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 F1 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.