REPORT #663

TAX SECTION

New York State Bar Association

REPORT ON PROPOSED AND TEMPORARY REGULATIONS
UNDER SECTION 367(e)

July 9, 1990

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TAX SECTION
New York State Bar Association

July 9, 1990

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue
Washington, D.C. 20224

Dear Commissioner Goldberg:

Enclosed is a Report on the Proposed and Temporary Regulations issued under Section 367 (e) of the Internal Revenue Code, concerning tax-free distributions of property to foreign shareholders under Sections 332 and 355 of the Code. The report was prepared by a committee chaired by Randall K.C. Kau and Kenneth R. Silbergleit. The principal draftsmen were Kenneth R. Silbergleit and David P. Hariton.

The report makes recommendations designed to clarify, simplify or better implement some of the rules contained in the Regulations. The report also notes that certain transactions which give rise, under the Regulations, to U.S. tax do not permit any property to leave U.S. tax jurisdiction. These transactions include (a) the liquidation of a foreign operating company engaged in a U.S. business into its foreign parent where the foreign parent continues to operate the U.S. business, (b) the liquidation of a U.S. corporation into a controlled foreign corporation which continues to use the U.S. corporation’s active business assets in a U.S. business for at least ten years and (c) the distribution, under Section 355, of the stock of a foreign corporation in cases where distribution o the stock of a U.S. corporation would, under the Regulations, be free of U.S. tax. The imposition of U.S. tax on these and certain other transactions described in the report appears to impede foreign investment in the United States without helping to effectuate the policies underlying Section 367 (e).

We would be happy to discuss any of our recommendations with your staff at their convenience.

Very, truly yours,

Arthur A. Feder
Chair

Enclosure

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Tax Report #663

NEW YORK STATE BAR ASSOCIATION TAX SECTION

COMMITTEE ON FOREIGN ACTIVITIES OF U.S. TAXPAYERS

REPORT ON PROPOSED AND TEMPORARY REGULATIONS UNDER SECTION 367(e)

July 9, 1990

New York State Bar Association
Tax Section
Committee on Foreign Activities of
U.S. Taxpayers
Report on Proposed and Temporary
Regulations Under Section 367 (e)*

This report of the Committee on Foreign Activities of U.S. Taxpayers (the "Committee") comments on temporary regulations proposed and issued on January 12, 1990 (herein after, the "Regulations") under the authority of Section 367(e) of the Internal Revenue Code of 1986 (the "Code"). The Regulations concern certain tax-free distributions of property by U.S. corporations to foreign shareholders under Sections 3 32, 3 37 and 355 of the Code.

I. Introduction

Section 367(e) was added to the Code as part of the Deficit Reduction Act of 1984. As originally enacted (and as amended by the 1986 Technical Corrections Act), Section 3 67(e) authorized the issuance of regulations which would require a domestic corporation to recognize gain on property distributed by the domestic corporation to a foreign corporation in complete liquidation (whether or not pursuant to Section 332), or to a non-U.S. person in a tax- free spinoff under Section 355, "under principles similar to the principles of [Section 367]." Section 367(e) was amended by the Tax Reform Act of 1986 to require both domestic and foreign corporations automatically to recognize gain

* This report was prepared by a subcommittee of the Committee on Foreign Activities of U.S. Taxpayers, which is chaired by Randall K.C. Kau and Kenneth R. Silbergleit. The principal draftspersons were Kenneth R. Silbergleit and David P. Hariton. Other subcommittee members participating in the drafting of the report were: Kimberly S. Blanchard, Mary Louise Dionne, Allen R. Friedman, Ian Schacter, and Isaac Sonsino. Helpful comments were received from John A. Corry, Arthur A. Feder, Harvey P. Dale, Michael L. Schler, Carolyn Joy Lee Ichel, Dennis E. Ross and Stanley I. Rubenfeld.

on property distributed to a foreign corporation in a complete liquidation (but only one to which Section 332 applies), except to the extent provided otherwise in regulations. In its current form, therefore, Section 367(e) contains no directive concerning how regulations should be drafted to permit tax-free distributions of property to a foreign corporation in complete liquidation, whereas regulations concerning the circumstances under which a domestic corporation will recognize gain when it distributes property to a foreign shareholder under Section 355 continue to be subject to the statutory mandate that they reflect principles similar to the principles of Section 367 generally. When a domestic corporation distributes all of its property to another domestic corporation in a complete liquidation to which Section 332 applies, the distributor, which would otherwise recognize gain in respect of the distribution under Section 336, does not recognize gain under Section 337. The logic behind the non-recognition rule of Section 337 is that both the income generated by the distributed property and any unrealized gain on the distributed property continue to be subject to U.S. corporate level tax. (The corporate distributee takes a carryover basis in the property it receives under Section 334(b)(1).) Because a foreign corporation is not generally subject to U.S. corporate tax on income derived from, or gain from the disposition of, property unless the property is used in a U.S. trade or business, a rule which permitted the tax-free distribution of property by a domestic corporation to a foreign shareholder under Section 332 would permit unrealized gain to escape U.S. corporate tax jurisdiction. Section 367(e)(2) therefore imposes corporate level tax on distributions in liquidation when the distributee is a foreign corporation. In this regard, the general rule of Section

367(e)(2) does not differ from the rule that nonrecognition under Section 337 is not available for distributions by a domestic corporation to an 80-percent individual shareholder or to a partnership.

