NEW YORK STATE BAR ASSOCIATION

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One Elk Street, Albany, New York 12207 PH 518.463.3200 www.nysba.org

Report No. 1420
August 29, 2019

The Honorable David J. Kautter
Assistant Secretary (Tax Policy)
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Charles P. Rettig
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable Michael J. Desmond
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: *Report No. 1420 – Report on the Branch Loss Recapture Rules of Section 91*

Dear Messrs. Kautter, Rettig, and Desmond:

I am pleased to submit our Report No. 1420 discussing Section 91 of the Internal Revenue Code.

We appreciate your consideration of our Report. If you have any questions or comments, please feel free to contact us and we will be glad to assist in any way.

Respectfully submitted,

Deborah L. Paul
Chair

Enclosure

Cc:

Lafayette "Chip" G. Harter III
Deputy Assistant Secretary (International Tax Affairs)
Department of the Treasury

Douglas L. Poms
International Tax Counsel
Department of the Treasury

Brian Jenn
Deputy International Tax Counsel
Department of the Treasury

Peter Blessing
Associate Chief Counsel (International)
Internal Revenue Service

Daniel M. McCall
Deputy Associate Chief Counsel (International-Technical)
Internal Revenue Service

Margaret O'Connor
Deputy Associate Chief Counsel (International)
Internal Revenue Service

John J. Merrick
Senior Level Counsel, Office of Associate Chief Counsel (International)
Internal Revenue Service

Report No. 1420

New York State Bar Association Tax Section

REPORT ON THE BRANCH LOSS RECAPTURE RULES OF SECTION 91

August 29, 2019

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I. INTRODUCTION

This Report[1] discusses section 91 of the Code[2] that was added by the legislation informally known as the Tax Cuts and Jobs Act (the "**TCJA**").[3] Section 91 generally requires a domestic corporation that transfers substantially all the assets of its foreign branch to a foreign corporation (with respect to which it is a section 951(b) United States shareholder after such transfer) to recapture the losses generated by the branch. The section 91 income is equal to the "transferred loss amount" (or "**TLA**") generated by the foreign branch since December 31, 2017, less any gain recognized on the transfer. Transition rules are also provided in the TCJA (but not the Code) for pre-2018 losses.

As a "branch loss recapture" rule, section 91 follows in the footsteps of similar loss recapture rules, particularly former section 367(a)(3)(C) (which was repealed by the TCJA), but also the overall foreign loss ("**OFL**") recapture rules of section 904(f), the foreign currency loss recapture provisions of section 987, and the dual consolidated loss ("**DCL**") recapture provisions of section 1503(d).

Part II of this Report is a summary of our recommendations. Part III provides the background of section 91 and the branch loss recapture rules that preceded it: we conclude that while in general section 91 and former section 367(a)(3)(C) share a common underlying structure and policy, they differ in a number of important respects.[4] Part IV discusses our recommendations in greater detail.

II. SUMMARY OF RECOMMENDATIONS

A. Foreign Branch

1. Consideration should be given to harmonizing the definitions of "foreign branches" among the rules of section 904(d), other provisions which incorporate those rules, and section 91. To the extent Treasury and the IRS believe that different definitions should apply, we recommend that the guidance explain how and why these terms are different.

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[1] The principal author of this Report is Meyer Fedida, with substantial assistance from David Maranjian. Helpful suggestions, input and comments were received from Kimberly Blanchard, Andrew Braiterman, Peter Connors, David Hardy, Andrew Herman, Michael Schler, Joseph Toce, Shun Tosaka, Deborah Paul, Richard Nugent and Diana Wollman. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("NYSBA") and not those of the NYSBA Executive Committee or the House of Delegates.

[2] Unless otherwise stated, all "Code" and "section" references are to the Internal Revenue Code of 1986, as amended.

[3] Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[4] For instance, while both rules require recapture of prior losses claimed by the taxpayer, former section 367(a)(3)(C) limited loss recapture to the built-in gain associated with the transferred assets, whereas section 91 applies to recapture losses without any gain limitation. Additionally, while former section 367(a)(3)(C) applied to outbound transfers by "U.S. persons", section 91 applies only to certain transfers by domestic corporations. Finally, while the gain recognized under former section 367(a)(3)(C) was foreign-source, any losses recaptured under section 91 are US-source.

