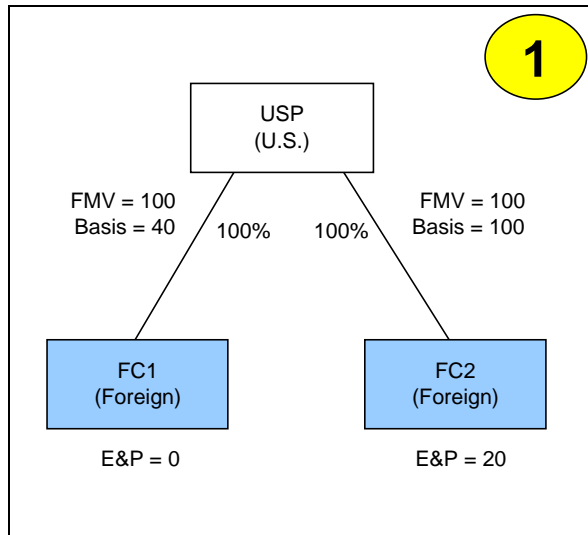


**Temp. Reg. 1.367(a)-9T(e),  
Example**

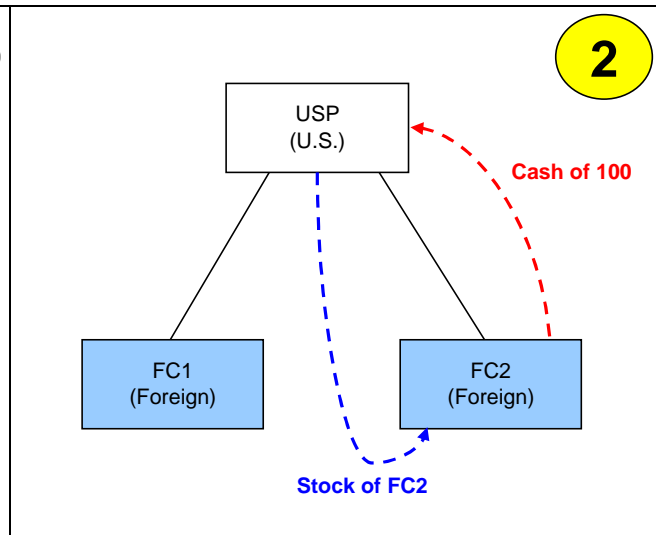
**367(a) Gain Recognition on Certain  
Outbound 304 Transactions**

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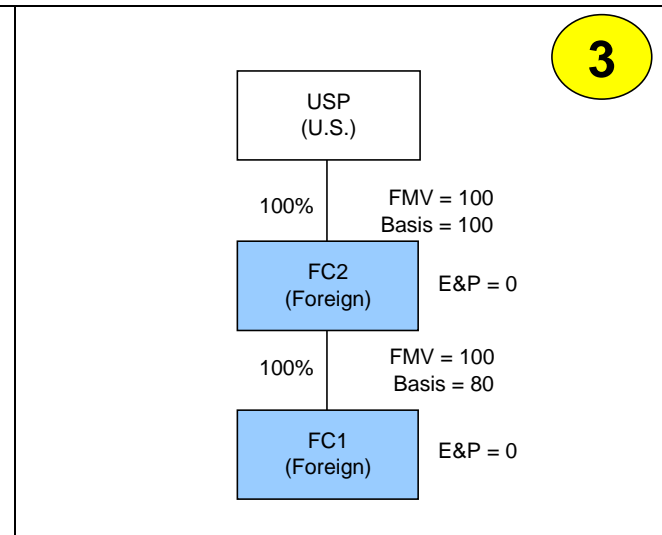
**Initial Structure**



**304 Transaction**



**Ending Point**



USP, a domestic corporation, wholly owns FC1 and FC2, each a foreign corporation. The FC1 stock has a \$40x basis and \$100x fair market value. The FC2 stock has a \$100x basis and \$100x fair market value. As of December 31, year 1, FC1 has zero earnings and profits, and FC2 has \$20x earnings and profits. On December 31, year 1, in a transaction described in section 304(a)(1), USP sells the FC1 stock to FC2 for \$100x cash.

Under section 304(a)(1), USP and FC2 are treated in the same manner as if USP contributed the FC1 stock to FC2 in a deemed section 351 exchange in exchange solely for \$100x of FC2 stock, and then FC2 redeemed for \$100x cash its stock deemed issued to USP. Pursuant to section 304(b)(2), \$20x of the distribution is treated as a dividend from FC2. With respect to the remaining \$80x, USP takes the position that \$40x is applied against and reduces the basis of the FC2 stock issued in the deemed section 351 exchange, and \$40x is applied against and reduces the basis of the FC2 stock held by USP prior to (and after) the transaction.

Because USP takes the position that \$40x is applied against and reduces the basis of the FC2 stock held by USP prior to (and after) the transaction, USP must recognize gain of \$40x on its transfer of the FC1 stock to FC2 in the deemed section 351 exchange (the amount by which the \$60x gain realized by USP on the deemed section 351 exchange with respect to the FC1 stock exceeds the \$20x dividend inclusion). The exception under §1.367(a)-3(b) is not available to the transfer of the FC1 stock by USP to FC2 in the deemed section 351 exchange. Thus, USP cannot avoid gain recognition by entering into a gain recognition agreement with respect to its transfer of the FC1 stock to FC2 in the deemed section 351 exchange.