Report No. 1377

New York State Bar Association

Tax Section

Report on Notice 2016-73

August 9, 2017

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New York State Bar Association

Tax Section

Report On Notice 2016-73

I. INTRODUCTION

This report[1] of the Tax Section of the New York State Bar Association provides comments on Notice 2016-73 (the "**Notice**").[2] The Notice announced the intention of the Treasury Department ("**Treasury**") and the Internal Revenue Service (the "**Service**") to issue regulations that would modify the rules under section 367 regarding cross-border triangular reorganizations and certain inbound nonrecognition transactions.[3] As announced in the Notice, these regulations generally will be effective for transactions entered into after the date of the Notice.

The remainder of this Introduction will provide a summary of the Notice provisions that are discussed in this report. Part II will provide a summary of our recommendations and proposals. Part III will discuss and explain in more detail these recommendations and proposals.

A. Background and Notice 2016-73

The Notice is the latest in a series of notices and regulations addressing cross-border reorganization transactions and is intended to discourage taxpayers from using triangular reorganizations and inbound nonrecognition transactions to facilitate repatriation of untaxed foreign earnings and tax basis without incurring federal income taxes.

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[1] The principal drafter of this report is Daniel Altman. Helpful comments were received from Kimberly Blanchard, Andrew Braiterman, Peter Connors, Michael Farber, Shane Kiggen, Deborah Paul, Brian Reed, Yaron Reich, Richard Reinhold, Michael Schler, David Sicular, Andrew Solomon, Karen Sowell, Joe Toce, Shun Tosaka, Philip Wagman and Gordon Warnke. The assistance of Tara Lancaster is gratefully acknowledged. This report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] 2016-52 I.R.B. 908 (Dec. 2, 2016).

[3] Except as otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended (the "**Code**"), and all references to "Treas. Regs." or "Treasury Regulations" are to the U.S. Treasury regulations promulgated thereunder.

Cross-border triangular reorganizations have been the subject of significant guidance over the past ten years. In Notice 2006-85,[4] Treasury and the Service announced their intention to issue regulations under section 367(b) addressing certain triangular reorganizations (commonly known as "Killer B" transactions) that were designed to avoid U.S. federal income taxes, including on the repatriation of a subsidiary's earnings. The transaction generally involved a foreign subsidiary (FS) purchasing stock of its domestic parent (DP) from DP in exchange for property and then transferring the DP stock in exchange for the stock or assets of an affiliated foreign corporation target in a triangular reorganization under section 368(a). In this transaction, taxpayers took the position that FS's purchase of DP stock was not taxable to DP,[5] and no gain was recognized by FS on the immediate disposition of DP shares.[6] The net effect of the transaction was a repatriation of the value of the property from FS to DP.[7] Under Notice 2006-85, Treasury and the Service announced that the intended regulations would treat FS's purchase of DP stock in exchange for property as a section 301 distribution. In Notice 2007-48,[8] Treasury and the Service, among other things, expanded the deemed section 301 distribution treatment to include triangular reorganizations where FS acquires DP stock from unrelated parties.

The intended regulations were issued in temporary and proposed form in 2008,[9] and finalized in 2011 as Treasury Regulations section 1.367(b)-10 (the "**Triangular Regulations**").[10] These regulations generally provided that, in the case of a triangular reorganization where (i) parent or subsidiary is foreign and (ii) subsidiary acquires parent stock

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4 Notice 2006-85, 2006-2 C.B. 677, *obsoleted by* T.D. 9400, 2008-1 C.B. 1139, *adopted with modification by* T.D. 9526, 76 Fed. Reg. 28890 (May 19, 2011).

5 DP's receipt of cash in exchange for its own shares would be nontaxable by reason of section 1032. *See* Treas. Regs. § 1.1032-1(a).

6 FS obtained a cost basis in DP shares by reason of section 1012 and, as such, recognized no gain upon the transfer of DP shares immediately thereafter. Treas. Regs. § 1.1032-2(c). In these transactions, DP's stock was disposed of before the close of the quarter-end in order to avoid an income inclusion under section 956. Furthermore, taxpayers took the position that, under Treasury Regulations section 1.367(b)-4(b)(1)(ii), target shareholders were not required to include in income as a deemed dividend the section 1248 amount attributable to the target stock.

7 In a variation, a domestic subsidiary of a foreign parent might buy its parent shares for use in a reorganization and take the view that this avoided the U.S. withholding tax that would be due on a distribution of cash by the subsidiary to the parent.

8 Notice 2007-48, 2007-1 C.B. 1428, *obsoleted by* T.D. 9400, 2008-1 C.B. 1139, *adopted with modification by* T.D. 9526, 76 Fed. Reg. 28890 (May 19, 2011).

9 T.D. 9400, 73 Fed. Reg. 30301 (May 27, 2008).

10 T.D. 9526, 76 Fed. Reg. 28890 (May 19, 2011). All references to the Triangular Regulations herein are to such regulations, as modified by the 2014 Notice (as defined below).

in exchange for property, adjustments must be made that are consistent with the adjustments that would have been made if subsidiary actually had distributed property to parent under section 301. The temporary and final regulations included rules intended to apply either section 367(a) or section 367(b) – but not both – to these triangular reorganizations (the "**Priority Rules**"). Under the Priority Rules, section 367(a) would apply to the transaction if the gain recognized by the shareholders of target under section 367(a) ("**Section 367(a) Income**") would be equal to or greater than the amount of the deemed distribution from the acquiring corporation to its parent, the issuing corporation, under the Triangular Regulations that would be treated as a dividend under section 301(c)(1) or gain under section 301(c)(3) ("**Section 367(b) Income**").[11] If the Section 367(a) Income would be less than the Section 367(b) Income, however, then the Triangular Regulations would apply to the transaction and the acquisition of the stock or securities of the parent by the subsidiary in exchange for property would be treated as a deemed distribution in the amount of the property by the subsidiary to its parent. In the preamble to the 2011 final Treasury Regulations, Treasury and the Service rejected a comment that suggested taking into account the amount of the resulting U.S. tax for purposes of measuring the Section 367(b) Income (rather than taking into account the total amount of section 301(c)(1) dividend and section 301(c)(3) gain without regard to U.S. tax) explaining that a rule looking at the actual tax amount would be difficult to administer.[12]

In 2014, in response to growing concerns with inversion transactions, Treasury and the Service revisited the final regulations. In Notice 2014-32 (the "**2014 Notice**"),[13] Treasury and the Service expressed a concern with triangular reorganizations undertaken to effectuate inversion transactions, where a domestic subsidiary (DS) acquired stock of its foreign parent (FP) in exchange for property and used that FP stock to acquire the stock or assets of a domestic target in a triangular reorganization. In these transactions, DS had only a small amount of earnings and profits. Under the Priority Rules described above, the deemed distribution from DS to FP would create a significant amount of Section 367(b) Income, although little or none of this income would be subject to U.S. tax. Specifically, the amount of Section 367(b) Income would exceed the amount of Section 367(a) Income that would otherwise be recognized by the U.S. shareholders of the domestic target. As such, based on the Priority Rules, the shareholders took the position that the Triangular Regulations, rather than section 367(a), should apply to this transaction because the Section 367(a) Income was less than the Section 367(b) Income. In response to these transactions, in the 2014 Notice Treasury and Service announced that they

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[11] Treas. Regs. § 1.367(b)-10(a)(2)(iii) (as modified by the 2014 Notice, the "**367(a) Priority Rule**"); Treas. Regs. § 1.367(a)-3(a)(2)(iv) (the "**367(b) Priority Rule**").

[12] T.D. 9526 (May 19, 2011).

[13] Notice 2014-32, 2014-20 I.R.B. 1006 (April 25, 2014).

intend to revise the Priority Rules so that only section 301(c)(1) dividends and section 301(c)(3) gain which would be subject to U.S. tax or give rise to subpart F income inclusion would be treated as Section 367(b) Income.

Because the changes proposed in the 2014 Notice applied equally to transactions involving both domestic targets and foreign targets, taxpayers were able to use these revised Priority Rules to obtain tax benefits that prompted the issuance of Notice 2016-73.

1. Transactions at Issue and Claimed Tax Treatment

In Notice 2016-73 Treasury and the Service expressed their concern with triangular reorganizations with respect to foreign targets that are described in the Triangular Regulations (an "**Applicable Triangular Reorganization**") and that are followed by inbound nonrecognition transactions. These transactions have the result of repatriating foreign earnings and profits and tax basis into the U.S. tax system without incurring federal income tax.

The example given in the Notice describes a transaction (a "**Lower-Tier Reorganization**") in which USP, a domestic corporation, wholly owns FP, a foreign corporation, which, in turn, wholly owns FS, another foreign corporation. FP has no earnings and profits, but FS has substantial earnings and profits. A dividend from FS to FP would qualify for the exception to foreign personal holding company income under section 954(c)(6).[14] USP also wholly owns USS, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation. In an Applicable Triangular Reorganization, FS acquires FP stock from FP in exchange for cash, a note, or other property (the "**Acquisition**") and uses the FP stock to acquire all of the stock of FT from USS in a transaction intended to qualify as a reorganization described in section 368(a)(1)(B)[15] (the "**Reorganization**"). On a later date and in a transaction purportedly unrelated to the Reorganization, FP engages in an inbound nonrecognition transaction described in Treasury Regulations section 1.367(b)-3 (an "**Inbound Transaction**"), such as an inbound F reorganization.