The mandate of Section 367(e)(1), which authorizes regulations requiring a domestic corporation to recognize gain in respect of distributions of stock and securities to a foreign shareholder under Section 3 55, is less clear. Because Section 355 applies to distributions to individuals and partnerships, as well as to corporations, and because the distributee takes a substituted, rather than a carryover, basis for the stock and securities it receives in a tax-free distribution under Section 3 55, a foreign distributee does not differ from a U.S. distributee in any fundamental sense which relates to the principles underlying Section 355. Put differently, while there is no doubt that the tax-free distribution of stock or securities to a foreign shareholder under Section 355 may permit unrealized gain to escape U.S. corporate tax jurisdiction, this is not because the distributee is foreign, but rather because that is the nature of Section 3 55. It is therefore not clear how regulations under Section 367(e)(1) should follow the general principles of Section 367, a section dealing with unrealized gain which may escape U.S. tax jurisdiction because the transferee is not a U.S. person.

In general, the Committee approves of the approach taken by the Regulations, which is consistent with the general purpose of Section 367, i.e., to prevent assets with unrealized gain from leaving U.S. tax jurisdiction in tax-free transactions. The Committee commends the Internal Revenue Service and the Treasury for the effort they have made in implementing Section 367(e) generally. The Committee believes, however, that the Regulations are in some cases broader than they need be to effectuate their purpose and, thus, unnecessarily impede foreign investment in the United States. In addition, the Committee seeks additional clarification and guidance with respect to certain aspects of the Regulations.

Unlike the preambles to most regulations proposed in the recent past, the preamble to the Regulations contains no substantive explanation of the provisions contained in the Regulations or of the logic behind them. As a result, particularly in the case of our comments on the Section 367(e)(1) portion of the Regulations, it has been necessary for the Committee to conjecture about the rationale for the provisions and what they are designed to achieve. The Committee hopes that any preambles to future regulations will be more enlightening. This would not only enable members of the bar to offer more constructive comments to the Service, but would also permit practitioners more effectively to advise their clients on how to comply with the spirit of the regulations.

II. Summary of Contents

In summary of what is set out at greater length below, the principal comments of the Committee are as follows. (The first ten comments relate to Section 367(e)(2) and the remainder relate to Section 367(e)(1).)

(1) The exception from gain recognition under Section 367(e)(2) for distributions of property which the foreign distributee continues to use for ten years in a U.S. trade or business ("Distributed U.S. Business -Property") should be available for distributions to controlled foreign corporations.

(2) The Regulations should require a foreign distributee that ceases to use Distributed U.S. Business Property in a U.S. trade or business within the ten year period to recognize gain as if it had disposed of the property for fair market value on the day it ceases to use the property in the U.S. trade or business, rather than requiring a no-longer-existing distributing corporation to file an amended return. Consideration should also be given to deferring gain recognition until the foreign distributee disposes of the withdrawn property.

(3) The Regulations should either permit a domestic corporation which distributes the stock of a domestic subsidiary to a foreign shareholder in complete liquidation to treat the distribution like a sale of the stock to an unrelated domestic corporation under Section 338(h)(10) or permit the domestic subsidiary to increase the inside basis of its assets by the amount of gain the liquidating domestic parent recognizes in respect of the distribution of the stock of the subsidiary.

(4) The Regulations should not contain an "anti-stuffing rule" for loss recognized on distributions to foreign shareholders in complete liquidation, because the anti-stuffing rules of Section 336 and the built-in loss limitations of Section 382 are sufficient.

(5) If a complete liquidation produces ordinary losses and capital gains, the "netting rules" should allow the ordinary losses to offset the capital gains.

(6) The Regulations should permit a distributing Corporation to use losses realized in the year of liquidation to offset gains that are recognized retroactively on an amended return because the foreign distributee ceases to use Distributed

U.S. Business Property in a U.S. trade or business or otherwise fails to comply with certain non-recognition requirements. (This would be unnecessary if recommendation #2 is accepted.)

(7) The Regulations should clarify the interaction between look-through rules for distributions of partnership interests in complete liquidation and gain recognition under FIRPTA.

(8) The Regulations should clarify the treatment of distributions in complete liquidation of interests in publicly-traded limited partnerships.

(9) The detailed reporting required by the Regulations in connection with the U.S. trade or business exception from gain recognition is unnecessarily burdensome and should be relaxed.

(10) The Regulations should not impose tax on foreign-to-foreign liquidations so long as the foreign distributee continues to be subject to U.S. tax on the distributed property to the same extent as the distributing corporation.

(11) The Regulations should not impose tax on the distribution of the stock of a U.S. real property holding corporation to a foreign shareholder under Section 355 merely because the U.S. distributor is not a U.S. real property holding corporation immediately after the distribution.

(12) The "five-or-fewer shareholders" exception from gain recognition for distributions to foreign shareholders under Section 355 should limit the number of foreign distributees, rather than the number of shareholders generally.

(13) The direct ownership, holding period and relative value requirements for the five-or-fewer shareholders exception limit opportunities for inbound planning without a corresponding protective benefit to the Service, and should be relaxed.

(14) Non recognition transfers of the stock of the controlled corporation by the foreign distributee should not trigger automatic gain recognition, at least where there is a single transferee that agrees to be subject to the requirements of the Regulations.

(15) The five-or-fewer shareholders exception and the "publicly-traded" exception should be available for distributions of the stock of foreign corporations.

(16) Public corporations making distributions to five or fewer greater-than-5% foreign shareholders should qualify for gain nonrecognition under rules similar to the five or fewer shareholders exception.

(17) Multi-tier cross-border spinoffs should be permitted to be accomplished tax-free where a single-tier spinoff would be permissible.

(18) The Regulations should provide attribution rules for purposes of determining the existence of a 5- percent foreign shareholder.

(19)Rules similar to Section 338(h)(10) should apply where gain is recognized on the distribution of a domestic controlled corporation to a foreign distributee.

