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By Peter M. Daub

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The first part of this two-part report showed that, beginning with its original enactment in 1932 and 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 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 other than one reflected in a specified provision. It also discussed how, in promulgating recent guidance aimed at retaining U.S. taxing jurisdiction over persons that have left it, the IRS has departed significantly from that understanding.

This part of the report shows how the IRS has began to pursue other goals such as subjecting 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 sense, and expanding the reach of U.S. taxing jurisdiction over income earned by foreign subsidiaries that has not been repatriated. It concludes with observations about how the IRS's departures from the decades'-long agreement about the proper scope of section 367 may be challenged.

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B. Repatriation

The chief focus of the guidance released under section 367 in the last 10 years, in contrast with the guidance issued in the 1990s, has been not inversions but what the IRS perceives as the illegitimate repatriation by U.S. multinationals of funds or other property without U.S. tax. As described below, in its efforts the IRS has arguably exceeded the historical function of section 367 and, in doing so, has created tension with basic U.S. income tax principles that conflict with its goals.

1. Return of basis. There are probably few U.S. tax principles more foundational than that gross income includes the amount realized from the sale or exchange of property only to the extent that the amount exceeds the taxpayer's basis in the property.[100] Under the statutory scheme, gross income includes ''gains from dealings in property,''[101] and ''the gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided . . . for determining gain.''[102] Regulations expand on the latter provision:

> The general method of computing such gain or loss is prescribed by section 1001(a) through (d) which contemplates that from the amount realized upon the sale or exchange there shall be withdrawn a sum sufficient to restore the adjusted basis prescribed by section 1011 and regulations thereunder (i.e., the cost or other basis adjusted for receipts, expenditures, losses, allowances, and other items chargeable against and applicable to such cost or other basis). The amount which remains after the

[100]Cases have suggested that this principle is founded in the U.S. Constitution, because the 16th Amendment allows tax to be assessed only on income and basis in contrast represents the taxpayer's invested capital. *See, e.g.*, *Anderson Oldsmobile Inc. v. Hofferbert*, 102 F. Supp. 902 (D. Md. 1952). *See also Pittsburgh Milk Co. v. Commissioner*, 26 T.C. 707, 715 (1956) (''Under both the Sixteenth Amendment and the Internal Revenue Code, the tax is imposed only on 'income['']. . . . Gains are taxed . . . but no more than the actual gross income can be subjected to income tax, in any event.'').
[101]Section 61(a)(3).
[102]Section 1001(a).

> adjusted basis has been restored to the taxpayer constitutes the realized gain. If the amount realized upon the sale or exchange is insufficient to restore to the taxpayer the adjusted basis of the property, a loss is sustained to the extent of the difference between such adjusted basis and the amount realized.[103]

Section 356, one of the provisions enumerated by both section 367(a) and (b), reflects these principles. It provides that if an exchanging shareholder in a reorganization receives not only stock of a party to the reorganization but also other property, the shareholder recognizes gain only to the extent of that other property received (the boot within gain limitation).[104] In other words, the exchanging shareholder includes in income the amount of the property received, but only to the extent of the shareholder's gain on the transaction. (Section 351(b), another provision cited by section 367(a), similarly provides that a transferor of property to a corporation in an exchange for its stock and other property otherwise qualifying for nonrecognition under section 351(a) includes the amount of the other property in income to the extent of the transferor's realized gain.) It is important to emphasize that these provisions reflect rules in the code outside subchapter C and general precepts because one principle of section 367 is that, in calling off the application of a subchapter C provision, it cannot produce a result that would not follow under extra-subchapter C provisions and principles. For example, if a shareholder exchanges stock in which he has a basis of $100 for stock and other property together worth $100, section 367 cannot require the shareholder to recognize income even if it calls off the application of section 356.

There are, of course, provisions in subchapter C (and perhaps other parts of the code) that override the basic principle that a person that realizes proceeds from the sale or exchange of property includes them in income only to the extent that they exceed the person's basis in the property. The "brother-sister" subsection of section 304,[105] the noteworthy subchapter C provision in this regard, often operates to require that a person that controls two corporations and sells the stock in one of them to the other corporation in exchange for non-stock property to include in gross income as a dividend some or all of the consideration, regardless of the basis the person has in the shares of either corporation. Importantly, however, before this provision was enacted in 1954, the IRS lost a series of cases in which it had urged the result that section 304 now provides but in which the courts sustained the taxpayer's sale treatment and recovery of basis.[106]

For several years the administration has proposed to repeal the boot within gain limitation,[107] so far without success. Nonetheless, beginning in 2006, in its efforts to tax otherwise tax-free repatriation, the IRS has effectively deployed its regulatory authority under section 367 against the boot within gain limitation. Equally if not more important, it has done so in a way unjustified by the historical purpose of section 367.

a. Notice 2008-10. Notice 2008-10,[108] issued December 28, 2007, presents the following facts:

> USP, a domestic corporation, owns 100 percent of the stock of FA, a foreign corporation, and USP's basis in its FA stock is $100x. USP also owns 100 percent of the stock of UST, a domestic corporation, and USP's basis in its UST stock equals its fair market value of $100x. UST's property consists of property with zero tax basis, such as self-created intangibles or fully depreciated tangible property. UST sells its property to FA in exchange for $100x cash and, in connection with the transaction, UST liquidates and FA transfers all the property acquired from UST to U.S. Newco, a newly formed domestic corporation, in exchange for 100 percent of the U.S. Newco stock (the transaction).

Although the notice does not so state, the transaction should qualify as an all-cash reorganization under section 368(a)(1)(D) of UST into FA in which USP receives, in exchange for its UST shares, $100x in cash and a nominal FA share,[109] followed by a

[103]Reg. section 1.1001-1.
[104]Section 356(a)(1).
[105]Section 304(a)(1).

[106]*See, e.g.*, *Trianon Hotel Co. v. Commissioner*, 30 T.C. 156 (1958).
[107]Treasury, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals," at 114-116 (Feb. 2016); Treasury, "General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals," at 119-121 (Feb. 2015); Treasury, "General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals," at 96-97 (Mar. 2014); Treasury, "General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals," at 91-92 (Apr. 2013); Treasury, "General Explanations of the Administration's Fiscal Year 2013 Revenue Proposals," at 133 (Feb. 2012); Treasury, "General Explanations of the Administration's Fiscal Year 2012 Revenue Proposals" (Feb. 2011); Treasury, "General Explanations of the Administration's Fiscal Year 2011 Revenue Proposals" (Feb. 2010); Treasury, "General Explanations of the Administration's Fiscal Year 2010 Revenue Proposals" (May 11, 2009).
[108]2008-1 C.B. 277.
[109]Section 368(a)(1)(D) provides that a reorganization includes "a transfer by a corporation [UST] of all or a part of its assets to another corporation [FA] if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before

(Footnote continued on next page.)

drop-down by FA of the assets received from UST to U.S. Newco. (Under authorities published by the IRS, the drop-down does not affect the qualification of the previous steps as a section 368(a)(1)(D) reorganization.[110])

Leaving aside the application of section 367, UST would not recognize gain on the exchange of property for the nominal FA share and the cash under section 361(a)[111] and (b),[112] respectively, and on the distribution of that property to USP under section 361(c)(1).[113] Because USP has a fair market value basis in its UST shares, it would not recognize gain under section 356(a) because of the application of the boot within gain limitation.

As indicated, section 361(a) and (b) describes UST's exchange of its property for the nominal FT share and cash — that is, UST, a party to the reorganization, exchanges its property, in pursuance of the plan of reorganization, for stock of another party (FT) and other property. Accordingly, section 367(a)(5) would require UST to recognize its gain in the property unless appropriate adjustments are made to the basis in USP's FT shares.[114] Also, although UST does not actually transfer any stock to FT, under the indirect stock transfer regulations in effect when the ruling was issued and continuing in effect,[115] UST is treated as exchanging stock in U.S. Newco for stock in FT. The idea behind this construct is that the transfer by a U.S. person (UST) of its assets to a foreign corporation (FT), followed by a drop-down of those assets to a controlled U.S. corporation (U.S. Newco), is the functional equivalent of the transfer by the U.S. person of its assets to the controlled U.S. corporation in exchange for its shares, followed by the transfer by the U.S. person of the stock of the controlled U.S. corporation to the transferee foreign corporation in exchange for its shares.

When Notice 2008-10 was issued, the regulations contained rules coordinating UST's actual asset transfer with its deemed stock transfer. (With modifications, those rules are still in effect.) The general rule is that both the asset and stock transfer rules apply, with the asset transfer rules applying first.[116] When, however, as in this case, the indirect stock transfer rules apply because a U.S. person (UST) transfers assets to a foreign corporation (FA) in exchange for its shares, followed by a drop-down of the assets by the foreign corporation to a controlled U.S. corporation (U.S. Newco), section 367(a) does not apply to the actual asset transfer, assuming the controlled U.S. corporation's (U.S. Newco's) basis in the transferred assets does not exceed the basis that

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the transfer) [USP], or any combination thereof, is in control of the corporation to which the assets are transferred [FA]; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred [FA] are distributed in a transaction which qualifies under section 354." Under regulations, since the value of the consideration ($100x in cash) received by the transferor in the transaction (UST) equals the FMV of the transferor corporation's assets, the transferee corporation (FA) is deemed to issue, in addition to the actual consideration, a nominal share of stock in exchange for the transferor's assets. This share is then deemed distributed by the transferor corporation to the shareholder (USP) of the transferor corporation as part of the exchange for the stock of the shareholder. Reg. section 1.368-2(l)(2)(i). Thus, the transaction satisfies the requirement that the transferee's stock be distributed. The distribution forms part of a transaction qualifying under section 354, since (1) USP exchanges stock in UST in part for stock in FA, both parties to the reorganization (section 354(a)(1)); (2) the corporation to which the assets are transferred (FA) acquires substantially all of the assets of the transferor (UST) (section 354(b)(1)(A)); and (3) the stock (the nominal FA share) and other properties (the $100x in cash) received by the transferor (UST) are distributed in pursuance of the plan of reorganization (section 354(b)(1)(B)).

[110]Rev. Rul. 2002-85, 2002-2 C.B. 986; reg. section 1.368-2(k)(1)(ii), -2(k)(2), Example 6.

[111]Section 361(a) provides that "no gain or loss shall be recognized to a corporation if such corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation [that is] a party to the reorganization." Accordingly, except as section 367 provided, UST would not recognize any gain upon the exchange of its property for a nominal share in FA as part of the D reorganization.

[112]Section 361(b) provides that if section 361(a) "would apply to an exchange [that] consists not only of stock or securities permitted by subsection (a) to be received without the recognition of gain, but also of other property or money, then . . . [i]f the corporation receiving such other property or money distributes it in pursuance of the plan of reorganization, no gain to the corporation shall be recognized from the exchange." Because UST distributes all the cash it receives from FA in the D reorganization, UST would not, except as section 367 provided, recognize any gain upon the exchange of its property for cash as part of the D reorganization.

[113]Section 361(c)(1) provides that "no gain or loss shall be recognized to a corporation [that is] a party to a reorganization on the distribution to its shareholders of property in pursuance of the plan of reorganization," except that this nonrecognition rule does not apply if "the corporation distributes property other than qualified property, and the fair market value of such property exceeds its adjusted basis (in the hands of the distributing corporation)." The term "qualified property" means "any stock in (or right to acquire stock in) the distributing corporation or obligation of the distributing corporation" and "any stock in (or right to acquire stock in) another corporation which is a party to the reorganization or obligation of another corporation which is such a party if such stock (or right) or obligation is received by the distributing corporation in the exchange." Section 361(c)(2)(B). Because the nominal FA share was the only appreciated property distributed by UST and the nominal FA share is qualified property (since it is stock in another party that was a party to the reorganization), UST would not, except as section 367 provided, recognize any gain under section 361(c).

(Footnote continued in next column.)

[114]*See supra* text accompanying Part 1, note 55.

[115]Reg. section 1.367(a)-3(d)(1)(v), -3(d)(2)(i), and -3(d)(2)(iii). T.D. 9243.

[116]Reg. section 1.367(a)-3(d)(2)(vi)(A).

the U.S. transferor (UST) had in the assets — the idea being that the gain on the transferred assets remains subject to U.S. taxing jurisdiction[117] — and the transaction satisfies the conditions of one of two alternative exceptions. U.S. Newco's basis in the assets should be the same as UST's basis in them, so the question becomes whether one of the two alternative exceptions applies.

The exception at issue in Notice 2008-10 — dubbed ''Exception One'' by the notice — provides:

> The domestic acquired corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions as provided in regulations under section 367(a)(5) are satisfied.[118]

Recall that, to protect the integrity of *General Utilities* repeal, section 367(a)(5) requires that the transferor domestic corporation in an outbound asset reorganization recognize gain on the transferred assets unless, under prescribed regulations, five or fewer domestic corporations control the transferor and the gain can through basis adjustments be preserved in their shares in the foreign transferee. Incidence of the corporate-level tax is thereby effectively shifted to the corporate shareholders. Presumably, drawing on this gain preservation notion, the theory of Exception One is that section 367(a) should not apply to the outbound asset transfer, assuming the gain in the assets can be preserved in the FT shares through a basis reduction. Indeed, since U.S. Newco acquires the assets with a carryover basis, it could be subject to tax on the same gain. (As made clear by an example in the regulations, the gain on the U.S. Newco shares indirectly deemed transferred by UST to FA would be preserved since UST's GRA requires it to recognize that gain if there is a triggering event regarding it.[119]) Thus, assuming USP has sufficient basis in its FA shares, the gain on the assets actually transferred is preserved at least once and arguably twice; the gain on the shares deemed transferred is preserved through the GRA mechanism.