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[14] While not mentioned in the Notice, similar results would also apply if the distribution is eligible for the same country exception under section 954(c)(3). While under Treasury Regulations section 1.367(b)-3(b)(3) the same country exception is turned off for Inbound Transactions, this is not the case for the deemed distribution under Treasury Regulations section 1.367(b)-10 prior to the inbound transaction. *See also* T.D. 8862, Explanation of Provisions, Part C(1) (Jan. 24, 2000).

[15] Treasury Regulations section 1.367(b)-10(a)(3)(iv) provides that, for purposes of the Triangular Regulations, the term "triangular reorganization" has the meaning set forth in Treasury Regulations section 1.358-6(b)(2). Accordingly, the following transactions, among others, qualify as a triangular reorganization for purposes of the Triangular Regulations: triangular B reorganizations, reverse triangular mergers, forward triangular mergers, and triangular C reorganizations.

For ease of reference, the mechanics of a Lower-Tier Reorganization are depicted in the two diagrams below. The mechanics of an Applicable Triangular Reorganization are shown below in Figure 1, and the subsequent Inbound Transaction on is shown below in Figure 2.

Figure 1.
Mechanics of an Applicable Triangular Reorganization

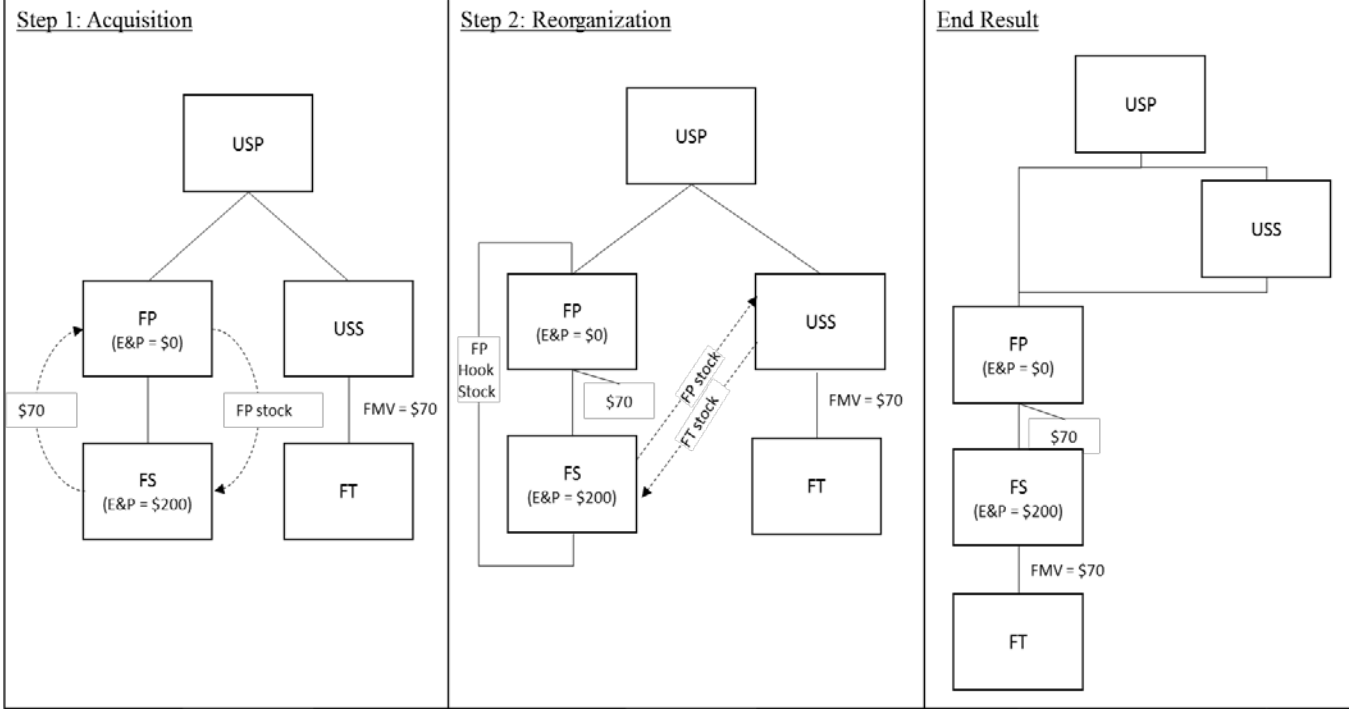
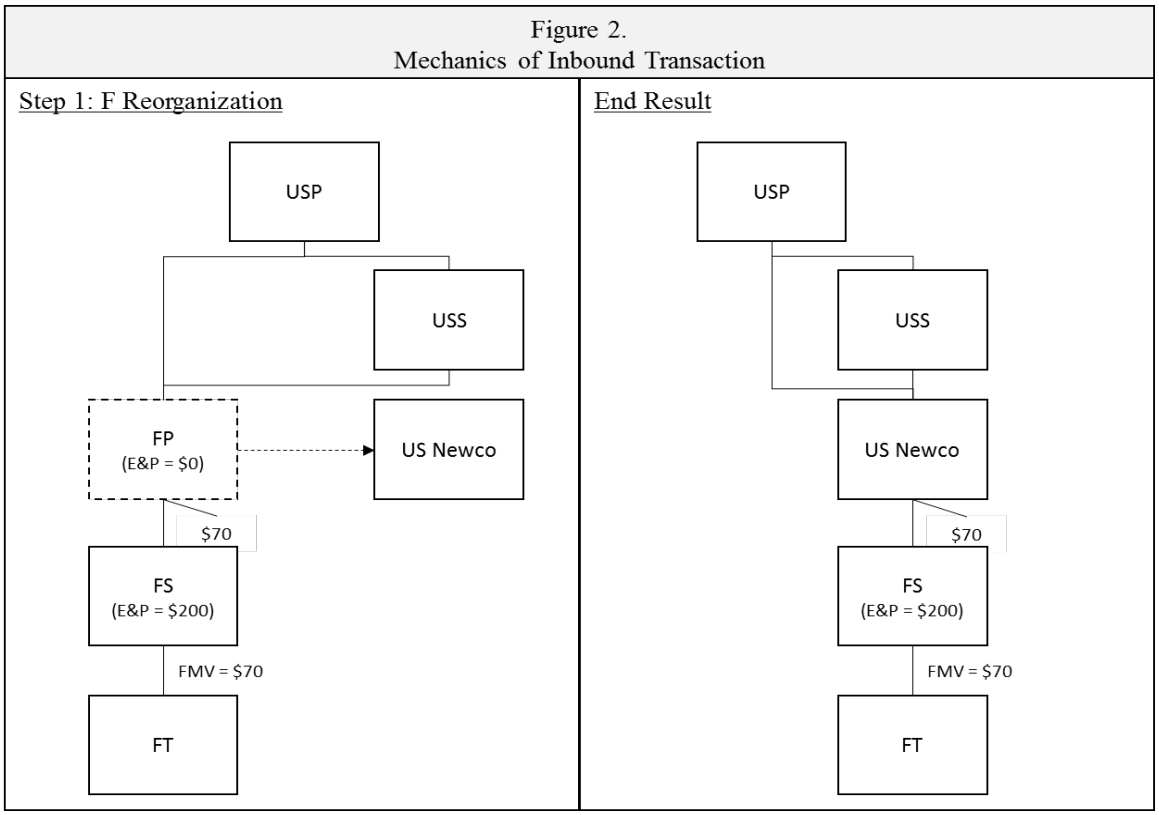


Figure 2.
Mechanics of Inbound Transaction



In the Lower-Tier Reorganization example described above, the taxpayer enters into a gain recognition agreement (a "**GRA**") under Treasury Regulations sections 1.367(a)-3 and -8 for all (or virtually all) of the gain on the stock of target. In computing the amount of income subject to tax under section 367(b), a deemed distribution from FS to FP would not be subject to federal income tax because the look-through rule under section 954(c)(6) would not give rise to a subpart F income inclusion.[16] The Section 367(a) Income is therefore equal to or greater than the Section 367(b) Income that is subject to U.S. tax. Accordingly, the taxpayer takes the position that, under the Priority Rules, the rules of section 367(a) – and not the Triangular Regulations – apply because of the absence of (or a small amount of) Section 367(a) Income, which is equal to or greater than the Section 367(b) Income. As a result, there is no deemed distribution under the Triangular Regulations and, thus, the earnings and profits of FP are not increased by the value of the property that FP received from FS in exchange for FP stock. Accordingly, there is no income inclusion under Treasury Regulations section 1.367(b)-3 (which requires the inclusion of the "all earnings and profit" amount)[17] when the value of that property is repatriated to the United States in the subsequent Inbound Transaction.[18]

2. Amendments with Respect to Applicable Triangular Regulations

The Notice affects Applicable Triangular Reorganizations in three ways: (i) it would revise the Priority Rules to give priority to the Triangular Regulations where the target is a foreign corporation, resulting in a deemed distribution from the subsidiary to the parent in the amount of the cash and property used to acquire the hook stock of parent; (ii) if the target is foreign, it would also require target's shareholders to recognize all the gain with respect to the target stock (either as a section 1248 amount or as gain) without the ability to enter into a

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[16] Under section 954(c)(6), distributions received from a related controlled foreign corporation ("**CFC**") are not treated as subpart F income if allocable to income that is not subpart F income and not effectively connected with a U.S. trade or business.

[17] *See* Treas. Regs. § 1.367(b)-2(d).