III. U.S.-to-Foreign Liquidations Under Section 367(e)(2)

1. General Rule

The Regulations generally impose U.S. tax on the distribution of property with unrealized gain by a domestic corporation to a foreign corporation in complete liquidation that would otherwise be tax-free under Section 337 of the Code. Reg. Sec. 1.367(e)-2T(b)(1)(i). The Regulations contain an exception, however, for the distribution of property that is used by the foreign distributee in a U.S. trade or business for ten years after the date of the distribution. Reg. Sec. 1.367(e)-2T(b)(2)(i).

The Committee approves of the general rule, because assets that are distributed to a foreign corporation, like assets that are distributed to a U.S. individual or partnership, cease to be subject to U.S. corporate tax. The Committee approves of the U.S. trade or business exception, because the income generated by property which the foreign distributee continues to use in a U.S. trade or business continues to be subject to U.S. tax under Section 882. Likewise, any unrealized gain on the property continues to be subject to U.S. tax under Section 882, and the foreign distributee takes a carryover basis in the property under Section 334(b)(1). There may, in addition, be branch profits tax on a withdrawal by the foreign distributee of some of the property used in a U.S. trade or business.

2. Distributions to Controlled Foreign Corporations

Under Reg. § 1.367(e)-2T(b)(2)(i)(A)(1), the U.S. trade or business exception is not available if the foreign distributee is a controlled foreign corporation. The Committee does not understand why U.S.-controlled foreign distributees should be treated less favorably than foreign-controlled foreign distributees. The rationale for the U.S. trade or business exception, as described above, applies equally to U.S.-controlled foreign distributees, which are not exempt from the rules of Sections 882 and 884. The Committee believes that the exception for the distribution of assets used in a U.S. trade or business should be avail-able without regard to the status of the foreign distributee as a controlled foreign corporation.

3. Retroactive Recognition of Gain

Under the U.S. trade or business exception, if within ten years of the liquidation the foreign distributee disposes of property used in the U.S. trade or business and reports any gain on a timely filed U.S. income tax return, the distributing domestic corporation is not required, on a retroactive basis, to recognize gain in respect of the distribution. Reg. Sec. 1.367(e)-2T(b)(2)(i)(C)(3). If, however, the foreign distributee withdraws the property from the U.S. trade or business, but does not dispose of it, the domestic corporation is required to file an amended income tax return for the year of the distribution reflecting the gain realized on the distribution and pay the resulting tax plus accrued interest. Reg. Sec. 1.367(e)-2T(b)(2)(i)(C)(1). An amended return by the domestic corporation is also required if the foreign distributee disposes of its U.S. trade or business property and fails to report its gain on a timely filed U.S. income tax return. Reg. Sec. 1.367(e)- 2T(b)(2)(i)(C)(3).

As an initial matter, it is not clear why the mere withdrawal of the property from the U.S. business should trigger the gain. Pursuant to Section 864(c)(7), the gain on disposition would continue to be subject to U.S. tax for ten years.[*] If a ten year period is considered too short for these purposes, Regulations could provide, as a condition to nonrecognition treatment on the liquidating distribution, that the foreign distributee agree to an unlimited period for purposes of applying Section 864(c)(7).

[*] This is true even if a treaty would ordinarily override Section 864(c)(7), since the foreign distributee is required to waive any treaty exemption from gain recognition pursuant to Reg. Sec. 1.367(e)-2T(b)(2)(i)(B)(4).

Even if the time of withdrawal is determined to be the appropriate time to trigger gain recognition, instead of requiring the domestic corporation to file an amended return for the year of the liquidation, a foreign distributee that withdraws Distributed U.S. Business Property from a U.S. trade or business should be treated under the Regulations as if it had disposed of the property for fair market value on the day of the withdrawal. This alternative approach would be equivalent to taxing the domestic corporation as if it had remained in existence and distributed the property to the foreign corporation on the day of the withdrawal, except that the tax would be imposed directly on the foreign corporation, rather than on a no-longer-existing domestic corporation.*

The amended return procedure set out under the Regulations complicates reporting for the years between the liquidation and the ultimate withdrawal or disposition.
Since the foreign corporation may step up the basis of the property it has received for gain recognized by the distributing domestic corporation, it must file amended returns for the intervening years to reflect greater depreciation deductions. In addition, any losses of the domestic corporation -to which the foreign distributee succeeded upon the Section 332 liquidation (pursuant to Section 381), would instead be utilizable by the domestic corporation on its amended return, which also could require the filing of amended returns by the foreign corporation

* The Section 332 context should be contrasted with the other situations in which an amended return procedure is - required (Reg. Sec. 1.367(e)-1T(c)(2)(iii)(B) and Reg. Sec. 1.367(a)-3T(g)(3)(i)). In the latter contexts the amended return procedure may be justified because the foreign transferee is receiving stock or securities (rather than U.S. business assets) so that only the domestic corporation may be subject to U.S. tax jurisdiction and is filing (or has filed) U.S. tax returns.

for all intervening years. Finally, the imposition of interest on a long-since liquidated domestic corporation is a form of penalty which is not only unwarranted, but does little to reduce the risk of non-compliance. The application of general Code provisions to reporting by the foreign distributee of gain that it recognizes from the withdrawal or disposition of effectively connected U.S. business assets (including civil and criminal penalties for failure to report) should be sufficient to ensure compliance.

4. Outbound Distributions of Stock of Lower-Tier Domestic Subsidiaries

The Regulations do not distinguish distributions of stock of lower-tier domestic subsidiaries from distributions of other property. If the liquidating domestic corporation is the parent of a U.S. consolidated group, the Regulations can create a double tax on unrealized gain at the corporate level where only a single tax would otherwise have been incurred.

