supporting the statutory regulatory structure is incipient. There are two kinds of "tax common law." The first is the judicial interpretation of specific provisions of the code and the regulations. The second, such as the substance-over-form doctrine or the step transaction doctrine, is extratextual, and independent of any particular provisions of the code and the regulations. The first kind is the one referred to here. Through taxpayer dispute and litigation, decisional law tends to, over time, address the Type I problems. *See, e.g., infra* Part III.B. Litigation, however, neither is efficient nor provides sufficient certainty in an area of statutory law where both are critical.

[6]That is, transactions.

[7]For discussions of the substance-over-form doctrine, see, e.g., *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978) (describing and applying substance-over-form doctrine in determining whether a transaction is a sale or a lease); *Grove v. Commissioner*, 440 F.2d 241 (2d Cir. 1973) (majority and dissenting opinions highlighting different philosophy about the use of the doctrine). Generally, the Tax Court is hesitant in applying the doctrine when Congress has clearly stated that specified tax consequences shall follow from the form of a transaction and a taxpayer has carefully structured the transaction to fall within the four corners of the form. *See, e.g., Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff'd* 886 F.2d 1318 (7th Cir. 1989).

[8]Section 304(a)(2). Section 304(a)(1) deals with the brother-sister transaction. The parent-subsidiary transaction is chosen for its relative simplicity; it raises more than enough deeming problems. *See infra* Parts III.B, III.C, and III.D.

[9]And, if applicable, section 303.

[10]Section 302(b).

[11]Sections 301, 1001.

[12]A fair question is whether section 304 should apply when the redeemed shareholders are corporations and not individuals. Another fair question is whether section 304(a)(2) should apply only when the redeemed shareholder is in control of the parent corporation. Both questions are, so to speak, "blood under the bridge." For a review of the history of section 304, see, e.g., Robert J. Staffaroni, "The International Boundaries of section 304," 46 *Tax Law*. 125, 125-39 (1992). *See also infra* note 45 and accompanying text.

[13]*See, e.g., Nicholls, North, Buse Co. v. Commissioner*, 56 T.C. 1225 (1971). Without section 304 or the constructive dividend doctrine, exchange treatment is likely for both the shareholder and the subsidiary, without involving the parent.

[14]For a general discussion regarding constructive dividends, see Boris I. Bittker and James S. Eustice, 1 *Federal Income Taxation of Corporations and Shareholders* at para. 8.05 (7th ed. 2002).

It should be noted, however, that most constructive dividend situations involve transactions in which a shareholder does not adequately pay for what he receives. *See, e.g.*, Boris I. Bittker and James S. Eustice, 1 *Federal Income Taxation of Corporations and Shareholders* at 8-40 (7th ed. 2002) ("The hallmark of a constructive distribution is value passing from, or a sufficiently specific economic benefit conferred by, the corporation to the shareholder, for which the shareholder does not give equivalent value in exchange."). In contrast, a section 304(a)(2) transaction usually takes place at the fair market value.

B. Flesh and Blood — Type I Issues

The deemed transaction is statutorily called into being. When there is confusion as to how the deeming is to be done, one should first turn to the code and the regulations. As illustrated below, many specifics of the deemed transaction necessary for implementing section 304(a)(2) are indeed statutorily provided, but some are not.

1. A simple example. Begin with a simple example. Because the transaction is deemed to be a redemption of the parent's stock, should only the parent's earnings and profits count in the dividend calculation under sections 301 and 316? Section 304(b)(2) says no, and both the subsidiary's and the parent's earnings and profits are included in the dividend calculation.[15]

Now, in that dividend calculation, should the parent's or the subsidiary's earnings and profits be counted first, if the amount of distribution is less than the combined earnings and profits of the parent and the subsidiary? Either answer serves section 304's purpose, and both would leave room for the parent and the subsidiary partially to manage the amount of dividend distribution and their earnings and profits profiles through a section 304(a)(2) transaction.[16] Yet it is an ambiguity that must be resolved for the deeming rule to work. Section 304(b)(2) removes this ambiguity: The subsidiary's earnings and profits go first.[17]

2. Another simple example. It would be asking for too much to request that Congress and the Treasury preemptively address all Type I issues. As an example, section 304(a)(2) applies only to the acquisition of a parent's stock by a subsidiary ''in return for property,''[18] and property, under section 317(a), ''does not include stock in the corporation making the distribution.''[19] In a section 304(a)(2) transaction, which is the corporation ''making the distribution'' for purposes of determining which corporation's stock is not property? One searches in vain in the code and the regulations for an answer to that question.