If, however, a harmonized definition would be acceptable, then this could be achieved by building on the same basic definition and then explicitly listing the exceptions or additions to that definition. Alternatively (or in addition), consideration should be given to adding a presumption in the regulations that a branch for section 91 purposes is also a branch for section 904(d) purposes (and vice versa).

2. Guidance should provide that stock or securities are included in the assets of a foreign branch for purposes of section 91 only if they form an integral part of the business operation carried on by the branch. The rules that apply to determine whether stock or securities are attributable to the U.S. trade or business of a non-U.S. person may be a good analogy.

3. In providing guidance on what "substantially all" means for purposes of section 91, no numerical guidelines should be used, but rather a qualitative analysis should be adopted drawing on the "substantially all" rules as they are applied in the section 368 context.

4. Guidance should be provided regarding situations in which transactions would be aggregated, disaggregated, or disregarded in contexts where the purpose of the transaction is to improperly avoid the application of section 91 by avoiding a transfer of substantially all of the assets of a foreign branch. A principal purpose test should be adopted for the broader universe of transactions that could be undertaken to avoid a transfer of assets of a foreign branch being treated as a transfer of "substantially all" of the assets of the branch. As in the regulations under former section 367(a)(3)(C), a rebuttable presumption of abuse should continue to apply for onshoring/offshoring transactions that take place within a two-year period.

B. Transfer and Transferors

5. Transfer should be defined to include all shifts of tax ownership following general tax principles. It should not however generally apply to situations where the right of use is granted to a foreign corporation but the ownership (and related revenues) remain with the owner of the foreign branch. Thus, a lease that does not transfer tax ownership or a qualified cost sharing agreement should not constitute a transfer for section 91 purposes. The analysis is more complex for the long-term licensing of intangible property and the Report proposes and compares three different approaches.

6. Section 91's reference to "after the transfer" should be interpreted in regulations to mean after the last of any "series of related transactions" (and IRS Form 926, its instructions, and the instructions to IRS Form 1120 should be revised to reflect this).

7. It is not clear whether section 91 should apply to certain situations where (i) the transferring corporation is a United States shareholder of the transferee foreign corporation by virtue of downstream attribution and (ii) the shareholder of the transferee foreign corporation whose ownership is attributed to the transferring corporation does not qualify for the benefit of section 245A and is not a foreign person whose income from the transferee foreign corporation is not subject to U.S. tax. We recommend that the regulations address this fact pattern explicitly. If Treasury and the

IRS believe that the application of section 91 in this context is appropriate, then we recommend that it be clearly stated in the regulations (through an example). If they do not, then regulations should provide that section 91 does not apply in this context. To the extent there is a concern as to whether Treasury and the IRS have sufficient authority to provide this guidance, we recommend that technical corrections be sought.

8. Section 91 should apply on an "aggregate" basis to certain transactions involving partnerships, including those where (i) assets of a foreign branch are transferred by a partnership and (ii) partnership interests are transferred.

9. On the other hand, section 91 should not apply to a transfer of a foreign branch's assets to a partnership whose partners include foreign corporations that are related to the transferring domestic corporation.

C. Calculating the TLA

10. The IRS should require a U.S. corporation with a foreign branch to report on an annual basis the amount of income or loss attributable to such branch for purposes of section 91. (This could be done through IRS Form 8858 for instance.)

11. In measuring branch losses, we recommend that Treasury and the IRS coordinate the guidance on section 904(d) with the guidance on section 91 such that the approach that is ultimately chosen for the section 904(d) foreign branch income basket apply also to measure section 91 losses, with appropriate adjustments.

12. The guidance under section 91 for measuring the TLA should follow the principles of the existing regulations under former section 367(a)(3)(C), with some exceptions.

    (a) In light of the changes to the section 172 loss carryover rules enacted by the TCJA, consideration should be given to reducing the TLA by unused and unexpired net operating losses or capital losses generated by the foreign branch prior to the year of the transfer.

    (b) Consideration should be given to whether a limited carryback for capital losses against a foreign branch's past income can be provided for in the regulations.

D. Reduction by Gain

13. Regulations should expressly include the transition rule that was included in the TCJA but is not in section 91 itself, as well as provide guidance regarding its application.

