tax notes

Volume 151, Number 9 ■ May 30, 2016

Section 367 Adrift: Old Statute, New Applications

By Peter M. Daub

Reprinted from *Tax Notes*, May 30, 2016, p. 1207

taxanalysts®

Section 367 Adrift: Old Statute, New Applications

By Peter M. Daub


Peter M. Daub

Peter M. Daub is a partner at Morgan, Lewis & Bockius LLP. He thanks his colleagues F. Scott Farmer, Daniel V. Stern, and John D. Barlow for their invaluable assistance. A prior version of this report was presented to a meeting of the Washington International Tax Study Group.

In this report, which is the first of two parts, Daub traces the development of section 367 policy and addresses how in recent antiabuse guidance the IRS has altered the application of section 367 to cross-border and foreign-to-foreign transactions.

Table of Contents

Except for relatively minor changes, section 367 remains in the form the 1988 Technical and Miscellaneous Revenue Act (TAMRA)[1] left it. Indeed, the legislative history of the statute's ultimate 1932 progenitor already reflected the basic rationale for the provision. One could argue that, with the IRS's fine-tuning of its approach to section 367 in the wake of the Revenue Act of 1962,[2] the general principles that would govern not only future administrative guidance but also statutory amendments were set. Those precepts have informed most section 367 guidance to this day.

Beginning in 1994 and accelerating rapidly 12 years later, however, the IRS has issued notices and proposed regulations under three of section 367's subsections that greatly deviate from these principles and arguably conflict with the statutory language. Section 367 historically functioned — and for the most part continues to function — as a housekeeping provision that adapts the operation of specified subchapter C nonrecognition provisions to cross-border and foreign-to-foreign transactions. Lately, however, when the IRS has detected abuse, it has seized on its broad but not unlimited authority under section 367 to negate the operation of basic code rules outside subchapter C and suspend the effect of hoary U.S. income tax principles. It has done so in furtherance of its own (and Treasury's) conception of proper U.S. taxing jurisdiction, of the appropriate time for levying tax on funds remitted from foreign subsidiaries, and of when foreign subsidiary earnings should be subject to tax without actual distribution. As might be inferred from this statement, Congress has furnished no evidence that it agrees with that conception. Indeed, Congress's failure to enact administration proposals reflected in the guidance suggests just the opposite.

The first part of this report addresses the development of section 367 policy. It starts with the enactment of the statute's ultimate predecessor in 1932, close on the heels of the enactment of the current income tax and even closer to the adoption of subchapter C's remote antecedents. As demonstrated by the discussion, section 367 has had a single purpose from its inception: to call off or modify the application of specified subchapter C provisions (such as section 351 or 332) to a cross-border or foreign-to-foreign transaction when applying them would thwart the application of any basic tax policies or provisions. Thus, as historically understood, section 367 applies only when (1) the satisfaction of a basic policy or provision, such as the clear reflection of income or the prevention of assignment of income, is at stake; and (2) the

[1] P.L. 100-647.

[2] P.L. 87-834.

unmodified application of a subchapter C provision specified in section 367 to a cross-border or foreign-to-foreign transaction would frustrate or inhibit that basic policy or provision.

As described below, this general principle evolved over the years. For example, section 367 at first applied only when the taxpayer had a subjective motive to avoid the application of a tax policy, such as the recognition of realized gain on an asset, through the application of a subchapter C provision to a cross-border transaction. Later the coverage expanded to call off the application of subchapter C provisions to a cross-border transaction whatever the taxpayer's motivation, as long as that application could frustrate or undermine the policy. The scope of section 367 grew with the development of tax policy outside section 367 generally. Thus, it served as a backstop to section 1248 before serving the same function for *General Utilities* repeal.

Until the release of antiabuse guidance beginning in 1996, however, neither the courts nor the IRS understood section 367 as applying unless the unmodified application of a subchapter C provision specified in section 367 to a cross-border or foreign-to-foreign transaction would thwart a basic tax policy or provision. The second part of this report addresses how in recent antiabuse guidance the IRS has, without justification in the statute's text or legislative history, selectively relaxed this requirement.

I. Development of Section 367 Policy

Since 1932 Congress and the IRS have tried to tailor the statute and the regulations ever more precisely to the underlying principles of the section 367 provisions now found in subsections (a), (b), and (d).[3] The mind-numbing complexity of the regulations understandably can, but should not, obscure the themes that have consistently reappeared over several decades. Admittedly, the many changes in the regulations testify to the difficulty of drafting rules to implement the principles, and overbreadth and underbreadth have characterized many intermediate positions. Nonetheless, by 1994, when the IRS began issuing guidance under section 367 attacking particular transactions, the lineaments of section 367 policy and rules, if not all the details, were fairly clear.

At least since 2000, the IRS has issued section 367 guidance in most years and occasionally more than once in a year. Yet the regulations released during this period largely refine policy positions established by legislation, regulations, and other guidance issued by the IRS by the early 1990s. Set forth below are the milestones in section 367 history that reflect the policies now reflected in section 367(a), (b), and (d).

A. The 1932 Act

Section 112(k) of the Revenue Act of 1932[4] included the common predecessor of current section 367(a), (b), and (d). Its single sentence provided:

> In determining the extent to which gain shall be recognized in the case of any of the exchanges or distributions . . . described in . . . [among other provisions, current sections 354, 361, 351, and 356], a foreign corporation shall not be considered as a corporation unless, prior to such exchange or distribution, it has been established to the satisfaction of the Commissioner that such exchange or distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

Despite its brevity, the original language suggests features that guided the legislative and administrative development of section 367 over the next 84 years.

First, the provision invests the IRS with the authority to suspend the operation of only the cited nonrecognition provisions of subchapter C regarding gain, and only when a foreign corporation's status as a corporation is critical to the provision's operation. For example, section 351, one of the cited provisions, requires nonrecognition of gain or loss only for a transfer of property to a corporation in exchange for its stock. It does not provide for nonrecognition of gain arising from the exchange of property for an interest in any other type of entity or indeed any other type of property. Section 367, at least in its initial form, had no relevance to such exchanges.

At the same time, section 367 does not give the IRS authority to call off the application of nonrecognition provisions not cited, even when the status of a corporation as a corporation is critical to their operation. Thus, as the IRS has itself acknowledged, section 367 does not suspend the application of section 1036, which provides that no gain or loss will be recognized if common or preferred stock in a corporation is exchanged solely for common or preferred stock, respectively, in the same corporation.[5] Similarly, as discussed below, although the

[3]For general discussion of section 367 policy, see Charles I. Kingson, "Seven Lessons on Section 367," *Tax Notes*, Sept. 13, 2004, p. 1015; Kingson, "The New Theory & Practice of Section 367," 69 *Taxes* 1008 (1991); and Kingson, "The Theory & Practice of Section 367," 37 *N.Y.U. Inst. on Fed. Tax'n*, section 22.01 (1979).

[4]P.L. 72-154.

[5]In Rev. Rul. 72-420, 1972-2 C.B. 473, *obsoleted by* Rev. Rul. 78-381, 1978-2 C.B. 347, a Dutch corporation amended its articles

(Footnote continued on next page.)

IRS has now claimed otherwise, section 367 should not affect the operation of section 1032(a), which provides for the nonrecognition of gain to a corporation on the receipt of money or other property in exchange for its stock. More basically, section 367 does not give the IRS authority to require the recognition of gain that has not been realized or gain or income that does not exist, since that recognition is obviously not fundamental tax policy. Thus, for example, section 367 should not give the IRS authority to require the recognition of income from the receipt of money in exchange for property when the amount of money received does not exceed the seller's basis in the property.

Second, as the statute's language indicates, section 367, at least in its initial form, applied only when it had not been established to the IRS's satisfaction that the transaction was ''not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes'' — that is, when the taxpayer had a subjective motive to avoid tax. Albeit tersely, the reports of the taxwriting committees illuminate the type of tax avoidance that animated the provision and continues to do so:

> Property may be transferred to foreign corporations without recognition of gain under the exchange and reorganization sections of the existing law. This constitutes a serious loophole for avoidance of taxes. Taxpayers having large unrealized profits in securities may transfer such securities to corporations organized in countries imposing no tax upon the sale of capital assets. Then, by subsequent sale of these assets in the foreign country, the entire tax upon the capital gain is avoided. For example, A, an American citizen, owns 100,000 shares of stock in corporation X, which originally cost him $1,000,000 but now has a market value of $10,000,000. Instead of selling the stock outright A organizes a corporation under the laws of Canada to which he transfers the 100,000 shares of stock in exchange for the entire capital stock of the Canadian company. This transaction is a nontaxable exchange. The Canadian corporation sells the stock of corporation X for $10,000,000 in cash. The latter transaction is exempt from tax under the Canadian law and is not taxable as United States income under the present law. The Canadian corporation organizes corporation Y under the laws of the United States and transfers the $10,000,000 cash received upon the sale of corporation X's stock in exchange for the entire capital stock of Y. The Canadian corporation then distributes the stock of Y to A in connection with a reorganization. By this series of transactions, A has had the stock of X converted into cash and now has it in complete control.
>
> While it is probable that the courts will not hold all transactions of this nature to be tax-free exchanges, the committee is convinced that the existing law may afford opportunity for substantial tax avoidance. To prevent this avoidance the bill withdraws the transaction from the operation of the nonrecognition sections where a foreign corporation is a party to the transaction, unless prior to the exchange the commissioner is satisfied that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of taxes.[6]

On the basis of the facts in the example, Congress concluded that the taxpayer's outbound transfer of securities had as one of its principal purposes the avoidance of the taxpayer's recognition of gain from the disposition of the securities under the predecessor of section 1001 through the assignment of that gain to a foreign corporation. Some of the facts that apparently led to this conclusion were that (1) the taxpayer was about to realize the gain from the securities (''instead of selling the securities outright'') and, because the taxpayer owned all its shares, could cause the Canadian corporation to sell the securities; (2) the assets were liquid; and (3) given that the Canadian corporation sold the securities, the taxpayer did not need to locate them outside the United States for business or investment

---

of association to change from a *naamloze vennootschap* to a *besloten vennootschap*. The IRS concluded that even though the exchange was a section 368(a)(1)(F) reorganization in which the shareholders (but for section 367) would not have recognized gain or loss under section 354, the exchanging shareholders also would not have recognized gain or loss under section 1036. Since, according to the IRS, ''the shareholders do not need to rely on section 354 of the Code for nonrecognition of gain upon the exchange of stock,'' they did not recognize gain or loss even though they failed to comply with the ruling requirement in section 367. Although the IRS later obsoleted Rev. Rul. 72-420 in light of the elimination of the ruling requirement for transactions now covered by section 367, the principle that nonrecognition of gain or loss under section 1036 does not depend on compliance with section 367 remains. Of course, other rules could call off the application of a nonrecognition rule. *See, e.g.*, reg. section 1.367(a)-7(b)(2), which, under the authority of section 337(d) (investing the IRS with the authority to prescribe regulations carrying out *General Utilities* repeal), provides for the nonapplication of a nonrecognition rule not enumerated in section 367(a)(1) to gain or loss realized on the transfer by a U.S. corporation of property to a foreign corporation.