[18] The same result would apply if FP was formed, and the Acquisition was completed, during the final 29 days of the taxable year. In that case, FP would not have been a CFC for an uninterrupted period of 30 days or more during the taxable year and any deemed distribution from FS to FP would not result in subpart F income. *See* section 951(a)(1)(A).

GRA;[19] and (iii) it would revise the definition of "property" for purposes of the Triangular Regulations to include nonqualified preferred stock of the subsidiary.[20]

3. Amendments with Respect to Inbound Transactions

In addition to modifying the rules under section 367 with respect to Applicable Triangular Reorganizations, the Notice also announced the intention to create a new set of rules under section 367(b) with respect to Inbound Transactions subject to Treasury Regulations section 1.367(b)-3. The proposed changes announced in the Notice are significant because they apply to all Inbound Transactions, regardless of whether those transactions follow an Applicable Triangular Reorganization.

Under Treasury Regulations section 1.367(b)-3, when a foreign corporation (foreign acquired corporation) transfers its assets to a domestic corporation (domestic acquiring corporation) in a nonrecognition liquidation under section 332 or an asset reorganization under section 368(a) (*i.e.*, an Inbound Transaction), certain shareholders of the foreign acquired corporation are required to include, as a deemed dividend, the net positive earnings and profits attributable to their stock of the foreign acquired corporation (the "**All E&P Amount**").[21] Importantly, the All E&P Amount does not include the earnings and profits of the subsidiaries of the foreign acquired corporation.[22]

The Notice is generally intended to address a concern on the part of Treasury and the Service that taxpayers are engaging in Inbound Transactions that have the result of repatriating

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[19] The regulations to be issued under the Notice would amend Treasury Regulations sections 1.367(b)-4 and -4T, which currently require recognition of the section 1248 amount in certain foreign-to-foreign transactions where the ability to tax the section 1248 amount is not preserved.

[20] Under the current Triangular Regulations, "property" has the meaning set forth in section 317(a) (*i.e.*, money, securities, and any other property, other than stock in the corporation making the distribution). Additionally, the definition was expanded in the Triangular Regulations to include a liability assumed by the subsidiary to acquire the parent's stock or securities, as well as subsidiary stock and rights to acquire subsidiary stock if used to acquire parent's stock or securities from a person other than the parent. The Notice expands this term to include nonqualified preferred stock of the subsidiary.

[21] Treas. Regs. § 1.367(b)-3(b)(3). The preamble to Treasury Regulations section 1.367(b)-3 explains that "[t]he section 367(b) regulations have historically focused on the carryover of earnings and profits and bases of assets… The requirement to include in income the all earnings and profits amount results in the taxation of previously unrepatriated earnings accumulated during a U.S. shareholder's (direct or indirect) holding period. This income inclusion prevents the conversion of a deferral of tax into a forgiveness of tax and generally ensures that the section 381 carryover basis reflects an after-tax amount." T.D. 8862, 2000-6 I.R.B. 466 (Jan. 24, 2000).

[22] Treas. Regs. § 1.367(b)-2(d)(3)(ii).

earnings and profits or tax basis without a corresponding federal income tax inclusion. For example, the acquisition of hook stock of the foreign parent by the foreign subsidiary in exchange for property as part of the Applicable Triangular Transaction, if not treated as a distribution, has the effect of moving the property from the subsidiary to the foreign parent without increasing the earnings and profits of the foreign parent.[23] A subsequent Inbound Transaction, in which the foreign parent distributes property to its domestic parent, would therefore result in a repatriation of the value of such property into the United States without any tax on the corresponding earnings and profits, which would be retained by the foreign subsidiary.

Under the Notice, under certain circumstances described below, the All E&P Amount of the foreign acquired corporation will be increased by all, or a portion of, the earnings and profits of the subsidiaries of the foreign acquired corporation. Specifically, if the foreign acquired corporation has "excess asset basis," then the exchanging shareholder must increase the All E&P Amount by the "specified earnings" with respect to the stock of the foreign acquired corporation. In general terms, "**Excess Asset Basis**" exists when the tax basis of the assets of the foreign acquired corporation (*i.e.*, FP in the example above) (the "**Inside Basis**") is greater than the sum of (i) the tax basis of the stock of the foreign acquired corporation (the "**Outside Basis**"), (ii) the earnings and profits of the foreign acquired corporation, and (iii) the liabilities of the foreign acquired corporation that are assumed by the acquiring domestic corporation. In other words, Excess Asset Basis describes an imbalance in the tax-basis balance sheet of the foreign acquired corporation. The "**Specified Earnings**" are generally the lesser of the following amounts: (i) the sum of the earnings and profits (including deficits) of the lower-tier subsidiaries of the foreign acquired corporation, (ii) the Excess Asset Basis, and (iii) the built-in gain in the stock of the foreign acquired corporation (reduced by the All E&P Amount determined without regard to the Notice).

The Notice further provides that, if a foreign acquired corporation has Excess Asset Basis, a taxpayer may reduce the Excess Asset Basis to the extent that the Excess Asset Basis is not attributable, directly or indirectly, to property provided to the foreign acquired corporation by a foreign subsidiary. The Notice also indicates that these regulations will include a new anti-abuse rule to address transactions that are undertaken with a view to avoiding the purposes of the new Excess Asset Basis rules set forth in the Notice.

While Treasury and the Service identified an Inbound Transaction that follows an Applicable Triangular Reorganization (*e.g.*, the Lower-Tier Reorganization) as a transaction that raises the policy concern described above, Treasury and the Service intend to apply these new

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[23] A contribution to the capital of a corporation in exchange for stock does not increase the earnings and profits of the corporation. Section 1032.

rules to all Inbound Transactions, and have requested comments on other transactions that may give rise to similar concerns.

4. Underlying Policy Considerations

Before turning to our recommendations, it is important to mention several policy considerations that are relevant to the Notice and to an understanding of our recommendations.

When issuing the Triangular Regulations, Treasury and the Service in effect regarded an acquisition of hook stock of parent by its subsidiary in exchange for property as being no different from a distribution of such property by the subsidiary to the parent, and sought to use their authority under section 367(b) to reach this treatment.[24] Congress, however, limited section 367(b) to reorganization transactions that are not subject to tax under section 367(a). A reorganization can therefore be subject to tax under either section 367(a) or section 367(b), but not both. It is this limitation, we believe, that led Treasury and the Service to limit the Triangular Regulations under section 367(b) to reorganization transactions that are not subject to section 367(a) and led to the adoption of the Priority Rules described above. The Notice seeks to preserve the integrity of the Priority Rules with respect to Lower-Tier Reorganizations followed by Inbound Transactions. In these Lower-Tier Reorganizations, instead of the domestic parent issuing stock to its subsidiary in exchange for property, the taxpayer interposes a foreign parent that issues that stock, and the foreign parent thereafter, in a purported unrelated transaction, converts into a domestic corporation. If we were to disregard the foreign parent in those transactions and treat the domestic parent as having issued the stock to its subsidiary in exchange for property, the deemed distribution under the section 367(b) Triangular Regulations (to the extent constituting a dividend or gain) would have been subject to U.S. tax. The mere fact that the taxpayer interposed a foreign parent, which later converted into a domestic corporation, should not change this result.[25] The Notice is intended to achieve this outcome.

Second, as mentioned above, under section 367, a reorganization can be subject to tax under either section 367(a) or section 367(b), but not both. Apparently, the Notice seeks to overcome this limitation and obtain the equivalence of concurrent taxation under both sections

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[24] Often, hook stock is disregarded for non-income tax purposes. Respecting the acquisition of the hook stock is what permits a subsidiary to shift property to its parent without also shifting to the parent the corresponding earnings and profits of the subsidiary. By treating the acquisition of hook stock as a distribution, the Notice treats the subsidiary's relevant earnings and profits as moving to the parent together with the property.

[25] We note that the Notice applies to all types of FPs, even if they are not transitory and even if they are old and cold, though we expect that most transactions that are caught by the Notice will be highly structured transactions that are designed to achieve the intended tax result.

367(a) (taxing the shareholders of target) and 367(b) (treating the acquisition of hook stock as a distribution) by way of a technical fix in which new regulations are added to section 367(b) that have the same effect as subjecting the shareholders of target to tax under section 367(a) (but without the ability to enter into a GRA). In this way, both sides of the transaction (tax on the shareholders of target, and a deemed distribution from the subsidiary to the parent) in an Applicable Triangular Reorganization with a foreign target are subject to tax under section 367(b).

Third, because the Triangular Regulations under section 367(b) treat the acquisition of hook stock for property in an Applicable Triangular Reorganization as a distribution, the earnings and profits of the subsidiary are moved to the parent along with the property used to purchase the hook stock. Where the parent is a domestic corporation, this deemed distribution results in the repatriation of the earnings and profits along with the value of the property, and it is therefore sound tax policy to impose U.S. tax on the distribution. With the new Excess Asset Basis rules, the Notice, however, goes one step further and seeks to impose tax even when the earnings and profits would otherwise have stayed offshore and been subject to future U.S. taxation. This is because the Specified Earnings of the lower-tier subsidiaries of the foreign acquired corporation are added under the Notice to the All E&P Amount that is subject to tax upon the Inbound Transaction. Presumably, the reasoning behind this rule is that the earnings and profits (*i.e.*, the property used to acquire the hook stock) has been repatriated to the United States in the Inbound Transaction and should be taxed. This begs the question whether this is the right approach, given that the earnings and profits remain offshore and could be subject to future taxation.[26] Support for this approach can be found in the preamble to the 1991 proposed regulations under section 367(b), in which Treasury and the Service explained that one of the underlying policies of section 367(b) is the "prevention of the repatriation of earnings and profits *or basis* without tax."[27] We note, however, that Treasury and the Service also stated in the preamble to the 1991 Proposed Regulations that the regulations under section 367(b) "do not operate to accelerate the recognition of income that is realized but which would not otherwise be recognized by reason of a nonrecognition provision" and that they generally attempt to "reduce taxpayer compliance burdens and the Treasury's administrative costs, and to improve

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[26] For a rule similarly imposing tax on the value of repatriated property while the related earnings and profits remain offshore, see Treasury Regulations section 1.956-1(b).