There are four possible choices: (1) the parent only, (2) the subsidiary only, (3) both, and (4) neither. If we set aside, for now, (3) and (4) on grounds that the former is too generous and the latter too harsh,[20] we are left with (1) and (2). Between (1) and (2), however, the technical reading and the practical considerations pull in opposite directions; the choice is not straightforward.

Technically, section 304(a)(2) seems to make the parent corporation the redeeming corporation. Moreover, section 317(a) should be read in conjunction with section 317(b), which makes the obvious point that the redeeming corporation should be the one whose shareholders receive the property. The subsidiary's shareholders, including the parent corporation, do not receive anything either in the original transaction or in the deemed transaction;[21] only the parent corporation's shareholders receive any property. Logic suggests that the parent is the corporation making the distribution.

But, practically, choice (2) makes more sense. Choice (1) would have no impact except in the rare cases in which (i) the subsidiary already owns the parent's stock before the transaction, and (ii) it uses that stock as consideration for the other stock of the parent that it receives in the section 304(a)(2) transaction. To choose (1) is to remove, to a large extent, section 317 from the operations of section 304(a)(2). That seems unlikely.

The resolution of this Type I issue, left open by the code and the regulations, required patience. The predecessor to section 304(a)(2), section 115(g)(2) of the Internal Revenue Code of 1939, was first enacted in 1950.[22] Section

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[15]Section 304(b)(2) (''In the case of any acquisition of stock to which [section 304(a)] applies, the determination of the amount which is a dividend (and the source thereof) shall be made as if the property were distributed . . . by the acquiring corporation to the extent of its earnings and profits, and . . . then by the issuing corporation to the extent of its earnings and profits.'').

[16]*See infra* note 36.

[17]There are other examples where ambiguities exist that cannot be resolved by looking to the evident objective of the deeming rule. Before we get to sections 301 and 316, section 302 contains four sets of tests that, if any one of the four is met by the deemed redemption, would provide for exchange treatment for the redemption. Which corporation, the parent or the subsidiary, should be the ''reference corporation'' in applying the section 302 tests? Again, the objective of section 304(b)(2) could be accomplished with either choice, but an answer must be given. Section 304(b)(1) removes that uncertainty, and requires the use of the ''issuing'' corporation, the parent in the section 304(a)(2) case, as the reference corporation. While the use of the parent corporation is sensible in the parent-subsidiary scenario, the subsidiary could also have been chosen, and the attribution rules of section 318, modified by section 302(c), would allow that choice practically to work. Had the subsidiary been chosen, different determinations under the section 304 tests could result when the parent does not own, directly or constructively, 100 percent of the subsidiary's stock.

The choice of the ''issuing'' corporation as the reference corporation makes less sense for a brother-sister transaction governed by section 304(a)(1), and that is deemed, when section 301 is applicable, ''as if the transferor had transferred the stock . . . to the acquiring corporation in exchange for stock of the acquiring corporation . . . , and then the acquiring corporation had redeemed the stock it was treated as issuing in such transaction.'' Section 304(a)(1). This is in essence a sub-deeming rule designed to help implement the deeming rule, and in the

(Footnote continued in next column.)

sub-deeming, the acquiring, and not the issuing, corporation is the redeeming corporation. *See infra* note 30.

[18]Section 304(a)(2)(A); *see also* section 304(a)(1)(B).

[19]Or ''rights to acquire such stock.'' Section 317(a).

[20]In practice, (3) is not very different from (2) and (4) is not very different from (1). *See* discussions immediately following, *infra*.

[21]There was some dispute, as a Type II problem, as to whether the parent corporation received any property in a section 304(a)(2) transaction through an imaginary ancillary transaction. *See infra* notes 28-32 and accompanying text.

