REPORT #873

TAX SECTION

New York State Bar Association

Report on Temporary and Proposed Regulations Section 1.367(a)-3T

April 16, 1996

Table of Contents

Cover Letter: i

I. Introduction 1

II. Ownership Limitation..4

III. Presumption of U.S. Ownership. 8

IV. "Active Trade or Business" Requirement 15

V. Other Comments 25

TAX SECTION

New York State Bar Association

April 16, 1996

Hon. Leslie B. Samuels
Assistant Secretary (Tax Policy)
Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington. D.C. 20224

Re. Temporary and Proposed Regulations Under Section 367(a)

Dear Secretary Samuels and Commissioner Richardson:

Enclosed is a report by the New York State Bar Association Tax Section regarding the temporary regulations and notice of proposed rulemaking concerning certain transfers of domestic stock or securities by United States persons to foreign corporations, issued December 22, 1995 (the “Temporary Regulations”). Peter H. Blessing, co-chair of our Committee on Foreign Activities of U.S. Taxpayers, was the principal author of the report.

The Tax Section commends the Internal Revenue Service and the Treasury Department for their incorporation of a number of recommendations contained in our report, dated October 18, 1994 on Notice 94-46. However, the enclosed report suggests certain areas in which

The Temporary Regulations might be appropriately modified and clarified. Most importantly, we think that the ownership threshold for the application of the rules provided in Temporary Regulations should be increased from more than 50 percent to two thirds or more of the stock of the transferee foreign corporation. We think the failure to adopt a more liberal standard such as we have recommended will significantly restrict bona fide business combinations involving a non-U.S. acquiror, without furthering any substantial tax policy interest. We also suggest that (i) certain limitations be imposed on the application of the U.S. ownership presumption to persons who transfer “other property” in exchange for stock of a transferee foreign corporation, and that a presumption of foreign ownership be allowed in certain cases, (ii) certain alternative means to rebut a presumption of U.S. ownership be adopted, and (iii) the active trade or business requirement of the Temporary Regulations be modified, including by eliminating the requirement in cases involving modest U.S. ownership, replacing the 36-month requirement with a “same plan” standard, tacking the holding period of businesses acquired in whole or major pan for equity consideration, clarifying the meaning of “substantial,” and reducing the threshold for affiliation. Finally, the report contains additional miscellaneous comments.

We hope that this report will be helpful in the development of final regulations on this topic. Please let me know if we can be of further help in this area.

Sincerely.

Richard L. Reinhold
Chair

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

COMMITTEE ON FOREIGN ACTIVITIES OF U.S. TAXPAYERS

Report on Temporary and Proposed Regulations Section 1.367(a)-3T[*]

April 16, 1996

I. Introduction

This report offers recommendations to the Internal Revenue Service (the “Service”) and the Treasury Department regarding the Temporary Treasury Regulations (T.D. 8638) and notice of proposed rulemaking (IL-9-95) concerning certain transfers of stock or securities of domestic corporations by United States persons to foreign corporations, which were issued on December 22, 1995 (the “Temporary Regulations”). The Temporary Regulations incorporate the rules announced in Notice 94-46, 1994-1 C.B. 356, with certain modifications. We previously submitted a report dated October 18, 1994 (the “1994 Report”) commenting on Notice 94-46.[1]

We commend the Service and the Treasury Department for their responsiveness to the comments contained in the 1994 Report. However, we believe that certain changes and clarifications to the Temporary Regulations are desirable. These may be summarized as follows:

* The principal author of this report was Peter H. Blessing, with substantial assistance provided by Richard E. Andersen and Douglas R. McFadyen. Helpful comments were received from Marco A. Blanco, Peter C. Canellos, Gary M. Friedman, Kevin Rowe, Richard O. Loengard, Pinchas Mendelson, Charles M. Morgan, III, John Narducci, Richard L. Reinhold, R.J. Ruble, and Steven C. Todrys.

1 The 1994 Report is reprinted in Highlights & Documents, Oct. 21, 1994, at 847.

1. The report suggests, consistently with the 1994 Report, that the ownership threshold at which U.S. transferors are required to recognize gain under the Temporary Regulations be increased from more than 50 percent of the voting power and value of the stock of the transferee foreign corporation to two-thirds or more of such stock.

2. The report suggests that the ownership presumption provisions of the Temporary Regulations with respect to persons who transfer “other property” in exchange for stock of a transferee foreign corporation be modified, including by adding a presumption of foreign ownership in certain cases involving transfers of foreign stock.

3. The report suggests that certain alternative means to rebut a presumption of U.S. ownership be adopted.

4. The report suggests certain modifications to the active trade or business requirement of the Temporary Regulations, including eliminating the requirement in certain cases involving modest U.S. ownership, replacing the 36-month requirement with a “same plan” standard coupled with a longevity-based safe harbor, tacking the holding period of businesses acquired in whole or major part for equity consideration, clarifying the meaning of “substantial,” and lowering the threshold for affiliate status.

5. Finally, the report contains certain miscellaneous technical comments.

In general, under section 1.367(a)-3T(c)(1), a U.S. person that transfers stock or securities of a domestic corporation (“U.S. target company”) for stock or securities of a foreign corporation in an exchange described in Internal Revenue Code section 367(a)(1) will be taxable in each of the following cases (the “four-part test”):

(i) U.S. transferors receive, in the aggregate, more than fifty percent of either the total voting power or the total value of the stock of the transferee foreign corporation in the transaction (the “50 percent ownership limitation”).

(ii) Immediately after the transfer, U.S. persons who are either officers or directors of the U.S. target company or five-percent target shareholders own, in the aggregate, more than 50 percent of either the total voting power or the total value of the stock of the transferee foreign corporation (the “control group” test).

(iii) In the case of a transfer occurring after January 25, 1996, the transferee foreign corporation or an affiliate has not been engaged, for the entire 36-month period immediately preceding the date of the transfer, in the active conduct of a trade or business that is substantial in comparison to the trade or business of the U.S. target company.