[27] 56 Fed. Reg. 41993, 41995 (Aug. 26, 1991) (the "**1991 Proposed Regulations**") ("A domestic acquirer of the foreign corporation's assets should not succeed to the basis or other tax attributes of the foreign corporation except to the extent that the United States tax jurisdiction has taken account of the United States person's share of the earnings and profits that gave rise to those tax attributes.")

enforcement of tax laws," in each case, to the extent consistent with the policy of preventing the repatriation of earnings and profits or basis without tax.[28]

II. SUMMARY OF RECOMMENDATIONS

1. We support the changes to the Priority Rules, according to which the Triangular Regulations would always apply to Applicable Triangular Reorganizations and therefore result in a deemed distribution from the subsidiary to the parent when the target is foreign. We further support the treatment of nonqualified preferred stock as "property" under the Triangular Regulations.

2. As an alternative to the approach taken by Treasury and the Service in the Notice, Treasury and the Service might consider a more surgical change to the Priority Rules where the target is foreign. Under this alternative approach, for purposes of the Priority Rules, in transactions in which the target is foreign, the Section 367(b) Income would be determined without regard to whether that income is subject to U.S. tax.[29]

3. We do not believe that it is necessary to require the shareholders of the target to recognize the section 1248 amount and the gain on their stock in an Applicable Triangular Reorganization in which the target is foreign. We support a policy under which the Acquisition of the hook stock is treated as a deemed distribution under section 367(b) and, concurrently, target's shareholders are subject to section 367(a) on their gain (requiring them to enter into GRAs to preserve nonrecognition treatment), but have reservations as to whether the Code permits such concurrent application of both section 367(a) and section 367(b).

4. We believe that the new Excess Asset Basis rules should be limited only to taxpayers that have already completed an Applicable Triangular Reorganization prior to the effective date of the Notice, have not treated the Acquisition as a deemed distribution under the existing Priority Rules, and engage in a future Inbound Transaction ("**Pipeline Transactions**").[30]

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[28] *Id.*

[29] As mentioned below, we note, however, that this approach may open the door to avoidance of section 301(c)(2) basis reduction in certain situations where the Section 367(a) Income is small and the basis reduction would be greater, and we recognize the intention of Treasury and the Service to adopt broader, rather than narrower, rules that would discourage tax avoidance.

[30] While the majority of the Executive Committee of the NYSBA Tax Section ("**Executive Committee**") believe that the scope of the Excess Asset Basis rules should be limited to Pipeline Transactions, we all recognize that Treasury and the Service are attempting to develop broad rules that would discourage future

5. If Treasury and the Service decide to adopt the recommendations in this report and limit the Excess Asset Basis rules to Pipeline Transactions, they should further consider whether to apply these rules on a permanent basis, or only on a transitional basis (*e.g.,* Inbound Transactions that occur within the ten year period following the date of the Notice).III.B.1.a(6)

6. If Treasury and the Service decide not to limit the Excess Asset Basis rules to Pipeline Transactions, then we would recommend the new rules apply only to foreign acquired corporations that participated in Applicable Triangular Reorganizations with foreign targets. Because we have not been able to identify other transactions in which it would be proper to apply the new Excess Asset Basis rules, we would not recommend applying these rules to any other transaction at this time.

7. We would further recommend the following with respect to the Excess Asset Basis rules:

a. Treasury and the Service should consider limiting the Excess Asset Basis to the tax-basis imbalance that is created by the Applicable Triangular Reorganization.

b. Treasury and the Service should also consider a simplifying rule that disregards the Outside Basis of small shareholders (and the related share of the Inside Basis, liabilities and earnings and profits) for purposes of determining the Excess Asset Basis.

8. Treasury and the Service should provide more guidance on the type of self-help transactions that are permitted to reduce the amount of the Excess Asset Basis without violating the new proposed anti-abuse rule.

9. We ask that Treasury and the Service reconsider the effective date of the Notice, especially with respect to the new Excess Asset Basis rules. We recognize, however, the need for an immediate effective date for Pipeline Transactions.

10. We see no reason to change the timing of the deemed distribution under the Triangular Regulations and it would be helpful if Treasury and the Service could clarify what reason they see to change the timing of the deemed distribution.

11. Unrelated to the Notice, we recommend that Treasury and the Service consider certain possible clarifications with respect to the scope of the existing anti-abuse rule under the Triangular Regulations, including (i) stating that the purpose of these rules is to prevent the

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tax avoidance opportunities, and a significant minority of the Executive Committee further believes that it is proper to apply the Excess Asset Basis rules to all Inbound Transactions. *See* Part III.B.1.e of the report.

repatriation of earnings and profits or tax basis without federal income tax, and (ii) clarifying the scope of the anti-abuse rule and whether it gives Treasury and the Service the authority not only to adjust earnings and profits but also to treat a transaction as meeting the requirements of a triangular reorganization that is subject to the Triangular Regulations where appropriate.

III. DISCUSSION OF RECOMMENDATIONS

A. Applicable Triangular Reorganizations

1. Revised Priority Rules

a. Support for the Proposed Changes to the Priority Rules

Stemming from concerns that taxpayers have been able to repatriate offshore earnings and profits and tax basis without incurring federal income taxes by applying the 367(a) Priority Rule, the Notice provides that Treasury and the Service intend to issue regulations that would limit the application of the 367(a) Priority Rule to domestic target corporations only. Under the revised rules, the Triangular Regulations would apply in all cases where the target is foreign, resulting in a deemed distribution from the subsidiary to the parent. We believe that forcing a deemed distribution from FS to FP in Applicable Triangular Reorganizations with foreign targets adequately addresses Treasury's and the Service's stated policy concerns, as the deemed distribution will have the effect of increasing the earnings and profits of FP by the amount of the distribution to the extent of the untaxed earnings and profits of FS (plus any gain recognized under section 301(c)(3)). In a subsequent Inbound Transaction, these earnings and profits will be taxed under the existing All E&P Amount rules. In other words, revising the 367(a) Priority Rule has the intended effect of moving the property together with the associated earnings and profits from FS to FP. We note that some of the deemed distribution may be treated as a return of capital under section 301(c)(2), which will not increase the earnings and profits of FP. This part of the deemed distribution, however, generally represents property of FP that was contributed to FS, and thus represents FP's own earnings and profits (which would be taxed under the All E&P Amount), or capital contributions from USP, which should not be subject to tax upon repatriation back to USP.[31]

[31] We have also considered whether the concerns expressed by Treasury and the Service could more properly be addressed by strengthening the existing anti-abuse rule under the Triangular Regulations (as an alternative to the changes proposed in the Notice) in order to adapt to unforeseen changes in circumstances and to facilitate non-abusive commercial transactions. While we believe, as mentioned below, that the

b. Alternative Suggestion: Revise the Priority Rules under the 2014 Notice

As an alternative, Treasury and the Service might consider a more surgical change to the Priority Rules. The treatment of Lower-Tier Reorganizations that concerns Treasury and the Service has its genesis in Treasury's and the Service's attempt to shut down certain inversion transactions designed to avoid an immediate triggering of shareholder-level gain that Treasury and the Service viewed as concerning. In an attempt to discourage those transactions, Treasury and the Service announced in the 2014 Notice that they intend to revise the Priority Rules contained in the Triangular Regulations. The 2014 Notice largely followed the Section 367(a) Priority Rule set forth in the Triangular Regulations, but provided that only Section 367(b) Income that is actually subject to federal income tax (either directly or as subpart F income) would be considered for purposes of applying the 367(a) Priority Rule. This led taxpayers to engage in two separate, seemingly unrelated, transactions: the Applicable Triangular Reorganization followed by the Inbound Transaction. For the reasons described in Part I.A.1 above, taxpayers took the position that the Applicable Triangular Reorganization was governed solely by section 367(a) (thus avoiding the deemed distribution rules under the Triangular Regulations), and that the subsequent Inbound Transaction resulted in federal income tax only to the extent of FP's All E&P Amount (which, notably, would not include the value of the property received by FP from FS in exchange for FP's stock, or the undistributed earnings and profits of FS or FT).[32] We believe that simply returning to the original version of the Section 367(a) Priority Rule set forth in the Triangular Regulations with respect to foreign targets (under which the Section 367(a) Income would be compared to the Section 367(b) Income from the deemed distribution, whether or not such Section 367(b) Income is subject to tax in the United States), would discourage taxpayers from entering into these Lower-Tier Reorganization transactions. Under this approach, in order to be able to repatriate foreign earnings without federal income tax, taxpayers would need to enter into a triangular reorganization that results in taxable Section 367(a) Income that is in excess of the Section 367(b) Income (whether taxable or not) from the deemed distribution.[33]

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existing anti-abuse rule under the Triangular Regulations should be clarified, and possibly strengthened, in general, we agree that the revisions to the Priority Rules described in the Notice are the more appropriate way to deal with the concerns raised in the Notice.