[6]H.R. Rep. No. 72-708, at 20 (1932); S. Rep. No. 72-665, at 26-27 (1932).

reasons. Thus, in this case, by calling off the application of section 351, a subchapter C provision, section 367 satisfied the assignment of income principle by preventing, through the expedient of a cross-border transaction, the taxpayer's permanent avoidance of tax on gain in the assets that arose during the taxpayer's holding period. The provision thus perfectly illustrates the point of section 367 to call off the application of a specified subchapter C provision to a cross-border transaction when that application would undermine a basic tax policy.

The transfer of the cash proceeds from the sale to a domestic corporation is another illustration. Since A owned all the stock of the Canadian corporation, even without having the Canadian corporation transfer the cash to the domestic corporation, A would have ''had the stock of X converted into cash and [would have had] it in complete control.'' What was troubling about the tax-free transfer of the cash to Y and the distribution of the stock to A without gain recognition (under the predecessor of section 355) to the Canadian corporation or A was that Y, unlike the Canadian corporation, was subject to U.S. tax. The domestic corporation could use the cash to purchase a depreciable asset for which it could claim $10 million of depreciation deductions, even though only $1 million (the amount that A originally paid for the securities) was ever subject to U.S. tax. Thus, section 367 satisfied the clear reflection of income principle by calling off the application of section 355 to the cross-border spinoff.

B. The Guidelines

Not until the Tax Reform Act of 1976 did Congress make any substantive changes to the statute as it appeared in 1932. Even before TRA 1976, however, the IRS determined that other legislation warranted the refinement of section 367's role. The introduction of section 1248 by the Revenue Act of 1962 led the IRS to expand the tax avoidance function of section 367. In general terms, section 1248 characterizes as a dividend the gain that a U.S. person (whether an individual or a corporation) recognizes on the sale of stock in a foreign corporation based on the corporation's earnings, including its subsidiaries' earnings, allocable to the person's shares during the period in the previous five years when the corporation was controlled by 10 percent U.S. shareholders, if the selling person was such a shareholder at any time during that period. The taxwriting committees declared that the legislation had ''as one of its objectives in the foreign income area the imposition of the full U.S. tax when income earned abroad is repatriated.'' They believed that section 1248 accomplished this objective.[7] Effectively, section 1248 deems a selling shareholder meeting the control requirements to have received, just before the sale, a dividend distribution from the corporation (and indirectly from its subsidiaries) partially or wholly in lieu of consideration from the buyer. Thus, section 1248 protects the shareholder-level tax on foreign corporate earnings when the control requirements are met.

In response to the enactment of section 1248, the IRS expanded the scope of what is now section 367(b) to prevent the avoidance of section 1248 through the subchapter C nonrecognition provisions. In effect, section 367 was to operate as a backstop to other provisions, in this case section 1248, whatever the taxpayer's subjective motive. The example in the 1932 legislation had suggested that section 367 should call off a nonrecognition provision when a taxpayer's actual tax avoidance motive could have been inferred — when, in the language of the statute, the transaction had been ''in pursuance of a plan'' to avoid tax that was about to be imposed. Now the existence of a plan would effectively be presumed if a nonrecognition transaction by its nature permanently avoided the application of a clearly stated policy, such as the policy of section 1248.

In Rev. Proc. 68-23,[8] the IRS provided guidelines describing the circumstances under which it would ordinarily grant an advance private letter ruling to the effect that a nonrecognition exchange specified in section 367 was not in pursuance of a plan having as one of its purposes the avoidance of federal income taxes. One guideline identified the conditions that would ensure that, as a result of the exchange, the United States would not lose taxing jurisdiction over the earnings that the exchanging shareholder would have included under section 1248 had it sold the shares rather than exchanged them in a nonrecognition transaction. For example, the IRS would grant a favorable ruling on a foreign-to-foreign asset reorganization in which the transferor corporation was a controlled foreign corporation[9] at any time during the five-year period

[7]S. Rep. No. 87-1881, 1962-3 C.B. 707, 813 (1962).

[8]1968-1 C.B. 821.

[9]*See* section 957(a) (defining a CFC as ''any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock of such corporation entitled to vote or the total value of the stock of such corporation, is owned (within the meaning of section 958(a)), or is owned by applying the rules of ownership of section 958(b), by United States shareholders ('U.S. Shareholders') on any day during the taxable year of such corporation''); and section 951(b) (providing that a U.S. shareholder ''means, with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as

(Footnote continued on next page.)

ending with the exchange only if the exchanging shareholders agreed to include in their gross income as a dividend the amount that they would have included under section 1248 had they sold their shares at the time of the exchange.[10]

As that provision illustrates, the guidelines of Rev. Proc. 68-23 were sometimes overbroad in the coverage of section 367's objective. As the current regulations under section 367(b) recognize, the United States will not lose taxing jurisdiction over the exchanging shareholder's section 1248 amount in the foreign-to-foreign asset reorganization if the acquiring corporation is itself a CFC in which the exchanging shareholder satisfies the section 1248 ownership requirements. So the provisions do not require an inclusion in that case.[11]

Overbreadth also characterized the guidelines' approach to matters not bearing on section 1248. For example, outbound transfers of stock could qualify under section 351 only if the stock was of a foreign corporation organized in the same foreign jurisdiction as the transferee corporation.[12] Although an exchange of stock in a domestic corporation for stock of a foreign corporation could qualify under section 354, it could do so only if the former shareholders of the domestic corporation did not own more than 50 percent of the total voting power of the foreign acquirer's shares.[13] Thus, even if the domestic corporation was an operating company or widely held (facts suggesting that its shares were not transferred to the foreign corporation to avoid tax on any gain on the shares), a ruling would not be forthcoming if the former shareholders met the 50 percent test.

In most other respects, the guidelines of Rev. Proc. 68-23 conformed reasonably well to the policies described above. They generally countenanced a U.S. person's transfer of property that the transferee foreign corporation would devote to the active conduct of a trade or business in a foreign country, presumably because tax avoidance was not a principal purpose for the transfer.[14] But a favorable ruling would not be issued when the property was U.S. patents, trademarks, or similar intangibles to be used in connection with (1) the conduct of a trade or business in the United States or (2) the manufacture of goods for sale or consumption in the United States; or foreign intangibles to be used in connection with the sale of goods manufactured in the United States.[15] This was evidently because there was no apparent business reason for the transfer of these intangibles abroad, and thus a tax avoidance purpose could be inferred.

In an acknowledgment of the clear reflection principle, the guidelines excluded from the active foreign trade or business rubric "property, such as accounts receivable or installment obligations, in respect of which income has been earned, unless the income attributable to such property has been or will be included in the gross income of the transferor for Federal income tax purposes."[16] Similarly, inventory did not qualify, presumably because the transferee could be expected to sell it quickly.[17]

The guidelines set forth a rule addressing Congress's concern (expressed in the example in the 1932 committee reports) that a tax-free inbound transaction in which a domestic corporation inherited a foreign corporation's tax attributes could result in the distortion of income. Thus, under the guidelines, section 332 applied to any gain realized by a domestic corporation on its receipt of property in complete liquidation of a foreign subsidiary only if the domestic corporation included in its income the accumulated earnings attributable to its stock in the subsidiary.[18] Similarly, section 354 applied to any gain realized by a domestic corporation owning at least 20 percent of the stock of a foreign corporation on the exchange of that stock for stock in another domestic corporation that had acquired the foreign corporation's assets only if the exchanging domestic corporation included in its income the accumulated earnings attributable to its stock in the foreign subsidiary.[19] The current section 367(b) regulations contain similar rules regarding inbound liquidations and reorganizations.[20]

Most important, in distinctions that survive in the current section 367(b) regulations, the guidelines' mechanics reflected the separate policies of

owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation").

[10]Rev. Proc. 68-23, section 3.03(1)(c).

[11]Reg. section 1.367(b)-4(b)(1)(i)(B)(1).

[12]Rev. Proc. 68-23, section 3.02(1)(a)(iii)(B)(2).

[13]*Id*. at section 3.03(1)(d).

[14]*Id*. at section 3.02(1).

[15]*Id*. at section 3.02(1)(b)(iii) and (iv).

[16]*Id*. at section 3.02(1)(a)(ii).

[17]*Id*. at section 3.02(1)(a)(i).

[18]*Id*. at section 3.01(1).

[19]*Id*. at section 3.03(1)(b).