(iv) The exchanging U.S. shareholder owns five percent or more of either the total voting power or the total value of the stock of the transferee foreign corporation (a “five percent shareholder”) and fails to enter into a gain recognition agreement (“GRA”) in accordance with the Temporary Regulations and/or satisfy the requirements of Code section 6038B. The duration of the GRA is five years if the transferor can demonstrate that all U.S. transferors in the aggregate own less than 50 percent of both the total voting power and the total value of the stock of the transferee foreign corporation immediately after the transfer, or ten years if either U.S. transferors own 50 percent or more of the transferee foreign corporation immediately after the transfer or the five percent shareholder is unable to determine whether or not they do.

For purposes of the four-part test, there is a rebuttable presumption that persons who transfer stock or securities of the U.S. target company or other property in exchange for stock of the transferee foreign corporation are U.S. persons.

Apart from the four circumstances enumerated above, a U.S. person who transfers stock or securities of a domestic corporation in exchange for stock of a transferee foreign corporation will not be taxable under section 367(a) provided that certain reporting requirements described in the Temporary Regulations are met.

II. Ownership Limitation

Section 1.367(a)-3T(c)(1)(i) provides that a U.S. person that transfers stock or securities of a domestic corporation to a foreign corporation in a section 367(a)(1) exchange will be taxable on such transfer if U.S. transferors receive, in the aggregate, more than 50 percent of either the total voting power or the total value of the stock of the transferee foreign corporation, in the transaction. Under the rule originally announced in Notice 94-46, a transfer by a U.S. person of stock or securities of a domestic corporation to a foreign corporation would be taxable if U.S. transferors owned, in the aggregate, 50 percent or more of the total voting power or total value of the stock of the transferee foreign corporation immediately after the exchange. The Temporary Regulations increased the ownership threshold at which an exchange automatically becomes taxable from 50 percent to more than 50 percent. The preamble to the Temporary Regulations indicates that this change was intended to facilitate the formation of joint ventures between domestic and foreign corporations. While we agree with this change, and support the underlying policy objective, we continue to have significant concerns regarding the impact of the Temporary Regulations on the ability of domestic corporations to expand internationally through joint ventures and on the ability of foreign corporations to engage in tax-free reorganizations with U.S. corporations.

We agree that a limitation on the aggregate amount of U.S. ownership of the transferee foreign corporation is an appropriate simplifying rule that can serve to curb tax-avoidance transactions;[2] however, the threshold should not be so low that it impedes legitimate transactions. The fact that a transferee foreign corporation is smaller than a U.S. target company does not, in and of itself, indicate that a transaction is tax-motivated.[3] In fact, such transactions are commonplace and, at least where the difference in size between the U.S. target company and the foreign acquiror is not substantial, should not automatically be denied non-recognition treatment. Even in those circumstances where the foreign acquiror is larger than the U.S. target company, it will often be difficult in the

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[2] We note, however, that the absence of an overriding exception for small (less than five percent) shareholders represents a significant change in policy under section 367(a) (compare Notice 87-85, 1987-2 C.B. 395; see also IRC § 897(c)(3)). Although this change reflects the nature of certain of the transactions targeted by the Temporary Regulations, the appropriateness of addressing such transactions in regulations under section 367 continues to be the subject of controversy.

[3] Business considerations and foreign legal, tax and financial accounting considerations frequently restrict the manner in which cross-border transactions can be implemented.

context of widely held companies to be comfortable that the 50 percent ownership limitation is not violated. The difficulty in this regard is substantially compounded by the ownership presumption for transferors of "other property," as discussed below.

An additional problem arises from the fact that the ownership tests in section 1.367(a)-3T(c) must be satisfied at the time of the exchange. In the case of large publicly traded corporations, with constantly changing share ownership, it is impossible to predict with certainty what the composition of the share ownership will be at the time of the exchange. Even if the mechanism for rebutting the U.S. ownership presumption is not liberalized (see our comment below), so that the domestic corporation would effectively be presumed to be wholly owned by U.S. persons, there may be uncertainty because the number of shares of the transferee foreign corporation to be received by such shareholders may fluctuate (at least within a collar), depending upon the trading values of the domestic and foreign companies. Under such circumstances, taxpayers would be in the untenable position of having to decide whether or not to proceed with an exchange without necessarily knowing its tax consequences.[4]

We understand that Treasury and the Service have expressed particular concern regarding the possibility of loss of U.S. taxing jurisdiction over future growth or expansion of foreign operations of a U.S. target company (including through

[4] It seems ironic that the tax law would structurally incorporate a test, with respect to transactions typically involving publicly held securities, that in certain cases is likely to run counter to an objective of the U.S. securities law, i.e., that shareholders be provided with sufficient information to determine the consequences, including tax consequences, of their investment decision.

possible decontrol of controlled foreign corporations of the company) following the company’s acquisition by a transferee foreign corporation. We respectfully submit that drawing the line at a 50 percent threshold outside of a control group context is not required by, or clearly related to this concern, and does not appear to derive from the policy considerations underlying section 367. The restriction is apparently based on the premise that there is a relationship between the degree of U.S. ownership of the transferee foreign corporation and the likelihood that the U.S. target company’s controlled foreign corporations will be decontrolled or that operations that otherwise would have been conducted by it instead would be conducted by foreign affiliates outside of the U.S. taxing net. In fact, however, there would appear to be no relationship between the two. If potential loss of U.S. taxing jurisdiction over future growth or expansion of the U.S. target company’s foreign operations is a real concern to the Treasury and Service, we would recommend that the problem be addressed directly and not by imposing an unnecessarily low limitation on all tax-free outbound transfers of shares of U.S. target companies.