The language of Exception One does not specify whether the negative basis adjustment has to be made in shares in the foreign acquiring corporation received by the exchanging shareholder in the transaction or whether they could be made to shares that the exchanging shareholder already owned. The IRS indicates that some taxpayers were taking the position that the adjustments could be made to the previously owned shares. The problem? ''The IRS and Treasury are aware that certain taxpayers are engaging in transactions intended to repatriate cash or other property from foreign subsidiaries without the recognition of gain or a dividend inclusion.'' The solution: The adjustments can be made only to shares received in the transaction; to the extent the exchanging shareholder has insufficient basis in those shares, ''the U.S. transferor's transfer of property to the foreign acquiring corporation shall be subject to sections 367(a) and (d).''[120] Since, in the notice's example, USP receives only a nominal share in FT, this rule would require UST to recognize all the gain in its assets transferred to FA. This treatment is effective for transactions on or after the date the notice was issued.

As the IRS correctly points out in Notice 2008-10, the relevant congressional committee reports indicated that section 367(a)(5) would not require gain recognition only if the exchanging U.S. corporate shareholder made appropriate adjustments to the basis in acquiring corporation stock ''received'' in the transaction.[121] Thus, according to the IRS, the gain ''must be preserved in the stock *received*'' (emphasis supplied). The IRS thought it had to take this position even though the statute itself does not distinguish between stock received and stock previously held, and even though, in at least one other respect, the IRS has not followed the literal language of the legislative history.[122] Clearly, however, the reduction in any basis in the acquiring corporation's shares equal to the amount of the gain in the transferred assets would fulfill section 367(a)(5)'s *General Utilities* repeal objective.

Thus, although the IRS indicates that it will promulgate a rule (as it eventually did) under its authority to issue regulations under section

[117]REG-125628-01.

[118]Former reg. section 1.367(a)-3(d)(2)(vi)(B)(1)(i) (2006).

[119]Former reg. section 1.367(a)-3(d)(3), Example 6B (2006).

[120]Proposed regulations issued in 2008 (REG-209006-89) incorporated this rule with modifications, but after becoming ''aware of additional transactions involving outbound asset reorganizations that involve the repatriation of earnings and profits of a foreign corporation where taxpayers take the position that the transaction does not require the recognition of gain or a dividend inclusion,'' the IRS eliminated Exception One. T.D. 9615.

[121]*See supra* Part 1, note 55.

[122]The quoted legislative history provided that the exchanging shareholder's basis in the acquiring corporation's stock is the lesser of what it otherwise would have been under section 358 and the shareholder's share of the corporate transferor's bases in the transferred assets. However, the regulations ultimately provided that the basis would be the section 358 basis reduced by any excess of the transferor's gain in its assets over the shareholder's outside gain in its shares (using the shareholder's section 358 basis for this purpose). Reg. section 1.367(a)-7(c)(3)(i)(A).

367(a)(5), the rule was unnecessary to fulfill the policy of that provision. Because of the statement in the legislative history and the technical incidence of tax on UST rather than USP under the notice, the notice's position might not exceed the IRS's authority. If, however, USP had no basis in its UST shares, section 356 would have required USP to include $100x. Thus, there is only one reason, having nothing to do with section 367(a)(5), that the IRS requires the fulfillment of section 367(a)(5)'s objective through a reduction in USP's basis in the nominal FA share received and through gain to UST in the amount of the excess of the total consideration over USP's basis in that share. The reason is that USP has an FMV basis in its UST shares and thus under section 356 could not be taxed on the exchange. Effectively, the notice uses section 367(a)(5) to require gain recognition by UST in lieu of the recognition of the dividend that USP would have included under section 301(c)(1) if it had received a distribution of earnings from FA.

Even if section 356 did not exist, USP would not, under sections 61 and 1001 and general principles, recognize gain on its exchange of UST shares for the nominal FA share and $100x in cash. Thus, the notice's position appears to violate the purpose of section 367 to effectuate fundamental U.S. tax policies. (A possible response might be that if section 361 did not exist, UST would be taxed on its transfer of assets to FA in exchange for FA shares.)

In any event, not only is the IRS's position overbroad in effectuating section 367(a)(5) policy, but no other section 367 policy accounts for the overbreadth. Although the IRS states that otherwise untaxed repatriation of foreign property prompted the notice, as described above, the anti-repatriation-without-tax policy of section 367 extends only to preventing, through the operation of sections 354 and 332, distortive inheritance of tax attributes. Since the U.S. group does not inherit FA's tax attributes, there is no such distortion. After the notice's rule applies, FA retains its tax attributes, ready for a toll-charge-triggering transfer by reason of its liquidation or reorganization into the U.S. group. It also retains its earnings, available for distribution and taxation as dividends under section 301(c)(1). It is no response to say that the taxpayer has through section 356 avoided the application of section 301(c)(1). Section 356 applies, and section 301(c)(1) does not apply, because USP has received property in exchange for its UST stock, not in a distribution with respect to its UST stock. That subchapter C taxes the exchanging shareholder in a reorganization differently than a shareholder receiving a distribution from a corporation on its stock is fundamental. There is no apparent reason — certainly no reason expressed by Congress — why this difference is any less fundamental when the shareholder is a U.S. person and the corporation is foreign.

Thus, the taxpayer has not circumvented any provision through application of the reorganization provisions to a cross-border transaction. Indeed, one could argue that by effectively imposing on the group a shareholder-level tax without reducing FA's earnings, the rules in the notice create the possibility for two taxes on the same earnings.

b. Notice 2012-39. These themes come into even starker relief in the IRS's next effort to overcome the boot within gain limitation and the calculation of gain that underlies it. Notice 2012-39,[123] issued on July 13, 2012, presents the following facts:

> USP, a domestic corporation, owns 100 percent of the stock of UST, a domestic corporation. USP's basis in its UST stock equals its value of $100x. UST's sole asset is a patent with a tax basis of zero. UST has no liabilities. USP also owns 100 percent of the stock of TFC, a foreign corporation. UST transfers the patent to TFC in exchange for $100x of cash and, in connection with the transfer, UST distributes the $100x of cash to USP and liquidates.

For the reasons described in connection with Notice 2008-10, the transaction should constitute an all-cash D reorganization — this time, however, without a drop-down. Leaving aside the application of section 367, UST would not recognize gain on the exchange of the patent for the cash and a nominal TFC share under section 361(b) and (a), respectively, or on the distribution of that property to USP under section 361(c)(1). Because USP has an FMV basis in its UST shares, it would not recognize gain under section 356(a) because of the application of the boot within gain rule.

Since section 936(h)(3)(B)[124] describes the patent, section 367(d), and not section 367(a), modifies the section 361 consequences of UST's transfer of the patent to TFC. Section 367(d) provides:

> (1) In general
>
> Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361 —

[123]2012-31 IRB 95.

[124]Section 367(d) applies to ''intangible property (within the meaning of Section 936(h)(3)(B)),'' and section 936(h)(3)(B) includes within the definition of intangible property ''any patent.'' *See* sections 367(d)(1) and 936(h)(3)(B)(i).

> (A) subsection (a) shall not apply to the transfer of such property, and
>
> (B) the provisions of this subsection shall apply to such transfer.
>
> (2) Transfer of intangibles treated as transfer pursuant to sale of contingent payments
>
> (A) In general
>
> If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as —
>
> (i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and
>
> (ii) receiving amounts which reasonably reflect the amounts which would have been received —
>
> (I) annually in the form of such payments over the useful life of such property, or
>
> (II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition.
>
> The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.

Notice 2012-39 indicates that the taxpayer takes the position that neither USP (presumably under section 356(a)) nor UST (presumably under section 361) recognizes gain or dividend income on the receipt of the $100x in cash. Under section 367(d)(2)(A)(ii)(I) and its implementing regulations,[125] according to the IRS, the taxpayer includes amounts in income in subsequent years. As permitted by the regulations,[126] the taxpayer establishes a receivable from TFC in the amount of USP's aggregate income inclusion. Under those regulations, payments can be made equal to the principal amount without any further inclusion by USP. The IRS concludes:

> Accordingly, under these positions, the transactions have resulted in a repatriation in excess of $100x ($100x at the time of the reorganization and then through repayment of the receivable in the amount of USP's income inclusions over time) while only recognizing income in the amount of the inclusions over time.[127]

The IRS indicates it will issue regulations (which it has not yet done) as follows to address the perceived problem in this transaction:

> The U.S. transferor will take into account income under section 367(d)(2)(A)(ii)(I) with respect to each qualified successor, if any, by treating as a prepayment of such income the product of the section 367(d) percentage multiplied by the sum of: (i) the money and fair market value of other property (within the meaning of section 356) received by the qualified successor in exchange for, or with respect to, stock of the U.S. transferor, reduced by the portion of any U.S. transferor distributions received by the qualified successor. As a prepayment of such income, the amount is included in income by the U.S. transferor in the year of the outbound section 367(d) transfer, regardless of the productivity of the transferred section 367(d) property in the year of the transfer or in subsequent years.[128]

A qualified successor is generally a shareholder of the U.S. transferor that is a domestic corporation, if that shareholder receives qualified stock in the reorganization or immediately after the reorganization owns qualified stock other than that received in the reorganization.[129] Qualified stock is stock in the transferee foreign corporation, including stock received in the transferee foreign corporation under section 354 or 356 in exchange for or on stock of the U.S. transferor.[130] The section 367(d) percentage is the ratio of the aggregate value of the section 367(d) property (property described in section 936(h)(3)(B)[131]) transferred by the U.S. transferor to the transferee foreign corporation in the section 361 exchange, to the aggregate value of all property (in other words, all section 367(a) and section 367(d) property) transferred by the U.S. transferor to the transferee foreign corporation in the section 361 exchange.[132] The treatment prescribed by the IRS applies to outbound section 367(d) transfers occurring on or after the date the notice was issued.

The shares in TFC that USP owns before the transaction and the nominal share in TFC that it receives in the transaction are stock in the transferee foreign corporation and thus qualified stock. USP is a qualified successor to UST because it is a corporate shareholder in UST, and both receives qualified stock (the nominal share in TFC) in the transaction

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[125]Reg. section 1.367(d)-1T(c)(1).

[126]Reg. section 1.367(d)-1T(g)(1).

[127]Notice 2012-39, section 3.

[128]*Id*. at section 4.02.

[129]*Id*. at section 4.05(5).

[130]*Id*. at section 4.05(4).

[131]*Id*. at section 4.05(3) (defining section 367(d) property as any property described in section 936(h)(3)(B)).

[132]*Id*. at section 4.05(6).

and owns after the transaction qualified stock not received in the transaction (the shares in TFC owned before the transaction). Since the only property transferred to TFC is property described in section 936(h)(3)(B), the section 367(d) percentage is 100 percent. The qualified successor (USP) receives $100x in money in exchange for stock of the U.S. transferor (UST) and has not received any distributions from UST. Accordingly, UST must take into account income under section 367(d)(2)(A)(ii)(I) regarding USP by treating as a prepayment of that income the product of the section 367(d) percentage (100 percent) and $100x.

The first thing to notice about the rule illustrated by this example is that there is at least a question whether it complies with the statutory language. Section 367(d)(1) gives the IRS authority (''except as provided in regulations prescribed by the Secretary'') not to apply section 367(d) to a particular category of outbound transfers of section 936(h)(3)(B) property. However, once the IRS determines that section 367(d) applies to the transfer, the transferring U.S. person must be treated as transferring that property in exchange for payments contingent on the productivity, use, or disposition of the property and as receiving amounts that reasonably reflect the amount that would have been received annually in the form of those payments over the useful life of the property.

Notice 2012-39 states that ''as a prepayment'' the lump sum must be included in the year of the transfer ''regardless of the productivity'' of the transferred property. Yet the statutory language suggests that all ''payments'' must be contingent on productivity, use, or disposition. In a later section of the notice, the IRS requires the qualified successor to include annual amounts for the transferred intangible in income and allows a credit against those annual inclusions for the lump sum.[133] Perhaps the IRS implicitly argues that this credit endows the lump sum with the required contingency, but there is no mechanism for refund of the tax on the lump sum should it exceed the aggregate annual payments. Also, the statute requires the receipt of amounts that ''reasonably reflect the amounts which would have been received annually in the form of such payments over the useful life of such property.'' There is some question whether a lump sum received in the year of the transfer can be a reasonable reflection of amounts that would have been received annually in the form of contingent payments. For these reasons, the IRS arguably lacks authority to require UST to include the lump sum in the year of the transfer and must require the transferor to include it over the useful life of the patent.

Of course, the difficulty is that UST disappears in the transaction. However, the IRS's own regulations supply an answer to this problem. When a U.S. person transfers property under section 367(d) to a foreign corporation in a section 361 exchange and, within the useful life of the property, the U.S. transferor transfers the stock in the foreign transferee to a related U.S. person, the related U.S. person steps into the shoes of the transferor and includes the annual payments in the transferor's stead.[134] Thus, the regulations as written would have fulfilled the section 367(d) policy by requiring USP to include annually amounts in income, contingent on the patent's productivity, use, or disposition.

What appears to have bothered the IRS, however, is that under the regulations, USP could establish a receivable for each inclusion of contingent income and repatriate an amount equal to each inclusion without an additional inclusion. Because the repatriated cash matches the inclusion, that makes economic sense, but what of the $100x received in year 1? USP receives that in exchange for its UST stock. Since USP has a $100 basis in the stock, under section 356(a), there is no tax on that exchange.

So again, just as in Notice 2008-10 the IRS invoked its authority under section 367(a)(5) to overcome the operation of section 356(a), in Notice 2012-39, the IRS invokes its (much more questionable) authority under section 367(d) to overcome the effect of the same provision. The implications of the IRS's position parallel those of its position in Notice 2008-10 in two additional ways. First, in conflict with the historical purpose of section 367, it strikes at the pervasive U.S. income tax concept that proceeds from an exchange are recognized as gain only to the extent they exceed basis. Second, just as the *General Utilities* repeal avoidance purpose of section 367(a)(5) did not justify Notice 2008-10, the anti-income-distortion policy of section 367, and in particular section 367(d), does not justify the prepayment concept, since the periodic inclusions required by the statute would have satisfied the policy in any event.