[20]Reg. section 1.367(b)-3(b) and -3(c). One might object that the application of these provisions when the includable accumulated earnings exceeded the gain that the corporate shareholder would recognize if section 332 or 354 did not apply violates the principle that section 367 grants the IRS authority to suspend the operation of only the cited nonrecognition provisions. Perhaps the response, not wholly satisfactory, is that the required inclusion put the corporate shareholder in the same position in which it would have been had it conducted the foreign corporation's business itself in the first instance.

section 1248 protection and clear reflection of income. The section 1248 policy was to prevent controlling shareholders from permanently avoiding the shareholder-level tax on the earnings of corporations under their control. Thus, in the foreign-to-foreign asset reorganization, an exchanging shareholder meeting the control requirements, whether an individual or a corporation, was required to include in income earnings of a corporation, whether directly or indirectly controlled. The clear reflection of income policy, however, was to prevent the distortion of the U.S. corporate income tax base through the allowance of deductions against unrelated income. Thus, the toll charge imposed on an inbound liquidation or asset reorganization applied only to a domestic corporate shareholder of the foreign corporate transferor. Since only the tax attributes (such as basis in assets) of the liquidated or reorganized foreign corporate transferor were made available or repatriated to the domestic corporate shareholder, only the earnings that gave rise to those attributes — the earnings of the foreign corporate transferor and not those of its subsidiaries — were required to be included. Correctly understood, the toll charge was thus not a tax on distributed earnings (which is the function of a shareholder-level tax, such as the tax imposed on a dividend inclusion under section 301(c)(1) or an inclusion under the subpart F or passive foreign investment company regimes) but a necessary complement to the repatriation of beneficial corporate tax attributes under section 381 or, for basis, section 334(b). As another manifestation of the basic purpose of section 367, the toll charge modifies the operation of other subchapter C provisions (sections 332 and 354) to prevent the inheritance of tax attributes in a manner that does not clearly reflect income.

C. The Tax Reform Act of 1976

TRA 1976[21] made significant changes to section 367. Structurally, it established the familiar separate coverage by section 367(a) of outbound transfers and by section 367(b) of all other transfers. It substituted for the advance ruling requirement applicable to outbound transfers a requirement to obtain a ruling within 183 days of the transfer,[22] although it gave the IRS authority (which it never used) to promulgate regulations dispensing with the requirement in what the taxwriting committees described as ''certain clear-cut situations involving outbound transfers where significant tax avoidance does not exist or where the amount of any section 367 toll charge can be ascertained without a ruling request.''[23]

TRA 1976 eliminated the ruling requirement entirely for transactions governed by section 367(b) and instead provided that the subchapter C nonrecognition rules would apply unless the IRS determined otherwise in regulations. Having survived without amendment to this day, section 367(b) provides as follows:

> (1) Effect of section to be determined under regulations. In the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in subsection (a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.
>
> (2) Regulations relating to sale or exchange of stock in foreign corporations. The regulations prescribed pursuant to paragraph (1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing — (A) the circumstances under which — (i) gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both, or (ii) gain or other amounts may be deferred for inclusion in the gross income of a shareholder (or his successor in interest) at a later date, and (B) the extent to which adjustments shall be made to [earnings and profits], basis of stock or securities, and basis of assets.

The broad language of paragraph (2) might suggest that Congress intended to grant the IRS unfettered discretion in the tax treatment of transactions covered by section 367(b). Yet again, the statute authorizes the nonapplication of only specified nonrecognition provisions. While several times expressing concern about the tax-free repatriation of previously untaxed foreign earnings, the committee reports suggest that, if anything, the guidelines may have gone a bit too far:

> While it is recognized that the present rules [as set forth in Rev. Proc. 68-23] are necessarily highly technical and largely procedural and while it is essential to provide against tax avoidance in transfers . . . upon the repatriation of previously untaxed foreign earnings,

[21]P.L. 95-455, section 1042(a).

[22]Former section 367(a)(1) (1976).

[23]S. Rep. No. 94-938, at 265 (1976).

> unnecessary barriers to justifiable and legitimate business transactions should be avoided.[24]

Perhaps most important, Congress provided for judicial review of the new section 367(b) regulations:

> These regulations are to be subject to normal court review as to whether the regulations are necessary or appropriate for the prevention of avoidance of federal income taxes. Thus, a taxpayer may challenge a proposed deficiency with respect to an exchange dealt within the regulations by arguing in the courts that the regulations, as applied in the taxpayer's case, are not necessary or appropriate to prevent the avoidance of federal income taxes. If the court should agree with the taxpayer, it is to apply the balance of the regulations to the extent appropriate.[25]

Temporary regulations published a year after the legislation's enactment,[26] and thus written by persons presumably familiar with what Congress intended, corrected some of the guidelines' overbreadth. Like the current section 367(b) regulations[27] but unlike the guidelines, the temporary regulations did not require an exchanging shareholder in a foreign-to-foreign asset reorganization to include in income its section 1248 amount if the acquiring corporation was itself a CFC in which the exchanging shareholder satisfied the section 1248 ownership requirements.[28] Also, the temporary regulations preserved the guidelines' mechanics for distinguishing between section 1248 avoidance and clear reflection of income policies underlying the statute.[29]

[24]S. Rep. No. 94-938, at 263 (1976); H.R. Rep. No. 94-658, at 241 (1976).

[25]S. Rep. No. 94-938, at 268 (1976); H.R. Rep. No. 94-658, at 245 (1976).

[26]T.D. 7530 (Dec. 27, 1977).

[27]Reg. section 1.367(b)-4(b).

[28]Former reg. section 7.367(b)-7(b) (1977).

[29]*Compare* former reg. sections 7.367(b)-7(b), -2(b), and -2(d) (1977) (requiring inclusion of the E&P of directly and indirectly owned CFCs by an exchanging U.S. shareholder (whether an individual or a corporation) that meets the control requirements when the transaction threatens loss of taxing jurisdiction over the shareholder's section 1248 amount), *with* former reg. sections 7.367(b)-5(b), -7(c)(2), and -2(f) (1977) (requiring inclusion, by a domestic corporate shareholder upon its receipt of property in complete liquidation of a foreign subsidiary or upon its exchange of stock in a foreign corporation for stock in a domestic corporation acquiring the foreign corporation's assets in an asset reorganization, of the allocable E&P of the foreign corporation and not of its subsidiaries).

D. TEFRA

In the 1982 Tax Equity and Fiscal Responsibility Act,[30] Congress cut back significantly on the possession tax credit under section 936. The committee reports noted that Congress was aware that some taxpayers had indicated that, as a result of the cutback, they would remove intangibles owned by a possession corporation to a foreign affiliate. According to the committee reports, the IRS already had the authority under section 367(a) to require gain recognition on the transfer of intangibles by a U.S. person (such as a possession corporation, a domestic corporation for which a section 936 election was in effect) to a foreign corporation in an exchange in which gain would otherwise not be recognized under subchapter C. Yet the guidelines required that recognition only when the intangibles were to be used in connection with (1) a trade or business in the United States or (2) manufacturing for sale or consumption in the United States. By inference, the guidelines thus suggested that section 367 would not apply to an outbound transfer of an intangible used in connection with a foreign trade or business or with manufacturing of a product for sale or for consumption outside the United States.[31] Accordingly, new section 367(d) required a possession corporation to recognize gain upon the transfer of any intangible property (as defined) to a foreign corporation.

The TEFRA version of section 367(d) is largely only of historical interest except for its incorporation by reference of the section 936(h)(3)(B) definition of intangible property used for section 936 purposes,[32] an incorporation that survives in section 367(d) to this day. The provision sets out a laundry list of manufacturing, process, and marketing intangibles — not including goodwill and going concern value (GWGCV) — and concludes with the catchall phrase "any similar item." In each case, the intangible must have "substantial value independent of the services of any individual."

E. The Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984 (DEFRA)[33] made major changes to section 367(a) and (d). With

[30]P.L. 97-248.

[31]Rev. Proc. 68-23, section 3.02(1)(b)(iii) and (iv).

[32]Section 936(h)(3)(B) defines intangible property as any (1) patent, invention, formula, process, design, pattern, or knowhow; (2) copyright, or literary, musical, or artistic composition; (3) trademark, trade name, or brand name; (4) franchise, license, or contract; (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data; or (6) any similar item that has substantial value independent of the services of any individual.

[33]P.L. 98-369 (1984).

some later refinements, the provisions as amended by DEFRA are the statute we know today.

In their description of the reasons for the changes to section 367(a), the committee reports indicated that while section 367(a) ''has generally worked well over the years,'' a series of Tax Court decisions restrictively interpreting the requirement for gain recognition of ''a plan having as one of its principal purposes the avoidance of Federal income taxes'' had convinced Congress of the need for reform. One of those cases had referred to a principal purpose as a purpose ''first in rank, authority, importance or degree.''[34] The reports stated:

> This narrow interpretation by the Tax Court of the principal purpose test has caused the Internal Revenue Service difficulty in administering section 367(a) in a way which restricts the types of tax avoidance transfers that the provisions of that section were intended to combat. This restrictive interpretation, with which the committee disagrees, threatens to undermine the utility of section 367, with the result being an incentive for foreign investment. The committee has no intention of condoning such a result.[35]

To address this concern, Congress dispensed with the ruling requirement and the principal purpose test and prescribed that a U.S. person would generally avoid gain recognition only if the person transferred the property for use by the foreign corporation in the active conduct of a trade or business outside the United States.

As the quoted language suggests, although Congress substituted the active trade or business test for the principal purpose test, it still, as it had since 1932, viewed as a major policy of section 367 the deterrence of the outbound transfer of property in a nonrecognition transaction for the purpose of avoiding the tax that would otherwise be imposed on a sale of the property. DEFRA's active trade or business exception thus could be interpreted as providing a bright-, or at least a brighter-, line test, more susceptible of administration than a test explicitly based on a subjective tax avoidance motive. Consistent with the continuing importance of purpose, the legislation generally excluded from qualification under the active trade or business exception assets (such as foreign currency) that were generally not needed in an active business. In harmony with the guidelines' application of the clear reflection principle, the statute also continued the unfavorable treatment of installment obligations, accounts receivable, and other assets on which income had been earned.

DEFRA guarded the clear reflection principle in two additional ways. In Rev. Rul. 78-201,[36] the IRS had ruled that when a U.S. corporation had incurred a loss through a foreign branch that offset the corporation's worldwide income, the later incorporation of the branch operations was deemed to be in pursuance of a plan having as one of its principal purposes the avoidance of tax under section 367(a) because the U.S. corporation would not include in its worldwide income the operations' income produced after incorporation. According to the IRS, the U.S. corporation could avoid recognition of gain on its assets only if it recognized as ordinary foreign-source income in the year of the transfer an amount equal to the branch losses previously incurred. The Tax Court agreed with a taxpayer whose facts were similar to those in Rev. Rul. 78-201 that its incorporation of a foreign loss branch did not have tax avoidance as a principal purpose.[37] The court thus concluded that the branch's loss or income was clearly reflected in income because it was clearly reflected annually. According to the court, the clear reflection principle did not apply to the branch's lifetime income and loss considered in the aggregate.