In light of the concerns noted above and consistently with the recommendation, contained in our 1994 Report, we urge that section 1.367(a)-3T(c)(I)(i) be amended to provide that transfers of stock or securities of a U.S. target company in exchange for stock of a transferee foreign corporation are not taxable if U.S. transferors own, immediately after the exchange, less than two-thirds of the voting power and value of the stock of the transferee foreign corporation. We believe that liberalizing the 50 percent ownership limitation, at least in the context of widely held companies, is appropriate to relieve pressure in situations such as those described above without detracting from the general efficacy of the Temporary

Regulations.[5] As we have previously noted, the presence of at least one-third unrelated foreign ownership of the transferee foreign corporation subsequent to the exchange adequately addresses the concerns with respect to certain tax-motivated restructurings that prompted the issuance of Notice 94-46, especially when combined with the requirements that (i) five percent shareholders enter into a GRA and (ii) the transferee foreign corporation be engaged in the active conduct of a comparatively substantial trade or business.[6] We believe that a lower U.S. ownership limitation would inappropriately result in current taxation of transactions that are not motivated by tax considerations and would be inconsistent with the policy objective of section 367(a).[7]

III. Presumption of U.S. Ownership.

Scope. Section 1.367(a)-3T(c)(2) provides that, for purposes of the fifty percent ownership limitation, “any persons who transfer stock or securities of the U.S. target company or

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5 While moving the benchmark would not eliminate the concerns addressed above regarding the difficulty of ascertaining compliance with the regulation due to changes in the U.S. target’s shareholder base, or the amount of the transferee’s stock to be issued in the transaction, it would serve to shift the situations in which difficulties may arise to cases away from the center of the spectrum, and reduce the number of situations in which these issues arise.

6 Notice 94-46 invited comments as to whether or not a safe harbor should be provided in certain situations, including where a domestic corporation is acquired by a foreign corporation that is engaged in an active trade or business and is unrelated to the domestic corporation and its shareholders. While the Temporary Regulations adopt an active trade or business concept, they do so solely as an additional requirement, rather than an exception to, the ownership test. The presence of this additional requirement substantially reduces the potential to engage in purely tax-motivated transactions and, as a result, should alleviate the concerns that led Treasury and the Service initially to adopt the 50 percent ownership threshold announced in Notice 94-46.

7 We do not suggest a change to the 50 percent threshold in the control group test.

other property in exchange for stock of the transferee foreign corporation are presumed to be U.S. persons."

While we appreciate the rationale for the presumption with respect to shareholders of the U.S. target company, we believe that the extension of the presumption to transferors of "other property" is overly broad and gives rise to many of the same inequities as did the broad cross-ownership presumption of Notice 94-46. For example, it is common in a joint venture or business combination context for the parties to utilize a newly established corporation as a holding company. For various reasons apart from any U.S. tax motivation, the holding company selected for a joint venture or business combination involving U.S. and foreign transferors may be a foreign corporation. Under certain circumstances, the transaction may take the form (at least as viewed for U.S. tax purposes) of a transfer of shares by the shareholders of the domestic corporation/joint venturer and the foreign corporation/joint venturer to the foreign holding company. Provided that the fair market value of the foreign joint venturer's shares is at least as large as that of the domestic joint venturer's shares, this transaction should, based on the policy considerations underlying the Temporary Regulations, be considered nonabusive. Section 1.367(a)-3T(c)(2), however, applies the U.S. ownership presumption to any transferor of "other property" to the transferee foreign corporation. Therefore, because shares of the foreign joint venturer are being exchanged for stock of the transferee foreign corporation, all of the foreign joint venturer's shareholders are presumed to be U.S. transferors. This presumption, and the inability, practically speaking, to rebut it, gives rise to the same inappropriate result that existed as a result of the cross-ownership presumption found in Notices 87-85 and 94-46.[8]

While we acknowledge the Service's concern regarding “stuffing” transactions, the scope of the ownership presumption as it is currently drafted goes further than needed and will result in application of section 367(a)(1) to transactions that are not motivated by tax avoidance simply because the U.S. target company is unable to rebut the presumption that certain transferors are U.S. persons pursuant to section 1.367(a)-3T(c)(6). We believe that the Service's concerns could be largely addressed by a rule that is more focused.

An alternative approach would be to apply the ownership presumption to transferors of “other property” only in potentially abusive situations.[9] In our view, an appropriate rule might provide that a transferor of property to a transferee foreign corporation is presumed to be (i) a foreign person if the property transferred by such person is part of a class of stock of a foreign corporation that is primarily traded[10] on an established securities market outside of the United States[11] (excluding for such purpose ADRs). and (ii) a U.S. person if the property transferred is <u>other than</u> (A) interests in an entity organized under foreign law (whether or not a corporation, but

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8 As noted below, a transaction of this type also may raise issues under the active business requirement.

9 Compare the anti-stuffing rules of section 382(1)(1) of the Code and section 1.1502-20(e)(2) of the Treasury regulations, which, in general terms, apply when property is transferred to a corporation with “a principal purpose” of avoiding, or “with a view to avoiding, directly or indirectly,” the relevant operative rule.

10 The regularity of trading would not seem to be a relevant criterion.

11 All established non-U.S. securities markets on which the stock is traded should be aggregated for this purpose.

excluding ADRs) or (B) assets that, within three months following the transfer, have commenced to be used in, or have been expended for the acquisition of assets used in, an active trade or business of the transferee foreign corporation or an affiliate.[12]

Adequacy of rebuttal exception. Under section 1.367(a)-3T(c)(4)(ii), the U.S. target company can rebut the U.S. ownership presumption for purposes of the fifty percent ownership limitation by obtaining ownership statements from those persons transferring stock or securities of the U.S. target company (or other property). The ownership statements must be signed under penalties of perjury and state, among other things, the person's identity, address and taxpayer identification number, that the person is not a U.S. person and that the stock or securities that the person owns in the U.S. target company are not attributable to a U.S. person under the rules of section 958 of the Code. The U.S. target company must attach to its U.S. income tax return for the year of the transfer a "Section 367(a) Compilation of Ownership Statements under Reg. § 1.367(a)-3T(c)" signed under penalties of perjury by an officer of the U.S. target company.