In at least two respects, however, Notice 2012-39 represents a more expansionary view of section 367's role than does Notice 2008-10. Although the IRS could point to a statement in the legislative history underlying section 367(a)(5), albeit irrational, to support its position in Notice 2008-10, no such support exists for its position in the later notice. Further, the general rule of section 367(a) at

[133]*Id*. at section 4.04.

[134]Reg. section 1.367(d)-1T(e)(1).

least cites section 356, the provision that really animates that notice. However, section 367(d), the provision at issue in Notice 2012-39, provides that section 367(a) does not apply to transactions covered by section 367(d), and it, in contrast with section 367(a), does not mention section 356.

2. Triangular reorganizations. Since 2006, under the authority of section 367(b), the IRS has waged a campaign against some aspects of triangular reorganizations as a mechanism for the repatriation of funds without U.S. tax. Section 356, the subchapter C provision at issue in both Notice 2008-10 and Notice 2012-39, is at least mentioned in two section 367 subsections (although, as we have seen, the notices attack yet more fundamental principles).[135] In contrast, the first four iterations of the triangular reorganization guidance did not modify the operation of any subchapter C provision, and the last one modified only the operation of a provision, section 358, not mentioned by section 367 at all. Leaving aside section 358, the IRS's concerns lie outside subchapter C — in section 1032 and in whether transactions on arm's-length terms between related parties should be respected. In this sense, the triangular reorganization guidance represents the apogee of the IRS's efforts to fashion a new section 367 loosened from its historical moorings.

a. Operation of the rules. The first in the series of triangular reorganization notices, Notice 2006-85,[136] generally effective for transactions on or after September 22, 2006 (the date the notice was issued), set out the following example and taxpayer position:

> Assume P, a domestic corporation, owns 100 percent of S, a foreign corporation, and S1, a domestic corporation. S1 owns 100 percent of T, a foreign corporation. S purchases P stock for either cash or a note, and provides the P stock to S1 in exchange for all the T stock in a triangular B reorganization.
>
> Taxpayers take the position that (i) when P sells its stock to S for cash or a note, P recognizes no gain or loss on the sale under section 1032,[137] (ii) S takes a cost basis in the P shares under section 1012, and (iii) S recognizes no gain under section 1.1032-2(c)[138] upon the transfer of the P shares immediately thereafter because the basis and fair market value of the shares are equal. Thus, taxpayers take the position that the cash or note used by S to acquire the P stock does not result in a distribution under section 301.

According to the IRS, the "policy concern" raised by this example is that "the transaction could have the effect of repatriating foreign earnings of S to P without a corresponding dividend to P that would be subject to U.S. income tax."

In claiming that the earnings have been repatriated from S to P, the IRS is wrong. If P receives cash or a note in exchange for its stock, P has not received a distribution on its stock in S that repatriates earnings. It has instead engaged in a purchase and sale transaction with S. If S has earnings, they remain in its corporate solution, available for distribution and taxation as a dividend at a later time.

A key problem for the IRS, as this analysis suggests, is that section 1032(a) broadly provides that gain or loss will not be recognized to a corporation on the receipt of money or other property in exchange for stock (including Treasury stock) of that corporation and that section 367(b) does not specify section 1032 as one of the provisions whose application the IRS can modify under section 367(b) regulations. Indeed, the Obama administration's budget proposal has included the following language, presumably to address the operation of section 1032 in this context:

> Because current law permits a corporation to receive cash without recognizing any income in exchange for issuing its stock, subsidiaries may distribute property tax-free to corporate shareholders in exchange for hook stock issued by such shareholder[s].
>
> . . .
>
> The proposal would disregard a subsidiary's purchase of hook stock for property so that the property used to purchase the hook stock gives rise to a deemed distribution from the purchasing subsidiary (through any intervening entities) to the issuing corporation. The hook stock would be treated as being contributed by the issuer (through any intervening entities) to the subsidiary.[139]

[135]As discussed above, however, the section 367 subsection at issue in Notice 2012-39 — section 367(d) — does not mention section 356.

[136]2006-2 C.B. 677.

[137]Section 1032(a) provides that "no gain or loss shall be recognized to a corporation on the receipt of money or other property in exchange for stock (including treasury stock) of such corporation."

[138]Reg. section 1.1032-2(c) requires S to recognize gain or loss on its exchange of P stock for T stock in a triangular B reorganization if S did not receive the P stock from P under the plan of reorganization.

[139]Fiscal 2016 revenue proposals, *supra* note 107, at 119-121.

As has been its wont in this area, the IRS has not waited for Congress to act and has instead prescribed a similar recharacterization by way of Notice 2008-65 and its successors, which have retained the general structure of the notice but modified it in important respects. Despite the application of general code rules such as section 1032(a), under the current final regulations, issued in 2011[140] and set forth in section 1.367(b)-10, the issuing corporation (P) in a triangular reorganization to which the regulations apply can have an inclusion in gross income as a result of the transaction. With exceptions, reg. section 1.367(b)-10 applies to a triangular section 368(a)(1)(B) reorganization[141] when (1) either P[142] or the acquiring corporation[143] (S) is a foreign corporation, and (2) in connection with the reorganization, S acquires in exchange for "property" (cash or an S note) all or a portion of P's stock used to acquire the stock or assets of the target corporation[144] (T) in the reorganization.[145]

Since (1) S is foreign and (2) in connection with the reorganization, S acquired P stock that was used to acquire stock of T in exchange for cash or an S note, the regulation would apply unless an exception applies.

When reg. section 1.367(b)-10 applies, adjustments are made that have the effect of a distribution of property by S to T.[146] The adjustments are made as if the deemed distribution occurs immediately before the triangular B reorganization in a transaction separate from it.[147] The adjustments are treated as occurring for all purposes of the code.[148]

Under both general code rules and reg. section 1.367(b)-10, the amount of the distribution is its FMV.[149] Thus, the amount of the distribution should be the amount of the cash and/or note.

In accordance with the rule treating the deemed distribution as a distribution for all purposes of the code, "the ordering rules in section 301(c) apply to characterize the deemed distribution."[150] As a result, P includes in its gross income[151] the portion of the distribution that is a dividend (the amount of the distribution to the extent of S's earnings and profits[152]). Amounts deemed distributed in excess of S's E&P are characterized as a tax-free return of capital to the extent of P's basis in its S stock and, thereafter, as gain from the sale or exchange of property.[153]

Under reg. section 1.367(b)-10, P is treated as having contributed to S property with an FMV and basis equal to the value of the property deemed distributed under the regulation.[154] The regulation provides that the deemed contribution "shall be treated as occurring for all purposes of the Internal Revenue Code."[155] Accordingly, P's aggregate basis in its S shares after the deemed distribution should be increased by the amount of the deemed distribution. Since the deemed distribution reduces P's aggregate basis in S by the excess of the amount of the distribution over the portion of it derived from S's E&P, and the deemed contribution increases P's aggregate basis in its S shares by the entirety of the deemed distribution, P's aggregate basis in its S shares after the deemed transactions should be no less than the bases before them.

b. The IRS's construct. As discussed below, the IRS later reconsidered the wisdom of the capital contribution prong of this construct. But does section 367 support any portion of the construct? In form, the IRS's regulations do not affect the tax consequences of the reorganization to its parties and the exchanging shareholder or shareholders, and section 1032 still applies. However, the tax effects of the fictional deemed distribution in the amount of property tendered for P's shares are that (1) S is treated not as having purchased the P shares with property but as having made a section 301 distribution to P in the amount of the purchase price; and (2) P is treated not as having sold its shares but as having contributed them to S.

Authorities, all of which are based on general tax principles and code provisions not mentioned by section 367, suggest that, if the purchase of P shares and the triangular reorganization are conducted on arm's-length terms, there is little justification for treating the transactions other than in accordance with their form — namely, a purchase by S of P stock for use in the reorganization, followed by the

[140]T.D. 9526.

[141]Reg. section 1.367(b)-10(a)(1), -10(a)(3)(iv); reg. section 1.358-6(b)(2)(iv). In a triangular B reorganization, an acquiring corporation exchanges stock in its parent for the stock of the target corporation. Reg. section 1.367(b)-10 can also affect the treatment of parties to a triangular C reorganization. In a triangular C reorganization, the acquirer exchanges its parent's stock for the assets of the target. For ease of explanation, however, the discussion in the text focuses solely on triangular B reorganizations.

[142]Reg. section 1.367(b)-10(a)(3)(i); reg. section 1.358-6(b)(1)(i).

[143]Reg. section 1.367(b)-10(a)(3)(i); reg. section 1.358-6(b)(1)(ii).

[144]Reg. section 1.367(b)-10(a)(3)(i); reg. section 1.358-6(b)(1)(iii).

[145]Reg. section 1.367(b)-10(a)(1).

[146]Reg. section 1.367(b)-10(b)(1).

[147]Reg. section 1.367(b)-10(b)(3).

[148]Reg. section 1.367(b)-10(c)(1).

[149]Section 301(b)(1); reg. section 1.367(b)-10(b)(1).

[150]Reg. section 1.367(b)-10(c)(1).

[151]Section 301(c)(1).

[152]Section 316(a).

[153]Section 301(c)(2) and (3).

[154]Reg. section 1.367(b)-10(b).

[155]Reg. section 1.367(b)-10(c)(2).

reorganization itself. Under section 1032, of course, P does not recognize income on the sale of its shares. So the validity of the IRS's recharacterization of the transaction is critical in sustaining the legality of its position.

Contrary to the IRS's construct, regulations and case law all confirm that a subsidiary's tender of cash or other property to its parent for its stock should be respected as a purchase of the parent's stock, even when, as here, the subsidiary disposes of the stock immediately after its acquisition.[156]

Regulations addressing a subsidiary's use of parent stock in a nontaxable acquisition recognize that a subsidiary's acquisition of parent shares other than through a capital contribution by the parent should be respected. When the subsidiary does not ''receive'' shares of its parent under a plan of reorganization, it must recognize gain or loss on its disposition of the parent shares for the target corporation in a reorganization that is otherwise nontaxable.[157] An example in the regulations calculates the subsidiary's gain by reference to its basis in the parent's stock and thus leaves open the possibility that the subsidiary acquired the stock by purchase.

A chief counsel advice memorandum[158] applies this regulation to a transaction that, like the transaction in the example, was a triangular B reorganization. In the transaction, a subsidiary issued a note to its foreign parent corporation in exchange for its stock, which the subsidiary used to acquire a subsidiary of the parent's foreign sister corporation. The IRS concluded that the regulation ''contemplates a subsidiary purchasing its parent corporation's stock and then using that stock as consideration in a triangular reorganization.''

Similarly, when a parent contributes its stock to its subsidiary in a nonrecognition transaction and the subsidiary immediately uses it to acquire property in a taxable transaction, regulations generally deem the subsidiary to have purchased the stock from the parent with cash contributed by the parent. The same regulations provide that if the subsidiary actually pays FMV for the stock, the parent is not deemed to have contributed any cash to the subsidiary.[159] Thus, the regulations respect the subsidiary's actual purchase of stock from the parent and its immediate disposition of the stock for other property in a taxable disposition.

An example in the consolidated return regulations assumes that a subsidiary's ''purchase'' of its parent's stock that the subsidiary used as consideration in a merger between it and an unrelated target will be respected as a purchase.[160]

Finally, there is at least one case in which a court respected a subsidiary's purchase of its parent's stock. *Litton*[161] involved a triangular reorganization under section 368(a)(1)(C) in which a subsidiary purchased stock from the parent. In *Litton*, the subsidiary needed shares in the parent with a total value of $28 million. The parent contributed $9 million in stock to the subsidiary, and the subsidiary purchased $19 million in stock with its debt. The IRS admitted that the transaction qualified as a reorganization, but it challenged the interest deductions on the intercompany debt on the grounds that it should be treated as equity for federal income tax purposes. By holding that the debt should be treated as true debt, the court respected the form of a transaction in which a subsidiary purchased its parent's stock for use in a reorganization.

Thus, there is little basis for the IRS's construct. Moreover, because section 367 does not reference the provisions that support treating the transaction in accordance with its form (such as section 1032 or other authorities), the regulations appear to violate the section 367 principle that the provision does not provide authority to alter tax consequences that would obtain even outside subchapter C. Finally, since P does not inherit S's or T's tax attributes, section 367(b)'s anti-income-distortion policy is not at stake.

c. Notice 2014-32. On April 25, 2014, the IRS issued the fifth and most recent in its series of notices under section 367(b) concerning triangular

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[156]Numerous cases have rejected attempts by the IRS to recast a sale of assets by a shareholder to a wholly owned corporation as a dividend if the corporation does not ''overpay'' its shareholders for the assets. *See, e.g.*, *Stuchell v. Commissioner*, T.C. Memo. 1978-236 (holding that payments a closely held corporation made to purchase timber transferred from its shareholders under a long-term timber-cutting contract were not a constructive dividend because the contract price and terms were fair and the purchase was bona fide).

[157]Reg. section 1.1032-2(c).

[158]ILM 201340016.

[159]Reg. section 1.1032-3(b).

[160]Reg. section 1.1502-31(g), Example 1(vi). In the example, P, the common parent of a consolidated group, forms a subsidiary, S, with a capital contribution of $100. Six years later, under a plan of reorganization, S ''purchases'' $100 of P stock and merges with the target, T, in a tax-free reorganization under section 368(a)(2)(D), with the T shareholders receiving the $100 of P stock. This example does not identify the transferor of the parent stock to the subsidiary. However, subsequent IRS guidance has interpreted the example as a case in which a subsidiary purchased its parent's stock from the parent. *See* ILM 201340016.