The committees viewed the Tax Court as incorrectly endorsing the allowance of a double benefit.[38] DEFRA thus provided that the active trade or business exception did not apply to gain realized on the transfer of the assets of a foreign branch of a U.S. person to a foreign corporation to the extent that deductible losses incurred by the branch before the transfer exceeded its aggregate taxable income for the years after the tax year in which the loss was incurred and through the close of the tax year of the transfer.[39]

In its second and far more important application of the clear reflection principle, Congress greatly expanded the scope of section 367(d). The taxwriting committees noted:

---

[34]*Dittler Bros. Inc. v. Commissioner*, 72 T.C. 896 (1979).

[35]H.R. Rep. No. 98-432, at 1315 (1984). *See also* S. Prt. 98-169, Vol. I, at 360 (1984) (1984 Senate report).

[36]1978-1 C.B. 91.

[37]*Hershey Foods Inc. v. Commissioner*, 76 T.C. 312 (1981).

[38]H.R. Rep. No. 98-432, at 1317-1318 (1984); 1984 Senate report, *supra* note 35, at 362.

[39]Section 367(a)(3)(C). Also based on the clear reflection principle, under regulations, a U.S. person that transfers depreciable property that has been used in the United States to a foreign corporation, even for the purpose of using the property in an active foreign business, must include in income in the year of the transfer ordinary income equal to the gain realized that would have been includable in income as ordinary income under the code's recapture provisions (such as sections 1245 and 1250) if at the time of the transfer the transferor had sold the property for its fair market value. Reg. section 1.367(a)-4T(b)(1).

> Under its published ruling guidelines, the IRS generally issued favorable rulings for transfers of patents and similar intangibles for use in an active trade or business of the foreign transferee corporation. The only exceptions were transfers of certain intangibles used in connection with a U.S. trade or business or in connection with goods to be manufactured, sold or consumed in the United States. In light of this favorable ruling policy, a number of U.S. companies adopted a practice of developing patents or similar intangibles at their facilities in the United States, with a view towards using the intangibles in foreign operations. When these intangibles were ready for profitable exploitation, they were transferred to a manufacturing subsidiary incorporated in a low-tax foreign jurisdiction (or in a high-tax jurisdiction that offered a tax holiday for specified local manufacturing operations). By engaging in such practices, the transferor U.S. companies hoped to reduce their U.S. taxable income by deducting substantial research and experimentation expenses associated with the development of the transferred intangible and, by transferring the intangible to a foreign corporation at the point of profitability, to ensure deferral of U.S. tax on the profits generated by the intangible. By incorporating the transferee in a low-tax jurisdiction, the U.S. companies also avoided any significant foreign tax on such profits.[40]

For GWGCV, the House report had the following to say:

> The committee does not anticipate that the transfer of goodwill or going concern value developed by a foreign branch to a newly organized foreign corporation will result in abuse of the U.S. tax system.[41]

The Senate report continued:

> The committee does not anticipate the transfer of goodwill or going concern value (or certain similar intangibles) developed by a foreign branch to a foreign corporation will result in abuse of the U.S. tax system (regardless of whether the foreign corporation is newly organized).[42]

In its report on the legislation, the Joint Committee on Taxation went yet further:

> Except in the case of an incorporation of a foreign loss branch, the Congress did not believe that transfers of goodwill, going concern value, or certain marketing intangibles should be subject to tax. Goodwill and going concern value are generated by earning income, not by incurring deductions. Thus, ordinarily, the transfer of these (or similar) intangibles does not result in avoidance of Federal income taxes.[43]

Congress thus enacted a rule[44] that required a U.S. person to be treated — upon the transfer of intangible property (as defined in section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361 that section 367(a) would otherwise cover — as receiving amounts that reasonably reflect the amounts that would have been received annually under an exclusive licensing agreement over the useful life of the property. The reports also provided:

> The Act contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill, going concern value, or marketing intangibles (such as trademarks or trade names) developed by a foreign branch to a foreign corporation (regardless of whether the foreign corporation is newly organized). Thus, where appropriate, it is expected that regulations relating to tainted assets and the special rule for intangibles will provide exceptions for this type of property.[45]

Finally, the new statute cut back on the guidelines of Rev. Proc. 68-23 in one important respect. As indicated, the guidelines had provided restrictive rules for the outbound transfer of stocks and securities, especially shares in a domestic corporation. The committee reports indicated that all exchanges involving transfers of stock and securities were to be tested under the active trade or business exception. Stock transferred under circumstances resembling those in *Kaiser*[46] was to

---

[40]H.R. Rep. No. 98-432, at 1316 (1984); 1984 Senate report, *supra* note 35, at 361.

[41]H.R. Rep. No. 98-432, at 1317 (1984).

[42]1984 Senate report, *supra* note 35, at 362.

[43]JCT, ''General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984,'' JCS-41-84, at 428 (1984).

[44]Section 367(d).

[45]*See* JCS-41-84, *supra* note 43, at 435. *See also* H.R. Rep. No. 98-432, at 1320 (1984) (similar); and 1984 Senate report, *supra* note 35, at 365 (similar).

[46]*Kaiser Aluminum & Chemical Co. v. Commissioner*, 76 T.C. 325 (1981). In *Kaiser*, the Tax Court held that a U.S. person's transfer of a 4 percent interest in a foreign corporation to a non-CFC corporate transferee in which the U.S. person's parent corporation owned a 45 percent interest was not in pursuance of a tax avoidance plan when the corporation whose stock was transferred acted as a source of supply of alumina used by the transferee in the production of aluminum. Given the business integration of the two companies, the transferred stock was

(Footnote continued on next page.)

qualify.[47] The committee reports also instructed the IRS to specify in regulations ''additional circumstances,'' such as substantial ownership by the transferee corporation of the transferred corporation's stock, that might argue for qualification.[48]

The committees finally required the IRS to prescribe in regulations that the transferor not recognize gain currently on the outbound transfer of a majority interest in a foreign corporation when the transferor agreed with the IRS that the transferee would not dispose of the interest for a substantial period following the year of the transfer. If, in violation of the agreement, the transferee did dispose of the stock within the period, the IRS was to require that the transferor recognize the gain that it realized in the year of the transfer.[49] The regulations, of course, extended and continue to extend the gain recognition agreement (GRA) exception to a broader set of stock transfers than those mentioned in the legislative history.[50] The important point is that the GRA exception, requiring as it does the transferee's ownership of the transferred stock for a substantial period after the transfer, constitutes yet another manifestation of the enduring policy to allow tax-free outbound transfers when avoidance of tax on the gain on the transferred asset does not appear to be a significant purpose.

F. TAMRA

TAMRA introduced another application of section 367's purpose to prevent the avoidance of a basic tax policy reflected in the code similar to the section 367(b) regulations' protection of the integrity of section 1248.

In the Tax Reform Act of 1986,[51] Congress had repealed the so-called *General Utilities* doctrine,[52] under which a corporation did not recognize gain on the distribution of an appreciated asset to its shareholder even though the shareholder obtained a stepped-up basis in the property.[53] In generally requiring gain recognition, TRA 1986 inserted an exception (under new section 337) from recognition for gain deemed realized on the distribution of an asset to an 80 percent corporate distributee that received a carryover basis in the property, on the theory that the potential for corporate income tax on the gain was preserved in the hands of the distributee. However, the rationale for the exception did not extend to a distribution to an 80 percent corporate distributee that was a foreign person, since a foreign person not engaged in a U.S. trade or business would generally not be subject to tax on a later disposition of the asset.[54] Accordingly, new section 367(e)(2), added to the code by TRA 1986, calls off section 337 when the 80 percent distributee is a foreign corporation. TAMRA conformed the treatment of an outbound transfer by a U.S. corporation of appreciated property otherwise subject to section 367(a) to a foreign corporation in a transaction covered by section 351 or 361 to the treatment under section 367(e)(2) of a distribution by a U.S. corporation of appreciated property to an 80 percent corporate distributee that was a foreign person. Thus, section 367(a)(5) provided that the active trade or business exception would not apply to gain recognized by a U.S. corporation on its exchange under section 351 or 361 of property for stock in a foreign corporation.

The statute said, however, that ''subject to such basis adjustments and such other conditions as would be provided in regulations,'' section 367(a)(5) would not apply if the U.S. corporate transferor was 80 percent controlled by five or fewer domestic corporations. The committee reports explained:

> It is expected that regulations will provide this relief only if the U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporate shareholders' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation. The requirement that five or fewer domestic corporations own at least 80 percent of the U.S. transferor corporation's stock assures that the bulk of the built-in gain will remain subject to U.S. taxing jurisdiction. In addition, it is also expected that regulations will require the U.S. corporate transferor to recognize immediately any built-in gain that does not remain subject to

---

more akin to an operating asset that the transferee was unlikely to sell than to portfolio stock that a foreign transferee would more likely sell.

[47]H.R. Rep. No. 98-432, at 1320 (1984); 1984 Senate report, *supra* note 35, at 365.

[48]H.R. Rep. No. 98-432, at 1320 (1984); 1984 Senate report, *supra* note 35, at 365.

[49]H.R. Rep. No. 98-432, at 1321 (1984); 1984 Senate report, *supra* note 35, at 365-366.

[50]*See generally* reg. section 1.367(a)-3.

[51]P.L. 99-514, section 631.

[52]*See General Utilities & Operating Co. v. Helvering*, 296 U.S. 200 (1935), which created the doctrine that was later codified by Congress in 1954 in section 311(a)(2).

[53]*See, e.g.*, Boris I. Bittker and James S. Eustice, *Federal Income Taxation of Corporations & Shareholders*, para. 8.20[3] (2013); and

(Footnote continued in next column.)