As a practical matter, a U.S. target company generally will be unable to rebut the presumption that all of its shareholders are U.S. persons unless it is very closely held. The difficulty is compounded by the fact that shares of a publicly held company ordinarily are held in "street name" and through depositary arrangements (e.g., through the Depositary Trust Company, in the United States). Accordingly, we believe the U.S. ownership rebuttal mechanism in the Temporary Regulations is

[12] Compare, e.g., IRC § 856(c)(6)(D) (one-year investment period for new capital in REIT); IRC § 1297(b)(2) (similar exception for PFIC determination).

effectively unusable, at least in the context of a widely held corporation.

To the extent possible, the mechanism for rebutting the U.S. ownership presumption should be based on information that is realistically obtainable by the U.S. target company.[13] A possible approach would be to permit the U.S. target company to rebut the U.S. ownership presumption with documentation that must be retained to comply with the dividend withholding obligation under section 1441 of the Code, including, to the extent feasible, appropriate documentation obtained by a custodian, depositary or other person.[14] While this approach would not enable the U.S. target company to identify U.S. persons to whom stock held by foreign shareholders may be attributable under section 958, it

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13 In this regard, we support the Service's decision to allow the U.S. target company to rely on the existence or absence of filings on Schedule 13-D or 13-G under the Securities Exchange Act of 1934 (or any similar schedules) for purposes of identifying "five-percent target shareholders" in connection with the control group test. Compare Treas. Regs. § 1.382-2T(k)(1).

14 Under newly proposed regulations under section 1441 (INTL-0032-93), a withholding agent for dividend payments would be expected to obtain from non-U.S. persons a Form W-8 or an "intermediary withholding certificate" issued by a "qualified intermediary." If the qualified intermediary would not assume primary withholding responsibility, it would represent in the intermediary withholding certificate as to the non-U.S. status of the payees. If instead, the qualified intermediary would assume primary withholding liability, it would represent only that it would withhold all appropriate amounts and comply with all applicable withholding requirements. The role of an "authorized foreign agent" under the proposed regulations would be similar. The U.S. target company could be permitted to rely on documentation obtained by such parties, at least if the company is provided with, e.g., certification as to the contents of such documentation. Optimally, a procedure would be available whereby the U.S. target company could obtain access to the contents of such documentation or to such a certification.

We note that the current Form 1001, Ownership, Exemption, or Reduced Rate Certificate, requires the foreign taxpayer to "certify that the information entered above is correct," not to sign under penalties of perjury. We believe that, considering the practical aspects of compliance, the absence of a "penalties of perjury" statement should be acceptable. We are not suggesting that a U.S. target company be permitted to rely on the current address rule.

would ease compliance, would be administrable and would represent a reasonable compromise between the need to prevent abuses and the objective of taxpayer fairness. The inability to identify section 958 attributees would not seem to be a major problem because in most cases U.S. persons do not own stock or securities of a U.S. issuer through a foreign entity and because of the restrictions on attribution from certain foreign persons to U.S. persons under sections 958(b)(1) and (b)(4).

As noted above, the U.S. ownership presumption under the Temporary Regulations extends to U.S. and non-U.S. transferors of “other property” for stock of the transferee foreign corporation. In connection with the establishment of a common holding company in, e.g., a “merger of equals,” such transferors will include shareholders of a foreign corporation. If our above recommendation that, in general, the U.S. ownership presumption not apply to shareholders of a foreign corporation (and, in fact, that presumption of a foreign ownership apply in certain cases) is not accepted, then a more usable rebuttal mechanism for a foreign corporation should be crafted to reflect the fact that, for example, shares of foreign corporations may be held by custodians that are subject to “know your customer” rules or other local law requirements. Further, such a mechanism may be appropriate to the extent that, under final regulations, no presumption, foreign or U.S. would apply to stockholders of a foreign corporation.

One approach would be to permit intermediate verification procedures analogous to those proposed under section 1441. In contrast to the considerations applicable in the withholding tax area, however, there would not seem to be the same need for intermediaries to enter into formal agreements with the Service. Further, as suggested by certain financial institutions in the context of the TIN initiative, it may be appropriate that a financial institution be permitted to certify an investor's residence and/or nationality to the Service without disclosing the investor's identity. A second approach would be to borrow from the branch profits regulations (which themselves, however, have substantial "real world" shortcomings). Under those regulations, an "intermediary verification statement" may serve in lieu of an ownership statement and certificate of residency.[15] In addition those regulations provide a conclusive presumption of non-U.S. ownership for certain registered holders of widely held corporations who have foreign addresses of record.

Gain recognition agreement. Section 1.367(a)-3T(c)(1)(iv)(B) provides that a five percent shareholder must enter into a GRA in order to avoid recognizing gain on an otherwise nontaxable exchange. Depending on whether or not U.S. transferors own in the aggregate 50 percent or more of either the total voting power or the total value of the stock of the transferee foreign corporation, the term of the GRA will be either five years or ten years. While the Temporary Regulations limit the application of the cross-ownership presumption generally, they do not do so in this context. As a result, five percent shareholders are required to file a ten-year GRA unless they can establish that less than 50 percent of the total voting power and total value of the stock of the transferee foreign corporation is owned by U.S. transferors. As discussed above, in the case of a transferee foreign corporation that is not closely held, this is for all intents and purposes an impossible task. Given the basic policy decision to allow five-year GRAs, it is appropriate that the Temporary Regulations provide a realistic mechanism by which taxpayers can reasonably avail themselves of

[15] See Treas. Regs. § 1.884-5(b)(3).

the reduced term in the context of a widely held transferee foreign corporation.

IV. <u>“Active Trade or Business” Requirement</u>

Section 1.367(a)-3T(c)(1)(iii) adds a requirement, not found in earlier iterations of the section 367 regulations or in Notices 87-85 or 94-46, to the effect that outbound stock transfers will not be excepted from section 367(a)(1) unless the foreign transferee corporation or one or more of its affiliates has been engaged in the active conduct of a trade or business that (1) is substantial in comparison to the trade or business of the U.S. target company and (2) was conducted throughout the 36-month period ending on the transfer date. In order to determine whether this requirement is satisfied, the existence of a trade or business is determined under section 1.367(a)-2T(b)(2) of the 1986 Temporary Regulations, and whether or not that trade or business has been actively conducted is governed by the rules of section 1.367(a)-2T(b)(3) of those Regulations.