[161]*Litton Business Systems Inc. v. Commissioner*, 61 T.C. 367 (1973). *See also* reg. section 1.358-6(d)(1) (requiring a basis adjustment in a subsidiary reorganization when the subsidiary uses stock of its parent that was not provided by the parent under the plan of reorganization); and reg. section 1.358-6(d)(3), Example (e) (example illustrating the rule).

reorganizations, generally effective for triangular reorganizations completed on or after the day the notice was issued. In Notice 2014-32,[162] the IRS announced that in future regulations it would "revise" reg. section 1.367(b)-10 in the fashion described below. Notice 2014-32 has the effect of increasing the divergence between traditional section 367(b) policy and the triangular reorganization guidance previously and purportedly issued under the provision's authority.

The notice states that Treasury and the IRS "are aware that taxpayers are engaging in transactions designed to avoid U.S. tax by exploiting the deemed contribution provided under the final regulations."[163] It goes on to say that the IRS and Treasury believe that the deemed contribution by P to S in the triangular reorganization, as provided by reg. section 1.367(b)-10(b)(2), is "inconsistent with the purpose of section 1.367(b)-10."[164] The notice indicates that in future regulations the IRS will revise reg. section 1.367(b)-10 to remove the deemed contribution rule. It also announces the following for transactions to which the notice applies (that is, transactions to which reg. section 1.367(b)-10 applies):

> P's adjustment to the basis in its S stock under Section 1.358-6 of the regulations will be determined as if P provided the P stock or securities pursuant to the plan of reorganization, notwithstanding that S in fact acquired the P stock or securities in exchange for property in the P acquisition.[165]

i. The applicability of reg. section 1.358-6. Some explanation of the practical effect of these changes is necessary. Reg. section 1.358-6(c) provides that in a triangular B reorganization:

> P's [issuing corporation's] basis in its S [acquiring corporation] stock is adjusted as if — (i) P acquired the T [target corporation's] stock acquired by S in the reorganization directly from the T shareholders in a transaction in which P's basis in the T stock was determined under section 362(b); and (ii) P transferred the T stock to S in a transaction in which P's basis in its S stock was determined under section 358.[166]

Section 362(b) provides:

> If property was acquired by a corporation in connection with a reorganization to which this part applies, then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain recognized to the transferor on such transfer. This subsection shall not apply if the property acquired consists of stock or securities in a corporation [that is] a party to the reorganization, unless acquired by the exchange of stock or securities of the transferee (or of a corporation which is in control of the transferee) as the consideration in whole or in part for the transfer.

Thus, as confirmed by an example,[167] clause (i) of reg. section 1.358-6(c) appears to hypothesize an acquisition by P of T stock ("stock . . . in a corporation [that is] a party to the reorganization") in exchange for stock in P ("a corporation which is in control of the transferee") directly from T's shareholders in a transaction in which T's shareholders do not recognize gain or loss.[168] On this basis, under section 362(b), P would have the same basis in its T stock that T's shareholders had in that stock. When P is the U.S. parent in a multinational enterprise and T is a long-owned foreign subsidiary, a T shareholder (possibly another member of the U.S. group, S1 in the example in Notice 2006-85) will typically have a low basis in the T shares in relation to their FMV.

As indicated, the second part of the construct would adjust P's basis in its S shares as if P had transferred its newly acquired T shares to S "in a transaction in which P's basis in its S stock was determined under section 358."[169]

Section 358 provides that in an exchange described in section 351 or 354 (among other provisions), the basis of property received without recognition of gain or loss will (with exceptions not relevant here) be the same as that of the property exchanged. The example cited above makes clear that the regulation's reference to section 358 means that, if reg. section 1.358-6(c) results in any positive basis adjustment, P should have, after the transfer of its T stock to S, a basis in its S stock that reflects the (low) basis in the T shares that P is deemed to have inherited from T's shareholder, S1, in addition to the basis that P had in its S stock before the transaction.

[162]2014-20 IRB 1006.
[163]Notice 2014-32, section 3.
[164]*Id*.
[165]*Id*. at section 4.01.
[166]Reg. section 1.358-6(c)(3).

[167]Reg. section 1.358-6(c)(4), Example 3.
[168]The hypothetical transaction would presumably have constituted a B reorganization (*i.e.*, "the acquisition by one corporation, in exchange solely for all or a part of its voting stock . . . of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation") in which T's shareholders did not recognize gain or loss under section 354(a)(1).
[169]Reg. section 1.358-6(c)(3)(ii).

In the absence of the rules announced by the notice, however, reg. section 1.358-6, and thus reg. section 1.358-6(c), should not apply at all.

Reg. section 1.358-6(d) provides that the positive basis adjustment described in reg. section 1.358-6(c) is decreased by "the fair market value of any consideration (including [P] stock in which gain or loss is recognized) that is exchanged in the reorganization and is not provided by [P] pursuant to the plan of reorganization."[170]

If the downward basis adjustment required under reg. section 1.358-6(d) equals or exceeds the positive basis adjustment required under reg. section 1.358-6(c), reg. section 1.358-6 should not apply in its entirety.[171]

The measure of any positive adjustment under reg. section 1.358-6(c) should be the basis in the T shares that P would be deemed to have inherited from S1 under that provision. The "consideration" (in the language of the above-quoted regulation) for those shares presumably has an FMV substantially exceeding that (low) basis. Accordingly, if, in the language of the regulations, P has not "provided" that consideration, the negative adjustment under reg. section 1.358-6(d) would more than offset the positive adjustment under reg. section 1.358-6(c), and the entirety of reg. section 1.358-6 would not apply.

The following examples provide the only guidance in reg. section 1.358-6 on the meaning of the phrase "provided by":

> *(a) Facts*. [T] has assets with an aggregate basis of $60 and fair market value of $100 and no liabilities. [S] is an operating company with substantial assets that has been in existence for several years. [P] has a $100 basis in its [S] stock. Pursuant to a plan, [T] merges into [S] and the [T] shareholders receive $70 of [P] stock provided by [P] pursuant to the plan and $30 of cash provided by [S] in exchange for their [target corporation] stock. The transaction is a reorganization to which sections 368(a)(1)(A) and (a)(2)(D) apply.
>
> *(b) Basis adjustment*. Under section 1.358-6(c)(1), [P]'s $100 basis in its [S] stock is increased by $60 in the [T] assets deemed transferred. Under section 1.358-6(d)(1), the $60 adjustment is decreased by the $30 of cash provided by [S] in the reorganization. Consequently, [P] has a net adjustment of $30 in its [S] stock, and [P] has a $130 basis in its [S] stock as a result of the reorganization.[172]

Reg. section 1.358-6 includes a variation on the example above involving S's use of P shares acquired in a transaction separate from the triangular reorganization:

> *(e) [P] Stock*. The facts are the same, except that in the reorganization [S] provides [P] stock with a fair market value of $30 instead of $30 of cash. [S] acquired the [P] stock in an unrelated transaction several years before the reorganization. [S] has a $20 adjusted basis in the [P] stock. The basis results are the same as [above]. In addition, [S] recognizes $10 of gain on its disposition of the [P] stock in the reorganization.[173]

The examples above suggest that consideration is treated as provided by the corporation whose assets are used to acquire T stock or assets (that is, the source of the acquisition consideration, economically speaking). P is regarded as providing acquisition consideration only if it delivers it to S for no consideration. Conversely, S is treated as providing acquisition consideration if it uses its assets to finance the acquisition independently.[174]

In issuing P stock to S on the facts of Notice 2006-85, P did not incur the cost of issuing its stock in exchange for T's shares. Instead, it incurred the cost of issuing its shares in exchange for the cash, note, or both tendered by S. Accordingly, under the section 358 regulations as written, P should not be deemed to have provided its shares for purposes of reg. section 1.358-6(d). Since the FMV of the consideration paid by S to acquire the T shares (the measure of the negative adjustment under that provision) exceeds the shareholder's basis in its T shares (the measure of the positive adjustment under reg. section 1.358-6(c)), reg. section 1.358-6 should not apply in its entirety.

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[170]Reg. section 1.358-6(d)(1).

[171]Reg. section 1.358-6(d)(2).

[172]Reg. section 1.358-6(d)(3).

[173]*Id*.

[174]For instance, reg. section 1.358-6(d)(3), Example (a), indicates that the $30 of cash that the acquiring corporation used to acquire the target corporation is "provided by S." Although the example does not describe how the acquiring corporation came to receive the cash, the implication is that the cash was independently earned or raised by the acquiring corporation (and, if raised, whether borrowed from P or another person). Similarly, in reg. section 1.358-6(d)(3), Example (e), the acquiring corporation is considered to "provide" issuing corporation shares to the target corporation. Although the example does not explain how the acquiring corporation obtained the funds to acquire the issuing corporation shares, the implication is again that the acquiring corporation independently financed the purchase of the shares.

As indicated above, under reg. section 1.367(b)-10 before its amendment by the rules announced by the notice, P's aggregate basis in its S shares after the deemed transactions had to be no less than the basis before them. This is because the deemed distribution reduces P's aggregate basis in its S shares by the excess of the amount of the distribution over the portion of the distribution derived from S's E&P, and the deemed contribution increases it by the entirety of the deemed distribution. Under the notice, however, P's aggregate basis in its S shares is still reduced by the amount of the deemed distribution — essentially the value of the T shares. Because the deemed contribution rule is eliminated and there is instead a requirement that P adjust its basis in its S stock under reg. section 1.358-6 as if P provided the P stock under the plan of reorganization, P increases its basis in its S shares only by S1's (low) basis in the T shares. Thus, in many cases, the application of the notice will substantially reduce P's basis in its S shares and commensurately reduce the availability of tax-free return of capital distributions.

ii. Does Notice 2014-32 represent sound tax policy? An article by Michael Schultz published after the release of Notice 2014-32 agrees that the deemed contribution rule makes economic sense in that it accounts for the lack of an actual removal of property from corporate solution in S corresponding to the distribution that the regulation deems to occur.[175] Schultz argues, however, that the notice's removal of the deemed contribution rule corrects for cross-border triangular reorganizations the perceived failure of the section 358 regulations to reduce the basis that P has in its S stock when the value of the consideration provided by S for the P stock exceeds the bases that the T shareholders have in their T stock. Thus, in his view, the pre-notice regulatory regime, taking both reg. section 1.358-6 and the deemed contribution rule into account, was conceptually incorrect. By contrast, "the regime announced in Notice 2014-32," according to Schultz, "simply takes a shortcut approach to reach results that should be viewed as conceptually appropriate."

Through the following example, Schultz illustrates what he perceives as the problem with the pre-notice basis adjustment regime:

> P, a domestic corporation, owns all of the stock of two subsidiaries, S and X. S is a foreign corporation, while X is domestic. The S stock is worth $100, and P has a basis of $30 in that stock. S has E&P of $25 that has not previously been subject to U.S. tax. X owns all of the stock of T, a foreign corporation. The T stock is worth $25, and X has a basis in that stock of $10. S pays P $25 for $25 worth of P voting stock, which S uses to acquire the T stock from X.

P has an unrealized gain of $70 in the S stock, and X has an unrealized gain of $15 in the T stock. P's basis in S stock would, under reg. section 1.358-6(c), be increased by the basis that X had in its T stock ($10). And, under reg. section 1.358-6(d)(1), the basis would be decreased by the amount S paid for the P stock used in the acquisition of T ($25), if under reg. section 1.358-6(d)(2) the net adjustment is not negative. Because the negative adjustment would exceed the positive adjustment, no adjustment is made, and P's basis in its X stock would remain at $30. Under reg. section 1.367(b)-10(b)(1), S would be deemed to distribute to P the amount of property ($25) that it paid for the P stock. Since S has E&P sufficient to absorb the distribution, it would not reduce P's basis in S's stock. The deemed contribution rule would, under reg. section 1.367(b)-10(b)(2), increase that basis by the amount of the distribution, to $55.

Under the notice, P's adjustment to the basis in its S stock under reg. section 1.358-6 would be determined as if P provided the P stock or securities under a plan of reorganization, even though S in fact acquired the P stock in exchange for property. Accordingly, P's $30 basis in its S stock would be increased under reg. section 1.358-6(c) by the $10 basis that X had in its T stock, to $40. Again, no downward adjustment would be made for the deemed distribution under reg. section 1.367(b)-10(b)(1). Now, also, no upward adjustment would be made under the deemed contribution rule, leaving P with a $40 basis in its S stock.

Schultz correctly points out that the $15 difference in the S stock basis pre- and post-notice is attributable to the appreciation in the T shares held by X. The result pre-notice does not reflect this appreciation, while the result post-notice does. The article also correctly identifies the source of the difference, namely, the reg. section 1.358-6(d)(2) prohibition on any adjustment to the basis that P has in its S stock as a result of the reorganization when the potential negative adjustment under reg. section 1.358-6(d)(1) for the value of P stock provided by S exceeds the potential positive adjustment under reg. section 1.358-6(c) for the basis that X had in its T shares. When S provides all the P stock used in the transaction, the stock's value equals the value of the T stock, and the excess of the negative adjustment over the positive adjustment therefore equals the appreciation in the T stock. Accordingly, the prohibition under reg. section

[175]Schultz, "Assessing the 'Killer B' Deemed Contribution Rule Controversy," *Tax Notes*, June 30, 2014, p. 1533.

1.358-6(d)(2) of a downward adjustment in the basis of the S stock by the amount of that excess prevents P's basis in S stock from reflecting the appreciation inherent in the T stock.