George K. Yin, ''Taxing Corporate Liquidations (and Related Matters) After the Tax Reform Act of 1986,'' 42 *Tax L. Rev*. 573 (1987).

[54]JCT, ''General Explanation of the Tax Reform Act of 1986,'' JCS-10-87, at 340 (1987).

> U.S. taxing jurisdiction by virtue of a substituted stock basis. This would occur, for example, where 20 percent or less of the U.S. corporate transferor is owned by foreign shareholders who receive substituted basis stock in the transferee corporation, which stock would not be subject to U.S. taxing jurisdiction on disposition.[55]

G. Other Legislation and Summary

Since 1986 there have been other changes to section 367(a), (b), and (d), some of them quite significant. For example, TRA 1986 conformed section 367(d) to section 482 (as amended by TRA 1986) by requiring that the amount taken into account under section 367(d) be "commensurate with the income attributable to the intangible."[56] Changes in 1997[57] and 2004[58] together gave this provision its current form. However, none of these changes reflected historical policies underlying section 367. A major change in transfer pricing policy, for example, prompted the inclusion of the commensurate with income standard in section 367.

Reviewing the development to this point: The primary, historical purpose of section 367 was to call off or modify the application of any specified subchapter C provision, such as section 351 or 332, to a cross-border or foreign-to-foreign transaction when an unmodified application would frustrate a basic tax policy (such as the clear reflection of income standard or the anti-assignment of income doctrine) or provision (such as the *General Utilities* repeal or section 1248).

H. Administrative Activity

The legislative framework of current section 367(a), (b), and (d) was thus largely complete in 1988. Regulations issued in 1986,[59] many of which remain in effective temporary form, implemented the DEFRA version of section 367(a) and (d). Largely tracking the statute and the legislative history, these regulations notably adopted a taxpayer-favorable position on foreign GWGCV. They defined it as "the residual value of a business operation conducted outside of the United States after all other tangible and intangible assets have been identified and valued"[60] and provided that section 367(d) would not apply to it.[61]

[55]S. Rep. No. 100-445, at 62-63 (1988).
[56]P.L. 99-514, section 1231(e)(2).
[57]Taxpayer Relief Act of 1997, P.L. 105-34, section 1131(b)(4).
[58]American Jobs Creation Act of 2004, P.L. 108-357, section 406(a).
[59]T.D. 8087 (May 15, 1986).
[60]Reg. section 1.367(a)-1T(d)(5)(iii).
[61]Reg. section 1.367(d)-1T(b).

As shown above, successive legislative enactments had cut back on positions taken in the guidelines that were overbroad in carrying out section 367 policies. Some of the guidance the IRS has issued in this area since the 1980s legislation has continued down that path. A good illustration is the rules for GRAs, under which a U.S. transferor can sometimes avoid immediate gain recognition on the outbound transfer of stock to a foreign corporation in exchange for its stock if the transferor agrees to ensure that the transferee retain the transferred stock for a specified period and that other triggering events (as defined in the regulations) do not occur. The original GRA regulations required that the transferee retain the transferred stock for 10 years.[62] The IRS later acknowledged that retention for only five years sufficed to rebut the inference of a tax avoidance purpose for the original transfer.[63]

The GRA regulations originally identified a series of specific transactions that were exceptions to triggering events and thus would not result in a breach of the GRA and require gain recognition.[64] Commentators complained that, in light of section 367 policy, a particular exception was insufficiently broad or another transactional exception needed to be added to the list. The IRS ultimately yielded and provided that, assuming other specified requirements were satisfied (including the execution of a new GRA), a disposition or other event that would otherwise constitute a triggering event would not be considered one if it was a nonrecognition transaction. Because a nonrecognition transaction would not include a monetization of the U.S. person's realized but unrecognized gain on the original transaction, this new general exception perfectly represented the section 367 policy of discouraging outbound transfers principally for tax purposes.[65] (Lest the regulations leave anything out or simplify a maddeningly complex regime, the IRS retained

[62]Former prop. reg. section 1.367(a)-8(b)(2)(i) (1991).
[63]Former reg. section 1.367(a)-8(b)(3)(i) (1998).
[64]Former reg. section 1.367(a)-8T(e) (2007).
[65]Reg. section 1.367(a)-8(k)(14). T.D. 9446 states:

> The IRS and Treasury Department agree that certain nonrecognition transactions that may not qualify for an exception under the 2007 regulations should not trigger an existing GRA. Because specific exceptions provide certainty to the relevant transactions, the final regulations retain the exceptions of the 2007 regulations with modifications so that the exceptions apply to transactions involving one or more entities not clearly described in the 2007 regulations. . . . The final regulations include additional specific exceptions and a general exception for certain transactions that cannot be adequately covered by a specific exception because of the myriad factual permutations.

the list of specific triggering event exceptions, although the general exception might have swallowed up many of them.)

Although the regulations may appear to be a chaotic patchwork, in proposing breathtakingly simplified section 367(b) regulations in 1991, the IRS indeed articulated general principles underlying the provision that roughly conform to those described in preceding sections of this report. Besides simplification, these principles were as follows, according to the IRS:

> (1) Prevention of the repatriation of earnings or basis without tax. The United States generally does not tax a foreign corporation on this foreign source E&P. If the foreign corporation is owned in whole or in part, directly or indirectly, by a United States person, in certain circumstances the United States does not tax the United States person on the foreign corporation's E&P until those E&P are repatriated (for example, through the payment of dividends) or the United States person disposes of an interest in the foreign corporation. One of the principles of the proposed regulations under section 367(b) is that the repatriation of a United States person's share of E&P of a foreign corporation through what would otherwise be a nonrecognition transaction (for example, a liquidation of a foreign subsidiary into its domestic parent in a transaction described in section 332, or an acquisition by a domestic corporation of the assets of a foreign corporation in a reorganization described in section 368) should generally cause recognition of income by the foreign corporation's shareholders. A domestic acquirer of the foreign corporation's assets should not succeed to the basis or other tax attributes of the foreign corporation except to the extent that the United States tax jurisdiction has taken account of the United States person's share of the E&P that gave rise to those tax attributes.
>
> (2) Prevention of material distortion in income. Another objective of the regulations under section 367(b) is to prevent the occurrence of a material distortion in income. For this purpose, a material distortion in income includes a distortion relating to the source, character, amount or timing of any item, if such distortion may materially affect the United States tax liability of any person for any year. Thus, for example, the regulations generally operate to prevent the avoidance of provisions such as section 1248 (which requires inclusion of certain gain on the disposition of stock as a dividend). For this purpose, the concept of ''avoidance'' includes a transaction that results in a material distortion in income even if such distortion was not a purpose of the transaction.[66]

The second principle is clear enough and consistent with section 367 policy dating back to 1932, although the prevention of the avoidance of section 1248 is more appropriately viewed as a legislatively approved backstop function rather than an anti-income-distortion function. The first principle, however, is distressingly ambiguous. The last sentence says that a domestic acquirer of the foreign corporation's assets — necessarily a corporation — should not succeed to the basis or other tax attributes of the foreign corporation except to the extent that the United States taxes the U.S. person's share of the E&P that gave rise to those tax attributes. Thus, in service of the statute's purpose to avoid income distortions, the inclusion of E&P functions as the predicate for the inheritance of tax attributes. Consistently, the preamble later states: ''Another principle of the section 367(b) regulations is to prevent the repatriation of basis without tax.''[67]

On the other hand, the caption reads: ''Prevention of the repatriation of earnings *or* basis without tax'' (emphasis supplied). One sentence flatly states: ''One of the principles of the proposed regulations under section 367(b) is that the repatriation of a United States person's share of E&P of a foreign corporation through what would otherwise be a nonrecognition transaction . . . should generally cause recognition of income by the foreign corporation's shareholders.'' Further along, the preamble says: ''One of the principles of the section 367(b) regulations is to prevent the repatriation of E&P without tax.''

In reviewing these passages, a fundamental question arises: If one of the principles of section 367(b) is to prevent the repatriation of E&P without tax, why is another of its principles to prevent the repatriation of basis (or other tax attributes) without tax on the earnings? In other words, if section 367(b) requires inclusion of the liquidating or reorganizing foreign corporation's E&P, why is it necessary for section 367(b) guidance to say anything about basis or tax attributes at all? Other, more generally applicable subchapter C provisions provide for the carryover of basis (section 362(b) or 334(b)) and inheritance of other tax attributes (section 381) in those transactions.

Nine years of further consideration did little to dispel the IRS's confusion. In finalizing the 1991 regulations in 2000, the IRS explained:

---

[66]INTL-054-91 and INTL-178-86, 56 F.R. 41993, 41995 (Aug. 26, 1991).

[67]56 F.R. at 41996.

> *The principal policy consideration of section 367(b) with respect to inbound nonrecognition transactions is the appropriate carryover of attributes from foreign to domestic corporations.* This consideration has interrelated shareholder-level and corporate-level components. At the shareholder level, the section 367(b) regulations are concerned with the proper taxation of previously deferred E&P. At the corporate level, the section 367(b) regulations are concerned with both the extent and manner in which tax attributes carry over in light of the variations between the Code's taxation of foreign and domestic corporations.
>
> *The section 367(b) regulations have historically focused on the carryover of E&P and bases of assets*, simultaneously addressing the shareholder and corporate level concerns by accounting for any necessary adjustments through an income inclusion by the U.S. shareholders of the foreign acquired corporation (and without limiting the extent to which the domestic acquiring corporation succeeds to the attributes). The 1991 proposed regulations required a U.S. shareholder of the foreign acquired corporation to currently include in income the allocable portion of the foreign acquired corporation's E&P accumulated during the U.S. shareholder's holding period (all E&P amount). The requirement to include in income the all E&P amount results in the taxation of previously unrepatriated earnings accumulated during a U.S. shareholder's (direct or indirect) holding period. This income inclusion prevents the conversion of a deferral of tax into a forgiveness of tax and generally ensures that the section 381 carryover basis reflects an after-tax amount.[68]

The italicized language at least acknowledges that the principal policy of section 367(b) regarding inbound nonrecognition transactions is the appropriate carryover of tax attributes — ''appropriate'' meaning that the United States taxes the E&P that gave rise to them. However, the preamble does not sufficiently explain why a carryover of tax attributes to a corporation has anything to do with an inclusion of income by its shareholders. Indeed, the final section 367(b) regulations, like the 1977 temporary section 367(b) regulations and the earlier guidelines of Rev. Proc. 68-23, require the exchanging shareholder, not the domestic corporation, to include the earnings that gave rise to the tax attributes.[69] If the tax attributes are carried over to the corporation, should not the corporation include the earnings that gave rise to them?