For example, assume that a foreign parent, FP, owns all the outstanding stock of a domestic holding company, DP, and DP has a first-tier operating subsidiary, DS. Both the assets owned by DS and the stock of DS have appreciated in value. If DP liquidates, distributing the stock of DS to FP, the Regulations require DP to recognize gain in respect of the distribution (assuming the stock of DS is not considered to be used in a U.S. trade or business of FP). Reg. Sec. 1.367(e)-2T(b)(4), Ex. (2)(iii). The recognition of gain does not increase the basis of the assets of DS, however, and DS remains subject to U.S. tax on a later disposition of those assets.

There is, of course, no tax reason to structure the outbound liquidation of a U.S. affiliated group in the manner described above. Before it liquidates into FP, DP can liquidate DS tax-free under Sections 332 and 337. DP can then distribute the assets of DS, rather than the stock of DS, to FP in liquidation of DP. If gain is recognized on the distribution (because FP does not use the assets in a U.S. trade or business), the basis of these assets will be increased to fair market value. Apart from creating a trap for the unwary, however, the difference in tax results may impede non-tax motivated transactions where business exigencies dictate that DS survive. DS may own property rights that cannot easily be transferred to its parent, or may have incurred liabilities that impede its legal dissolution. Even where DS can be liquidated at little cost, the difference in tax results forces FP to operate the business of DS in branch, rather than subsidiary, form.

The Committee recommends that final regulations adopt one of two methods of imposing tax on the distribution of the stock of a domestic subsidiary that would not create a second level of tax. The first approach would be to invoke the authority granted by Section 336(e) and permit DP to make the equivalent of a Section 338(h)(10) election for its distribution of the stock of DS to FP. Under the election, DS would be treated as if it had sold its assets to FP, recognized gain accordingly, and then liquidated tax free into DP under Section 3 32. This approach would be consistent with the partnership look-through rules of Reg. Sec. 1.367(e)-2T(b)(1)(iii).

The second approach would permit DS to step up the inside basis of its assets by the amount of gain recognized by DP in respect of the distribution by DP of the stock of DS to FP. Where DP’s basis for the stock of DS is higher than the aggregate inside basis of the assets owned by DS, this approach would permit DP to avoid double taxation without foregoing the benefit of the excess, if any, of the outside basis of the stock of DS over the inside basis of DS's assets.

5. Limitations on Loss Recognition

Reg. Sec. 1.367(e)-2T(b)(1)(ii) limits the loss recognized on assets distributed in an outbound liquidation to the amount of gain recognized in respect of the distribution of other assets. The Regulations thus prevent the domestic subsidiary of a foreign corporation from recognizing a net loss in complete liquidation, presumably for anti-abuse reasons similar to those which motivated the enactment of Section 267.* The Regulations include additional limitations on loss recognition, however, which the Committee believes may not be necessary.

First, the Regulations contain an unwarranted "anti-stuffing rule" under which the distributing corporation may not recognize loss on property which it acquires within the five year period preceding the liquidation through a capital contribution, an exchange under Section 351(a) or 361(a), or a liquidation under Section 332. Reg. Sec. 367(e)-2T(b)(1)(ii). Section 336(d) already contains a complex anti-stuffing rule for loss recognized on complete liquidations to which Section 337 does not apply. Since Section 367(e)(2) renders Section 337 inapplicable to the distribution by the domestic corporation to the foreign distributee, Section 336(d) would apply to prevent the foreign distributee from contributing built-in loss assets to the domestic corporation in contemplation of liquidation. In addition, the built-in loss provisions of Section 382 generally restrict the ability of the domestic corporation to benefit from

* Section 267 does not apply to property distributed in complete liquidation. Section 267(a)(1).

built-in loss assets acquired in a tax-free acquisition to which Section 361(a) applies. Finally, the Committee does not see any abuse in permitting a domestic holding company to utilize losses with respect to assets of a domestic operating subsidiary acquired in a Section 332 liquidation of the subsidiary to offset the gain on its other assets that it recognizes in respect of its own complete liquidation. As noted above, the Committee favors a Section 338(h)(10) approach, under which a liquidating U.S. holding company recognizes gain by reference to the basis of the assets of all the members of its affiliated group, to a more formalistic approach under which multiple levels of corporate tax are assessed in respect of the same unrealized gain.

Second, the Regulations permit capital losses realized in respect of the distribution to be recognized only to the extent of capital gains realized in respect of the distribution, and ordinary losses realized in respect of the distribution to be recognized only to the extent of ordinary income realized in respect of the distribution. Reg. Sec. 367(e)-2T(b)(1)(ii). The Committee does not understand the prohibition on the use of ordinary losses to offset capital gain and recommends that this limitation be deleted from the final regulations.

Third, if the distributing corporation initially meets the requirements for nonrecognition under Reg. Sec. 1.367(e)-2T(b)(2)(i), but a disqualifying event occurs at a later time within the ten-year post-distribution filing period, the distributing corporation is required to recognize gains, but not losses, arising from the original liquidation, and file an amended return. The Committee sees no reason to treat the distributing corporation in these cases more severely than it would have been treated under the general recognition rules of Section 367(e)(2). Realized losses should be recognized by the distributing corporation to the extent that they would have been recognized had the distributing corporation not qualified for an exception from gain recognition in the year of the liquidation.*

6. FIRPTA Rules; Rules for Partnerships

Under the Regulations, a distributing domestic corporation generally does not recognize gain on the outbound distribution of a U.S. real property interest. Reg. Sec. 1.367(e)-2T(b)(2)(ii). The distributing corporation does recognize gain, however, when it distributes the stock of a former U.S. real property holding company (“USRPHC”) that is treated as a U.S. real property interest for five years under Reg. Sec. 1.897-5T(c)(1). The Committee assumes that a distributing corporation may also recognize loss, subject to applicable limitations, when it distributes the stock of a former USRPHC. This issue should be clarified. In addition, the reference to Reg. Section 1.897-5T(c)(1) should be checked, since that section deals with liquidations of foreign, not U.S., corporations. The correct citation would appear to be Reg. Section 1.897-1(c)(1).