[22]Section 105(g)(2) of the Internal Revenue Code of 1939 (effective August 31, 1950). It read: ''If stock of a corporation (hereinafter referred to as the issuing corporation) is acquired by another corporation (hereinafter referred to as the acquiring corporation) and the issuing corporation controls (directly or indirectly) the acquiring corporation, the amount paid for the acquisition of the stock shall constitute a taxable dividend from the issuing corporation to the extent that the amount paid for

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304(a)(2) was first adopted in 1954.[23] Uncertainties continued from 1950 for approximately four decades: In 1987, the Tax Court held that the subsidiary is the corporation "making the distribution,"[24] and in 1990, the Service openly acquiesced.[25]

Even now not all aspects of this simple issue have been firmly resolved.[26] For example, what should the treatment be when the fair market value of the subsidiary's stock, now not a section 317 property, exceeds the earnings and profits of the subsidiary and, therefore, it would otherwise have constituted dividend distributed from the parent's earnings and profits?[27] Should the identity of the "corporation making the distribution" depend on the amount of the subsidiary's stock distributed?

C. Ancillary Steps — Type II Issues

Type II issues are even easier to spot; one needs only to know to look for them. The deemed transaction is a different transaction from the original, and ancillary steps are required to fill the gap. What should the taxpayers, some of whom are nonparties to the original transaction but are parties to the deemed transaction, do regarding the tax consequences of these ancillary transactions?

Although easy to identify, Type II issues are difficult to deal with because the ancillary transactions are almost never addressed in the code or the regulations dictating the deeming. In the case of a section 304(a)(2) transaction, two ancillary transactions are clearly needed to connect the original purchase by the subsidiary to the deemed redemption by the parent; neither one is dealt with in the statutory regime.

1. The first shoe. First, the property needs to get from the subsidiary to the parent for the parent to use in the deemed redemption. For tax purposes, should this imaginary step be treated as an actual distribution of property by the subsidiary to its parent?[28]

In Rev. Rul. 69-261,[29] the Service insisted that such a distribution did indeed take place for tax purposes. That ruling relied principally on the language of the pre-1984 section 304(b)(2)(B) and, with also a quick nod to the "principle of constructive dividend," held that the parent received the property from the subsidiary.[30]

Leaving aside the merits of that position, for present purposes it suffices to point out that, from the issuance of Rev. Rul. 69-261, it took over one decade of litigation, an explicit reversal of the position of the Tax Court by the Tax Court itself, and affirmations of the postreversal Tax Court position by more than one federal circuit court[31] before the Service reversed Rev. Rul. 69-261 and issued

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such stock would have been considered, under paragraph [115(g)(1)], as essentially equivalent to a taxable dividend if such amount had been distributed by the acquiring corporation to the issuing corporation and had been applied by the issuing corporation in redemption of its stock."

[23]Section 304(a)(2) of the Internal Revenue Code of 1954 (effective June 22, 1954).

[24]*Bhada v. Commissioner*, 89 T.C. 959 (1987), *aff'd Bhada v. Commissioner*, 892 F.2d 39 (6th Cir. 1989), *and aff'd sub nom. Caamano v. Commissioner*, 879 F.2d 156 (5th Cir. 1989).

[25]GCM 39820 (July 3, 1990).

[26]As another example, there is a "retroactivity" issue still hanging after *Bhada v. Commissioner*, 89 T.C. 959 (1987). The Tax Court relied, first and foremost, on its reading of section 304(b)(3), a provision that did not exist until 1982. The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, section 226(a)(1)(A), 96 Stat. 324 (effective for transfers occurring after Aug. 31, 1982 in tax years ending after Aug. 31, 1982); amended in the Deficit Reduction Act of 1984, Pub. L. No. 98-369, section 712(l)(3)(A), 98 Stat. 494, 953. The tax year in dispute in *Bhada v. Commissioner*, 89 T.C. 959 (1987), happened to be 1982 and the transaction took place after Aug. 31, 1982. So the 1982 version of section 304(b)(3) applies and the Tax Court may rely on it. But what should be the result for transactions on or before August 31, 1982?

[27]Attribution rules do not operate to make a parent corporation an attributed subsidiary of the subsidiary corporation, Rev. Rul. 74-605, 1974-2 C.B. 97, so there is no downstream deemed redemption that would otherwise sweep in transactions in which a parent corporation simply buys out shares of the subsidiary not already owned.