[32] Treas. Regs. §§ 1.367(b)-3(b)(3), 1.367(b)-2(d)(3)(ii).

[33] If the Section 367(b) Income was greater than the Section 367(a) Income, the deemed distribution would result in an increase to the All E&P Amount of FP and thereby result in current taxation upon the Inbound Transaction.

These rules would therefore discourage taxpayers from entering into these transactions without much change to the existing rules and without the need to turn off the 367(a) Priority Rule completely with respect to foreign targets. The benefit of this approach is that shareholders of a foreign target may remain subject to taxation under section 367(a) in cases in which the Section 367(a) Income is greater than the income from the deemed distribution.

We note, however, that this approach may open the door to avoidance of section 301(c)(2) basis reduction in certain situations where the Section 367(a) Income is small and the basis reduction would be greater, and we recognize the intention of Treasury and the Service to adopt broader, rather than narrower, rules that would discourage tax avoidance.

2. Treatment of Target's Shareholders

a. Section 1248 Dividend and Recognition of Remaining Gain

As discussed above, the Notice also announced the intention of Treasury and the Service to revise Treasury Regulations sections 1.367(b)-4 and -4T to require the exchanging shareholders of a foreign target involved in an Applicable Triangular Reorganization to recognize the section 1248 amount and any remaining gain on their target stock, and would deny them the ability to enter into a GRA.

As an initial matter, these proposed changes are inconsistent with the general approach taken in 2011 when the Triangular Regulations were originally issued.[34] At that time, Treasury and the Service generally sought to tax either the target shareholder's side of the transaction (under section 367(a)) or the acquiror's side of the transaction (under section 367(b)), but not both. Moreover, the Notice is also inconsistent with the approach and policies adopted by Treasury and the Service in 1998 under Treasury Regulations section 1.367(a)-3(b)(2) according to which transactions that would be subject to both section 367(a) and section 367(b) should be subject to tax only under one of these provisions, not both.[35] This approach is also fully consistent with the provisions of section 367(b)(1) that states that 367(b) only applies "where there is no transfer of property described in subsection (a)(1)."

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[34] T.D. 9526, 76 Fed. Reg. 28890 (May 19, 2011).

[35] Treasury Regulations section 1.367(a)-3(b)(2) generally provides that the section 367(b) regulations do not apply where the transaction is taxable under section 367(a). Where the transaction is not taxable under section 367(a) (because of a GRA for example), the section 367(b) regulations would apply. *See also* T.D. 8770 (June 18, 1998) ("Thus, these final regulations adopt the approach contained in the proposed regulations: that all outbound transfers of foreign stock will be subject to section 367(a) and section 367(b) concurrently, except to the extent that the exchange is fully taxable under section 367(a)(1). See §1.367(a)-3(b)(2).")

In the Notice, it appears that Treasury and the Service are attempting to obtain concurrent taxation under both sections 367(a) and 367(b) by a technical fix in which new regulations are adopted under section 367(b) that have the same effect as having the shareholders of target being taxed under section 367(a). It is unclear to us what new policy concerns Treasury and the Service have identified to warrant this departure in policy and, if this departure was intended, we believe that Treasury and the Service should state so clearly and provide their reasoning for the change.

Moreover, under the Notice, taxpayers are now worse off doing a leveraged Applicable Triangular Reorganization (subjecting the shareholders of target to tax on their stock) than doing a distribution from subsidiary to parent followed by a separate stock-for-stock reorganization (where the shareholders of target may be eligible to defer the tax by entering into a GRA, and smaller shareholders may not be subject to tax). From an economic and policy perspective there should not be any difference between these two transactions. We note further that this means that taxation under Treasury Regulations sections 1.367(b)-4 and 4T would, in effect, become elective given proper counsel, and while it would have limited effect on properly advised taxpayers, it may become a trap for the unwary who have not engaged in these transactions with a view to obtaining the proscribed tax benefits.

We believe that Treasury's and the Service's concerns with Applicable Triangular Reorganizations facilitating repatriation of untaxed earnings is adequately addressed by deeming there to be a distribution under the Triangular Regulations, and could not find any policy reason why, in addition, the shareholders of target should also be subject to tax at the time of the Applicable Triangular Reorganization. Such shareholders will continue to be subject to future tax as a result of their carryover basis in their stock of parent and their continued indirect equity interest in the target. Furthermore, we believe that imposing a tax on shareholders of target that are unrelated to the acquiror is particularly unwarranted and that those shareholders may not even be aware that they are subject to tax (as this will depend on whether the stock of parent that they received was purchased for property).[36]

Example 1 in the Notice demonstrates the concerns we have with these proposed changes. This example includes facts similar to the Lower-Tier Reorganization described above, except that (i) USS owns 100 shares of FT stock, which constitutes a single block of stock with a fair market value of $100, an adjusted basis of $20, and a section 1248 amount of $50, and (ii) FS has earnings and profits of $60. In an Applicable Triangular Reorganization, FP issues 100 shares of voting stock with a fair market value of $100 to FS in exchange for $40 of common

[36] This situation, however, is not unique to the Notice; it equally applied before the Notice was issued where the Section 367(a) Income was greater than the Section 367(b) Income albeit, prior to the Notice being issued, the shareholders were entitled to enter into a GRA.

stock of FS and $60 of cash, then FS acquires all of the stock of FT in exchange for the $100 of FP voting stock. In the example, the shareholders of the foreign target are subject to tax under the revised rules in the Notice, even though no cash is transferred to the target shareholders, no cash or property is repatriated into the United States,[37] the earnings and profits of FS are subject to future taxation, and the target shareholders will continue to be subject to U.S. taxing jurisdiction through their carryover basis in FP's stock and their continuing indirect interests in the target. For this reason, we believe that the Notice has adopted a position at odds with the general policy of sections 367(b) and 1248(f)(2) of permitting deferral when no assets are transferred out of corporate solution and the section 1248 amount and other U.S. taxing rights are preserved.[38]

b. Non-Application of Section 367(a) to Transactions Subject to the Triangular Regulations

Under the broader change to the Priority Rule suggested in the Notice, an Applicable Triangular Reorganization with a foreign target will always be subject to the Triangular Regulations. This will discourage taxpayers from entering into Lower-Tier Reorganizations. If our recommendations are adopted, consistency with the policy of the Triangular Regulations under which Applicable Triangular Reorganizations are subject to the Triangular Regulations or section 367(a), but not both, would likewise require the rules of section 367(a) to be turned off where the target is foreign without subjecting target's shareholders to tax on the exchange. The alternative, more surgical change to the Priority Rules suggested above also fits nicely with the existing Triangular Regulations. Under this approach, the Section 367(b) Income would be determined without regard to whether the deemed distribution (dividend and gain) was subject to federal income tax, taxpayers would be discouraged from entering into Lower-Tier Reorganizations, and the basic structure of the Priority Rules would be preserved. Under this

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[37] In the example, the earnings and profits of FT will still be subject to tax in the future because FT remains a CFC with respect to USP. Additionally, while a dividend from FS to FP will not be taxed currently, it increases the earnings and profits of FP, and therefore will be subject to tax once repatriated to USP in the future.

[38] The relevant legislative history to section 367 indicates that Congress believed that nonrecognition transactions generally should be tax-free "if the U.S. tax on accumulated earnings and profits (in the case of transfers into the United States by a foreign corporation) or if the U.S. tax on the potential earnings from liquid or passive investment assets (in the case of transfers of property outside the United States) is paid or is preserved for future payment." S. Rep. No. 938, 94th Cong., 2d Sess., 261, 262 (1976) (the "**TRA 76 Senate Report**"). As mentioned above, Treasury and the Service have acknowledged the permissibility of deferral. 1991 Proposed Regulations, at 41996.

proposal as well, an Applicable Triangular Reorganization will be subject to either the section 367(a) rules or the deemed distribution under the Triangular Regulations, but not to both.

c. Potential Application of Section 367(a) to Transactions Subject to the Triangular Regulations with Foreign Targets

From a policy perspective, we think that the shareholders of the foreign target involved in an Applicable Triangular Reorganization that is subject to the Triangular Regulations should be treated the same as shareholders of foreign targets involved in triangular reorganizations that are not subject to the Triangular Regulations (*e.g.*, where the stock of parent is not purchased by the subsidiary in exchange for property). We believe that from a policy perspective it makes sense to apply the rules of section 367(a) to these shareholders (including the right to enter into a GRA).

Our concern with this approach, however, is that it does not appear to be supported by the language of the Code that states that section 367(b) only applies to transactions "in connection with which there is no transfer of property described in [367(a)(1)]." As mentioned above, the Code applies section 367(b) only to transactions that are not subject to section 367(a), which we believe was the reason for adopting the Priority Rules. Therefore, if the Acquisition of the hook stock and the Reorganization are treated as components of a single transaction, that transaction is subject to either section 367(a) or section 367(b), but not both. We have further considered whether these components of an Applicable Triangular Reorganization could be treated as two separate and distinct transactions: the Acquisition of parent hook stock by the subsidiary (to which section 367(b) applies) and the Reorganization (to which section 367(a) applies). The concern with this approach is that the separation of the Applicable Triangular Reorganization into these two components negates the authority of the Treasury and the Service to issue regulations under section 367(b) with respect to the Acquisition of the hook stock. This is because that Acquisition is not an "exchange described in section 332, 351, 354, 355, 356 or 361" as required by section 367(b). It is the connection of the Acquisition of the hook stock to the Reorganization that (arguably) gives Treasury the authority to issue regulations under section 367(b) with respect to the Acquisition, treating it as a distribution.[39] The regulations under section 367(a) acknowledge that triangular reorganizations may potentially be subject to concurrent application of both sections 367(a) and 367(b) under certain circumstances, and therefore provide that section 367(b) and the regulations thereunder do not apply if a foreign

[39] It is for this reason, we believe, that the Treasury and the Service applied the Triangular Regulations only if the hook stock is acquired "*in connection with the reorganization*," and only if that hook stock is then used to acquire the target in the triangular reorganization. Treas. Regs. § 1.367(b)-10(a).

corporation is not treated as a corporation under section 367(a).[40] Applying both the section 367(a) and the section 367(b) regulations concurrently to an Applicable Triangular Reorganization would therefore require an amendment to the Code.