A correction would also appear to be necessary in the second sentence of subparagraph (iii) of Example (2) of Reg. Sec. 1.367(e)-2T(c)(4). A foreign corporation that has made a Section 897(i) election is not subject to Section 897(d).

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* This recommendation would not be necessary if our earlier suggestion to have current gain recognition by the foreign distributee (rather than retroactive gain recognition by the distributing corporation) is adopted.

In general, the Committee approves of Reg. Sec. 1.367(e)-2T(b)(1)(iii), which adopts a complete look-through approach to liquidating distributions of partnership interests. The Committee seeks clarification, however, of the coordination of the FIRPTA nonrecognition rule, the general nonrecognition rule of Reg. Sec. 1.367(e)-2T(b)- (2)(i), and the statute and regulations under Section 897(g), which do not incorporate a complete look- through approach to the treatment of partnership interests. Under Reg. Sec. 1.897-7T, a partnership interest itself may be treated in full, in part, or not at all, as a U.S. real property interest. (But see Notice 88-72, 1988-2 C.B. 383.) The Committee assumes that the look-through rules of Reg. Sec. 1.367(e)-2T(b) take precedence, but this should be clarified.

The Committee also seeks clarification of the effect of the rule which treats the distribution of a publicly-traded limited partnership interest "in the same manner as a distribution of stock." Reg. Sec. 1.367(e)-2T(b)(1)(iii)(C). Presumably, this rule was adapted from the partnership rules of Reg. Sec. 1.367(a)-1T(c)(3), where the effect of treatment as "stock" is clear. Treatment as stock under Section 1.367(e) of the Regulations, however, does not answer whether the limited partnership interest is a U.S. trade or business asset* and leaves other open questions, such as how gain or loss recognized in respect of such a distribution interacts with the "netting rules" for recognition of ordinary and capital losses.

* The holder of even a publicly traded limited partnership interest is treated as engaged in a U.S. trade or business under Section 875 and is therefore subject to U.S. taxation on its allocable share of partnership income.

7. Reporting Requirements

The Committee believes that the reporting requirements of Reg. Secs. 1.367(e)-2T(b)(2)(i)(B) and (c)(2)(i).(B) are unnecessarily burdensome, particularly when viewed in conjunction with the reporting requirements of other regulations. Reg. Secs. 1.367(e)-2T(b)(2)(i)(B) and (c)(2)(i)(B) require a description of every item of U.S. business property transferred, its location, adjusted basis and fair market value. At a minimum, the Reg. Sec. 1.367-2T reporting provisions should permit the grouping of related assets as well as similar assets, and should contain a de minimis rule excluding assets below a certain dollar value (for example, $1000).

8. Cessation of U.S. Business

The Regulations require gain recognition if property ceases to be used in a U.S. trade or business "for any reason." Reg. Sec. 1.367(e)-2T(b)(2)(i)(C)(1). The Regulations contain exceptions for exchanges or involuntary conversions under Sections 1031 or 103 3 for other property used in a U.S. business, and for abandonment or disposal of worthless property. Reg. Sec. 1.367(e)-2T(b)(2)(i)(C)(4). The Committee believes that the exceptions should be expanded to include expropriation by a foreign government, casualty losses and Section 721 contributions to partnerships which continue to use the property in a U.S. trade or business.

IV. Foreign-to-Foreign Liquidations Under Section 367(e)(2)

1. General Rule

In general, the Regulations appropriately provide that a foreign corporation which distributes property to a foreign parent in complete liquidation under Section 3 32 does not recognize gain in respect of the distribution. Reg. Sec. 1.367(e)-2T(c)(1). A foreign corporation does recognize gain, however, when it distributes property used in a U.S. trade or business, unless the property is used in a U.S. trade or business by the foreign distributee for ten years after the distribution.* Reg. Sec. 1.367(e)- 2T(c)(2)(i).

The Committee does not believe that U.S. tax should be imposed in a foreign-to-foreign liquidation, regardless of how the distributed property has been or will be used by the foreign distributor and distributee, with one possible exception. Assets held by a foreign corporation are already “outbound” in the sense that the corporation which holds them is not subject to U.S. tax on its worldwide income. If the transferee in a foreign-to-foreign liquidation ceases to use the assets it receives in a U.S. trade or business, it accomplishes nothing which the foreign transferor could not have accomplished. The foreign transferor is free to withdraw assets with unrealized gain from a U.S. trade or business and use them to generate income that is free of U.S.

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* Under an exception that the Committee finds perplexing, gain recognition is not required with respect to liquidating distributions between controlled foreign corporations, subject to certain other requirements. Reg. Sec. 1.367 (e)-2T(c)(2)(i)(A).

tax, subject to the possible imposition of a branch profits tax on previously reinvested earnings and profits. Unrealized gain on assets that are withdrawn from a U.S. trade or business continues to be subject to U.S. tax for ten years under Section 864(c)(7), and the foreign transferee in a Section 3 32 liquidation takes a carryover basis in the assets it receives from a foreign transferor.

The restrictions described above on tax-free foreign-to-foreign liquidations effectively impose U.S. tax, for example, on a U.K. company that chooses, for whatever reasons of its own, to liquidate one of its U.K. operating companies which happens to be engaged in a U.S. business. This represents an artificial encumbrance on the form of business conducted by a foreign corporation in the United States. It in effect forces the U.K. company either to maintain the existence of an inefficient U.K. holding company solely to avoid an unnecessary U.S. tax or to conduct its U.S. operations in subsidiary, rather than branch, form.