Schultz notes that in the cross-border context the elimination of the deemed contribution rule compensates for that asserted failure. This would be the case whether S has E&P sufficient to absorb the deemed distribution under reg. section 1.367(b)-10(b)(1) or S lacks sufficient E&P but P has sufficient basis in its S stock to absorb the distribution under that provision. If, for example, the facts were the same except that S had no E&P, pre-notice, P would not increase or decrease its basis in S under reg. section 1.358-6, and the upward basis adjustment of $25 occasioned by the deemed contribution under reg. section 1.367(b)-10(b)(2) would offset the $25 downward basis adjustment resulting from the deemed distribution under reg. section 1.367(b)-10(b)(1). Consequently, P would have a basis of $30 in S after the transaction. Post-notice, P would, under reg. section 1.358-6(c), increase its $30 basis in S by the $10 basis that X had in T and decrease it by the $25 constructive distribution by S to P under reg. section 1.367(b)-10(b)(1). P would thus have a $15 basis in S after the transaction. The $15 difference pre- and post-notice would again reflect the appreciation in the T shares. Pre-notice, if S made a $30 distribution to P after the transaction, P would have zero gain or loss, but post-notice, P would have a $15 gain.

Thus, Schultz concludes that in the cross-border context, the notice corrects for the asserted failure of the section 358 regulations to reflect the appreciation in T's shares. "While the particular mechanism chosen by the government to address the flaw in the existing regulations may be confusing at first blush," he argues, "the results of that choice, taken as a whole, are sound."

Schultz notes that the preamble to the 1994 proposed regulations on which the current section 358 regulations are based states that "the over-the-top model [adopted by the regulations] achieves neutrality for P between a sale of the S stock and a sale by S of the assets or stock acquired in the reorganization."[176] Thus, according to Schultz, by not permitting a net negative adjustment to basis to reflect S's provision of the P shares, the regulations thwarted a basic objective "to preserve the gain in the T stock at the P-S level as well as the S-T level." There seems to be little question that, as the article contends, the reg. section 1.358-6 regulations do not, in the nonconsolidated context, extend the over-the-top model to its logical extreme.

Apparently, the reason is that the IRS had to mesh the objective of the over-the-top model with other legitimate tax policy goals. First, the IRS had to contend with the exotic concept of negative basis. Reg. section 1.358-6, as originally proposed in 1981, did not contain a prohibition on a net negative adjustment to P's basis in S. By way of explaining the prohibition, the preamble to the 1994 regulations[177] states: "A strict application of the over-the-top model would require P to adjust its historic basis in its S stock, if any, even below zero. . . . [T]he concept of negative basis generally is not used under the Code."[178] Although one commentator has suggested that negative basis might be appropriate in some situations,[179] the primary authorities (with the exception of the consolidated return regulations, as discussed below) have uniformly rejected it.[180] Various reasons have been offered for the aversion to the concept of negative basis. Since basis is ultimately traceable to a person's cost and adjustments to basis such as depreciation usually cannot exceed cost, negative basis is usually impossible. Also, the sale of property with a negative basis could result in gain or even tax exceeding proceeds. Whatever the reason, well before the promulgation of the 1994 proposed regulations, the IRS had stated that negative basis is not a "recognized principle of tax law."[181]

To see how the absence of the prohibition on a net negative adjustment under reg. section 1.358-6(d)(2) could result in negative basis, consider the situation in which P has a basis of $100 in its S stock, which has a value of $500. X has a basis of $150 in its T stock, which has a value of $400. S purchases $400 worth of P stock from P, which it uses to acquire the T stock. If the prohibition did not apply, P would increase its $100 basis in its S stock by X's basis in its T stock ($150) and decrease it by the value of the P stock exchanged for the T stock ($400), leaving P with a negative $150 basis in its S stock. Since the value of the S stock is $500, if P sold the stock, P would recognize $650 of gain. This gain would reflect the pre-transaction gain of $400 that P had in its S stock ($500 minus $100) and the pre-transaction gain of $250 that X had in its T stock

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[176] CO-993-71, 59 F.R. 66280, 66281 (Dec. 23, 1994).

[177] *Id*.

[178] *Id*. at 66281-66282.

[179] George Cooper, "Negative Basis," 75 *Harv. L. Rev*. 1352 (1962).

[180] *Wilhelm v. Commissioner*, T.C. Memo. 1983-274; New York State Bar Association Tax Section, "Stock Basis Adjustments in Triangular Reorganizations" (Sept. 18, 1995) (cases and rulings cited at n.17). *See* Boris I. Bittker and James S. Lokken, *Federal Taxation of Income, Estates, and Gifts*, para. 42.7 (2013).

[181] GCM 37528 (May 3, 1978).

($400 minus $150). The over-the-top model's objective of capturing in the S stock the gain inherent in the T stock would be fully achieved, but only through the rejected construct of a negative basis.

If P's basis in its S shares before the transaction had been $250 rather than $100, P's basis in the S stock after the transaction would have been zero ($250 original basis plus $150 basis of X in T stock minus $400 value of P stock exchanged for the T stock). Thus, although the application of the basis adjustment rules would produce the same $250 net negative adjustment, it would not reduce basis below zero. To avoid discriminating between a situation in which a net negative adjustment in P's basis in S's stock would result in a negative basis in S's stock and a situation in which a net negative adjustment would not result in a negative basis, reg. section 1.358-6(d)(2) prohibits all negative adjustments.

One might argue that the IRS, in proposing the section 358 regulations, could have avoided negative basis results and at the same time more fully satisfied the policy of reflecting the T shares' appreciation in P's basis in its S stock by simply prohibiting a net negative adjustment that would result in negative basis. In addition to favoring the use of an existing S, such a regime would be complex. Indeed, in response to the proposed regulations, some commentators argued that, to avoid complexity, the rule proposed for nonconsolidated situations should extend to the consolidated context, which the IRS rejected in finalizing the regulations.[182] In any event, given that the IRS in 1981 proposed a regime without a prohibition on a net negative adjustment,[183] in 1994 proposed a regime with that prohibition,[184] and in 1995 finalized the 1994 proposal[185] and considered submitted comments (as shown in successive preamble discussions), it consciously adopted a regime that in some nonconsolidated contexts required the neutrality envisioned by the over-the-top model to yield to other concerns.

Even apart from concerns about negative basis and the need to treat likes alike, the rationale for the over-the-top model is not as compelling in the separate entity context as in the consolidated setting. As indicated in the IRS's own words, "the over-the-top model achieves neutrality for P between a sale of the S stock and a sale by S of the assets or stock acquired in the reorganization."[186] Why is that neutrality desirable in the first place?

To answer this question, assume that in the example above, S and T were assets instead of corporations. P has a basis of $100 in its asset S, which has a value of $500. X has a basis of $150 in its only asset, T, which has a value of $400. X merges into P in a tax-free section 368(a)(1)(A) reorganization. P inherits X's $150 basis in asset T. P then sells both assets and recognizes gain of $400 on asset S and $250 on asset T, or $650 of aggregate gain.

This is the model for the results in which P, S, and T are corporations filing a consolidated return and S has acquired T in a tax-free triangular reorganization using P stock. "The purpose of the adjustments" required by the investment adjustment system under the consolidated return regulations, according to the regulations themselves, "is to treat [P] and S [P's subsidiary] as a single entity so that consolidated taxable income reflects the group's income."[187] Thus, the goal of the investment adjustment system in this setting would be achieved if the same consequences attach to P's sale of its S stock after the T stock acquisition as would have arisen had P sold its assets S and T after the T asset acquisition — that is, $650 of aggregate gain.

Since the value of the S stock is $500, P can have $650 of aggregate gain on a sale of its S stock only if it has a negative basis of $150 in the stock, precisely the basis that P would have had in its S stock under reg. section 1.358-6 in the example above if the prohibition on a net negative adjustment in reg. section 1.358-6(d)(2) did not apply.

As it happens, the consolidated return regulations require this result. Despite the general aversion to negative basis, the consolidated return investment adjustment system specifically contemplates that negative adjustments to P's basis in S's stock could exceed that basis — that excess treated, in the parlance of the consolidated return regulations, as an "excess loss account" or "for all Federal income tax purposes as basis that is a negative amount."[188] The consolidated return regulations consistently provide that the reg. section 1.358-6(d)(2) prohibition on a net negative adjustment does not apply in the consolidated context and that P in a triangular B reorganization must adjust its basis in its S shares by the full value of the consideration it does not provide.[189] Finally, if P disposes of its S stock, it takes into account its excess loss

[182]T.D. 8648.
[183]LR-1993, 46 F.R. 112 (Jan. 2, 1981).
[184]CO-993-71, 59 F.R. 66280.
[185]T.D. 8648.
[186]CO-993-71, 59 F.R. 66282.
[187]Reg. section 1.1502-32(a)(1).
[188]Reg. section 1.1502-19(a)(2).
[189]Reg. section 1.1502-30(b)(1).

account as income or gain from the disposition.[190] Accordingly, in the example, P would have aggregate gain of $650 on its disposition of its S stock.

The application of the single entity concept underlying the investment adjustment system — to treat P and S as a single entity so that consolidated taxable income reflects the group's income — thus appears to produce the same result as the over-the-top model, namely, to make the economic group tax indifferent between P's sale of S stock and S's sale of its own asset, the stock of T. Perhaps this is not surprising since, under the single entity concept and the over-the-top model, the consequences to P of its sale of S shares depend not so much on the characteristics of the S shares themselves but significantly on the characteristics of S's asset, the T shares — that is, S's basis in them and how S acquired them.

The single entity concept underlying the investment adjustment system of course does not apply outside the consolidated return context, in which separate entity treatment of corporations is the norm. Thus, if P contributes $50 to newly formed S, with which it does not file a consolidated return, S purchases asset A with the cash, A appreciates in value, and S sells A for $75, S recognizes $25 of gain on the sale. Since P's S stock is now worth $75, P would recognize another $25 of tax gain for the same economic gain if P sold its S stock thereafter. If, however, P and S filed a consolidated return, P would increase its S stock basis by the $25 gain S recognized and would recognize no gain on the stock sale.

Indeed, the separate entity concept is so well entrenched outside the consolidated context that it extends to the treatment of transactions between commonly controlled corporations that do not file consolidated returns. In *Kraft Foods*,[191] the taxpayer, a wholly owned subsidiary of the parent company, sought to deduct interest on a note that it had distributed to its parent. Consolidated returns were not authorized in the years at issue. The Tax Court supported the IRS's denial of the deductions on the grounds that the taxpayer, "for all practical purposes, was a department of National Dairy, even though incorporated, and that National Dairy did not in a real sense become a creditor of" the taxpayer.[192] Reversing, the Second Circuit stated:

> In a broad economic sense, of course, it is of limited significance what form a sole stockholder's investment in a wholly-owned corporation takes. That is equally true of any transaction or arrangement between affiliates, whether it be an operating contract, a sale, a lease, or a payment of interest or dividends. But the law generally and the applicable tax law deliberately, through [their] insistence on taxing affiliates separately, [afford] significance to and [honor] the type of investment chosen. In consequence, all legitimate and genuine corporation-stockholder arrangements have legal — and hence economic — significance, and must be respected in so far as the rights of third parties, including the tax collector, are concerned.[193]

In summary, in addition to the concern about negative basis, a justification for the prohibition on net negative adjustments in S stock in the nonconsolidated context is that, in that context, affiliated corporations are generally treated as separate entities, with the consequence that S's shares have tax significance to the economic group that they do not have in the consolidated context.

iii. Does the notice represent sound section 367 policy? Thus, for a group of affiliated corporations not filing a consolidated return, the policy of reflecting the appreciation in the T stock in P's S shares runs up against other policies. Yet the notice applies only to a subset of triangular reorganizations engaged in by those corporations, that is, transactions covered by reg. section 1.367(b)-10 — where (1) P or S (or both) is a foreign corporation; (2) in connection with the reorganization, S acquires in exchange for property all or a portion of the P stock used to acquire the T stock;[194] and (3) the regulation,[195] as modified by the rules outlined in the notice,[196] does not itself specifically exclude the transaction from coverage (as for some transactions subject to section 367(a)).

This group of transactions is an odd choice. Although the notice cites no authority for the anticipated removal of the deemed contribution rule and imposition of the reg. section 1.358-6 construct, it is presumably the same authority cited by the Treasury decision in promulgating reg. section 1.367(b)-10, which the notice's rules would modify.

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[190]Reg. section 1.1502-19(b)(1)(i).

[191]*Kraft Foods Co. v. Commissioner*, 232 F.2d 118 (2d Cir. 1956), *rev'g* 21 T.C. 513 (1954).

[192]*Id.*, 21 T.C. at 594. Regulations proposed on April 8, 2016 (REG-108060-15), would treat as equity the debt of a member of an expanded affiliated group that is distributed to another member, thus overturning *Kraft Foods* on its facts. *See* prop. reg. section 1.385-3(b)(2)(i). Even if the IRS finalizes this highly controversial regulation and it survives legal challenge, the Second Circuit's general statement about transactions between affiliates remains sound.

[193]*Kraft Foods*, 232 F.2d at 124.

[194]Reg. section 1.367(b)-10(a)(1).

[195]Reg. section 1.367(b)-10(a)(2).

[196]Notice 2014-32, section 4.02.

Like all Treasury decisions promulgating tax regulations, that document[197] cites as authority section 7805(a), under which Treasury may issue "all needful rules and regulations for the enforcement of" the statutory provisions regarding federal tax. However, in considering the validity of the notice's rules, a court would certainly focus much more on the other and much more specific cited authority, section 367(b).

Section 367(b)(1) provides:

> 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.

It is far from clear that the statutory text supports the removal of the deemed contribution rule and the imposition of the reg. section 1.358-6 construct. First, considered by itself, S's purchase of T's stock is a taxable purchase of property and is not an "exchange described in section 332, 351, 354, 355, 356, or 361." As stated repeatedly above, section 1032(a), not cited in the statute, applies to this transaction.