14. The transition rule should be applied by reducing the section 91(c) amount by any gain which could have been taxed under former section 367(a)(3)(C) for pre-2018 losses, regardless of the actual form of the transaction.

15. Regulations should provide that the portion of a foreign branch's post-2017 income not used to reduce the TLA can be used to reduce pre-2018 losses, to the extent the transferor would have been able to do so under the 367(a)(3)(C) Regulations.

16. For non-calendar year transferring corporations, the regulations should apportion losses generated pre-2018 and post-2017 by applying principles similar to those in section 382(d)(1) and Treasury regulation section 1.382-6.

E. Basis Issues

17. In transfers where the section 91 income is less than the unrecognized built-in gain in the assets transferred, we recommend that both the basis of the foreign corporation stock in the hands of the transferor, and the foreign corporation's basis in the assets transferred be increased by the amount of section 91 income. This approach comes closest to placing the transferor in the same position that it would have been had the business been operated in corporate form all along.

18. In transfers where the section 91 income exceeds the unrecognized gain in the assets transferred, we would recommend that both inside and outside bases be increased by the amount of section 91 income, but that the transferee corporation's inside basis be limited to the fair market value of the assets.

19. In transfers where section 91 applies to a transfer of a foreign branch for cash or other property, we recommend that the transferor's basis in its existing shares in the specified foreign corporation be increased by the amount of section 91 income.

F. Coordination with Other Loss Recapture Provisions

20. We recommend that the section 91 guidance be coordinated with the OFL regulations to avoid a "double recapture" of a branch loss, by amending the OFL regulations to reduce the taxpayer's OFL balance attributable to the branch losses which have already been recaptured under section 91. If Treasury and the IRS have concerns regarding whether they have the necessary regulatory authority, we recommend that a statutory amendment be sought.

21. The DCL regulations should be modified to provide that the DCL of the applicable separate unit (or combined separate unit) be reduced by the income recaptured under section 91.

22. The DCL regulations should be modified to provide that a transfer that triggers a section 91 recapture does not constitute a "foreign use" or a "triggering event" for DCL purposes.

G. Coordination of Section 91 and Section 367(d)

23. Regulations under section 367(d) should be amended such that if there is a transfer of a section 367(d) intangible as part of the transfer of assets of a foreign branch and such transfer qualifies for nonrecognition treatment under section 367(d), then the section 91 recaptured income that is attributable to the intangible will be credited against the income that is required to be recognized under section 367(d). Since section 91 does not use built-in gains as a basis for taxation, we recommend that the section 91 income that is allocated to the section 367(d) property be equal to the product of (i) the TLA

(*i.e.*, the section 91 income before any reduction for gain under section 91(c)) and (ii) the ratio of (x) the fair market value of the section 367(d) property, to (y) the fair market value of all of the foreign branch's assets that are transferred to the foreign corporation. The amount so allocated however would be capped at the amount of section 91 income.

III. BACKGROUND

Section 91 was enacted at the same time as the branch loss recapture rules in former section 367(a)(3)(C) were repealed (along with the rest of the foreign trade or business exception in former section 367(a)(3)). As discussed throughout this Report, there are important differences between the new section 91 and former section 367(a)(3)(C). However, section 91 is best understood in light of the history of section 367 and the context in which section 367(a)(3)(C) was enacted. This Part III discusses the history of section 367(a)(3)(C) and the enactment of section 91.

A. Section 367(a)(3)(C)

1. Background[5]

Congress and the IRS have long been concerned with the ability of a taxpayer to take advantage of the different U.S. tax treatment of foreign activities conducted by a branch as compared with a foreign subsidiary. In the paradigmatic situation, a U.S. taxpayer operates a foreign business in branch (or other pass-through) form during its start-up period when the business is generating losses (thus allowing the use of those losses against income that would otherwise be subject to U.S. tax). Then, when the business starts generating income, it is transferred to a foreign corporation, potentially deferring tax on the income of the business until repatriated, or, after the TCJA, subjecting the income to a lower rate of tax altogether. In addition, historically, the incorporation itself could often be accomplished without material U.S. taxes, such that there were no significant hurdles that would prevent this strategy.