An exception to nonrecognition treatment may be appropriate in one instance. If the foreign distributee does not continue the distributing corporation’s U.S. business for even an instant, Section 864(c)(7) may not apply to a disposition by the distributee within ten years of the distribution. As a condition to nonrecognition treatment for the distributing corporation, however, the Regulations could require the distributee to agree to be subject to the rules of Section 864(c)(7).

2. Other Comments

Most of the recommendations made in III, above, apply as well in the foreign-to-foreign Section 332 liquidation context. Those recommendations are not restated here.

The Regulations indicate that Section 367(b) and Reg. Sec. 7.367(b)-5(c) may also apply to the foreign-to- foreign liquidation. Reg. Sec. 1.367(e)-2T(c)(2)(ii). The only requirement under Reg. Sec. 7.367(b)-5(c) for treating a foreign corporation as a corporation is the filing of a notice under Reg. Sec. 7.367(b)-1(c). If the final regulations do require certain distributees in foreign-to-foreign liquidations to continue to use U.S. business assets in a U.S. trade or business for ten years, the Committee recommends that they provide that Section 367(b) does not apply to the liquidation, since the reporting obligations under the ten-year business requirement provide more information than is generally required under Section 367(b).

The Committee notes that Reg. Sec. 1.367(e)-2T(c)-(2)(i)(A)(3) requires, as one condition to nonrecognition in certain cases, that there have been no prior domestic-to-foreign liquidations under Reg. Sec. 1.367(e)-2T(b)(2)(i). This appears to be a technical error. Reg. Sec. 1.367(e)-2T(b)(2)(i) accords nonrecognition treatment to domestic-to- foreign distributions only where the distributee is not a controlled foreign corporation, whereas the exception at issue in Reg. Sec. 1.367(e)-2T(c)(2)(i)(A) is available only where the foreign distributor (*i.e.*, the foreign distributee in the prior transaction) is a controlled foreign corporation.

V. Effective Date of Rea. Sec. 1.367(e)-2T

Section 1006(e)(13)(C) of the Technical and Miscellaneous Revenue Act of 1988 provides that Section 367(e)(2) will not apply to liquidations occurring before June 10, 1987 where the foreign parent is entitled to the benefit of an income, tax treaty with the United States. An effective date provision to this effect is found in Reg. Sec. 1.367(e)-2T(d). Reg. Sec. 1.367(e)-2T(b)(2)(iii) provides a transitional rule where the foreign parent is a resident of a treaty country and the applicable treaty contains a nondiscrimination provision. Pursuant to Notice 875, as modified by Notice 87-66, the transitional rule extends to liquidations before September 29, 1987. The Committee assumes that this later date applies where the specific provisions of that paragraph are met and recommends that subsection (d) be clarified accordingly.

VI. Section 355 Distributions Under Section 367(e)(1)

Section 1.367(e)-IT provides in general that if a domestic corporation distributes stock or securities of a subsidiary to a foreign distributee in a transaction that otherwise qualifies under Section 355(a), the distributing corporation recognizes gain (but not loss) under Section 367(e)(1). The Committee believes that this general rule is consistent with the purpose of Section 367(e) and of Section 3 67 generally, i.e., to limit the tax-free removal of appreciated assets from U.S. tax jurisdiction, but, as noted in the introduction above, is inconsistent with the general principles of Section 355. The Regulations contain exceptions to the general rule, subject to restrictions that are more fully discussed below. In general, the Committee believes that some of the restrictions are broader than they need be to effectuate their purpose.

1. The FIRPTA Exception

Reg. Sec. 1.367(e)-1T(c)(1) provides an exception from general gain recognition for a distribution of stock of a U.S. real property holding corporation (“USRPHC”) under Section 355(a). There is no need to impose U.S. tax on such a distribution because U.S. tax jurisdiction over the unrealized gain is preserved in the hands of the foreign distributee under Section 897 to the same extent as if the distributee were a U.S. person.*

The exception includes a requirement, however, that the U.S. distributor itself be a USRPHC immediately after the distribution. Where the U.S. distributor is not a USRPHC immediately before the distribution, the Committee sees no reason for denying the exception. Application of the exception preserves U.S. tax jurisdiction over the distributed USRPHC and involves no change in the taxability for U.S. purposes of the foreign distributee’s continuing interest in the U.S. distributor.

* Since the basis of the stock of the distributed USRPHC in the hands of the distributee (whether U.S. or foreign) is a substituted basis under Section 358 rather than a carryover basis, the amount of gain “preserved” in the hands of the distributee could be greater or less than the gain inherent in the USRPHC in the hands of the distributor.

Even where the U.S. distributor is a USRPHC immediately before, but not immediately after, the distribution, the Committee believes the exception should apply. It might be argued that, in this case, application of the exception would permit the foreign distributee to “cleanse” its interest in the U.S. distributor of USRPHC status on a tax-free basis. Any risk of abuse, however, is limited because the foreign distributee’s interest in the U.S. distributor continues to be treated as a U.S. real property interest for five years under Section 897(c)(1)(A)(ii). Since retaining the distributed shares for five years is sufficient for - purposes of the five or fewer shareholder exception discussed below, a five year taint should be sufficient for purposes of the FIRPTA exception. In any event, the solution is not to impose U.S. tax on distribution of the subsidiary USRPHCs, a tax which is already preserved under Section 897.

2. The Five-or-Fewer Shareholder Exception

General Rule

Reg. Sec. 1.367(e)-1T(c)(2) provides an exception from gain recognition for the distribution of the stock or securities of a domestic corporation under Section 355 where the distributing corporation is owned by five or fewer shareholders, provided that foreign distributees hold the stock for at least five years and a substantial number of other requirements are met. The Committee assumes that this exception is designed to permit a domestic corporation to distribute the stock and securities of a domestic subsidiary to a foreign shareholder under Section 355, subject to limitations that are consistent with the general principles of Section 367.