The requirement that an active business be conducted by the transferee foreign corporation is intended to confine the ability of shareholders of a U.S. target company to effect a tax-free transfer of their shares to a transferee foreign corporation to cases “where a combination of two active businesses is contemplated”[16] and, conversely, to impede transactions in which a foreign acquiror may be “formed and capitalized with a view to enabling [a smaller U.S. target company] to move offshore.”[17] The

[16] We note, however, that the Temporary Regulations require that only the transferee foreign corporation or its affiliate, and not the U.S. target company, meet an active business test.

[17] T.D. 8638, “Explanation of Provision.” reprinted in Highlights & Documents, Dec. 26. 1995, at 4954, 4958.

36-month period was selected by the Service in the belief that "the opportunity for tax avoidance is ameliorated when such businesses have been conducted for a period of at least 36 months prior to the exchange."[18] Based on these statements, the Service's concern seems to be with tax-motivated transactions. Under the Temporary Regulations, the deemed tax motivation arising from the failure to satisfy the active business requirement taints the exchange with no possibility of purgation through proof of economic substance.[19] To circumscribe the scope of factual inquiries, in lieu of either a subjective purpose test[20] or a step transaction test, a bright-line 36-month rule has been adopted.

We agree that a trade or business requirement can be helpful in curbing abusive transactions and differentiating between such transactions and those that do not have a prohibited tax-motivated purpose.[21] However, we question whether the requirement should have been included in the Temporary Regulations without a notice of proposed rulemaking, and believe that certain modifications should be made to the rule set forth in the Temporary Regulations.

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[18] Id. As noted below, we believe that a 36-month period may be unduly long for this purpose.

[19] For example, the fact that a business recently acquired by a transferee foreign corporation is larger than the business received from the U.S. target company, and such transferee foreign corporation holds no passive assets, would not be relevant.

[20] The difficulties in administering a "principal purpose" test under section 367(a) prompted Congress to eliminate such standard in 1984.

[21] Such a standard was suggested in the 1994 Report as an appropriate basis, in the context of a transaction in which U.S. persons received between 50% and two-thirds of the shares of the transferee foreign corporation, for presuming that a "combination transaction is being undertaken for legitimate business reasons and should be permitted to occur tax-free."

Exception for certain transactions involving modest U.S. ownership. In cases in which the level of ownership of the transferee foreign corporation by shareholders of the U.S. target company following the exchange is relatively low, there should be little concern that the transaction represents a tax-motivated transfer of a U.S. company to a foreign receptacle rather than a legitimate business transaction. It follows that the premise for the active business requirement is not present in such cases. Because of various requirements imposed in connection with the active business requirement (e.g., the nature of the activity required,[22] the period for which it must be conducted and the threshold for affiliate status), however, the active business requirement may not be able to be met in certain such cases in which no tax motivation is present. Imposing the requirement in such cases results in an arbitrary impediment to legitimate transactions. While an appropriate level at which an active business requirement should be waived altogether may be debated (we had suggested 50 percent or less ownership by U.S. transferors in our 1994 Report, but a maximum of one-third or even 25 percent might be considered appropriate), we believe final regulations should incorporate the principle.

Issues concerning duration of active business. The Temporary Regulations state that the active business must have been conducted by the transferee foreign corporation or an affiliate during the entire 36-month period prior to the exchange. Expressed in terms of the rule's underlying rationale, an acquisition of an active business within the 36-month period would be conclusively presumed to have been made for tax

[22] To cite one example, we understand that there may be some uncertainty within the Service as to the scope and essential elements of Rev. Rul. 92-17, 1992-1 CB 142, dealing with a general partner of a limited partnership in the context of the active business requirement of Section 355.

avoidance. The Temporary Regulations are unclear as to whether, in the case of a business conducted by an affiliate, the affiliation must have been satisfied throughout the 36-month period or only at the time of the exchange. They also are unclear concerning the effect of additional business assets acquired during the 36-month period on the measurement of substantiality. Proceeding from the tax avoidance rationale underlying the requirement, no distinction logically would be drawn between an asset acquisition and a share acquisition. In addition, while, in theory, no distinction would be drawn between an acquisition to establish a new active business (whether or not the only active business) and making an existing active business “substantial,” theory presumably must bend to practical reality to accommodate growth, even abnormally rapid growth, of a business through acquisitions.

We question, however, whether, even in cases involving too high a percentage of U.S. ownership of the transferee foreign corporation to warrant an exemption (as suggested above) from the active business requirement, a fixed “business continuity” period is truly needed to restrict potential abuses or is necessary from an administrability standpoint. Sales of business operations are frequent transactions, even to companies with no prior active business (e.g., a management-led leveraged buyout), and easily could precede, by a year or two years or less, a share-for-share acquisition of a U.S. target company. We believe that, considering the potential interference with legitimate business transactions that would result from the 36-month rule, the Treasury’s interests would be sufficiently protected by a requirement that the acquisition of an active business by the transferee foreign corporation not be part of the same plan as the acquisition of the U.S. target company’s shares, with a conclusive presumption that the transactions are not part of the same plan if, within 24 months[23] following a binding commitment to complete the first transaction, there is no binding commitment to enter into the second transaction.

If, however, a fixed business continuity period is considered necessary, we believe that a 36-month period, which generally is a period, used in the Code and the Treasury regulations as an appropriately long base period to measure financial results, is unnecessarily long for the requisite business continuity.[24] In any event, an exception may be appropriate for enterprises that have lengthy start-up phases and hence might be active in an ordinary sense for a number of years (sufficient to alleviate any antiabuse concern) without technically having commenced an active business under the principles of the Code and regulations until some later time.

Even if a conclusive presumption of tax avoidance is accepted in certain cases involving an acquisition for consideration consisting of cash or debt securities, such a presumption would not seem appropriate in the case of an acquisition of an existing business for consideration consisting, in whole or major part, of equity of the acquiror or an affiliate (whether or not technically qualifying as a tax-free transaction under the Code and Treasury regulations).[25] For example, in the

[23] As discussed immediately below, we believe that a 24-month period rather than an 36-month period may be more appropriate in the context of the Temporary Regulations.