The IRS first requested that Congress address foreign branch loss issues in 1972, when the IRS proposed a new Code section that would have required recapture of "foreign losses" where the property that had generated the losses was disposed of.[6] Although the provision was not adopted, the Tax Reform Act of 1976 did address some of these issues with the enactment of section 904(f). Under the OFL rules of section 904(f)(1), if a U.S. taxpayer's net foreign loss has reduced its U.S. source income, then subsequent foreign source income is recharacterized as U.S. source for purposes of calculating the foreign tax credit limitation, thus decreasing the amount of

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5 For an in-depth description of the history and background of former section 367(a)(3)(C) *see* James C. Koenig, *An Analysis of the Section 367(a)(3)(C) Temporary Regulations*, 5 Berkeley J. Int'l L. 330, 332-57 (1987) and William Carl Sias, *Transfers of Property to Foreign Entities under Section 367(a)(3)(C)*, 18 Int'l Tax J. 31 (1992) (analyzing and describing the function and purpose of section 367(a)(3)(C) and attendant regulations under Treas. Reg. § 1.367(a)-6T).

6 *See General Tax Reform: Hearings Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 6901, 7072 (1973) (proposing a new section 84 which would "eliminate the tax disadvantages borne by the United States Treasury in some situations where taxpayers deduct from their United States income losses from overseas operations, and do not pay United States income tax on income earned in later years through the use of the foreign tax credit, or by disposing of the loss generating assets [by] recaptur[ing those losses] if they are not taken into account for computing foreign taxes in later years".).

foreign tax credits a U.S. taxpayer can use to offset its tax liability on foreign source income. While section 904(f)(1) limits the use of the foreign tax credit only with respect to income that would otherwise be foreign source, section 904(f)(3) goes one step further. Section 904(f)(3) provides that, regardless of most nonrecognition provisions in the Code, upon the disposition of property used in a non-U.S. trade or business, the lesser of the built-in gain in such property and the unrecouped OFL from prior years is recognized, and treated as U.S. source income.

Section 904(f) does not apply however to the incorporation of a branch that generated losses that were used to offset other foreign source income (as opposed to U.S. source income). The IRS used its authority under section 367 to curtail these transactions: Prior to 1984, in order to secure non-recognition treatment, section 367(a) required that a U.S. taxpayer engaging in an outbound exchange described under sections 332, 351, 354, 355, 356, or 361 could obtain non-recognition treatment only if it applied for a ruling and demonstrated to the IRS that such exchange was not in "pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."

In Revenue Ruling 78-201,[7] a domestic corporation (P) transferred assets to a newly formed foreign branch. The branch initially sustained losses which were used by P to offset other foreign-source income. Two years later, P transferred the branch to a newly formed foreign corporation in an outbound exchange described in section 351, and the taxpayer sought a ruling that the transaction did not have a tax avoidance motive and so could qualify for nonrecognition treatment under section 367. In analyzing the request, the ruling notes:

> "…losses incurred by the foreign branch operations prior to its incorporation were taken into account by P and reduced the amount of P's worldwide income subject to Federal income tax. However, as a result of the incorporation of the foreign branch operations, the income to be produced by these operations will not be taken into account by P and, thus, will not increase the amount of P's worldwide income subject to Federal income tax. Therefore, the transfer by P of the assets of the branch to the foreign corporation will be deemed to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes within the meaning of section 367 of the Code."

As a result, the IRS conditioned the ruling on the taxpayer agreeing to recognize "as gain on the transfer an amount of ordinary foreign source income equal to the . . . branch losses previously incurred."[8]

The principles of Revenue Ruling 78-201 were subsequently expanded and refined in a number of rulings.[9] Revenue Ruling 80-163 in particular is important when analyzing section

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[7] Rev. Rul. 78-201, 1978-1 C.B. 91.

[8] *Id*.

[9] Rev. Rul. 80-246, 1980-2 C.B. 125 (in cases where both section 904(f) and Rev. Rul. 78-201 would require recognition of gain on the same pre-incorporation losses, the gain recognized under section 904(f) could be used to offset the Rev. Rul. 78-201 recapture amount); Rev. Rul. 80-247, 1980-2 C.B. 127 (all losses of foreign branch were required to be recaptured, even if less than all assets were transferred); Rev. Rul. 81-82, 1981-1 C.B. 127 (pre-incorporation losses were only offset by pre-incorporation income earned by the same line of business); Rev. Rul. 81-89, 1981-1 C.B. 129 (income of a foreign branch owned by one corporation could not be used to offset the pre-incorporation losses of another foreign branch in same line of business

91.[10] In that ruling, the IRS required the taxpayer to recapture foreign branch losses *in excess* of the built-in gain in the assets. In doing so, the IRS noted that limiting the amount of recapture to the amount of gain in the assets transferred "would not take into consideration the full amount of the losses associated with the transferred assets that [the U.S. taxpayer] used to reduce its income subject to federal income tax, and therefore would not prevent the potential mismatching of related income and losses, the tax avoidance at which Rev. Rul. 78-201 is directed."