The Committee believes that the exception is generally consistent with the principles of Section 367. Section 367(a)(2) and Reg. Sec. 1.367(a)-3T, as effectively amended by Notice 87-85, 1987-2 C.B. 395, generally permit a domestic corporation to transfer the stock of a foreign subsidiary to a foreign corporation in a tax-free transaction, provided that the domestic corporation (a) receives stock of a controlled foreign corporation in exchange, and (b) signs an agreement requiring it to recognize gain if the foreign transferee disposes of the stock in less than five (or in some cases ten) years. They likewise permit a domestic corporation to transfer the stock of a domestic subsidiary to a foreign corporation in a tax-free transaction, provided that the domestic corporation (a) does not own more than 50 percent of the foreign transferee, and (b) signs a similar five or ten year gain recognition agreement.

The Committee is puzzled by the limitation of the five or fewer shareholder exception to distribution of the stock or securities of domestic corporations. Section 367(a)(2) permits a U.S. corporation to transfer the stock of a foreign, but not a domestic, corporation outbound in a tax-free transaction. Notice 87-85 likewise permits a U.S. corporation to contribute the stock of a foreign, but not a domestic, corporation to a controlled foreign corporation -in a tax-free transaction. An exception which permits distribution of the stock of a domestic, but not a foreign, corporation would appear to be inconsistent with Section 367(e)(1)’s authorization to issue regulations which cause a domestic corporation to recognize gain on distributions of stock under Section 355 “under principles similar to the principles of [Section 367].”

The limitation may be based on the fact that the inside assets of a distributed domestic corporation, unlike the inside assets of a distributed foreign corporation, continue to be subject to U.S. tax jurisdiction. However, it is U.S. tax on the outside appreciation in the value of the distributed stock, not inside appreciation in the value of U.S. business assets, that Section 367(e) is designed to protect.

The Committee also does not understand why the exception is limited to situations where the distributing corporation is owned by five or fewer shareholders. If the limitation is imposed due to concern that it may be difficult to monitor subsequent sales of the distributed stock by a larger number of shareholders, the limitation should be on the number of foreign distributees rather than on the total number of shareholders. Why, for example, is the exception not available for distributions to nine U.S shareholders (who have no ongoing reporting obligations and the disposition of shares by whom does not trigger retroactive gain recognition) and one foreign shareholder? Similarly, why is it not available where the distributing corporation is owned by ten foreign shareholders but makes a distribution to only one foreign shareholder? If the limitation is not modified to apply only to foreign distributees, then, at a minimum, some mechanism is required in order to permit closely-held corporations owned directly by six or more family members, or which have an incentive compensation plan pursuant to which shares may be issued to several employees, to qualify for the exception.

Aside from the more fundamental concerns discussed above, the Committee observes that some of the restrictions and requirements of this exception might be relaxed without compromising their objectives, as more fully discussed below.

Shareholder Limitations

Among the requirements for the exception is that (a) immediately before the distribution, five or fewer “persons” (limited, for this purpose, to individuals and corporations) directly own 100 percent of the stock of the distributing corporation, and (b) at least 90 percent of the total value of the distributing corporation and all of the stock held by foreign distributees must have a holding period of at least two years (determined, for this purpose, without regard to carryover basis transactions other than Section 381 transactions). Reg. Sec. 1.367(e)-1 T(c)(2)(i). The Committee assumes that these restrictions are designed to limit availability of the exception to longstanding shareholders and to facilitate the monitoring by the IRS of future sales of stock.

The Committee assumes that the purpose of the requirement that shareholders be individuals or corporations is to prevent shareholders from indirectly disposing of their shares within five years after the distribution by disposing of their interest in a pass-through entity that holds the shares directly. If so, an exception should be provided for pass-through entities the interests in which generally may not be transferred (such as ESOPs and many trusts).

In addition, the requirement that 100 percent of the stock be held by the five or fewer persons seems unduly restrictive. A 95% requirement would seem adequate to prevent any abuse.

Furthermore, the two year holding period requirement seems unnecessarily rigid. Both a gift and a contribution to the capital of a wholly owned subsidiary, as well as an inheritance or bequest, start a new holding period under the Regulations. As currently drafted, the Regulations unnecessarily impede both estate and affiliated group business planning.

Value Requirements

The exception also provides that if stock of the distributing corporation is held by a foreign corporate distributee immediately before the distribution, such stock must have a fair market value that is less than 50% of the total fair market value of the stock of the foreign corporate distributee (excluding cash, cash items and marketable securities). Reg. Sec. 1.367(e)-1T(c)(2)(i)(C). In addition, the stock of the distributing corporation, measured immediately after the distribution, must have a fair market value at least equal to that of the controlled corporation, measured immediately before the distribution. Reg. Sec.
1.367(e)-1T(C)(2)(i)(F).

The Committee assumes that the first value requirement is designed to prevent a foreign corporation from being used as a vehicle to avoid the other requirements of the exception (e.g., ten foreign shareholders contribute stock of the distributing corporation to a single newly-formed foreign corporation to create one shareholder). We note that the holding period limitations should restrict this possibility (unless our suggestions discussed above are adopted). More importantly, however, if the purpose of the five or fewer shareholder requirement is merely to ease the burden of monitoring future sales, there is no abuse in combining multiple holdings into one.

If this first value requirement is retained, it should be modified by substituting the gross value of the assets of the foreign distributee for the value of the stock of the foreign distributee. This would result in a more accurate determination of the portion of the foreign distributee's value that is attributable to stock of the distributing corporation. If felt necessary, anti-abuse rules could be provided for situations where gross assets are acquired with offsetting debt for the purpose of avoiding the limitation.