[28]Clearly, how this question is answered has no effect on the effectiveness of the deeming rule itself. Nevertheless, and despite the availability of the dividend received deduction, *see generally* section 243, the answer to this question is important. First, there are numerous limitations on dividend received deductions. *See, e.g.,* Treas. reg. section 1.246-2 (limiting dividend received deduction as percentage of taxable income); section 246A (limiting dividend received deduction in cases of debt-financed portfolio stock); section 1059 (requiring basis reduction for extraordinary dividends). Moreover, many collateral issues are affected. *See, e.g.*, section 6501(e) (the statute of limitation extended if the deemed income contributes to an omission of income by 25 percent or more); section 541 (deemed dividend income potentially helping to fulfill the "income test" for the parent corporation as a personal holding company); section 902 (deemed dividend affecting foreign tax credit for the parent).

[29]Rev. Rul. 69-261, 1969-1 C.B. 94.

[30]A pre-1984 version of section 304(b)(2)(B) provided that "the determination of the amount which is a dividend shall be made *as if* the property were distributed by the acquiring corporation to the issuing corporation and immediately thereafter distributed by the issuing corporation." Section 304(b)(2)(B) (before 1984) (emphasis added). On its face, the language treats the subsidiary as having distributed the property to the parent, but only for the specific purpose of "determination of the amount which is a dividend."

Two other notes regarding the pre-1984 section 304(b)(2)(B). First, its "as if" language introduces a sub-deeming rule within the original deeming rule. For another such example, see *supra* note 17 regarding the meaning of the "issuing" corporation. Second, it is also an example in which the resolution of a Type II issue for the deeming (is there a distribution by the subsidiary to the parent?) depended on the resolution of a Type III issue for a sub-deeming (should the sub-deeming be transplanted for a purpose beyond the calculation of the parent's earnings and profits?) designed to implement the deeming, that is, to address a Type I issue for the deeming (how should the relevant earnings and profits be calculated to determine the amount of dividend?).

[31]*Webb v. Commissioner*, 67 T.C. 293 (1976), *aff'd per curiam* 572 F.2d 135 (5th Cir. 1978), *reversing Union Bankers Insurance Co. v. Commissioner*, 64 T.C. 807 (1975); *Virginia Materials Corp. v.*

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Rev. Rul. 80-189 in its stead.[32] So while a deemed section 304(a)(2) transaction is one in which the parent redeems its stock, the parent manages to use the subsidiary's property for the redemption without somehow receiving, taxwise, that property from the subsidiary.

2. The other shoe. There is the other shoe. In the original transaction, the subsidiary receives the parent's stock from the parent's shareholder. In the deemed transaction, the parent redeems that stock. Should the subsidiary be treated as receiving the parent's stock, so redeemed, from its parent? If yes, it might be argued that the subsidiary takes the parent's stock with a basis that may be less than the amount paid by the subsidiary, or even zero.[33]

This other shoe is as visible as the first, likewise has no effect on the effectiveness of the deeming rule itself, and is also not addressed by the deeming statute.[34] Without any fanfare, Rev. Rul. 80-189 stated that the subsidiary "under section 1012 of the Code . . . will have a basis in [parent's] stock acquired in the transaction equal to the amount paid therefore." In the end both Type II issues were resolved in taxpayers' favor.

D. Transplantation: Type III Issues

Type III issues are a different beast. Even their identification requires one to look beyond the deeming rules. Like the Type II issues, Type III issues are almost never addressed by the deeming statutes. But unlike most Type II issues, which are often traps for the unwary, Type III issues may offer taxpayers planning opportunities that are opened up by the deeming rules.

1. An obvious Type III issue: parent corporation's earnings and profits. Again begin with a simple example. To the extent there is a deemed dividend distribution by the parent corporation, is that deeming ported to the calculation of the parent's earnings and profits for purposes beyond section 304(a)(2)? Rev. Rul. 91-5 says yes. [35] As a result, when making a dividend payment to its shareholders, the parent could either take a distribution from the subsidiary, and then make a dividend distribution, or have its subsidiary engage in a section 304(a)(2) transaction, or do a combination of both.[36] With a suitable subsidiary with sufficient earnings and profits and also sufficient cash (or other distributable assets), the parent has an extraordinary freedom in landing at its desired spot in the two dimensional, (earnings and profits) versus (dividends paid to shareholders) space.