One might read the "exchange described" as the exchange by T's shareholders of their T stock for P stock, otherwise not taxable under section 354. In this reading, a T shareholder's nonrecognition of gain on its T shares would depend on the satisfaction of regulatory requirements that are necessary or appropriate to prevent the avoidance of federal income taxes. On the other hand, section 367(b)(1) says that for any exchange described in section 354, a foreign corporation will be considered a corporation except to the extent otherwise provided in regulations. Section 354 applies to S1's exchange of T shares for P shares. The IRS might well have the authority to adjust the basis that S1 has in its P shares.[198] It is less clear that the IRS has the authority to adjust the basis that P, a person that does not even participate in any actual exchange described in section 367(b)(1), has in its S shares.

Even if the IRS does have that authority, its exercise seems inappropriate. For the transactions it covers, the notice effectively averts not taking into account the gain inherent in the T shares at the S-share level by requiring P, at the time of the triangular reorganization, to reduce its basis in the S shares by the value of the T shares permanently and to recognize gain equal to any excess of that value over its basis in the S shares (assuming, for the sake of simplicity, that S has no E&P). Yet that requirement is clearly not, in the language of the statute, "necessary" to avoid nonrecognition of the gain inherent in the T shares. Because of the general application of the prohibition on net negative basis adjustments, when P, S, and T are domestic but do not file a consolidated return, some or all of the gain would not be recognized until S disposes of the T shares. Similarly, when P is domestic but S is foreign, section 954(c)(1)(B) would treat as foreign personal holding company income the gain inherent in the T shares in the year that S disposed of them, and section 951(a)(1)(A) would require P to include the gain in its income in that year. Thus, the notice's rules are unnecessary to ensure that the gain in the T shares is subject to tax to the same extent and at the same time, regardless of whether S is domestic or foreign, assuming domestic S does not join in the filing of a consolidated return.

By contrast, in the consolidated context the gain on the T shares could be recognized before their disposition — that is, when P disposes of the S shares. Surely it is not "appropriate," in the language of section 367(b)(1), to use the provision effectively to force a group in which P is domestic and S is foreign into the elective consolidation regime for this purpose. The response might be that most nonconsolidated situations involve foreign groups and that the need to address those situations is acute because of the repatriation concern. The counter response, yet again, is that repatriation is a proper concern of section 367(b) only when tax attributes accompany earnings. Even under the IRS's recharacterization of cross-border triangular reorganizations, the U.S. group does not inherit S's (or T's) tax attributes or indeed their earnings.

3. Summary. Tellingly, the only legislative history that the above guidance cites regarding section 367's repatriation concerns (specifically, section 367(b)'s repatriation concerns) is the committee report language, quoted above, accompanying Tax Reform Act of 1976: "It is essential to provide against tax avoidance in transfers . . . upon the repatriation of previously untaxed foreign *earnings*."[199] Contrary to an expansive reading of this language, the repatriation policy of section 367 has, until recently, been limited to ensuring that tax attributes are not repatriated without tax on the earnings that gave rise to them. Thus, subpart F,

[197] T.D. 9526.

[198] Section 367(b)(2)(B).

[199] Emphasis supplied. *See supra* text accompanying Part 1, note 24, cited in Notice 2008-10 and T.D. 9400 (preamble to temporary regulations on triangular reorganizations).

section 1248, the passive foreign investment company provisions (at least in their qualified electing fund incarnation), and, of course, section 301(c)(1) describe when a corporation distributes, or is deemed to distribute, earnings to its shareholders. It is unclear how the transactions described avoid the application of these provisions, since the earnings remain in corporate solution.

Some of the guidance does explain the rules therein as targeting the tax-free repatriation of earnings. Notice 2006-85 states that the "policy concern" raised by transactions of the type addressed by the notice "could have the effect of repatriating foreign earnings of S to P without a corresponding dividend to P that would be subject to U.S. income tax."

Yet the guidance quickly slips into the expression of a broader and frankly radical idea, to wit, that section 367's remit is the avoidance of the repatriation without tax of cash or other property, regardless of whether that cash or other property represents earnings. Thus, Notice 2006-85 expresses the IRS's concern about the triangular reorganization described therein: "The IRS and Treasury are aware that certain taxpayers are engaging in triangular reorganizations involving foreign corporations that result in a tax-advantaged transfer of *property* from S to P" (emphasis supplied). Notice 2008-10's worry is that the all-cash D reorganization described in that notice would "repatriate *cash or other property* from foreign subsidiaries without the recognition of gain or a dividend inclusion" (emphasis supplied). Notice 2012-39 criticizes taxpayer positions to the effect that "the transactions have resulted in a repatriation in excess of *$100x ($100x* at the time of the reorganization and then through *repayment* of the receivable in the amount of USP's income inclusions over time) while only recognizing income in the amount of the inclusions over time" (emphasis supplied). The authorities described above indeed implement this newfound objective that property should not pass from a foreign corporation to its domestic shareholder without tax.

In fact, there exists no policy that a movement of property from a foreign corporation to a U.S. shareholder, or indeed from any person to any other person, is necessarily a remittance of income. When the property is money, for example, it could represent the proceeds of a loan, the repayment of a loan, a return of basis, a reimbursement of an expense, a subscription for shares in a corporation, or any of many other types of cash movements that do not represent income under code provisions or general tax principles. The "repatriation" authorities described above share the unfortunate characteristic that, in violation of those provisions and principles, they seek to tax movements of funds not representing earnings or gain at all. In all cases, earnings — and tax attributes — remain in foreign corporate solution. Thus, the authorities seize on what the IRS interprets as the very broad language of section 367 to tax movements of cash that would not result in the recognition of income in the wholly domestic context. As indicated in the first section of this report, section 367 was designed to prevent taxpayers from using the nonrecognition provisions of subchapter C to subvert the application of otherwise applicable provisions and policies. It was not designed to give the IRS the authority, when the transaction is cross-border or foreign to foreign, to eliminate the differential tax treatment of, on the one hand, the receipt of property by a shareholder in the form of a distribution on corporate stock and, on the other hand, the receipt of property by a corporation as consideration for its stock or the receipt by a shareholder of property in exchange for its stock.

C. Goodwill and Going Concern Value

This report would be remiss to complete its *tour d'horizon* of recent and provocative section 367 guidance without a brief discussion of the September 2015 proposed regulations on outbound transfers of goodwill and going concern value (GWGCV) and their relationship to the themes pursued above. As indicated,[200] although the statutory language does not directly speak to the issue, the taxwriting committee reports for the Deficit Reduction Act of 1984 (DEFRA) clearly anticipated that section 367(a) (except for an incorporation of a foreign loss branch) and section 367(d) would not apply to the transfer by a U.S. person of GWGCV developed by a foreign branch to a foreign corporation. Also, as noted above, the Joint Committee on Taxation staff explained that the goal of section 367(d) was to prevent the distortion of income that would ensue if a U.S. person were both (1) allowed deductions for expenses incurred by its foreign branch for research and development of an intangible, and (2) permitted to avoid current inclusion of income from the intangible because of the incorporation of the branch at the point of the intangible's profitability. According to the JCT staff, although the incurrence of R&D expenses results in the creation of other intangibles, it does not result in the generation of GWGCV; the generation of income does. Thus, the tax-free outbound transfer of foreign GWGCV does not result in the distortion of income, the avoidance of which is one of section 367's primary objectives.

The outbound transfer of GWGCV does not otherwise promote tax avoidance. As explained

[200]Part 1, Section I.E.

above, the guidelines' use (and later DEFRA's adoption) of an active trade or business test recognized that tax avoidance probably does not principally motivate a taxpayer that transfers assets to a foreign corporation for the corporation's use in an active trade or business outside the United States. There are exceptions, however. Desiring to sell tax-depreciable (but economically appreciated) personal property used in a trade or business, a U.S. person could conceivably transfer it, along with the other assets of the business, to a foreign corporation and, without an inclusion under subpart F,[201] have the foreign corporation shortly thereafter sell the depreciable property and retain the other assets.

In contrast with other trade or business assets, however, GWGCV by its nature cannot be transferred separately from the trade or business itself and thus is not susceptible to transfer for tax avoidance reasons.

The nature of GWGCV as residual assets is critical here. The temporary section 367(a) regulations issued May 15, 1986 defined foreign GWGCV 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''[202] (emphasis supplied).

Comtemporaneous statutory and regulatory provisions are consistent. On May 29, 1986 — two weeks after the release of the section 367(a) regulations — the Finance Committee released its report on its version of the legislation that became TRA 1986, including what is now section 1060. The report states: ''The Committee . . . is requiring taxpayers to apply the residual method in allocating basis to goodwill and going concern value in all purchases of a going business.''[203] Section 1060(a) itself provides that the allocation of consideration among assets is to be made ''in the same manner as amounts are allocated to assets under section 338(b)(5).'' Finally, on March 28, 1986 (less than two months before the publication of the section 367 regulations), the IRS published regulations under section 338(b)(5) that for the first time adopted the residual value approach for valuing GWGCV.[204]

The reason all these authorities conceive of GWGCV as the residual value of a business is that it cannot by its nature be transferred separately from the business. Section 1060 and the regulations thereunder provide the method for allocating the consideration paid in an ''applicable asset acquisition,'' which includes only the acquisition of ''assets which constitute a trade or business.''[205] The Finance Committee report states: ''A group of assets will constitute a business for this purpose if their character is such that goodwill or going concern value could under any circumstances attach to such assets.'' Like its predecessors stretching back to shortly after the enactment of section 1060, the current version of the section 1060 regulations has adopted this (alternative[206]) definition of a trade or business.[207]

The nature of GWGCV suggests why it cannot be transferred separately from a trade or business. The section 1060 regulations provide:

> Goodwill is the value of a trade or business attributable to the expectancy of continued customer patronage. This expectancy may be due to the name or reputation of a trade or business or any other factor. Going concern value is the additional value that attaches to property because of its existence as an integral part of an ongoing business activity. Going concern value includes the value attributable to the ability of a trade or business (or a part of a trade or business) to continue functioning or generating income without interruption notwithstanding a change in ownership. It also includes the value that is attributable to the immediate use or availability of an acquired trade or business, such as, for example, the use of the revenues or net earnings that otherwise would not be received during any period if the acquired trade or business were not available or operational.[208]

Although the first predecessor of this language appeared in the section 1060 regulations in 1999, 13 years after the issuance of the temporary section 367(a) regulations, it has much older case law antecedents.[209]

By defining GWGCV as the residual value of a business, that portion of the business that cannot be

[201]Reg. section 1.954-2(e)(3)(ii).

[202]Reg. section 1.367(a)-1T(d)(5)(iii).

[203]S. Rep. No. 99-313, at 254 (1986).

[204]T.D. 8072 (Mar. 28, 1986).

[205]Section 1060(a) and (c)(1).

[206]A group of assets also constitutes a trade or business if the use of the assets would constitute an active trade or business under section 355. Reg. section 1.1060-1(b)(2)(i)(A).

[207]Reg. section 1.1060-1(b)(2)(i)(B).

[208]Reg. section 1.1060-1(b)(2)(ii).

[209]*See, e.g.*, *Boe v. Commissioner*, 307 F.2d 339, 343 (9th Cir. 1962), *aff'g* 35 T.C. 720 (1961) (''The essence of goodwill is the expectancy of continued patronage, for whatever reason.''); *Wilmot Fleming Engineering Co. v. Commissioner*, 65 T.C. 847, 861 (1976) (goodwill exists when there is an ''expectancy of both continuing excess earning capacity and also of competitive advantage or continued patronage''); and *VSG Inc. v. Commissioner*, 68 T.C. 563, 591 (1977) (''Going-concern value is, in essence, the additional element of value which attaches to property by reason of its existence as an integral part of a going-concern.'').

associated with *particular* assets, the temporary section 367 regulations presuppose that GWGCV necessarily attaches to *all* the other business assets. Because GWGCV is inextricably tied to all other business assets, it, unlike virtually any other business asset, cannot be transferred separately from the transfer of those assets. Accordingly, if, as suggested by the guidelines and the 1984 Act, the outbound transfer of assets for use in a foreign trade or business is presumptively not for tax avoidance purposes, a fortiori, the outbound transfer of GWGCV is even more clearly not for those purposes.

Thus, because its transfer does not result in the distortion of income or otherwise promote tax avoidance, GWGCV is not the sort of asset that section 367 should address as a policy matter. The 1986 temporary regulations recognized this reality in sensibly excluding foreign GWGCV from the operation of section 367(d).[210] Any foreign GWGCV that was otherwise covered by section 367(a) could qualify for the active trade or business exception from that provision's operation.

Proposed regulations that would generally be effective for transfers occurring on or after their release date, September 14, 2015,[211] would remove the exclusion of foreign GWGCV from section 367(d)'s coverage. Thus, under the proposed regulations, if section 936(h)(3)(B) describes an item of GWGCV, the periodic inclusion regime of section 367(d) would apply to it. Proposed regulations with the same effective date[212] would render GWGCV that is not section 936(h)(3)(B) property ineligible for the active trade or business exception of section 367(a)(3), since it is not tangible property or other property eligible for that exception under the proposed regulations[213] (although the taxpayer could elect to subject the gain to the section 367(d) regime).[214] Yet again, these regulations parallel an administration proposal that Congress has failed to enact.[215]

According to the preamble to these regulations:

> The Treasury Department and the IRS are aware that, in the context of outbound transfers, certain taxpayers attempt to avoid recognizing gain or income attributable to high-value intangible property by asserting that an inappropriately large share (in many cases, the majority) of the value of the property transferred is foreign goodwill or going concern value that is eligible for favorable treatment under Section 367.[216]

The preamble goes on to discuss the specific problems with taxpayers' valuation methods, alleged inappropriate characterization of domestic business operations as giving rise to foreign GWGCV, and regulatory approaches that might have preserved the integrity of the foreign GWGCV exception without its abandonment. However, Treasury and the IRS decided to remove the exception because, in their view, alternatives would have been unadministrable:

> There will continue to be challenges in administering the transfer pricing rules whenever the transfer of different types of intangible property gives rise to significantly different tax consequences. Given the amounts at stake, as long as foreign goodwill and going concern value are afforded favorable treatment, taxpayers will continue to have strong incentives to take aggressive transfer pricing positions to inappropriately exploit the favorable treatment of foreign goodwill and going concern value, however defined, and thereby erode the U.S. tax base.[217]

As indicated above, section 1060 and the section 338 regulations, both of which were adopted contemporaneously with the issuance of the temporary section 367(d) regulations, used the same method for valuing GWGCV that the temporary section 367(d) regulations used — the residual method. As shown below, they did this (in part) for precisely the same reason — the difficulty in valuing GWGCV — that the IRS now cites for abandoning the foreign GWGCV exemption from tax under section 367 intended by Congress.