We have further considered an approach, similar to the approach taken in the Notice, according to which new regulations under section 367(b) that are similar to the section 367(a) regulations would be issued. Under this approach, the regulations would not only require the shareholders of FT to recognize gain on the exchange of their stock for FP stock (as per the Notice), but would also permit the shareholders to enter into a GRA with respect to this exchange.[41] We believe, however, that issuing these regulations under section 367(b) may prove to be difficult given that the authority to issue regulations under section 367(b) is limited to those regulations "which are necessary or appropriate to prevent avoidance of federal income taxes,"[42] and when looking at the shareholders of target in an Applicable Triangular Reorganization, presumably they would not be avoiding any tax because of the exchange basis that they would have in the stock of FP, which is generally equal to the tax basis they had in the stock of FT.

It might therefore be difficult to treat the shareholders of FT in an Applicable Triangular Reorganization the same as shareholders of foreign targets involved in triangular reorganizations that are subject to the regulations under section 367(a) and are not subject to the Triangular Regulations under section 367(b) (*e.g.*, where the stock of parent is not purchased by the subsidiary in exchange for property) absent an amendment to the Code.

B. Inbound Transactions

1. Recommendations Concerning the Excess Asset Basis Rules

As explained in the Notice, Excess Asset Basis attempts to capture asset basis that was created in transactions that did not generate earnings and profits, is not from borrowed funds, and is not a result of a shareholder contribution. Treasury and the Service are concerned that this asset basis (*i.e.*, the Excess Asset Basis) will not be subject to tax when repatriated in an Inbound Transaction under the existing All E&P Amount. Accordingly, the modifications to Treasury

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[40] Treas. Regs. §§ 1.367(a)-3(b)(2) and 1.367(a)-3(d)(3), Ex. 14 and 15 (describing asset reorganizations in which the assets of a target CFC are transferred to another foreign corporation, and in return, the sole domestic shareholder of the target receives stock in the foreign parent of the acquiring corporation, which is not a CFC).

[41] As set forth above, Treasury and the Service announced in the Notice their intention to issue regulations under Treasury Regulations section 1.367(b)-4 and 4T that would require the shareholders to recognize gain on the exchange of their FT stock for FP stock, without the right to enter into any GRA.

[42] Section 367(b)(1).

Regulations section 1.367(b)-3 proposed in the Notice generally have the effect of requiring an exchanging shareholder in an affected Inbound Transaction to increase the All E&P Amount that is treated as a dividend by the amount of the earnings and profits of the subsidiaries of the foreign acquired corporation (that presumably created the Excess Asset Basis) to the extent of the Excess Asset Basis (and the built-in gain on the stock of the foreign acquired corporation). The Notice takes a tax-basis balance sheet approach, comparing the Inside Basis of FP's assets to the sum of the Outside Basis of the FP stock, the assumed liabilities of FP and the earnings and profits of FP. Although the Notice describes Treasury's and the Service's concern with Inbound Transactions that are preceded by Applicable Triangular Reorganizations, these changes, nevertheless, are generally applicable to, and can affect, all inbound reorganization and liquidation transactions (including those that are not preceded by triangular reorganizations).[43]

a. Limit Application of Rules to Pipeline Transactions

We believe that the new Excess Asset Basis rules should only apply to taxpayers that have completed Pipeline Transactions, *i.e.*, to taxpayers that, as of the date the Notice was issued, had already completed an Applicable Triangular Reorganization involving a foreign target, did not treat the Acquisition as resulting in a deemed distribution under the existing Priority Rules and Triangular Reorganizations, and engage in a future Inbound Transaction. Treasury and the Service may view these Pipeline Transactions as raising the same policy concerns identified in the Notice.[44]

We would not, however, recommend applying these new Excess Asset Basis rules to other transactions for several reasons:

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[43] The section 367(a) and section 367(b) regulations are limited by the Code to nonrecognition transactions. We note, however, that a taxable triangular transaction that is not a reorganization under section 368(a) might not result in any Excess Asset Basis because of the cost basis that the shareholders of target have in the parent's stock. This outside basis will generally be equal to or greater than the inside basis of the property used by the subsidiary to acquire parent's stock. A taxable transaction would generally not result in Excess Asset Basis.

[44] We acknowledge that if the Excess Asset Basis rules described in the Notice are adopted without change and applied only to Pipeline Transactions, the tax consequences with respect to such Pipeline Transactions may be harsher than the tax consequences that apply to other Applicable Triangular Reorganizations that are followed by a subsequent Inbound Transaction. This is because the Specified Earnings that increase the All E&P Amount in the case of Pipeline Transactions may be much greater than the additional earnings and profits generated by the deemed distribution under the proposed revisions to the Triangular Regulations.

(1) *Issue Adequately Addressed by the Deemed Distribution and Other Existing Regulations*

The deemed distribution mandated by the Notice coupled with the existing rules under Treasury Regulations section 1.367(b)-13 generally resolve the tax-basis imbalance created by an applicable Triangular Reorganization, limiting the need for the new Excess Asset Basis rules. The deemed distribution mandated by revisions to the 367(a) Priority Rule ensures that, after the issue date of the Notice, Applicable Triangular Reorganizations cannot be used to facilitate repatriation of untaxed foreign earnings and basis. The deemed distribution increases the earnings and profits of FP by the amount of the property transferred to it by FS[45] and, therefore, generally fixes the tax-basis balance sheet imbalance created by the property used by FS to acquire the stock of FP. Additionally, the tax-basis imbalance created as a result of FP not succeeding to the earnings and profits of FT is generally addressed by Treasury Regulations section 1.367(b)-13. Presumably, Treasury and the Service are concerned with triangular reorganizations in which FP increases its tax basis in the stock of FS but does not succeed to the earnings and profits of FT; instead, FS (or its subsidiaries) succeed to, or retain, those earnings and profits. For example, assume FT merged with and into FS in a forward subsidiary merger. For tax basis purposes, absent Treasury Regulations section 1.367(b)-13, FP would be treated as if it acquired FT's assets (with a carryover basis) and then contributed these assets to FS (thereby increasing the basis in the stock of FS held by FP, *i.e.*, FP's Inside Basis). As a result, FP would increase its Inside Basis by the amount of the inside asset basis of target,[46] the basis in the stock of FP (*i.e.*, FP's Outside Basis) would be increased by the outside basis that the shareholders of FT had in their FT stock,[47] but FP would not succeed to the earnings and profits of FT, which would be succeeded to FS.[48] The end result in this example is an imbalance in the tax-basis balance sheet of FP because FP would increase its Inside Basis and Outside Basis by amounts succeeded from FT, but FP would not increase its earnings and profits by the earnings and profits of FT. As mentioned above, this imbalance, however, is generally resolved by Treasury Regulations section 1.367(b)-13 in situations where target has section 1248 shareholders, in which case, FP's Inside Basis (*i.e.*, basis in FS stock held by FP) is increased by the outside basis

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45 As mentioned above, we note that some of the deemed distribution may be treated as a return of capital under section 301(c)(2), which will not increase the earnings and profits of FP. We do not believe, however, that this part of the deemed distribution should be subject to tax upon repatriation to USP because, as mentioned above, this capital represents either FP's own earnings and profits (which would be taxed under the existing All E&P Amount) or FP's own liabilities or capital contributions from USP.

46 *See* Treas. Regs. § 1.358-6.

47 Section 358(a).

48 *See* Treas. Regs. § 1.381(a)-1(b)(2)

that the shareholders of FT had in their FT stock (rather than the Inside Basis of FT's assets). Moreover, the imbalance created by the acquisition of FP stock by FS in exchange for property (as a result of replacing the cost basis that FS had in the FP stock, with the carryover basis in the FP stock after it is received by FT shareholders) is generally resolved by reason of the deemed distribution as set forth in the Notice. The combination of the Triangular Regulations and Treasury Regulations section 1.367(b)-13, therefore, adequately deals with the imbalance of FP's tax-basis balance sheet.

(2) *Policy for a Balanced Tax-Basis Balance Sheet*

The second reason why we would not recommend applying the new Excess Asset Basis rules to transactions other than Pipeline Transactions is that the new Excess Asset Basis rules are based on a balanced tax-basis balance sheet approach, which is not settled tax policy under our tax Code. While there are examples in which the connection between tax basis and earnings and profits is made,[49] it is not a fundamental principle that is accepted throughout the Code.[50] Also noteworthy is that the approach in the Notice is the opposite of the approach taken by Treasury and the Service when Treasury Regulations section 1.362-3 were issued addressing loss importation, where Treasury and the Service refused to reduce the All E&P Amount to account for lost tax basis.[51] For these reasons, it is not the case that maintaining an equilibrium between earnings and profits and inside tax basis in connection with Inbound Transaction is a clear and accepted principle of tax law.[52]

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[49] *See, e.g.*, Treas. Regs. § 1.861-12T(c)(2)(i) (for purposes of apportioning expenses based on the tax book value of assets method, the taxpayer's tax basis in the stock of certain corporations is adjusted by the earnings and profits of that corporation and certain lower tier corporations).