The first signs of challenge by taxpayers against these requirements by the IRS that branch losses be recaptured were Tax Court decisions in which the court found the IRS had erred in requiring recapture, typically because there was no tax avoidance motive.[11] One of the most publicized of these cases was *Hershey Foods Corp. v. Commissioner*[12] in 1981. In *Hershey,* a U.S. corporation sought to transfer the operations of two Canadian branches of U.S. corporations to a Canadian subsidiary (as part of a post-acquisition restructuring). The IRS, consistent with Revenue Ruling 78-201, conditioned the issuance of a favorable ruling under section 367 on the recognition of the previously recognized losses of the branches. The corporation petitioned the Tax Court for judicial review of the IRS's ruling. The court found that the U.S. corporation had valid business reasons for combining the branches with the Canadian corporation and thus that the IRS could not deny the ruling.

The IRS nevertheless continued to apply Revenue Ruling 78-201 when addressing ruling requests under section 367(a) after *Hershey,*[13] although it revoked Revenue Ruling 80-163 in Revenue Ruling 82-146[14] and, from that point on, the IRS took the position that recapture of branch losses should be limited to the amount of aggregate realized gains of the assets transferred. Interestingly, Revenue Ruling 82-146 does not contain any explanation of what caused the IRS to revoke Revenue Ruling 80-163 or other reasoning explaining the change in its view on whether

previously owned by corporation with which first corporation merged until branches were integrated); and Priv. Ltr. Rul. 7845060 (Aug. 14, 1978) (allowing a taxpayer to offset the recapture amount by any pre-incorporation income generated by the foreign branch, thus limiting recapture to pre-incorporation net losses).

10 Rev. Rul. 80-163, 1980-1 C.B. 78

11 *See generally Dittler Bros., Inc. v. Commissioner*, 72 T.C. 896 (1979) (rejecting an IRS determination that a taxpayer's transfer of cash and know-how to a newly formed foreign corporation as part of a joint venture did not qualify as tax free under sections 351 and 367(a)(1), holding that the IRS's reasoning for the determination—that one of the principal purposes of the transaction was tax avoidance—was unreasonable, and that the proper test for determining whether tax avoidance is one of the principal purposes of the transaction is whether tax avoidance was a "first-in-importance" purpose of the transaction), *aff'd. without published opinion* 642 F.2d 1211 (5th Cir. 1981); *Kaiser Aluminum & Chemical Corp. v. Commissioner*, 76 T.C. 325 (1981) (following *Dittler*, holding that tax avoidance was not the principal purpose of the transaction, and that even if it were, respondent has obligation to propose "terms and conditions" to obviate such purpose); *Pitcher v. Commissioner*, 84 T.C. 85 (1985) (following *Dittler*, holding that neither the potential for tax avoidance nor the presence of tax deferral alone are adequate evidence that tax avoidance is "first-in-importance" purpose of the transaction); *Ellis v. Commissioner*, T.C. Memo. 1985-511 (following *Pitcher).*

12 *Hershey Foods Corp. v. Commissioner*, 76 T.C. 312 (1981), *appeal dismissed* (3rd Cir. 1981).

13 Rev. Rul. 81-82, 1981-1 C.B. 127; Rev. Rul. 81-89, 1981-1 C.B. 129.

14 Rev. Rul. 82-146, 1982-2 C.B. 84.

recapture was limited to gain. It is possible that the court decisions critical of the IRS's refusal to issue rulings under section 367 caused the IRS to reconsider its position.