The preamble to the 1986 section 338 regulations, which adopted the residual method for the first time, stated: ''Because of the difficulty in valuing goodwill and going concern value, it was decided to value and assign basis to other assets first, with the residual excess (i.e., the amount of adjusted grossed-up basis over the amount allocated to those other assets), if any, being assigned to goodwill and going concern value.''[218]

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[210] Reg. section 1.367(d)-1T(a).

[211] Prop. reg. section 1.367(d)-1(j).

[212] Prop. reg. section 1.367(a)-2(k)(1).

[213] Prop. reg. section 1.367(a)-2(a)(2).

[214] Prop. reg. section 1.367(a)-1(b)(5).

[215] Treasury, ''General Explanation of the Administration's Fiscal Year 2017 Revenue Proposals,'' at 14 (Feb. 2016); Treasury, ''General Explanations of the Administration's Fiscal Year 2016 Revenue Proposals,'' at 24 (Feb. 2015); Treasury, ''General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals,'' at 47 (Mar. 2014); Treasury, ''General Explanations of the Administration's Fiscal Year 2014 Revenue Proposals,'' at 51 (Apr. 2013).

[216] REG-139483-13, 80 F.R. 55568, 55570 (Sept. 16, 2015).

[217] *Id*. at 80 F.R. 55571.

[218] T.D. 8072.

In describing the current-law background to the 1986 enactment of section 1060, the Finance Committee stated that (1) the seller and buyer of a trade or business often, but do not necessarily, have adverse interests in allocating the consideration for the business among the business's assets; (2) ''the valuation of goodwill and going concern value is generally recognized as more difficult than the valuation of tangible assets or certain other types of intangibles''; (3) ''the two most commonly used methods to value goodwill and going concern value are the residual method and the formula method''; (4) the IRS and the courts traditionally disfavored the formula method because of the subjectivity involved in selecting the rates of return and capitalization that the method requires; and (5) the IRS had just adopted regulations requiring the use of the residual method for section 338 purposes.[219]

In its statement of the reasons for changing the law, the Finance Committee noted that purchase price allocations had been ''an endless source of controversy between the Internal Revenue Service and taxpayers, principally because of the difficulty of establishing the value of goodwill and going concern value.''[220] It said that for those and other reasons, it was ''requiring taxpayers to apply the residual method in allocating basis to goodwill and going concern value in all purchases of a going business.''[221] Accordingly, one point of section 1060 was to mandate what Congress thought was the simplest method for valuing GWGCV transferred as part of the transfer of a trade or business: the residual method.[222]

Of course, in 1986 the tax stakes were the opposite of what they are today. In 1986, before the enactment of section 197,[223] GWGCV, unlike most other intangibles, was not amortizable because it did not have a definite useful life.[224] Thus, it was in the government's interest to allocate as much consideration as possible to GWGCV. Because the temporary regulations exclude foreign GWGCV from the scope of section 367(d), the government has had the opposite incentive — to allocate as much consideration as possible away from GWGCV.

Yet it seems clear that when the 1986 regulations were adopted, both Congress and the IRS understood that section 367 should not tax transfers of foreign GWGCV. Surely the drafters of the 1986 regulations understood that the residual method in valuing GWGCV would burden taxpayers in claiming deductions on amortizable intangibles but that defining GWGCV as residual value would benefit them in applying section 367. Yet neutrality demanded consistency. Given that section 367 has not changed in any substantive way and there is no evidence to suggest that the difficulties in valuing GWGCV differ materially from those faced by taxpayers and the IRS when section 367(d) was enacted, it is hard to understand how the IRS can support a resolution to these difficulties so at odds with the one that Congress, the courts, and the IRS itself have historically favored.

In a recent discussion of the regulations, a Treasury official characterized section 367(a) and (d) as levying an exit tax (in section 367(d)'s case, collected over a period of years) on outbound transfers unless an exception applies. In contrast, as shown above, Congress, the courts, and the IRS have historically understood section 367 not as imposing a tax but as modifying the application of specified subchapter C provisions to a cross-border transaction whose unmodified application would thwart a basic tax policy or provision. For section 367(d), as amply documented by the legislative history, that policy is the clear reflection of income, which the outbound transfer of foreign GWGCV in a nonrecognition transaction does not threaten. The only policy rationale for section 367 as an exit tax is that if section 367 does not pick up the income or gain from the transferred property either at the point of transfer or, in section 367(d)'s case, over a period of years after the transfer, no other provision will do so until the income from the property is actually repatriated. In that sense, then, the IRS's position on GWGCV represents not a legitimate interpretation of section 367 but rather an unauthorized expansion of U.S. anti-deferral regimes.

III. The Way Forward

Section 367's statutory provisions have remained essentially unchanged since 1988, and the principles underlying them, as disclosed by the legislative history and the IRS's own guidance and practice, have not changed in any significant respect since the publication of the guidelines in 1968, and perhaps earlier. Yet over the past 22 years, and especially over the last 10 years, the IRS has used its authority under a tool designed to ensure the appropriate operation of subchapter C's nonrecognition provisions in the cross-border context to make substantive law in selected cases — by extending U.S. taxing jurisdiction, taxing proceeds before return of basis, effectively requiring consolidation of a foreign corporation with a U.S. corporation for some purposes, and, in practical effect,

[219]S. Rep. No. 99-313, at 251-255 (1986).
[220]*Id*. at 253-254.
[221]*Id*. at 254.
[222]*See* former reg. section 1.167(a)-3 (1986).
[223]Section 197 was enacted as part of the Omnibus Budget Reconciliation Act of 1993. *See* P.L. 103-66, section 13261(a).
[224]*See* former reg. section 1.167(a)-3 (1986).

enlarging the scope of the code's anti-deferral regimes. If the IRS were to propose a deficiency based on any of the final[225] regulations discussed above or final regulations incorporating the principles of notices and proposed regulations discussed above, could the taxpayer successfully argue that the regulation is invalid? There are two bodies of law to consider.

A. *Mayo Foundation* and *Chevron*

In a 2011 case, *Mayo Foundation*,[226] the Supreme Court clarified the standard to be applied in evaluating the legality of tax regulations. At issue in *Mayo Foundation* was a regulation[227] issued in 2004 — decades after the enactment of the relevant statutory provision and in response to litigation — providing that the services of an employee normally scheduled to work at least 40 hours per week could not qualify for the so-called student exception from FICA tax, which applies to services "performed by a student who is enrolled and regularly attending classes at such school, college, or university."[228]

In compliance with this regulation, the taxpayer had withheld FICA taxes from medical residents that it employed who were scheduled to work for at least 40 hours per week. It then sued for a refund in district court. Although the district court granted the taxpayer's motion for summary judgment,[229] both the Eighth Circuit[230] and a unanimous Supreme Court held for the government. Both courts relied on *Chevron*,[231] a nontax case that prescribes the standards for assessing the validity of regulations. Applying the *Chevron* standard, both courts held that Treasury's interpretation of the statute was reasonable.

According to the Supreme Court in *Chevron*:

> When a court reviews an agency's construction of the statute which it administers, it is confronted with two questions. First, always, is the question whether Congress has directly spoken to the precise question at issue. If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.[232]

In divining the "unambiguously expressed intent of Congress" — the exercise commonly referred to as *Chevron* step one — the Supreme Court has searched well beyond the statutory text. In *Brown & Williamson Tobacco*,[233] for example, the Court had to determine the validity of Food and Drug Administration regulations restricting the sale, distribution, and advertisement of tobacco products. The Federal Food, Drug, and Cosmetic Act (FDCA) authorized[234] the FDA to regulate "drugs,"[235] defined to include "articles (other than food) intended to affect the structure or any function of the body," and a "device," defined in pertinent part as:

> an instrument, apparatus, implement, machine, contrivance . . . or other similar or related article . . . intended to affect the structure or any function of the body . . . which does not achieve its primary intended purposes through chemical action within or on the body . . . and which is not dependent upon being metabolized for the achievement of its primary intended purposes.[236]

One might logically infer from this language that a drug must be intended to affect the structure or any function of the body and must either achieve its primary intended purposes through a chemical action or depend on metabolization for the achievement of those purposes.

Evidence before the Court made abundantly clear that the tobacco companies had long known that nicotine affects the function of the body and that it achieves the psychological and physical effects sought by smokers through chemical action and metabolization. Indeed, for many years the cigarette manufacturers marketed cigarettes as having just those effects. It therefore could be reasonably concluded, based on an application of the statutory language alone, that nicotine is intended to affect the structure or function of the body, that its intended purposes are the psychological and physical effects sought by smokers, and that those purposes are accomplished through chemical action and metabolization. One might also conclude that as the "apparatus" or "implement" for delivery of nicotine, a cigarette itself (the paper containing the tobacco and the tobacco containing the nicotine) intentionally affects the body, but not through a

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[225]No inference is intended on whether a taxpayer could challenge the guidance issued before being enshrined as a final regulation.

[226]*Mayo Foundation for Medical Education & Research v. United States*, 562 U.S. 44 (2011), *aff'g* 568 F.3d 675 (8th Cir. 2009), *rev'g* 503 F. Supp.2d 1164 (D. Minn. 2007).

[227]Reg. section 31.3121(b)(10)-2(d)(3)(iii).

[228]Section 3121(b)(10); reg. section 31.3121(b)(10)-2.

[229]*Mayo Foundation*, 503 F. Supp.2d 1164.

[230]*Mayo Foundation*, 568 F.3d 675.

[231]*Chevron U.S.A. Inc. v. National Resources Defense Council Inc.*, 467 U.S. 837 (1984).

[232]*Id*. at 842-843.

[233]*FDA v. Brown & Williamson Tobacco Corp.*, 529 U.S. 120 (2000).

[234]21 U.S.C. sections 321(g)-(h) and 393.

[235]21 U.S.C. section 321(g)(1)(C).

[236]21 U.S.C. section 321(h).

chemical reaction to or metabolization of the paper and the tobacco themselves. Therefore, based on the language of the statute, the cigarette appears to be a device.

The Court nevertheless concluded that nicotine and cigarettes would not meet these statutory definitions since the opposite conclusion would require the FDA to ban them under other provisions of the FDCA. In light of other statutes regulating the marketing and sale of cigarettes, adopted long after the enactment of the FDCA, the Court concluded that the authors of the FDCA could not have possibly intended the banning of cigarettes. Under *Chevron* step one, the Court therefore struck down the regulations treating nicotine as a drug and a cigarette as a device as contrary to the unambiguously expressed intent of Congress.

Thus, in applying *Chevron* step one, although a court may look primarily at the face of the statute, it can also take legislative history into account. To varying degrees the statutory language and legislative history at issue in the section 367 guidance might give a taxpayer some support in attacking recent section 367 guidance. As described above, although Congress has given the IRS broad regulatory authority in implementing several section 367 subsections, there is at least a question whether the rules described in some of the notices and regulations comport with the literal language of the statute. There is also some question whether the language of section 367(d) authorizes the IRS, in the rules anticipated by Notice 2012-39, to require the U.S. transferor of an intangible in an outbound section 361 transaction to accelerate the annual inclusions into the year of the transfer. As another example, it is at least doubtful that section 367(b) authorizes the IRS, in the series of notices and regulations on triangular reorganizations, to override section 1032, which is not even mentioned in section 367(b). Moreover, since the courts do look to legislative history in applying *Chevron* step one, a strong case can certainly be made — in light of the language of the taxwriting committee reports — that the regulations proposing to subject gain on foreign GWGCV to tax under either section 367(a) or (d) would be invalid if finalized in their current form.

When a court applying *Chevron* cannot determine the "unambiguously expressed intent of Congress," it must proceed to *Chevron* step two:

> If . . . the court determines Congress has not directly addressed the precise question at issue, the court does not simply impose its own construction on the statute, as would be necessary in the absence of an administrative interpretation. Rather, if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute. . . . If Congress has explicitly left a gap for the agency to fill, there is an express delegation of authority to the agency to elucidate a specific provision of the statute by regulation. Such legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.[237]

In *Mayo Foundation*, the Court found that *Chevron* step one could not resolve the issue before it because the FICA statute did not define the term "student" for purposes of the FICA exemption. Turning to step two, the Court found that Treasury's regulation treating someone who worked for at least 40 hours as a worker rather than student was a "perfectly sensible way" to distinguish between "workers who study and students who work." The Court noted that the preamble to the regulation had offered reasonable explanations for the rule — namely, that unlike a case-by-case approach, the rule would improve administrability and further the purpose of the Social Security Act by including workers whom Congress "intended to both contribute to and benefit from the Social Security system."[238]

One might think that it would be difficult to show that, in the face of an ambiguous statute, a tax regulation is as a substantive matter an impermissible construction of the statute or is arbitrary or capricious. Yet at least one court has invalidated a tax regulation on this basis. In *Dominion Resources*,[239] a 2012 case, the Federal Circuit applied *Chevron* to invalidate a regulation[240] on the basis that it was not a "reasonable interpretation" of a code provision[241] requiring the capitalization of interest to the extent the taxpayer's interest costs could have been reduced if production expenditures on improvements to property had not been incurred. The theory is that if the production expenditures had not been incurred, interest on debt to finance the costs would not have been incurred. The regulation at issue requires the capitalization of an amount of interest determined by applying an interest rate to the adjusted basis, including the cost

[237]*Chevron*, 467 U.S. at 843-844.