[50] *See, e.g., Bennett v. U.S.*, 192 Ct. Cl. 448, 470 (Ct. Cl. 1970) (specifically rejecting the taxpayer's argument with respect to a divisive spinoff that earnings and profits should be allocated based on book value/asset basis as opposed to fair market value). *See also* Treas. Regs. § 1.312-10 (allocation of earnings and profits in divisive spinoffs is based on fair market value, but in "proper cases" the allocation is made based on net basis). For a detailed discussion, see New York State Bar Association Tax Section, *Report on Proposed Regulations § 1.312-11: Allocation of Earnings and Profits in Connection with Asset Reorganizations*, 16-20 (Rep. No. 1275, Oct. 16, 2012). As is evident in our report on Proposed Regulations section 1.312-11, there are many instances in which tax-basis imbalances can result from ordinary course transactions that are not intended to be, and in fact are not, abusive.

[51] Treas. Regs. § 1.362-3(b)(4)(iii). For a detailed discussion, see New York State Bar Association Tax Section, *Report on Proposed Anti-Loss Importation Regulations Under Section 362(e)(1) and 334(b)(1)(B)*, 10-16 (Rep. No. 1302, Mar. 14, 2014).

[52] Moreover, if Treasury and the Service believe that a balanced tax-basis balance sheet is an important aspect of the section 367(b) regulations, consideration should be given to reducing the All E&P Amount

(3) *Earnings and Profit Can Be Subject To Tax at a Future Date*

The third reason why we would not recommend applying the new Excess Asset Basis rules to transactions other than Pipeline Transactions is that it appears to be inconsistent with the purpose of Section 367(b). All that the Excess Asset Basis rule does is increase the All E&P Amount by the amount (subject to caps) of the earnings and profits of lower-tier subsidiaries of the foreign acquired corporation. Absent this rule, those earnings and profits would nonetheless be subject to future inclusion. This approach appears to be inconsistent with the purpose of section 367(b) not to tax what are otherwise nonrecognition transactions in which U.S. tax can be preserved for future payment.[53]

(4) *Complexity*

The fourth reason why we would not recommend applying the new Excess Asset Basis rules to transactions other than Pipeline Transactions is that these new rules add complexity to *all* future Inbound Transactions, even though the specific concern identified by the Treasury and the Service was either already addressed by the forced deemed distribution under the Notice, or could be addressed by limiting the new Excess Asset Basis rules to foreign acquired corporations that issue hook stock in exchange for property, which is a simpler and more administratively feasible way to address these transactions. The new Excess Asset Basis rules add complexity by requiring taxpayers to determine (i) the origin of the tax basis of the foreign acquired corporation (to determine whether it is attributable to foreign subsidiaries), (ii) the outside basis of all the stock of the foreign acquired corporation (including stock held by unrelated shareholders, who may not be willing to disclose their cost basis in the stock), (iii) the earnings and profits of all foreign subsidiaries of the foreign acquired corporation, and (iv) the value of the stock of the foreign acquired corporation. Applying this complexity to all future Inbound Transactions appears to be at odds with the intent of the regulations under section 367(b) to minimize complexity and reduce compliance costs to the extent consistent with the prevention of repatriation without tax and material distortions in income.[54]

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where there is a deficit in inside asset basis (*e.g.* where there are excess earnings and profits). As set forth above, a similar approach was rejected by Treasury and the Service with respect to loss importation transactions.

53 Preamble to the 1991 Proposed Regulations, at 41996.

54 Preamble to the 1991 Proposed Regulations, at 41995 ("The regulations under section 367(b) also generally attempt to minimize complexity to the extent not inconsistent with [the prevention of repatriation without tax and the prevention of material distortion in income] in order to reduce taxpayer compliance burdens and the Treasury's administrative costs, and to improve enforcement of the tax laws.")

(5) *New Rule Would Apply to Normal Transactions*

The final reason why we would not recommend applying the new Excess Asset Basis rules to transactions other than Pipeline Transactions is that these rules may result in tax being imposed as a result of normal transactions that have little to do with a repatriation of assets to the United States without tax. The new Excess Asset Basis rules establish, in effect, a rebuttable presumption that the Excess Asset Basis originated from the earnings and profits of lower-tier subsidiaries, subjecting them to tax on those earnings and profits. Given this presumption, these rules may capture tax-basis balance sheet imbalances that were created by normal transactions that have little to do with repatriation. For example, an imbalance in the foreign acquired corporation's tax-basis balance sheet can be created by a step-down in the Outside Basis of the foreign acquired corporation as a result of a taxable sale of the stock of the foreign acquired corporation. As long as there is no appreciation in the value of the stock of that foreign acquired corporation, the new rules under the Notice would not require the recognition of the Specified Earnings upon an inbound Transaction with respect to that foreign acquired corporation because there would not be any built-in gain on its stock (and therefore the Specified Earnings, which are capped by the amount of that gain, would be zero). On the other hand, if after the sale, the value of the stock of that foreign acquired corporation appreciates,[55] following which the foreign acquired corporation engages in an Inbound Transaction, there might be Specified Earnings if the taxpayer is unable to demonstrate that the Excess Asset Basis did not originate from its subsidiaries, for example, because the taxpayer does not have all the necessary information from pre-acquisition periods or because the analysis proves to be too complex.[56] It is difficult to discern a policy rationale for this anomalous result, and we do not believe that this represents the type of circumstances that section 367(b) was intended to prevent or that is of concern to Treasury and the Service.[57]

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[55] If the appreciation is equal to the step-down in the Outside Basis of the stock as a result of the sale, the imbalance would be corrected. If the appreciation is less than the step-down resulting from the sale, there could be Specified Earnings.

[56] The appreciation in the value of the stock might be the result of market factors, earnings and profits, or other factors, but may not have anything to do with transactions that shift value to the foreign acquired corporation from its subsidiaries without the corresponding earnings and profits. As explained above, Specified Earnings are the lesser of (i) the sum of the earnings and profits (including deficits) of the lower tier subsidiaries of the foreign acquired corporation, (ii) the Excess Asset Basis or (iii) the built-in gain in the stock of the foreign acquired corporation (reduced by the All E&P Amount determined without regard to the Notice).

[57] Section 367(b) was intended to permit nonrecognition treatment. *See* supra note 38.

(6) *Transition Rule*

If our recommendation to limit the Excess Asset Basis rule to Pipeline Transactions is accepted by Treasury and the Service, consideration should be given to whether these rules should apply to Pipeline Transactions on a transitional basis, for example for only ten years following the date of the Notice,[58] on a permanent basis, or somewhere in between. As taxpayers have shown their willingness to keep cash offshore for very long periods of time, Treasury and the Service should consider applying these rules for a substantial period of time. Nevertheless, the transition rules would require taxpayers involved in all future Inbound Transactions to determine whether the foreign acquired corporation was involved in a Pipeline Transaction prior to the date of the Notice, and, as time goes by, the administrative burdens resulting from that rule would outweigh its benefits (for example, 30 years from now, taxpayers involved in Inbound Transactions would nonetheless need to determine whether the foreign acquired corporation or its predecessors participated in a Applicable Triangular Reorganization). A balance should therefore be found.

b. Alternatively, Limit Application of Rules to Inbound Transactions That Follow an Applicable Triangular Reorganization Involving a Foreign Target and Other Identified Transactions

If Treasury and the Service ultimately reject our recommendations discussed above and decides not to limit the Excess Asset Basis rules to Pipeline Transactions, we recommend that the application of these rules be limited to Inbound Transactions that follow Applicable Triangular Reorganizations and other transactions that are specifically identified by Treasury and the Service. These transactions could include, for example, the issuance by the foreign acquired corporation of hook stock to a subsidiary.[59] As mentioned above, we are aware of no other situation in which an inbound nonrecognition transaction not related to a triangular reorganization could give rise to the types of policy concerns Treasury and the Service have described in the Notice. Alternatively, if Treasury and the Service are aware of other transactions that raise policy concerns, those transactions should be specifically identified and subjected to

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[58] With respect to GRAs, five years was determined to be a sufficiently long period to discourage abuse.