There is no policy reason for this result, but as Charles I. Kingson suggested[70] over 20 years before the IRS wrote this passage, the answer lies in the language of section 367. Recall that section 367 can affect the operation of only specified provisions. For section 367(b), those provisions are sections 332, 351, 354, 355, 356, and 361. In the liquidation of a corporation into its corporate shareholder, only section 332 prevents the corporate shareholder from recognizing gain, and as indicated, section 367(b) gives the IRS authority to call off the application of section 332. In a section 332 liquidation, the corporate parent is both the exchanging shareholder (it exchanges its shares in its subsidiary for the subsidiary's assets) and the successor to its subsidiary's tax attributes. The final section 367(b) regulations require that when a domestic corporation acquires the assets of a foreign corporation in a section 332 transaction, the ''exchanging shareholder'' must include the foreign corporation's allocable E&P. By calling off the application of section 332 in that situation, the regulations in effect place the E&P where it should be — in the hands of the corporation that inherits the tax attributes.

In an asset reorganization, however, section 1032, not section 332, protects the transferee corporation from gain recognition. Since section 367(b) does not specify section 1032 as one of the provisions whose application it can suspend, the IRS lacks authority to require the transferee domestic corporation to include the foreign transferor's earnings, which the IRS should be able to do from a policy perspective because the domestic transferee inherits the foreign transferor's tax attributes. The IRS does, however, have the authority to call off nonrecognition under section 354 by the exchanging shareholder. The guidelines, the temporary regulations, and the final regulations therefore address the mismatch of corporate tax attributes and the income responsible for them by requiring the exchanging shareholder to include earnings that rightfully the transferee corporation should include.

Because taxing the shareholder is effectively a proxy for taxing the transferee corporation, all three authorities tax only specified shareholders. Thus, as indicated, the guidelines tax only a 20 percent or

[68]T.D. 8862 (emphasis supplied).

[69]Reg. section 1.367(b)-3(b)(3)(i).

[70]Kingson, ''The Theory & Practice of Section 367,'' 37 *N.Y.U. Inst. on Fed. Tax'n*, sections 22-29 n.57.

greater corporate shareholder in the foreign transferor;[71] the temporary regulations tax only a domestic corporate shareholder in the foreign transferor, whatever its percentage ownership;[72] and the final regulations tax only a 10 percent shareholder, whether an individual or a corporation.[73] Since this is a proxy tax, it should not matter whether the shareholder is a corporation or an individual, and, as suggested by both the guidelines and the final regulations, the level of control should be the touchstone.

The key point, however, is that, despite the shareholder-level incidence of tax, the policy of the statute is to require an income inclusion only to the extent that the domestic corporate transferee and successor inherits the foreign corporate transferor's tax attributes. The only justification for taxing under section 367 the corporate transferee (or its shareholder acting as a proxy) on the transferor's E&P is that in a cross-border parent-subsidiary liquidation or asset reorganization, sections 332, 334, 354, 362(b), and 381 would, absent any modification, permit the carryover of corporate tax attributes to the corporate successor without the taxation of the E&P that gave rise to them — in violation of the fundamental tax policy requiring the clear reflection of income.

Unlike the corporate successor in an asset reorganization or parent-subsidiary liquidation, a shareholder acting in its capacity as a shareholder does not inherit the tax attributes of the corporation whose E&P it must include. (The parent in a parent-subsidiary liquidation inherits tax attributes and is of course a shareholder in the subsidiary, but it inherits tax attributes not as a shareholder but as the corporate transferee and successor.) Section 301(c)(1) and the code's anti-deferral rules define the time and the extent of a U.S. shareholder's inclusion of the E&P of the foreign corporation in which it owns shares without regard to the inheritance of corporate tax attributes. Accordingly, unless the subchapter C provisions specified in section 367 facilitate the improper application of section 301(c)(1) and the anti-deferral rules in a cross-border transaction, there is no basis for section 367 to tax E&P of the foreign transferee other than E&P associated with imported tax attributes.

I. Conclusion

As indicated by the foregoing discussion, the original statutory language and legislative history of section 367 permitted the provision to negate or modify the application of specified subchapter C provisions to a cross-border transaction when the taxpayer subjectively intended, through the use of those provisions, to frustrate a basic tax policy, such as clear reflection of income or assignment of income. As the statute and its interpretation evolved, however, it began to apply in some situations in which the taxpayer's avoidance purpose was irrebuttably presumed (as in the outbound transfer of assets not in connection with a trade or business) or a tax avoidance purpose was not even required (as in the inbound transfer of assets potentially distorting the reflection of income or a transaction facilitating the permanent avoidance of *General Utilities* repeal or of section 1248). *But throughout this evolution, and continuing through the 1980s, when the statute effectively took its current form, Congress, the courts, and the IRS understood section 367 to apply only when the unmodified application of the specified subchapter C provisions to a cross-border transaction would thwart a basic tax policy or provision.*

II. New Uses for Section 367

Accordingly, by the early 1990s, the scope and policy of section 367 seemed fairly settled. Then things started to change. In 1994 the IRS began issuing guidance targeting transactions it deemed abusive. Although there was an eight-year hiatus from 1998 through 2006, in the latter year the releases started again in earnest. Typically, the guidance — issued in the form of a relatively short notice or proposed regulation with no immediate legal effect — announces the eventual promulgation of regulations that will have adverse, retroactive effect on transactions entered into after the publication of the original guidance. Thus, the intent is to communicate to taxpayers that engage in transactions described in the guidance that they proceed at their own peril. Based on anecdotal evidence, the releases seem to have had the intended effect in that transactions of the type described therein are abandoned or modified (although, undoubtedly to the IRS's displeasure, they are sometimes modified to fall outside the scope of the guidance but still achieve the intended tax consequences).

So far, these notices and regulations appear to have had three objectives: (1) to retain U.S. taxing jurisdiction over persons that have departed therefrom, at least according to the rules in effect when the guidance was issued; (2) to subject to U.S. income tax funds or other property transferred from a foreign subsidiary to its U.S. parent, even if the property does not represent income or gain in any conventional U.S. income tax sense; and (3) to

[71] Rev. Proc. 68-23, section 3.03(1)(b).
[72] Former reg. section 7.367(b)-7(b), (c) (1977).
[73] Reg. section 1.367(b)-3(b).

expand the reach of U.S. taxing jurisdiction over income earned by foreign subsidiaries that has not yet been repatriated.

Characterizing the IRS's objectives in this fashion, if accurate, suggests that the agency has well passed the boundaries of section 367 policy and authority as described in the discussion above. Indeed, in several instances, Treasury has, perhaps in a concession of questionable authority, sought legislation to accomplish more or less what the guidance purports to do. None of this legislation has yet been enacted, although in one instance a Senate-inspired bill denying the anticipated tax consequences of transactions addressed by one item of the guidance has made it into law.

A. Inversions

In early 1994, Helen of Troy Corp. (Texas Helen), a publicly traded Texas corporation engaged in the manufacture and sale of hair dryers and other beauty products, submitted for shareholder approval a proposal under which its shareholders would transfer their shares in Texas Helen to a new corporation organized in Bermuda (Bermuda Helen) in exchange for its shares. Texas Helen would thereby become a subsidiary of Bermuda Helen.[74] The proposal indicated that counsel believed that the shareholders would not recognize gain or loss on the exchange under section 351 or 354 (the latter in tandem with section 368(a)(1)(B)) and that section 367(a) would not apply to shareholders with any gain in their shares, assuming, for a shareholder that would own more than 5 percent of Bermuda Helen, that the shareholder entered into a GRA.[75]

The prospectus also stated that after the inversion transaction the foreign manufacturing subsidiaries of Texas Helen (operating in low-tax jurisdictions) would sell their assets to new foreign subsidiaries owned by Bermuda Helen outside the Texas Helen chain. Because of the wide ownership of Bermuda Helen's shares, neither Bermuda Helen itself nor the new foreign subsidiaries would be CFCs. Thus, according to counsel, the transactions would collectively remove the earnings of the foreign businesses from inclusion under subpart F and U.S. taxing jurisdiction generally.[76]

This did not sit well with the IRS. A few months after the issuance of the prospectus, the IRS announced in Notice 94-46[77] that it would eventually promulgate regulations, with effect for transactions undertaken after the release of the notice, that would require an exchanging shareholder in a transaction similar to Helen of Troy's to recognize gain on the transaction. In making this announcement, the IRS stated:

> The Internal Revenue Service and Treasury Department are concerned that widely-held U.S. companies with foreign subsidiaries recently have undertaken certain restructurings for tax-motivated purposes. . . . [They] are concerned that these transactions, or related transactions undertaken pursuant to the restructurings, present opportunities for avoidance of U.S. tax.

Neither in the notice nor in the preambles to the two sets of regulations that followed did the IRS explain in any greater detail the tax avoidance that the guidance sought to combat.

Although the final regulations ultimately issued in 1998 differed in some significant respects from the rules laid out in it, the notice had sketched out the basic architecture. In general terms, the final regulations provide that a U.S. person that transfers stock in a domestic corporation to a foreign corporation must recognize any gain on the shares unless (1) the U.S. transferors in the aggregate receive in the transaction no more than 50 percent of the stock in the foreign transferee; (2) U.S. persons that are officers, directors, or 5 percent shareholders of the U.S. corporation in the aggregate own no more than 50 percent of the stock in the foreign transferee after the transaction; and (3) an active trade or business test is satisfied. Under that test, (1) the transferee must have been engaged in an active trade or business outside the United States for the entire 36-month period immediately before the transfer; (2) at the time of the transfer, neither the transferors nor the transferee can have an intention to dispose substantially of or discontinue that trade or business; and (3) at the time of the transfer, the transferee must be no less valuable than the domestic corporation.[78]

The history of the stock transfer rules provides some explanation for the IRS's swift and vehement reaction. As discussed above, the guidelines of Rev. Proc. 68-23 had provided that section 367 would not apply to an outbound transfer of domestic shares only when the U.S. transferor received shares in a reorganization, and then only when the former shareholders of the domestic corporation did not

[74]Helen of Troy Ltd., Prospectus/Proxy Statement, at 29 (Jan. 5, 1994). *See generally* Robert J. Staffaroni, "Size Matters: Section 367(a) and Acquisitions of U.S. Corporations by Foreign Corporations," 52 *Tax Law*. 523, 534-535 (1999).