The purpose of the second value requirement, that the distributing corporation be at least as valuable as the distributed stock, is not clear. Perhaps it is designed to assure that the distributing corporation has sufficient resources to pay any tax. Adding alternative compliance methods, such as shareholder guarantees or controlled corporation indemnity participation, could meet this objective while allowing needed planning flexibility for the distributing and controlled corporations.

Restrictions on Transfer

For five years after the distribution, the exception requires each foreign distributee to provide the distributing corporation with a certificate, signed under the penalties of perjury, that such distributee has, without any post-distribution interruption, directly owned all of the stock of the distributing corporation and the controlled company that it owned immediately after the distribution. Reg. Sec. 1.367(e)-1T(c)(2)(ii). Under this requirement, a gift, a control group reorganization* and a contribution to the capital of a wholly owned subsidiary, each a non-abusive change of ownership, trigger U.S. tax. The Committee recommends a more lenient requirement which allows for greater flexibility. We note that the gain recognition agreement provisions of Reg. Sec. 1.367(a)-3T(g), on which the gain recognition provisions of the Regulations appear to be based, generally permit the foreign transferee to undertake nonrecognition transfers of the stock or securities without

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* This appears to be the case even in the case of an “F” reorganization, since subparagraph (ii)(F), unlike subparagraph (i)(G), of Reg. §1.367(e)-1T(c)(2) contains no exception for F reorganizations.

triggering gain recognition to the original domestic transferor (see Reg. Sec. 1.367(a)-3T(g)(7)). If a similar provision has been omitted from the Regulations due to a concern about increasing the Service’s burden in monitoring the shareholders, a compromise would be to permit nonrecognition transfers of the foreign distributee’s entire interest in the controlled corporation so that the number of foreign shareholders to monitor would not increase.

In addition, as discussed below, the Regulations should specifically authorize multi-tier cross-border spinoffs where a single-tier spinoff would be permissible.

3. The Publicly-Traded Exception

Reg. Sec. 1.367(e)-1T(c)(3) provides an exception for distributions by publicly-traded corporations of the stock or securities of domestic corporations to foreign distributees holding 5% or less of the distributing corporation’s stock. The Committee assumes that this exception is provided partly as a matter of administrative convenience, since it would be difficult for a publicly-traded domestic corporation to determine or control the percentage of its shares that was held by less-than-5-percent foreign shareholders, and partly because there is less opportunity for abuse in this situation. The Committee believes that a distribution to a greater-than-5% shareholder of a public corporation involves no greater (and probably less) opportunity for abuse than a distribution to a greater-than-5% shareholder of a closely-held corporation. Accordingly, a public corporation should not be required to recognize gain on a distribution to five or fewer greater-than-5% foreign shareholders who comply with the other requirements applicable to the five-or-fewer exception.

In addition, as noted above, the Regulations should specifically authorize multi-tier cross-border spinoffs. For example, assume that FC, a publicly-traded country X corporation having no five percent or greater shareholder, owns all the stock of DC1, a domestic corporation, that owns all the stock of DC2, also a domestic corporation. Assume the stock of DC2 is first distributed by DC1 to FC, and then distributed to the shareholders of FC. While the- first distribution could be made tax-free because DC1 has only one shareholder, the second distribution would trigger the gain on the first distribution. If, on the other hand, the public shareholders held their shares in DC1 directly rather than through FC, and the stock of DC1 were publicly- traded, the DC2 shares could be distributed by DC1 to the public shareholders tax-free under the publicly-traded exception.

Furthermore, for the reasons discussed above with respect to the five or fewer shareholders exception, the Committee questions why the publicly-traded exception does not apply to distributions of stock or securities of foreign corporations.

To qualify for the exception, (1) the classes of stock of the distributing corporation that are regularly traded on an established securities market in the United States must represent at least 80% of the total value of all classes of the distributing corporation’s outstanding stock, (2)the shareholders of those classes of the distributing corporation’s stock that are regularly traded on established securities markets (apparently without regard to whether such markets are in the United States) must receive stock of the controlled corporation with a value greater than 80% of the total value of the controlled corporation, and (3) the distributing corporation must not know, or have reason to know, that the relevant foreign distributee owns, directly or indirectly, more than 5% (by value) of the shares of the class of the distributing corporation’s stock with respect to which the stock of the controlled corporation was distributed. Reg. Sec. 1.367(e)-1T(c)(3)(i). The Committee recommends clarification of certain aspects of these requirements.

First, the Regulations should clarify when the two 80% determinations must be made. The Committee assumes that they should be made immediately before the distribution.

Second, the “reason to know” standard with respect to foreign shareholders is likely to be difficult to administer, particularly since most of the stock of a publicly-traded corporation typically is held through a clearing system or by other nominees. We suggest that the Regulations delete the “reason to know” standard but retain the rule that receipt of an SEC notice constitutes knowledge of the existence of a 5% foreign shareholder. The Regulations should likewise indicate the point in time at which the distributing corporation must not know of the existence of a 5% foreign shareholder. The Regulations presumably mean at the time of the distribution.

Third, the Regulations should clarify what is meant by “direct or indirect” ownership on the part of a foreign distributee. Read literally, no gain recognition is required if ten foreign subsidiaries wholly owned by the same common parent each owns 5% of the stock of the distributing corporation. The

Regulations might adopt attribution rules for this purpose by reference to some other Code provision, such as Section 2 67 or 318.

4. <u>Distributions of Stock of Lower-Tier Domestic Subsidiaries</u>

Our comments in III.4., above, relating to gain recognized on the distribution by a first-tier domestic corporation of the stock of a second-tier domestic corporation to a foreign parent corporation, apply as well to any gain recognized on the distribution by a domestic corporation of stock of a domestic subsidiary to a foreign shareholder in a Section 355 transaction. Again it would appear to be appropriate to invoke the authority granted by Section 336(e).