In 1983, the Supreme Court's decision in *Bliss Dairy, Inc. v. Commissioner* provided new grounds for the IRS to require recapture of losses as a condition to a section 367(a) ruling.[15] *Bliss Dairy* (one of two cases consolidated before the Court) did not address section 367 or foreign operations but concerned instead the "tax benefit" principle, which the IRS would come to view as related to its loss-recapture rulings. In *Bliss Dairy*, a domestic corporation that was engaged in the farming business purchased cattle feed and took a deduction for the purchase as an ordinary and necessary business expense. In a subsequent year, before the feed was actually used the corporation liquidated and distributed its assets (including the feed) to its shareholders. The IRS required the corporation to recapture the previous deduction under the "tax benefit" principle. The Court agreed with the IRS, noting that a prior deduction must be recouped by reporting an equal amount of income under the tax benefit rule whenever a "later event [occurs that is] fundamentally inconsistent with the premise on which the deduction was initially based."[16] The distribution of the feed to the shareholders was fundamentally inconsistent with the premise underlying the prior deduction (*i.e.*, that the deduction for the feed was an expense of the corporation for use by the corporation to earn income). The IRS relied on *Bliss Dairy* to justify continuing to follow Revenue Ruling 78-201 in a 1984 private letter ruling in which the IRS applied Revenue Ruling 78-201 to require the recapture of losses upon the incorporation of a foreign partnership.[17] While the Tax Court disagreed with the reliance on *Bliss Dairy* in this context,[18] the question soon became moot when Congress codified the IRS's approach in section 367(a)(3)(C).

2. <u>Section 367(a)(3)(C) and Treasury Regulation Section 1.367(a)-6T</u>

In 1984, the Deficit Reduction Act[19] overhauled section 367(a) eliminating the ruling condition which had been burdensome to taxpayers and the IRS.[20] The 1984 amendments brought

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15 460 U.S. 370, 373 (1983).

16 *Id.* at 381.

17 Priv. Ltr. Rul. 8427066 (April 03, 1984).

18 *See Mars, Inc. and Uncle Bens Inc. v. Commissioner.*, 88 T.C. 428 (following *Hershey* and declining to apply *Bliss Dairy* to recapture losses, noting "There is no fundamentally inconsistent event here. There has been no recovery of previously deducted losses. The incorporation of a foreign loss branch is not a fundamentally inconsistent event as that term is defined in Bliss Dairy. To hold otherwise would suggest taxability under Bliss Dairy on incorporation of any partnership that had incurred losses.") For additional commentary, *see also* Lashbrooke, *Recapture of Past Foreign Branch Losses on Transfer of Branch Assets to a Foreign Corporation*, 4 Nw. J. Int'l Law & Bus. 359, 369 (1982) (arguing that tax benefit rule should not apply absent nexus between losses and subsequent income).

19 Pub. L. 98–369.

20 The House Report indicates that Congress observed "many taxpayers consider the ruling requirement burdensome, and the requirement has placed a steadily increasing demand on Service resources as outbound transfers have increased in number." H.R. Rep. No. 432, 98th Cong., 2d Sess. 1318 (1984).

Section 367(a) to its modern-day structure: a broad denial of nonrecognition treatment for outbound transactions, followed by exceptions to be implemented by regulation.

Former section 367(a)(3) was one of these exceptions allowing tax-free treatment of the transfer of certain property used in a foreign trade or business. However, as explained by the Conference Committee, former section 367(a)(3)(C) was also added to codify Revenue Ruling 78-201 and its derivative rulings.[21]

Thus, former section 367(a)(3)(C)[22] limited the nonrecognition treatment available under former section 367(a)(3) for the transfer of *any* asset of a foreign branch by requiring the taxpayer to recognize an amount equal to the lesser of (a) the gain realized, and (b) the amount of losses previously realized by such branch (as reduced by the amount of "taxable income incurred [by the] branch" after the "year in which the loss was incurred and through the close of the taxable year of

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21 H.R. Rep. No. 98-861, 1984-3 C.B. Vol. 2, at 952-56 (1984) (providing an explanation of the mechanics of section 367(a)(3)(C) and specifically citing Rev. Rul. 78-201 as the basis of the section).