To be specific, denote the earning and profits of the parent and the subsidiary before the section 304(a)(2) transaction for dividend calculation purposes to be $P^0_{E\&P}$ and $S^0_{E\&P}$. Assume that the parent wishes to make a total dividend distribution of D, while setting its postdistribution earnings and profit at $P^1_{E\&P}$. This can be done by dividing D between DP, a section 302 dividend distribution by the parent itself to its shareholders, and DS, a section 304(a)(2) dividend distribution by the subsidiary also to the parent's shareholders, with $D_P=P^0_{E\&P}-P^1_{E\&P}$ and $D_S=D-(P^0_{E\&P}-P^1_{E\&P})$.[37]

2. A less obvious Type III issue: subsidiary's withholding obligation. If the subsidiary is a domestic corporation, and the parent corporation's shareholders foreign, would the deemed dividend payments from the subsidiary subject the subsidiary to withholding obligations under sections 1441 and 1442?

If section 304(a)(2) did not apply, the domestic subsidiary would have merely engaged in a transaction to which section 1001 applies and it would generally have

Commissioner, 67 T.C. 372 (1976), *aff'd without opinion* 577 F.2d 739 (4th Cir. 1978). *See also Broadview Lumber Co. v. United States*, 561 F.2d 698 (7th Cir. 1977).

For present purposes, there is no need to rehash the reasoning adopted by the Tax Court in *Webb. v. Commissioner* in reversing *Union Bankers Insurance Co*. However, it is worth noting that, to the extent that the pre-1984 section 304(b)(2)(B) introduced a sub-deeming rule, the Tax Court in *Webb v. Commissioner* refused to transplant that sub-deeming written for the purpose of determining the amount of dividends to the different and broader issue of the proper treatment of the ancillary imaginary transaction. 67 T.C. 293 (1976). The affirming circuit courts essentially followed the Tax Court reasoning. *Virginia Materials Corp. v. Commissioner*, 577 F.2d 739 (4th Cir. 1978); *Broadview Lumber Co. v. United States*, 561 F.2d 698 (7th Cir. 1977).

[32]Rev. Rul. 80-189, 1980-2 C.B. 106, *reversing* Rev. Rul. 69-261, 1969-1 C.B. 94.

[33]There are at least three options for the amount of that basis: (a) the amount paid by the subsidiary to the parent's shareholders; (b) the amount in (a) less the portion treated as dividend distribution to the parent's shareholders; (c) zero, as would be the case if the parent had contributed its own stock to the subsidiary in a stand-alone transaction. Although option (b) may be the most logical, there was no authority on this, until the issuance of Rev. Rul. 80-189, 1980-2 C.B. 106, which adopted option (a).

[34]Compared to its sibling, this problem has received less attention. Its relative obscurity may have been due to the less immediate nature of the issues arising from it, because treatment of the basis of the parent's stock may not resurface and be subject to dispute until the subsequent disposition of the stock by the subsidiary; but that is a mere conjecture and is more of an excuse than a reason.

[35]Rev. Rul. 91-5, 1991-1 C.B. 114. Although Rev. Rul. 91-5 deals with the brother-sister situation, its reasoning relies on legislative history that applies equally to the parent-subsidiary transactions. Rev. Rul. 91-5 was subsequently modified and amplified, Rev. Rul. 92-86, 1992-2 C.B. 199, but not in this regard.

This flexibility is not required by either the language of the code or the language of the regulations. Section 304(b)(4)(A) allows "proper adjustments" for the earnings and profits of a corporation in a section 304(a) transaction that is a member of an affiliated group. Section 304(b)(4)(A). But Rev. Rul. 91-5 is not the only possible approach. For example, it could have allowed the subsidiary to take an earnings and profits deficit or required the parent to reduce its basis in the subsidiary's stock.

[36]In part, this flexibility is due to the treatment of the two Type II issues. *See supra* Part III.C.