[24] Compare, e.g., IRC § 382 (1)(1)(B), Treas. Regs. § 1.707-3(d), § 1.1502-20(e)(2), Prop. Regs. § 1.367(b)-4(b)(3)(i), Rev. Proc. 93-27, 1993-2 CB 343, and Rev. Rul. 74-5, 1974-1 C.B. 82 (obsoleted by Rev. Rul. 89-37, 1989-1 C.B. 107), all applying a 2-year rule.

[25] Compare IRC § 355(b). Requiring compliance with U.S. tax principles would seem too restrictive given the fact that foreign legal regimes would be involved and in many cases the transactions would be consummated without consideration of a future U.S. acquisition.

case of a transferee foreign holding company newly formed in connection with a joint venture or business combination, the active business requirement should be able to be satisfied on the basis of an appropriately seasoned active business conducted by a foreign operating company the shares of which are transferred to the holding company as part of the overall transaction (regardless of the exact sequence of the steps). The proper result can be reached, under the Temporary Regulations, by construing the term “affiliate” to include the newly transferred operating company, but clarification is needed to confirm this result.

Further, in certain cases it may not be possible or desirable for the foreign joint venturer to transfer shares of a foreign operating company (and, in fact, the business may have been conducted in, for example, partnership form). In such a case, active business assets may be transferred directly to the transferee foreign corporation. Under such circumstances, we believe that the active business requirement of section 1.367(a)-3T(c)(1)(iii) should be considered met on a “tacking” basis and that the Temporary Regulations should be clarified to provide this result.

More generally, assuming that, as suggested above, the transfer of an active business of sufficient size and longevity to a transferee foreign corporation in connection with the establishment of a joint venture or business combination may satisfy the active business requirement, such requirement should be able to be met through the transfer of such a business at an earlier date during the relevant business continuity period, whether as part of a restructuring of the transferee foreign corporation or as an expansion of an existing business, provided the business is transferred in whole or major part for equity of the transferee foreign corporation or an affiliate. Tacking should be permitted even if a foreign corporation is the acquired company rather than the acquiring company in an acquisition or reorganization, for sufficient equity consideration, since the designation of a corporation as acquiror versus target is often arbitrary.[26] Another example of a transaction that should permit the holding period of an active business to tack would be the acquisition of an active business by a transferee foreign corporation pursuant to the incorporation of a partnership.

A minimum level of equity consideration such as 50 percent, would be an appropriate requirement to permit an active business to tack for purposes of testing business continuity. Further, qualifying equity consideration might appropriately be limited to common (ordinary) shares (or preference shares that provide the holder no or only a long-term right to redemption) in the transferee foreign corporation or its direct or indirect parent corporation.

A related question is whether the substantiality of the active business should be tested throughout the requisite business continuity period, as opposed to only as of the time of the exchange in question. The relative sizes of the businesses at the time of the exchange would seem to be the most appropriate comparison. Further, an ongoing requirement would not seem necessary given the limitations on having an acquired business tack. Moreover, an ongoing requirement would greatly add to the complexity of compliance, since multiple comparisons would be required.

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[26] Compare Treas. Regs. § 1.1502-75(d)(3) (reverse acquisition). Even where the transaction would not be a reverse acquisition under the principles of the Treasury regulations addressing U.S. consolidated returns, we believe that tacking is appropriate for a business acquired for consideration consisting of equity of the acquiror group.

Measurement of substantiality. Section 1.367(a)-3T(c)(1)(iii) provides that the active business must be substantial in relation to the U.S. target's "trade or business" (apparently, without regard to whether the U.S. target's trade or business is active). We agree with the objective of not allowing a de minimis business of the transferee foreign corporation to satisfy the active business requirement.

Under the test of the Temporary Regulations, given the 50 percent ownership limitation, substantiality questions are likely to arise only where the transferee foreign corporation also holds substantial assets that are not part of an active trade or business.[27] Nevertheless, certain aspects of the definition of "substantial" should be clarified.

One question is how to measure substantiality. For example, a transferee foreign corporation may be as profitable, or more so than the U.S. target company, but have substantially lower sales, fewer assets, or fewer employees. Depending upon which criteria are used in determining substantiality, an exchange may or may not satisfy section 1.367(a)-3T(c)(1)(iii). The issue is further complicated where very different types of businesses are involved. For example, assuming that multiple businesses (whether or not held in separate affiliates) of a corporation may be aggregated, how should one, for example, compare the aggregate size of a labor-intensive service business

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[27] Because the test in the Temporary Regulations is by reference to the U.S. target company's trade or business rather than by reference to its total balance sheet, the question might also arise as to whether certain assets of a domestic corporation are considered nonbusiness assets for this purpose (e.g., a securities portfolio held for investment). We note, however, that assets held by a domestic corporation are generally assumed to be held in connection with a business of some sort, at least for purposes of section 162. Clarification that a presumption to that effect is applicable for purposes of the active business test would be helpful.

with a capital-intensive manufacturing business? A third question is whether, under whichever measure is selected, a transferee foreign corporation's active business is substantial, relatively speaking, if it is only, for example, half or one-third of the size of the U.S. target company's business? We suggest that one or more "safe harbors" be made available such as, for example, where the transferee foreign corporation's active business has gross sales or gross receipts equal to one-third or more of the gross sales or gross receipts of the U.S. target company's, business (generally using the most recent available audited financial statements, conformed, where appropriate, to U.S. GAAP).[28]

We have considered whether the use of a "window dressing" business could be prevented with less dislocation to bona fide combinations if the substantiality requirement were replaced with a rule that would disqualify an active trade or business if it was established, acquired or availed of for a "principal purpose" of allowing a subsequent acquisition of stock or securities of a U.S. target company to qualify for deferral from taxation. While such a test would be consistent with the anti-abuse concern identified in the Preamble to the Temporary Regulations, we believe that it would itself be unduly vague, and would impose an unrealistically high burden on the Service and, possibly, on taxpayers. Accordingly, on balance, we support the substantiality standard, with clarifications as noted above. •

Measurement of affiliate status. The 1994 Report suggested that the active business could be found in either the transferee foreign corporation or a subsidiary, applying a 50

[28] Compare, e.g., Treas. Regs. § 1.368-l(d)(5), Ex. (1); Rev. Rul. 72-48, 1972-1 C.B. 102 (construing "a substantial part" in pre-1984 IRC § 341(b)(1)(A) as meaning one third or more).

percent threshold for affiliation. The Temporary Regulations adopt a section 1504(a) consolidated return affiliation test (modified to include foreign corporations), and make clear that the active business may be conducted by any member of the affiliated group (e.g., a parent or sister corporation of the transferee foreign corporation).