[238]*Mayo Foundation*, 562 U.S. at 60.

[239]*Dominion Resources v. United States*, 681 F.3d 1313 (Fed. Cir. 2012), *rev'g* 97 Fed. Cl. 239 (2011).

[240]Reg. section 1.263A-11(e)(1)(ii)(B).

[241]Section 263A(f)(2)(A)(ii).

of improvements, of any property that must be withdrawn from service to complete the improvement.[242]

The Federal Circuit found that the statute was circular and thus "ambiguous" and "opaque" because it assumed that if the taxpayer had not incurred production expenditures, it would have spent the funds to pay down debt. Accordingly, the court proceeded to *Chevron* step two. In that part of its analysis, the Federal Circuit determined the regulation to be an unreasonable interpretation of the statute since, by including not only the cost of improvements but the cost of the unimproved property in the base for computation of the capitalized interest, the regulation unreasonably assumed that, if it had not incurred the debt to pay for the improvement, the taxpayer would have sold the property to pay down debt.

One might certainly argue that it was arbitrary or capricious for the IRS, in order to avoid section 1032's command, to create in the triangular reorganization guidance a fictional and unsupportable construct that technically would not fall under the provision. It might also have been arbitrary or capricious for the IRS in Notice 2008-10 and Notice 2012-39 to have used its authority under section 367(a)(5) and (d) to tax a person on income that the IRS believed another person should rightfully include but could not include because section 356 and the basic income tax principle regarding the computation of gain prevented that inclusion. The techniques that these notices and the triangular reorganization guidance generally deploy in the interest of achieving their dubious objectives strike one as regulatory legerdemain that a court may not countenance.

B. The Administrative Procedure Act

This general approach in *Mayo Foundation* has led other courts to conclude that the Administrative Procedure Act[243] (APA) applies to the judicial review of tax regulations to the same extent that it applies to all binding agency actions. After holding the regulation in question invalid under *Chevron*, the Federal Circuit in *Dominion Resources* went on to hold that the regulation, as applied to property temporarily withdrawn from service, violated the requirement of *State Farm*[244] that a federal agency "articulate a satisfactory explanation for its action, including a rational connection between the facts found and the choice made." The court noted that the preamble to the proposed version of the final regulation at issue provided no rationale for including the basis of the unimproved property in the interest calculation base. "The notice [of proposed rulemaking]," the court said, "provides no explanation for the way that use of an adjusted basis implements the avoided-cost rule. Indeed, it does not satisfy the avoided-cost rule."[245]

As described in more detail below, *State Farm* had addressed a claim under section 706(2)(A) of the APA, which requires a reviewing court to "hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law." The trial court in *Dominion Resources*, the Court of Federal Claims, had granted the government's motion for summary judgment against Dominion's claim that Treasury had, in promulgating the regulation, violated section 706(2)(A).[246] The Federal Circuit reversed that determination.

The issue before the Supreme Court in *State Farm* was whether the Department of Transportation had acted arbitrarily and capriciously under section 706(2)(A) in rescinding, before it became effective, a regulation requiring either automatic seat belts or airbags — two alternative forms of "passive restraint" — in automobiles. In reaching its conclusion, the Court set out the standard required of an agency in taking a final action:

> The agency must examine the relevant data and articulate a satisfactory explanation for its action including a "rational connection between the facts found and the choice made." . . . In reviewing that explanation, we must "consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment." Normally, an agency rule would be arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise. The reviewing court should not attempt itself to make up for such deficiencies; we may not supply a reasoned basis for the agency's action that the agency itself has not given. We will, however, "uphold a decision of less than ideal clarity if the agency's path may reasonably be discerned." For purposes of these cases, it is also relevant that

[242]Reg. section 1.263A-11(e)(1)(ii)(B).

[243]5 U.S.C. section 500 et seq.

[244]*United States v. State Farm Mutual Automobile Insurance Co.*, 463 U.S. 29 (1983).

[245]*Dominion Resources*, 681 F.3d at 1319.

[246]*Dominion Resources*, 97 Fed. Cl. 239.

> Congress required a record of the rulemaking proceedings to be compiled and submitted to a reviewing court . . . and intended that agency findings under the Act would be supported by ''substantial evidence on the record considered as a whole.'' . . . While an agency's interpretation of a statute may be confirmed or ratified by subsequent congressional failure to change that interpretation, . . . in the cases before us, even an unequivocal ratification — short of statutory incorporation — of the passive restraint standard would not connote approval or disapproval of an agency's later decision to rescind the regulation.[247]

Studies had shown that automatic seat belts were ineffective because individuals detached them. Because the logical response was therefore to require as the constraint airbags, which had been determined to be effective, rather than rescinding the standard altogether, the Court concluded that the rescission did not manifest a ''rational connection between the facts found and the choice made.'' By failing to consider mandatory airbags (as disclosed by the evidence from the rulemaking), the department had neglected to consider the ''relevant factors'' in its decision. Moreover, in rescinding the regulation, the department had not given ''adequate reasons'' for abandoning a possible airbags-only solution and thus had failed to ''articulate a satisfactory explanation for its action.'' Finally, the Court concluded that the department had failed to make a ''rational connection between facts and judgment required'' by not considering nondetachable automatic seat belts and had ''failed to articulate a basis'' for not requiring them.

The Tax Court recently applied the *State Farm* standard to strike down a section 482 regulation. In *Altera*,[248] Altera Corp., a Delaware corporation and the parent of a group, and Altera International, a Cayman Islands member, agreed to pool their resources to conduct R&D. They shared their respective costs under a qualified cost-sharing agreement (QCSA).[249] During the QCSA's term, Altera granted stock-based compensation to its employees who performed R&D activities subject to the QCSA. The parties to the QCSA did not include the costs of the stock-based compensation in the pool of costs to be shared, even though a regulation[250] in effect explicitly required that inclusion. Based on the regulation and because Altera had been the party that incurred and deducted the stock-based compensation expenses, the IRS increased the amount of Altera International's cost-sharing payment to Altera under the QCSA, which resulted in an increase in Altera's taxable income.

The Tax Court concluded that the regulation did not meet *State Farm*'s requirement for ''reasoned decisionmaking'' as a basis of agency action. It found that as an empirical matter the regulation was inconsistent with the arm's-length standard set forth in the section 482 regulations,[251] whose application the IRS had never denied in promulgating the cost-sharing regulation. The court determined the following:

- the IRS had failed to engage in any fact-finding on whether unrelated parties entering into QCSAs would generally share stock-based compensation costs;
- the preamble to the final regulations did not provide a reasoned basis founded on evidence in the administrative record for reaching the conclusion that unrelated parties entering into QCSAs would generally share those costs;
- by treating all cost-sharing arrangements the same, the IRS had failed to make a rational connection between the facts found and the promulgated regulation;
- the IRS failed to meaningfully respond to numerous relevant and significant comments on the proposed regulation that preceded the final regulation; and
- the regulation was contrary to the evidence submitted by commentators on the proposed regulation.

According to the IRS's own statements, administrative concerns drove it to require recognition under section 367(a) or (d), as appropriate, of any gain on foreign GWGCV transferred to a foreign corporation. It thus seems clear that the analysis of cases like *State Farm* and *Altera* will be critical in

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[247]*State Farm*, 463 U.S. at 42-44 (internal citations omitted).

[248]*Altera Corp. v. Commissioner*, 145 T.C. No. 3 (2015).

[249]Under the regulations in effect for the years at issue, a cost-sharing agreement is an agreement under which two or more parties agree to share the costs of development of one or more intangibles in proportion to the parties' shares of reasonably anticipated benefits from their individual exploitation of the interests in the intangibles assigned to them under the arrangement. Former reg. section 1.482-7(a)(1) (2004). A QCSA is a cost-sharing agreement that meets the specific documentation and allocation requirements of former reg. section 1.482-7(b) (2004).

[250]Reg. section 1.482-7(d)(2).

[251]Reg. section 1.482-1(b)(1): ''In determining the true taxable income of a controlled taxpayer, the standard to be applied in every case is that of a taxpayer dealing at arm's length with an uncontrolled taxpayer. A controlled transaction meets the arm's length standard if the results of the transaction are consistent with the results that would have been realized if uncontrolled taxpayers had engaged in the same transaction under the same circumstances (arm's length result).''

determining whether the position in the new proposed regulations survives. As indicated, the Tax Court in *Altera* saw its task as making an ''empirical determination'' — that is, whether based on data about third-party transactions, the regulation on stock-based compensation comported with the arm's-length standard. According to the court:

> The reasonableness of Treasury's conclusion in no way depends on its interpretation of section 482 or any other statute. As the Supreme Court recently articulated, *State Farm* [rather than *Chevron*] review is ''the more apt analytic framework'' where the challenged regulation does not rely on an agency's interpretation of a statute.[252]

Ultimately, the *Altera* court did not decide whether its decision was based on *Chevron* or *State Farm*, since it believed that *Chevron* incorporated by reference the *State Farm* reasoned decision-making standard. What seems clear based on *Altera*, however, is that, because the IRS's belief in the unadministrability of a standard treating GWGCV and other intangibles differently under section 367(a) and (d) is a position that only empirical data could support or refute, the *State Farm* standard will figure critically in assessing the validity of the regulation if finalized in its current form.

According to the IRS, the provisions of the temporary regulations, which effectively excluded foreign GWGCV from the coverage of section 367(a) and (d), led to so many problems with taxpayers' valuation methods and with their characterization of business operations that any solution short of subjecting the gain to section 367 would have been unsatisfactory. Accordingly, to satisfy *State Farm*'s demands in promulgating a final regulation that resembles the proposed regulation, the IRS will have to document its assertions about taxpayer behavior; show why the facts as found by the IRS and as submitted by commentators justify rules of the proposed regulation's breadth; and rationally respond to taxpayer comments, which will likely be legion. Given that the IRS adopted the residual valuation approach in the temporary regulations precisely because of its administrability in comparison with alternatives, this may well be a tall order.

As indicated, the Tax Court in *Altera* had to address the empirical question whether businesses in the real world share stock-based compensation. A court assessing whether the process by which final regulations on GWGCV comports with the APA will likewise need to assess whether a standard that differentiates between GWGCV and other intangibles is, based on facts drawn from the real world, so inherently unadministrable as to be unworkable. It is also true, as in *State Farm* itself, that judicial decisions addressing whether an agency rule meets the reasoned decision-making standard outside the tax context frequently, or even usually, address empirical issues. Again, the Court in *State Farm* stated:

> The agency must examine the relevant data and articulate a satisfactory explanation for its action including a ''rational connection between the facts found and the choice made.''[253]

Probably the bulk of the questions addressed in this report, such as whether section 367(b) authorizes the apparent override of section 1032 by the triangular B reorganization guidance, are issues of statutory construction and intent and do not lend themselves to data gathering. Nonetheless, section 706(2)(A) of the APA, the provision under which the *State Farm* Court determined that the Department of Transportation had acted arbitrarily and capriciously in rescinding a regulation, does not confine itself to whether a reviewing agency has made an appropriate empirical determination. It requires a reviewing court to ''hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with the law.'' If a court were to determine that the IRS engaged in faulty reasoning or did not set forth its reasoning in concluding that the triangular reorganization rules are consistent with section 1032, the court might very well find that the IRS had acted arbitrarily and capriciously in finalizing the regulations containing those rules. Indeed, in this sense, the earlier case, *Dominion Resources*, may be more instructive than *Altera* since the Federal Circuit in that case explicitly determined that the IRS had failed to make the ''rational connection between the facts found and the choice made,'' not because it failed to collect and consider relevant data but because it ''provide[d] no *explanation* for the way that use of an adjusted basis implements the avoided-cost rule.''[254]

C. Concluding Observations

One can sympathize with those at the IRS and Treasury who, despite calls for congressional action, cannot get the legislature to give the agencies the clear authority to address transactions that they find abusive. Moreover, it may give those individuals little solace to say that even if the taxpayer's

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[252]*Altera*, slip op. at 68, quoting *Judulang v. Holder*, 132 S. Ct. 476, 483 (2011).

[253]*State Farm*, 463 U.S. at 42-44 (internal citations omitted).

[254]*See supra* text accompanying note 245.

position regarding triangular reorganizations is correct, the earnings that they believe the IRS should tax at the time of the reorganization will be taxed upon an actual distribution of the earnings to the U.S. shareholder. Similarly, Treasury and IRS officials may find little comfort in the knowledge that if the taxpayer's position in the all-cash D reorganizations is correct, an actual distribution by the acquiring corporation, as opposed to an exchange by the U.S. shareholder of high-basis shares for acquiring corporation shares, will bring out for taxation earnings that the IRS believes should be taxed at the time of the exchange. In the government's view, there may never be an actual distribution. Or Congress may enact a one-year repatriation tax holiday, as it did in 2004. Or it may enact a territorial system and, in transition, permit the repatriation of the earnings still in corporate solution at a special, low-tax rate. And, most dispiriting of all, even if Congress should, as it has for inversions, enact legislation that speaks to perceived abuses previously addressed by guidance of questionable authority, there will inevitably be abusive transactions that get around the legislation or for which the legislation is irrelevant.

Those have to be some of the thoughts on the minds of those who, charged with the protection of the fisc, feel compelled to ignore statutory language, legislative history, and embedded tax principles. But does frustration justify taking lawless action?

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For more information contact:

Nancy Abramowitz at 202-274-4164 (nabramo@wcl.american.edu).