[37]For this arrangement to work, the subsidiary must have sufficient earnings and profits, or $S^0_{E\&P}\geq D+P^1_{E\&P}-P^0_{E\&P}$. If not, D_P and D_s may instead be set at $D_P=D-S^0_{E\&P}$, and $D_S= S^0_{E\&P}$. In this case, the postdistribution earnings and profits of the parent corporation would be $P^0_{E\&P}-D_P$ $(=P^0_{E\&P}+S^0_{E\&P}-D_P)$, rather than being more flexible.

In neither case are the parent's earnings and profits reduced because of demed dividends paid under section 304(a)(2), but Rev. Rul. 91-5 lends support to arrangements of this kind.

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incurred no withholding obligation for such a transaction.[38] It is only on account of section 304(a)(2) that a portion or all of the subsidiary's payment might be deemed a dividend. Should the deeming, and its consequences, be ''transplanted'' to sections 1441 and 1442?

As to the deemed dividend payment made by the subsidiary, Rev. Rul. 92-85 says yes. [39] It goes on to say that, if the parent corporation[40] is a foreign corporation, that much of the dividends deemed to be paid by the parent corporation would not be subject to withholding, if the parent corporation does not have U.S.-sourced income.[41]

3. A planning opportunity: foreign tax credit. When a mechanical deeming rule replaces a more contextual and flexible substance-over-form doctrine, the mechanicality of the deeming rule for one purpose opens up planning opportunities elsewhere. The foreign tax credit under section 902 is a good example in the section 304(a)(2) context.[42]

This planning opportunity is essentially the reverse of the withholding problem discussed above. Instead of a domestic corporation making deemed dividend payments to a foreign shareholder, the opportunity involves a foreign corporation making deemed dividend payments to a U.S. shareholder. Under section 902, ''a domestic corporation owning 10 percent or more of the voting stock of a foreign corporation from which it receives dividends in any taxable year shall be deemed to have paid the same proportion of such foreign corporation's post-1986 foreign income taxes'' as the amount ''of such dividends . . . bears to such foreign corporation's post-1986 undistributed earnings.''[43] So, when the parent's shareholder is a domestic corporation, and the subsidiary foreign, are deemed dividends from the subsidiary to its grandparent ''good dividends'' for section 902 purposes?

Before answering this question, recall that section 304(a)(2) was enacted to prevent a bailout of ordinary income as capital gain by the parent corporation's shareholders, an issue that is moot when those shareholders are corporations rather than individuals.[44] Recall also that the deeming already makes the corporate shareholders in general better off, because of the dividend received deduction, than they would be in the absence of section 304(a)(2). Should section 304(a)(2) be transplanted still further to section 902, and lead to additional potential benefits for these corporate shareholders?

The IRS says yes. Under Rev. Rul. 92-86, the corporate grandparent may compute foreign taxes deemed paid on dividends deemed distributed under section 304(a)(2) by the subsidiary.[45] Moreover, if the parent corporation is a foreign corporation, any deemed dividend distribution by the parent would also allow the parent's corporate shareholder to claim foreign tax credit for that portion of the deemed dividend distribution.[46]

At least inasmuch as section 902 alone does not by itself invoke any attribution rules,[47] and that a section

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[38]The United States does not in general tax capital gains on stock of U.S. corporations held by foreign stockholders not otherwise subject to U.S. tax. *See, e.g.*, Harvey P. Dale, ''Withholding Tax on Payments to Foreign Persons,'' 36 *Tax L. Rev*. 49, 60 (1980) (no withholding obligation generally if the determination of the amount subject to withholding requires knowledge of basis of property held by a foreign person). Section 897 is a major exception to this general rule.

[39]Rev. Rul. 92-85, 1992-2 C.B. 69. It deals with a brother-sister transaction, but it is clear the same rule applies to a parent-subsidiary transaction.

[40]The ''issuing'' corporation in the case of the brother-sister transaction of Rev. Rul. 92-85.

[41]This latter result seems generous because it allows a U.S. corporation to pay dividends for its foreign parent with the U.S. corporations U.S.-sourced income. This seeming generosity should not be overstated in the post-1984 regime, in which the subsidiary's earnings and profits would be counted first in the determination of dividend amount. *See supra* note 17 and accompanying text. By the time there are deemed dividends made by the parent, the subsidiary's earnings and profits have already been exhausted; as a result, had the subsidiary directly paid its parent the amount deemed to be dividends from the parent, that amount would not be dividends from the subsidiary to its parent and therefore may not be subject to withholding in any event under sections 1441 and 1442 if the parent is foreign.