We support applying the test on a group-wide basis, but believe the section 1504(a) standard is too restrictive. First, the 80-percent of voting power and value threshold required under section 1504(a) makes it impossible for a foreign corporation acting solely as a joint venture party in any number of, e.g., 50-50 corporate joint ventures, no matter how substantial, to satisfy section 1.367(a)-3T(c)(1)(iii). In addition, use of the section 1504(a) rules penalizes foreign groups having other than the most straightforward intercompany share ownership structures, since those groups might not be consolidated for section 1501 purposes even though the parents have unqualified control over their subsidiaries. Finally, it is not obvious why a transferee foreign corporation having active affiliates that are disqualified from consolidation (e.g., domestic or foreign insurance companies taxable under section 801. or domestic affiliates having a section 936 election in effect) should be unable to use those affiliates’ businesses to satisfy the active business test.

Therefore, we recommend that the definition of “affiliate” contained in section 1.367(a)-3T(c)(6)(vii) be modified to replace the reference to the consolidated return rules with a reference to the “control” test of section 267(f), but adopting a 50 percent test rather than more-than-50 percent test.[29]

V. Other Comments

Certification requirement. In order for a U.S. transferor to avoid recognizing gain on a transfer of stock or securities of a U.S. target company, an officer of the U.S. target company must certify under penalties of perjury that, among other things, there is an active trade or business that satisfies the substantiality test. In our view, it seems inappropriate that the ability of a shareholder of a U.S. target company to defer gain recognition rests on a ministerial requirement imposed on a third party, which could result in taxation of the shareholder even in circumstances in which the substantive requirements of the Temporary Regulations are met. Therefore, we would eliminate the certification requirement, but leave the active business and substantiality requirements (in whatever form they ultimately are adopted) as substantive tests that must be satisfied to obtain non-recognition treatment. If this recommendation is not adopted, we would then suggest that the Temporary Regulations be clarified to indicate the wording of the requisite statement (specifically, that it is made only to the best of the maker's "knowledge and belief").[30]

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[29] A case can be made that the appropriate threshold, at least in the case of affiliates that are subsidiaries, should be the 25 percent test used in Section 1296, since the Congress has determined that level of ownership is sufficient to consider share ownership as representing a direct investment rather than a passive, portfolio investment. Further, it is not uncommon for an active joint venture participant to have a less than 50 percent stake, including in situations in which there are three joint venturers. Accordingly, it would be equitable to allow for ruling relief in appropriate situations.

[30] Compare, e.g., Treas. Regs. § 1.103(n)-5T, Q/A-l, § 1.897-2(h)(1)(i), § 1.897-2(h)(2)(v).

“Indirect and constructive transfers.” Section 1.367(a)-3T(a) provides that, in general, section 367(a)(1) applies to a transfer of stock or securities by a U.S. person to a foreign corporation “directly, indirectly or constructively.” Similarly, section 1.367(a)-3T(c)(6)(v) defines a U.S. transferor as a U.S. person who “transfers directly, indirectly or constructively stock or securities of the U.S. target company or other property in exchange for stock of the transferee foreign corporation.”

Section 1.367(a)-1T(c) of the 1986 Temporary Regulations provides that “indirect or constructive transfers” of property “include” those described in such paragraph. For example, “indirect” transfers includes cases such as reorganizations described in sections 368(a)(2)(D) and 368(a)(2)(E).[31] In addition, section 1.367(a)-1T(f) of the 1986 Temporary Regulations provides that an outbound reorganization described in Code section 368(a)(1)(F) “is considered” to result in, among other things, an exchange by the shareholders and security holders under Code section 354(a). On the other hand, the Service has ruled favorably with respect to an outbound reorganization described in section 368(a)(1)(F), apparently without testing the transaction as a share exchange,[32] and we understand informally from certain Service personnel that such transactions are not intended to be covered by section 1.367(a)-3T(c).

Accordingly, we are unclear as to what type of “constructive transfer” might be considered to be within the

[31] It is arguable that, notwithstanding the position taken in section 1.367(a)-lT(c)(2)(ii) of the 1986 Temporary Regulations, an indirect transfer should not include a triangular Type B reorganization in which the acquiring company is domestic (and has a substantial active business) and the controlling company is foreign, since the domestic company would be subject to U.S. tax on disposition of the stock of the U.S. target.

[32] Ltr. Rul. 9533005 (April 28, 1995).

scope of section 1.367(a)-3T(c), and believe that clarification is needed. More generally, to the extent that there is an intention to cover transfers described in section 1.367(a)-lT(c), we believe that a cross-reference in section 1.367(a)-3T(a) or 1.367(a)-3T(c)(6)(v) to the appropriate provision(s) is desirable.

"Timely filing" rule. Section 1.367(a)-3T(c)(4)(iii) provides that, for purposes of the reporting requirements, an initial or amended income tax return will be deemed timely "if it is filed prior to the time that the Internal Revenue Service discovers that the reporting requirements of [that] paragraph have not been satisfied." (Emphasis supplied.) We believe that the use of the term "discovers" raises unnecessary uncertainties concerning the actual filing deadline, since discovery by the Service may be deemed to have taken place at any of a number of times (e.g., the date on which an examiner notes the absence of the requisite schedules on a U.S. target company's return, the date on which the examiner makes a formal determination that the paperwork was required to be filed, or the date on which the examiner notifies the taxpayer of that determination).