[75]Helen of Troy Prospectus, *supra* note 74, at 31-33.

[76]*Id*. at 5, 14, and 30.

[77]1994-1 C.B. 356.

[78]Reg. section 1.367(a)-3(c).

own more than 50 percent of the foreign acquirer's shares after the transaction. The DEFRA taxwriting committees had urged the IRS to relax the stock transfer rules through the mechanism of the GRA and otherwise. At first the IRS was not very receptive to the suggestion: The first post-DEFRA stock transfer rules, issued in May 1986, generally required that U.S. transferors own less than 50 percent of the transferee after the transaction.[79] Nineteen months later, however, the IRS relented. In Notice 87-85,[80] the IRS announced that the U.S. transferors could own as much as all the stock in the transferee if no single U.S. transferor owned more than 50 percent of the transferee after the transfer and if the transferee was a CFC. Proposed regulations issued in 1991 generally adopted the notice's rules and even liberalized them by dropping the CFC requirement.[81]

So the IRS at first resisted Congress, then gave in, and for its newfound cooperation was rewarded with the Helen of Troy transaction. Yet the history should not obscure the deviation from sound section 367 policy. The regulations require even a de minimis U.S. shareholder in the U.S. corporation (or the transferee) to recognize gain on the transfer of domestic shares. The original design of the 1932 statute as applied to an outbound transfer of property was intended to discourage a U.S. person from transferring appreciated property to a foreign corporation for the purpose of having that corporation, instead of the transferor, recognize the gain. A de minimis shareholder in a public company would have no control over the transferee's decision to sell the transferred shares. In any event, an inversion is never structured with the expectation that the new foreign parent will dispose of the shares in the inverting domestic corporation immediately after the inversion; one of the major tax objectives of the inversion is to create a foreign parent for the domestic business. Even a shareholder that owns just 5 percent of the stock of the transferee — a shareholder that must, even if the final regulations' other requirements are met, enter into a GRA to avoid triggering gain[82] — could not order the transferee to sell the transferred shares.

One of the drafters of the regulations has written that the purpose of the regulations was to protect the operation of subpart F.[83] As discussed above, section 367 policy has indeed developed as a backstop to section 1248, a legislative companion to subpart F. Yet the section 367 rules designed for this function are a very close fit: When a U.S. person owning at least 10 percent of the stock of a CFC exchanges in a nonrecognition transaction that stock for stock in a foreign corporation that is not a CFC, the section 1248 taint vanishes. The section 367(b) rules requiring the inclusion of the section 1248 amount[84] provide a precise solution to this problem. Similarly, a U.S. corporation's outbound section 361 transfer of appreciated assets to a foreign corporation removes the assets from U.S. corporate income taxing jurisdiction. Gain recognition or shareholder basis reduction under section 367(a)(5) also precisely targets this loophole.

In contrast, the outbound transfer of stock in the U.S. corporation alone does not affect the operation of subpart F or U.S. taxing jurisdiction over the earnings of the U.S. corporation's foreign subsidiaries. More needs to be done, such as the sale by Texas Helen's foreign subsidiaries of their assets to new foreign subsidiaries of Bermuda Helen not owned through Texas Helen, or the distribution by the transferred domestic corporation of its stock in its foreign subsidiaries to the new foreign parent. Yet because it calls off the application of only nonrecognition provisions, section 367(a) is irrelevant to the first transaction, and section 367(e)(2)[85] picks up the gain on the second. Alternatively, without further restructuring, a CFC of the U.S. corporation could have lent accumulated earnings to the new foreign parent, thereby bypassing the operation of sections 951(a)(1)(B)[86] and 956.[87] But a self-inverted group could service the loan only through distributions from the U.S. corporation that would be subject to withholding tax at 30 percent.[88] If the U.S. corporation itself had lacked adequate cash, it would have

[79]Former reg. section 1.367(a)-3T(c)(4)(i) (1986).

[80]1987-2 C.B. 20.

[81]Former prop. reg. section 1.367(a)-3 (1991).

[82]Reg. section 1.367(a)-3(c)(1)(iii)(B).

[83]Philip Tretiak, "U.S. Section 367(a) Stock Transfers in 1998: All You Need to Know!" *Tax Notes*, July 13, 1998, p. 239.

[84]Reg. section 1.367(b)-4(b).

[85]Section 367(e)(2) generally turns off the section 337 nonrecognition provision for the liquidating corporation in a section 332 liquidation when the distributee is a foreign corporation.

[86]Section 951(a)(1)(B) provides that each U.S. shareholder that owns stock in a CFC on the last day of the tax year in which it is a CFC must include in gross income, for the U.S. shareholder's tax year in which or with which that CFC's tax year ends, the amount determined under section 956 for that U.S. shareholder for that year.

[87]For any tax year of a CFC, the section 956 amount for a U.S. shareholder is limited to the lesser of two amounts: (1) the U.S. shareholder's pro rata share of the average amounts of specified types of property (U.S. property) held by the CFC as of the close of each quarter of its tax year, net of income previously taxed to the U.S. shareholder under section 951(a)(1)(B) (section 956 previously taxed income); or (2) the sum of the CFC's accumulated and current E&P reduced by actual distributions and section 956 previously taxed income.

[88]Unless reduced by treaty, increasingly difficult even in the 1990s for a self-inverted group.

had to draw it out in taxable distributions from the CFC, thereby defeating the purpose of the plan.

Thus, if the regulations' goal is the protection of the integrity of subpart F and U.S. taxing jurisdiction, the section 367 policy must be broadly construed to turn off the application of the specified nonrecognition provision in order to not only avoid the direct result of that application but also to discourage the taxpayer from undertaking subsequent and probably taxable transactions that would remove parts of the group from U.S. taxing jurisdiction entirely. The history of section 367 policy provides no precedent, and the legislative history offers no justification, for such an attenuated link between rule and objective. In any event, when the regulations were promulgated, there was no legislative policy against expatriation of businesses under U.S. taxing jurisdiction.

That of course changed with the enactment of section 7874 in 2003, at the initiation of two senators,[89] nine years after the publication of Notice 94-46. Section 7874 treats the foreign parent in an inverted group as a domestic corporation when the former shareholders of the inverted U.S. corporation after the inversion own, because of their former stock ownership in the U.S. corporation, at least 80 percent of the stock in the foreign parent.[90] If the former shareholders own at least 60 percent but less than 80 percent of the stock, the U.S. corporation cannot, for a period of 10 years following the inversion, use tax attributes such as net operating losses and foreign tax credits to reduce the U.S. tax on gain recognized because of the transfer during that period of stock or other properties to a related foreign person or on any income received because of a license of property to such a person.[91]

One would have thought that the statute itself would have defined the scope of the anti-expatriation policy. Again deploying section 367 — this time section 367(b) — the IRS begged to differ and proceeded to go beyond the results that section 7874 prescribed. As background, in furtherance of section 367's function to backstop section 1248, when a U.S. person that has met the section 1248 stock ownership requirement for a foreign corporation during the previous five years exchanges stock in that corporation for stock in another foreign corporation, the U.S. person will not include any income under section 367(b) if, immediately after the exchange, the stock received is stock in a CFC in which the U.S. person satisfies the section 1248 stock ownership requirements and the acquired corporation is a CFC in which the U.S. person satisfies those requirements.[92] Together with a rule under the section 1248 regulations that attributes to the acquiring corporation stock received in the nonrecognition exchange earnings attributable to the stock exchanged for purposes of a later, taxable disposition covered by section 1248(a) of the acquiring corporation stock, these conditions ensure that a section 1248 toll charge at the time of the nonrecognition exchange is unnecessary to preserve U.S. taxing jurisdiction over earnings that the U.S. person would have recognized as a dividend under section 1248 if, at the time of the nonrecognition exchange, the U.S. person had sold rather than exchanged the shares that it held.[93]

In Notice 2014-52,[94] the IRS announced that it would amend the section 367(b) regulations to require that the U.S. person include the section 1248 amount for its exchanged stock in one situation despite the satisfaction of the stock ownership and CFC conditions for the acquired and acquiring corporations immediately after the exchange. The U.S. person must include the section 1248 amount when (1) the exchanged stock is stock in a CFC in which a domestic corporation that has expatriated in a transaction covered by section 7874 is a U.S. shareholder; (2) the stock received, although stock in a CFC, is not stock in which the expatriated domestic corporation is such a shareholder; and (3) the exchange occurs within the 10-year period beginning with the inversion, during which the statute limits the use of U.S. tax attributes in reducing taxable gain on property transferred to or income on royalties received from a foreign related person.[95]

In an example provided by Notice 2014-52,[96] an expatriated U.S. corporation (DT) exchanges all the stock of its CFC (FT) solely for 60 percent of the stock of FS, a foreign corporation in which, before the exchange, the new foreign parent (FA) owned all the shares and in which DT was thus not a U.S. shareholder. The example concludes that DT must include in income its section 1248 amount for the FT stock exchanged, even though the FS stock received by DT in the exchange is stock in a CFC for which DT satisfies the section 1248 stock ownership requirements and FT is also a CFC for which DT satisfies those requirements.

[89]Sen. Chuck Grassley, R-Iowa, and former Sen. Max Baucus. *See generally* Martin A. Sullivan, ''Lessons From the Last War on Inversions,'' *Tax Notes*, May 26, 2014, p. 861.

[90]Section 7874(b).