Under Rev. Rul. 92-85, it appears the subsidiary, and not the parent, is the entity thought to have the requisite "control, receipt, custody, disposal, or payment" under section 1441. Rev. Rul. 92-85, 1992-2 C.B. 69 (Situation 2). So if the parent corporation is domestic, the parent corporation should not be subject to withholding obligations for that portion of the deemed dividend amount from the parent's earnings and profits. In this regard, Rev. Rul. 80-189 is clearly more sensible than Rev. Rul. 69-261. *See supra* Part III.C.1. Under Rev. Rul. 69-261, the subsidiary may be subject to withholding obligations twice on the same amount for a single transaction, once for the ''constructive dividend'' paid to the (foreign) parent, and the other for the section 304(a)(2) dividend paid to the parent's (foreign) shareholders.

[42]Similar section 902 opportunities are opened up by section 304(a)(1).

[43]Section 902(a). Section 902 credit is subject to limitations under section 904 and recapture under section 960. Rev. Rul. 91-5, 1991-1 C.B. 114. There is no attribution of ownership, other than the rules under section 902(b). Rev. Rul. 85-3, 1985-1 C.B. 222; *First Chicago Corp. v. Commissioner*, 96 T.C. 421 (1991).

[44]There is no doubt that section 304(a)(2) applies when the shareholders are corporations. *See, e.g.*, *Continental Bankers Life Ins. Co. v. Commissioner*, 93 T.C. 52 (1989).

[45]Rev. Rul. 92-86, 1992-2 C.B. 199 (dealing directly with a brother-sister situation). This liberal rule appears to have consistently been applied for section 902 purposes. *See, e.g.*, LTR 8224117 (Mar. 22, 1982) (consent dividends under section 565 eligible); Rev. Rul. 74-387, 1974-2 C.B. 207 (section 356(a)(2) dividends eligible).

[46]Rev. Rul. 92-86, 1992-2 C.B. 19.

[47]There is allowed, however, an increase in deemed taxes paid by a foreign corporation that has ''certain lower tier corporations.'' Section 902(b). But the section 318 attribution rules that are much more far-reaching. Section 318 (going beyond corporations to reach partnerships, estates and trusts and, subject to limitations, treating constructive ownership as actual for further attributions).

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304(a)(2) parent-subsidiary relationship may result from section 318 attributions, Rev. Rul. 92-86 is generous.[48]

IV. A Proposal for Modest Reform

A. Recapping the Typology

Type I issues are about the flesh and blood of the deemed transaction. They appear as one tries to implement the deeming rules. They must be resolved for the deeming to work at all. Many, but not all, Type I issues are addressed in the deeming statute.

Type II issues arise in connecting the original transaction with the deemed transaction. They do not relate to the operations of the deeming rules. Unlike the Type I issues, Type II issues are almost never addressed within the deeming statutes. Also, their resolutions one way or another normally do not advance or frustrate the objectives of the deeming rules.

Type III issues occur when one considers whether the deeming should be given effect in contexts beyond the deeming rule itself. They are the most difficult, both to identify and to deal with; their breadth is limited only by one's imagination. Resolutions of these issues are, on occasion, informed by the deeming rules. Like the Type II issues, they are rarely addressed within the structure of the deeming rules.

B. A Modest Reform Proposal

There are more Type I problems than Congress and the Treasury believe; left unaddressed, it is often unclear how they should be dealt with. If Congress and the Treasury want to tell taxpayers to disregard a transaction and deem it as another, they should do a better job in telling the taxpayers what this ''another'' is. That is so obvious that it is stunning when one pauses to consider how many headaches taxpayers and the IRS have had dealing with the Type I problems.[49]

Regarding the Type III issues there is even less to say. Their broad and ill-defined nature does not allow a clean treatment. On one hand, it is unwise to adopt the bright-line rule that the deeming would never be applied to any other context. To the extent that many deeming rules are animated by one or another substance-over-form doctrine, the doctrine remains a part of the tax law after the respective deeming rules are codified, and remains needed beyond the codified context. On the other hand, it is equally unwise to adopt the opposite bright-line rule that the deeming should be applied to all other contexts. It is simply impossible to think of all the situations to which the deeming may be relevant; the potential for unintended externalities is too great and hard to control.