A more objective standard has been adopted in analogous areas of the tax law. For instance, the Treasury regulations under section 882(c)(2) (relating to the requirement that a foreign corporation file an income tax return as a condition to claiming deductions for that year) provide that, in certain cases, a return is timely filed if it is filed before the Service mails a notice to the taxpayer that the return has not been filed and that deductions will therefore not be allowed.[33] We recommend

[33] Treas. Reg. § 1.882-4(a)(3)(i). See also Treas. Reg. § 1.874-l(b(1) (similar rules for nonresident alien individuals).

that, to avoid unnecessary disputes, such a rule be adopted in the Temporary Regulations in place of the discovery standard.

Ownership attribution. There appears to be several technical drafting issues in regard to the application of section 958 to the various determinations required to be made under the Temporary Regulations.

Section 1.367(a)-3T(c)(5)(iv) provides that, for all purposes of section 1.367(a)-3T(c), the rules of section 958 shall apply “for purposes of determining the ownership of stock, securities or other property.” Under section 1.367(a)-3T(c)(6)(iii), if the stock of the U.S. target company is described in Rule 13d-1(d) of Regulation 13D promulgated under the Securities Exchange Act of 1934, taxpayers may rely upon the existence or absence of Schedules 13-D or 13-G filed under that Act (or similar schedules) “for purposes of identifying five-percent target shareholders.” The relationship of these provisions should be clarified. A reasonable interpretation is that section 958 is intended to be inapplicable in any case in which the stock of the U.S. target company is described in Rule 13d-1(d) (even if, for example, the U.S. target company has actual knowledge of the section 958 relationship), except that, once a five percent target shareholder has been so identified, section 958 is applicable in determining the number of shares owned by that shareholder, not only in the foreign transferee corporation but also in the U.S. target company.

The reporting rules of section 1.367(a)-3T(c) also require clarification. Under section 1.367(a)-3T(c)(6)(i)(C), an ownership statement must contain a representation that:

> the person making the statement is not <u>related</u> to any U.S. person to whom the stock or securities owned by the person making the statement are attributable under the rules of section 958, or. if stock or securities are so attributable, the identity and taxpayer identification number of the relevant U.S. person[.]

(Emphasis supplied.) The use of the term “related” suggests that this representation requirement covers only persons to whom stock or securities[34] are attributable under the modified section 318 rules of section 958(b). since section 958(a)(2) also attributes <u>de</u> <u>minimis</u> stock ownership that would not. in ordinary parlance, involve a “relationship” between the actual and deemed owners. We do not believe that it would be appropriate to prevent a publicly traded foreign corporation from providing an ownership statement simply because, as a practical matter, it is impossible for a foreign corporation to determine its ultimate share ownership under the standards of section 958(a).[35] Therefore, we recommend that section 1.367(a)-3T(c)(6)(i)(C) be clarified to refer specifically to section 958(b) alone.

<u>Treatment of pass-through entities.</u> The Temporary Regulations adopt a pure aggregate rule for purposes of applying section 1.367(a)-3T(c) to a stock transfer by a domestic or foreign partnership, referring to the similar rule set forth in section 1.367(a)- lT(c)(3)(i) of the 1986 Temporary Regulations. While there in some logic to this rule in the application of the substantive rules of section 367(a), the substantiation

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[34] We note that section 958 does not attribute ownership of securities. Hence, the reference to attribution of securities in section 1.367(a)-3T(c)(6)(i)(C) of the Temporary Regulations presumably should refer to the principles of section 958.

[35] Compare Staff, Jt. Comm, on Taxation, <u>Description of the Technical Corrections Act of 1988</u> 274 (1988) (anticipation that Secretary will exercise authority under section 953(c)(8)(B) to exclude U.S. persons from U.S. shareholder status under section 953(c) where administratively impractical to identify such persons by reason of indirect share ownership).

requirements introduced by the Temporary Regulations are made substantially more onerous if they are applied at the partner level. This is particularly true in the current environment, where multiple tiers of investment partnerships having numerous partners at the ultimate ownership level often are formed for bona fide business reasons; in many cases the lower-tier partnerships have no way of knowing or learning the identity of their partners' upper-tier partners.

We note that, in a similar context, the Service has recognized that a de minimis safe harbor may be appropriate. In the recently issued publicly-traded partnership regulations under section 7704, the Service has stated that the rules of section 304(c) made applicable to certain determinations under section 7704 with respect to grandfathered partnerships will not apply to less-than-five percent partners unless "a principal purpose of the arrangement is to avoid tax at the corporate level."[36] We recommend that section 1.367(a)-3T(c)(5)(i) be amended to provide that the rule currently contained in that provision will not apply to cause a less-than-five percent partner to be deemed the owner or transferor of stock or securities actually owned or transferred by the partnership in which he is a partner (or by a lower-tier partnership) unless a principal purpose of the partner's acquisition of its partnership interest, or of the partnership's acquisition of the stock or securities in question, was to avoid the application of section 367(a) and the regulations thereunder.

Need for further examples. Section 1.367(a)-3T(c)(8) contains several examples illustrating the application of the Temporary Regulations. While these examples are helpful, we

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[36] Treas. Reg. § 1.7704-2(e)(3).. See also Treas. Reg. § 1.7704-l(h)(3).

believe that a few additional examples would be appropriate. Of particular help would be examples indicating when a transferee foreign corporation's active trade or business satisfies the temporal requirement and is "substantial" in comparison to that of the U.S. target company, so as to satisfy the requirements of section 1.367(a)-3T(c)(1)(iii).

Effective date. The extension of the U.S. ownership presumption to transferors of "other property" represents a significant change in the Temporary Regulations that was not foreshadowed in Notice 94-46. In this report, we have suggested modifications to this presumption. In any event, we believe that it would be unfair to subject transfers to this presumption without providing grandfather relief for transfers of such property on or before January 25, 1996, with further relief for, e.g., transfers pursuant to a commitment that was binding on such date.