[91]Section 7874(d)(1), (d)(2), (e)(1), and (d)(3).

[92]Reg. section 1.367(b)-4(b)(1)(i).

[93]Reg. section 1.1248-8(b)(2)(ii).

[94]2014-42 IRB 712.

[95]Notice 2014-52, section 3.02(e)(ii).

[96]*Id*. at section 3.02(e)(iii), Example 3.

Because the stock ownership and CFC status conditions are satisfied for FS immediately after the exchange, the amount that DT would have included under section 1248 had it sold the FT shares rather than exchanged them for FS shares would generally[97] have been preserved in the FS shares received. Thus, the purpose of this provision is to prevent the loss of U.S. taxing jurisdiction over the 40 percent of FT's future earnings that would have been included in DT's section 1248 amount for its FT shares had it not transferred them to FA. That the United States has acquired, in return, taxing jurisdiction over 60 percent of FS's earnings that would have been outside U.S. taxing jurisdiction had the exchange not occurred is of no consequence. The provision therefore not only accelerates the tax on earnings already accrued (with no threat of loss of taxing jurisdiction) but also asserts U.S. taxing jurisdiction over earnings yet to be derived that the United States would not have taxed absent the transaction. It is thus difficult to see the provision as doing anything other than deterring a U.S. person from diverting a future flow of earnings outside U.S. taxing jurisdiction, even though all accrued earnings and inherent gain in shares remain subject to that jurisdiction. The history of section 367 does not appear to provide any basis for this position.

In Notice 2015-79,[98] the IRS announced that it would expand the amendment set out in Notice 2014-52 to require the U.S. shareholder to include, in the circumstances described in the earlier notice, not only the section 1248 amount for the stock in the CFC exchanged but also all gain exceeding the section 1248 amount. The IRS explained:

> The Treasury Department and the IRS are concerned that certain nonrecognition transactions that dilute a U.S. shareholder's ownership of an expatriated foreign subsidiary may allow the U.S. shareholder to avoid U.S. tax on unrealized appreciation in property held by the expatriated foreign subsidiary at the time of the exchange. This could occur when the amount of realized gain in the stock of the expatriated foreign subsidiary that is exchanged in the specified exchange exceeds the earnings and profits attributable to such stock for purposes of section 1248. For example, at the time of the exchange, the expatriated foreign subsidiary could hold valuable self-developed intangible property that has not yet been brought to market and therefore has not generated any significant earnings and profits. Any unrealized appreciation in the intangible property, when recognized by the expatriated foreign subsidiary after the exchange, would create earnings and profits that are attributable to gain that economically had accrued at the time of the exchange.

The IRS expands the example from the earlier notice, discussed above, to require DT to include at the time of the exchange not only its section 1248 amount for the FT stock but also any gain in its FT shares in excess of the section 1248 amount. This expansion cannot be justified, for the same reason that the earlier amendment cannot: The appreciation in the assets, reflected in the FT shares, is also reflected in the FS shares received by DT. Moreover, section 1248, designed to preserve taxing jurisdiction over E&P, cannot supply a rationale for accelerating gain recognition on property exchanged for substituted basis property in a transaction in which gain would not otherwise be recognized currently. Of course, the value of FT's or FS's assets and therefore the value of the FT or FS stock could decline after the exchange, but there appears to be no tax policy or provision that would require gain recognition on the exchange because of that possibility. Thus, the rationale for section 367's calling off

[97]There may be situations in which transactions after the exchange but before DT's later sale of its FS stock may divert pre-reorganization FT E&P to a shareholder other than DT. These might include a non-pro-rata distribution of some of the FS stock or a transfer by FA of its FS stock to another person when FT has a deficit in E&P in one or more years. However, that effect would arise from features of the section 367(b) regulations, the section 1248 regulations, or both. It would not be peculiar to an inverted structure (although the IRS might argue that an inverted structure, permitting as it does the holding of a portion of the FS stock outside the U.S. group, facilitates the exploitation of those features). Moreover, the post-exchange transaction siphoning off of E&P may never be undertaken. The appropriate response, if permitted under the section 367(b) or section 1248 regulations, would therefore be to amend those regulations to negate the effect such post-exchange transactions would have on FT's and FS's E&P, regardless of whether the exchange was undertaken in connection with an inversion. It is inappropriate to suspend only in connection with an inversion the general rule that an otherwise nontaxable exchange does not trigger the inclusion of a section 1248 amount to the exchanging shareholder when after the exchange the target remains a CFC with the same, albeit now indirect, U.S. shareholder.

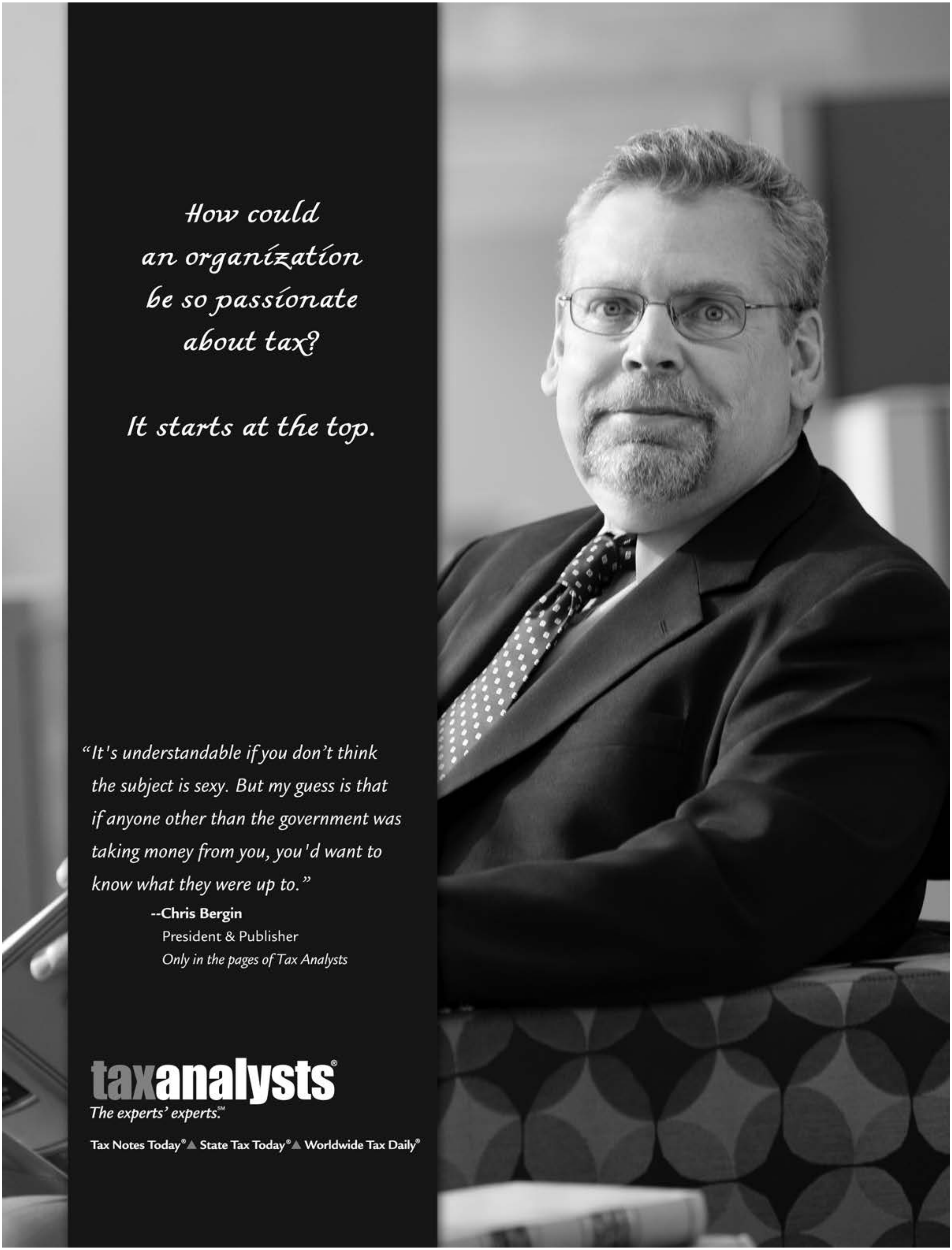
[98]2015-49 IRB 775, section 3.02(b).

a specified nonrecognition provision (presumably section 354) would not appear to apply.[99]

[99]The IRS incorporated these rules into temporary regulations issued on April 8, 2016 (T.D. 9761). *See* reg. section 1.367(b)-4T(e). The regulations also introduced a new rule requiring the foreign subsidiary of an expatriated U.S. corporation to recognize realized gain that would otherwise qualify for nonrecognition under section 351 on the transfer of an asset to a foreign corporation. Reg. section 1.367(b)-4T(f). The preamble explains:

> Absent such a rule, the transfer could dilute a United States shareholder's indirect interest in the property and, as a result, could allow the United States shareholder to avoid federal income tax on realized gain that is not recognized at the time of the transfer. For example, under section 351, an expatriated foreign subsidiary could transfer appreciated intangible property to a transferee foreign corporation in connection with a transfer by a non-CFC foreign related person to the transferee foreign corporation. Realized gain in the transferred property that is not recognized at the time of the transfer would, when recognized by the transferee foreign corporation after the transfer, create earnings and profits that are attributable to gain that economically had accrued within the federal income tax system at the time of the transfer (Emphasis supplied.)

Again, the gain is preserved in the shares of the transferee foreign corporation received by the transferor. The policy of section 1248, moreover, extends only to the preservation of U.S. taxing jurisdiction over earnings realized while a CFC owned the property generating the earnings. Finally, contrary to the assertion in the italicized language, the yet-to-be-realized earnings reflected in the gain might never materialize.


How could
an organization
be so passionate
about tax?
It starts at the top.
"It's understandable if you don't think the subject is sexy. But my guess is that if anyone other than the government was taking money from you, you'd want to know what they were up to."
--Chris Bergin
President & Publisher
Only in the pages of Tax Analysts
taxanalysts®
The experts' experts.℠
Tax Notes Today® ▲ State Tax Today® ▲ Worldwide Tax Daily®