About the Type II issues, however, much can be done, and relatively easily. A simple, bright-line rule should be adopted: Absent explicit instructions from Congress and Treasury to the contrary, all imaginary ancillary transactions should be given no tax effect.

There are primarily three reasons for the proposal. First, as illustrated above, whether to give tax effect to the ancillary transactions typically does not affect how well the objectives of the deeming rules will be accomplished.[50] The bright-line rule does not impede the legislative objectives behind the deeming rules.

Second, practically, it is exceedingly difficult to give effect to these imaginary transactions. The difficulties have two sources, and both sources give rise to intractable questions that no taxpayers should have to answer. One is that to give effect to any such imaginary transaction amounts to another deeming rule, leading at least to yet another set of Type I problems that, as opposed to the Type I problems for the original deeming, are never touched on in the deeming statute. The other is that the looming presence of the ''step transaction doctrine,'' with its various incarnations,[51] when several transactions, including the deemed transaction and the ancillary transactions, appear under a broad umbrella and all are by definition closely related, add additional complication.

Third, empirically, it seems that, to the extent these Type II issues have led to disputes with the Service, the ultimately adopted rule is the general rule proposed.[52]

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[48]Rev. Rul. 92-86 cites the legislative history to support its holding. ''[T]he Conference agreement revises the deemed distribution rules of [S]ection 304 to provide that in all cases, i.e, both brother-sister and parent-subsidiary transactions, the characterization of a distribution as a dividend, and the source of the dividend will be determined by treating the distribution as made by the acquiring corporation directly to the selling shareholder to the extent of the earnings and profits of the acquiring corporation and then made by the issuing corporation directly to the selling shareholder to the extent of its earnings and profits. Thus, any dividend received deduction or foreign tax credit will be allowed to the same extent as if the distribution had been made directly by the corporation that is treated as having made the distribution. Also, the earnings and profits of the corporation that is treated as having made a distribution will be reduced.'' H.R. Rep. No. 98-861, 98th Cong., 2d Sess., 1223 (1984), 1984-3 (Vol. 2) C.B. 477. But it is not clear that Congress here had in mind situations where attribution rules brought a transaction under section 304(a)(2).

The benefits are reduced but not eliminated by section 78, which requires treating the amount of foreign taxes deemed paid under section 902(a) as additional dividend income. Section 78; Treas. reg. section 1.78-1. Also, section 304(b)(5), enacted in 1997, Pub. L. No. 105-34, 105th Cong., 1st Sess., section 1013(c) (effective June 9, 1997), limits the amount of the acquiring corporation's earnings and profits to that ''accumulated during the period or periods such stock was owned by the [U.S.] person while the acquiring corporation was a controlled foreign corporation.'' Section 304(b)(5)(A)(ii). Also, the ''controlled foreign corporation'' requirement appears to exclude any earnings and profits of the foreign acquiring corporation for such dividend purposes, in the brother-sister situation when the ultimate parent is a foreign entity. *See* section 958(b)(4) (Attributions to entities ''shall not be applied so as to consider a United States person as owning stock which is owned by a person who is not a United States person.'').

[49]*See supra* Part III.B.

[50]*See supra* Part III.C.

[51]*See, e.g.*, *McDonald's Restaurants of Illinois v. Commissioner*, 688 F.2d 520, 524-25 (7th Cir. 1982) (discussing the three versions of the doctrine: the ''end result'' test, the ''interdependence'' test, and the ''binding commitment'' test).

[52]*See supra* Part III.C.

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So, why not promulgate a modest reform measure that appears to do no harm and much good?

Meanwhile, however, taxpayers must be mindful of all three types of issues whenever a transaction involves a deeming rule. Although oversight is inevitable and will continue, there should be enough patience for thinking through the Type I issues. Moreover, there is no excuse not to identify all the Type II issues, and the ultimate approach to them in any given transaction must, until the present proposal is adopted, take into account the cost of ending up on the ''wrong'' side if challenged. Finally, Type III issues may prove a more productive inquiry for taxpayers; for that reason alone nothing more needs to be said.

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