[59] We note that no Excess Asset Basis would be created upon the issuance of hook stock by FP to FS in exchange for property, followed by a taxable acquisition of the stock or assets of a foreign target in exchange for that stock. This is because the Outside Basis in the FP stock used in the acquisition of target would remain the same and would equal the Inside Basis of the property used to acquire it. Nevertheless, if FP were subsequently to engage in an Inbound Transaction, there is the potential of repatriating the value of such property without corresponding U.S. tax, if the stock or assets of target were acquired from a foreign person that was not subject to U.S. tax on the sale.

the new rules. We further note that the second example in the Notice does not explain how the tax-basis imbalance was created but simply provides a static situation where the imbalance exists (although it resembles the structure resulting from a Lower-Tier Reorganization). It would be helpful to have an example of a transaction, other than an Applicable Triangular Reorganization, that results in the same concerns that were raised by Treasury and the Service in the Notice.

c. Adopt Simplified Mechanics – Limit Excess Asset Basis to Imbalances Created by the Applicable Triangular Reorganization and Other Identified Transactions

We further recommend that the Excess Asset Basis rules be clarified and simplified in several respects. Section 4.03(g) of the Notice provides that a taxpayer may reduce the Excess Asset Basis to the extent that basis is not attributable, directly or indirectly, to property provided by a foreign subsidiary of the foreign acquired corporation. The Notice provides an example in which built-in loss property is contributed to the foreign acquired corporation and an election under section 362(e)(2)(C) is made to limit the outside basis (but not the inside basis) to the fair market value of the property, resulting in Excess Asset Basis (as inside basis is greater than outside basis). Applying this rule will be difficult in practice. In order to establish that none of the Excess Asset Basis was created, directly or indirectly, by property of the subsidiary, taxpayers would need to review all transactions engaged in by the foreign acquired corporation that affect its asset basis, outside stock basis, liabilities and earnings and profits in order to prove the underlying sources of the Excess Asset Basis. Under this approach, taxpayers would need to engage in a forensic accounting exercise across many transactions dating back many years, relying on information that will likely be not readily available or may not exist. Alternatively, taxpayers could also try to prove that none of the assets of the foreign acquired corporation originated from its subsidiaries – *i.e.*, could try to prove a negative. It would, therefore, be helpful if the rule were revised to permit the taxpayer to look only at Applicable Triangular Reorganizations (and any other transaction identified by Treasury or the Service) that preceded the Inbound Transaction to demonstrate to the satisfaction of the Commissioner that the Excess Asset Basis was not created by that transaction.[60]

d. Simplifying Rule for Small Shareholders

The Excess Asset Basis rule requires the foreign acquired corporation to determine the Outside Basis that all of its shareholders have in its stock, which might be difficult or impossible,

[60] For example, Treasury and the Service might want to apply the Excess Asset Basis rules to all Inbound Transactions involving a foreign acquired corporation that has issued hook stock to its subsidiaries in exchange for property.

for example in cases in which the foreign acquired corporation has unrelated small shareholders who acquired the stock in carryover or secondary market transactions. Treasury and the Service should therefore consider a simplifying rule that disregards the Outside Basis of small shareholders (and the related share of Inside Basis, liabilities and earnings and profits) for purposes of determining Excess Asset Basis.

e. Minority Views

While the majority of the Executive Committee believe that the scope of the Excess Asset Basis rules should be limited as set forth in this report, the Executive Committee recognizes that Treasury and the Service are attempting to develop broad rules that would discourage future tax avoidance opportunities, and a significant minority of the Executive Committee believes that it is not inappropriate to apply the Excess Asset Basis rules to all Inbound Transactions. The minority generally believes that the use of broad anti-avoidance rules, such as the Excess Asset Basis rules, may be necessary to prevent tax avoidance and limit the opportunity of taxpayers to find ways around narrowly tailored rules.

2. Recommendations Concerning the New Anti-Abuse Rule under Treasury Regulations Section 1.367(b)-3.

The Notice also announced that the Excess Asset Basis rules to be issued under Treasury Regulations section 1.367(b)-3 will include a new anti-abuse rule.[61] This anti-abuse rule would allow for adjustments to be made, including disregarding the effects of certain transactions, that are carried out with a view to avoid the purposes of the rules, as described in the Notice. For example, if a transaction is engaged in with a view to reducing Excess Asset Basis, including by increasing the basis in the stock of the foreign acquired corporation without a corresponding increase in inside basis, the increase in the tax basis of the stock of the foreign acquired corporation could be disregarded for purposes of computing the Excess Asset Basis.

It would be helpful if Treasury and the Service could clarify the purpose of the Excess Asset Basis rules, which is not clearly set out in the Notice. At the beginning of the Notice, Treasury and the Service explain that Treasury Regulations section 1.367(b)-3 is intended to ensure that a domestic acquiring corporation does not succeed to the basis in the assets of the foreign acquired corporation except to the extent that a U.S. person that is a shareholder of the foreign acquired corporation has been subject to U.S. tax on its share of the earnings and profits that gave rise, in whole or in part, to the basis. It is unclear, however, if moving lower-tier

[61] Notice, at § 4.03(h).

earnings and profits from under the foreign acquired corporation, *e.g.*, in a section 304 transaction, would violate this purpose.

We further note that there are several types of transactions that taxpayers can use to reduce Excess Asset Basis. For example, each of the following transactions has the potential to reduce the Excess Asset Basis:

- A section 332 liquidation of a subsidiary into the foreign acquired corporation would have the effect of reducing inside asset basis (*e.g.*, where high outside basis in the stock of the liquidated subsidiary is replaced with low inside basis of the assets of the liquidated subsidiary);
- A transfer of built-in loss property to the foreign acquired corporation with respect to which no section 362(e) election is made would have the effect of increasing the outside stock basis in the foreign acquired corporation by the tax basis in the property, while the inside basis of the assets of the foreign acquired corporation would be stepped down to fair market value; and
- The purchase of foreign target (FT) by foreign parent (FP) in a section 304 transaction. For example, assume FP has no earnings and profits and purchases FT for $100 cash. Assume further that FT has $100 of earnings and profits and no outside basis. The section 304 transaction would have the effect of decreasing FP's Inside Basis (because cash is replaced with zero basis FT stock) while FP's earnings and profits and Outside Basis would be unaffected.

Treasury and the Service might, therefore, consider clarifying the anti-abuse rule with further examples that demonstrate what types of self-help transactions they believe raise policy concerns and what types do not.[62]

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[62] Treasury and the Service might also consider providing taxpayers with the right to elect to reduce tax basis instead of including the Specified Earnings in income. We note, however, that this election should not be available for foreign acquired corporations involved in Pipeline Transactions where there was no deemed distribution under the Triangular Regulations (as it would permit deferral, for example, of the tax on the cash used to acquire the stock of the parent, even though the value of that property was repatriated to the U.S. in the Inbound Transaction).

If Treasury and the Service decide to permit taxpayers to make such election, they would need to provide some form of priority rule under which the basis in certain assets is reduced before basis in other assets is reduced. For example, the rule could require taxpayers to reduce the basis in the property that was used to acquire the hook stock, but if that property is cash, taxpayers could be required to reduce the basis in other property. If basis in other property was required to be reduced, then Treasury and the Service might want taxpayers to reduce the tax basis of depreciable assets first, because it accelerates the

C. Effective Date

According to the Notice, the revised regulations will apply to transactions completed on or after December 2, 2016 and to any Inbound Transactions treated as completed before December 2, 2016 as a result of an entity classification election that is filed on or after December 2, 2016.

With respect to amending the Priority Rules relating to Applicable Triangular Reorganizations, we agree that the regulations should have an effective date of December 2, 2016.

With respect to the new Excess Asset Basis rules, however, at least with respect to non-Pipeline Transactions, we ask Treasury and the Service to reconsider the effective date of these rules. We recommend a more thorough rulemaking process before these rules become operative. These new rules are based on a balanced tax-basis balance sheet approach – a principle of tax law that is not settled, has sometimes been outright rejected by Treasury and the Service, and has not been consistently used. Additionally, the broad scope of the new rules, applying to all Inbound Transactions, mandate in our view a more comprehensive rulemaking process. We nevertheless understand that with respect to Pipeline Transactions there is a more urgent need for these regulations to apply.

D. Timing of Deemed Distribution under the Triangular Regulations

The Notice requests comments on whether, in light of the modifications announced by the Notice, it would be appropriate to treat the deemed distribution as occurring immediately

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imposition of tax on the Inbound Transaction (albeit on a more deferred basis that the rule set forth in the Notice).

When finalizing the section 367(b) regulations in 2000, Treasury and the Service rejected a rule that would have permitted taxpayers to elect to be taxed on their gain on the stock of the foreign acquired corporation instead of including the All E&P Amount in income, and would have required a reduction in the tax attributes of the foreign acquired corporation if that election was made. *See* T.D. 8862, Explanation of Provisions, Part C(1) (Jan. 24, 2000). In the preamble to the 2000 final regulations, Treasury and the Service expressed their concern that allowing shareholders to make this election and reduce the tax attributes of the foreign acquired corporation may be unfair to those shareholders who elected to include their share of the All E&P Amount in income, as it would shift the tax burden from the electing shareholders to the non-electing shareholders (by reducing the tax attributes of the foreign acquired corporation, which are shared among all shareholders). Therefore, if this recommendation is adopted, the election should be available only if all the shareholders of the foreign acquired corporation that are subject to either an inclusion of the All E&P Amount or taxation of the gain on their shares consent.

As is apparent, the rules related to this election may prove to be complex.

after, rather than before, the triangular reorganization. While a triangular reorganizations may increase the earnings and profits of a subsidiary,[63] the property being used to purchase the hook stock of parent was generally produced by the earnings and profits of the subsidiary before the Reorganization. Moreover, where the property being used by the subsidiary to acquire the hook stock of the parent was funded by the target, the 2014 Notice clarified that the existing anti-abuse rule in the Triangular Regulations may apply to such situations and increase the earnings and profits of the subsidiary by the earnings and profits of the target.[64] We see no reason to change the timing of the deemed distribution. It would therefore be helpful if Treasury and the Service could clarify what reason they see to change the timing of the deemed distribution.

[63] The earnings and profits of the subsidiary may be directly increased by the earnings and profits of the target in the case of forward triangular reorganizations, triangular C and G reorganizations and reverse triangular mergers. The earnings and profits of the subsidiary may also be increased by a distribution from the target to the subsidiary following a triangular B reorganization.

[64] Notice 2014-32, at § 4.03.