22 Section 367(a)(3)(C), before its repeal by the TCJA read as follows:

> "<u>Transfer of foreign branch with previously deducted losses</u>. Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to gain realized on the transfer of the assets of a foreign branch of a United States person to a foreign corporation in an exchange described in paragraph (1) to the extent that—
>
> (i) the sum of losses—
>
> (I) which were incurred by the foreign branch before the transfer, and
>
> (II) with respect to which a deduction was allowed to the taxpayer, exceeds
>
> (ii) the sum of—
>
> (I) any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer, and
>
> (II) the amount which is recognized under section 904(f)(3) on account of the transfer.
>
> Any gain recognized by reason of the preceding sentence shall be treated for purposes of this chapter as income from sources outside the United States having the same character as such losses had."

the transfer" and gain "recognized under section 904(f)(3)"). Any recaptured losses were treated as foreign-source income.

With the possible exception of intangibles,[23] former section 367(a)(3)(C) applied only to assets within the scope of former section 367(a)(3). Thus, for instance, it did not apply to a transfer of stock or securities in an exchange subject to Treasury regulations section 1.367(a)-3.[24]

Section 367(a) generally grants, and former section 367(a)(3)(C) in particular, granted significant regulatory authority to Treasury.[25]

Treasury issued Temporary Treasury regulations 1.367(a)-6T in 1986.[26] With the exception of a few provisions promulgated in 2016,[27] no corresponding final regulations were issued.[28] (We refer to the final and temporary regulations issued under former 367(a)(3)(C) as the "**367(a)(3)(C) Regulations**.")

The 367(a)(3)(C) Regulations established a multi-step process for computing the loss recapture amount required under section 367(a)(3)(C) in order to include only those amounts that had provided the taxpayer with an actual net tax benefit. First, the regulations calculated both ordinary and capital losses deducted by the transferred branch in previous years.[29] Second, the previously deducted branch ordinary loss for each branch loss year was reduced by the taxpayer's expired net ordinary losses and the previously deducted capital loss for each loss year was reduced by the taxpayer's expired net capital losses.[30] Third, the remaining previously deducted branch ordinary loss and the remaining previously deducted branch capital loss were then reduced to reflect the taxpayer's expired foreign tax credits. Finally, similar reductions were made to reflect expired investment credits.

[23] Treas. Reg. § 1.367(a)-6(c)(4).

[24] Treas. Reg. § 1.367(a)-2(a)(1).

[25] Section 367(a)(3)(C) ("Except as provided in regulations prescribed by the Secretary…").

[26] Treas. Reg. § 1.367(a)-6T (1986).

[27] Treas. Reg. § 1.367(a)-6.

[28] The temporary regulations were amended in 2013 and 2016 to coordinate other changes made to the regulations under section 367(a). T.D. 9615, 2013-1 C.B. 1026; T.D. 9760, 2016-15 I.R.B. 564.

Section 7805(e) (which causes temporary regulations to expire within three years after the date of their issuance) did not apply to the 1986 regulations since it only applied to temporary regulations issued after its enactment in 1988. (P.L. 100-647, Section 6232(b)).

[29] Treas. Reg. § 1.367(a)-6T(b)(1).

[30] For this purpose, an expired net operating loss or an expired capital loss was defined as a loss incurred in such year or that could be carried back or carried forward to such year that had not been claimed by the taxpayer and which could not be carried forward anymore.

B. Section 91

1. Camp Bill

The Camp Bill,[31] introduced on February 21, 2014 by Representative Camp, then Chairman of the House Ways and Means Committee, would have significantly overhauled the U.S. taxation of foreign activities, including by introducing (a) a participation exemption[32] and (b) a new category of subpart F income (foreign base company intangible income).[33]

A proposal for section 91, included in the Camp Bill, is very similar to the provision that was ultimately enacted by the TCJA. While there is relatively little guidance as to what the Camp Bill's version of section 91 was intended to do,[34] the structure of the Bill indicates that it was conceived of as an integral part of the "participation exemption system." Proposed section 91 was found in Title IV, Subtitle A of the Bill which deals with the "Establishment of Exemption System".[35]

One significant difference between the Camp Bill proposal for loss recapture and section 91 is that the Camp Bill proposal would have applied *in addition to* section 367(a)(3) (including section 367(a)(3)(C)). Thus, the branch loss recapture provisions found in Camp's proposed section 91 would have applied to branch losses that exceeded gain taxable under section 367(a)(3)(C).

In addition, the Camp Bill's section 91 would not have caused immediate taxation but rather applied over time to deny the taxpayer the benefit of the participation exemption for dividends from all foreign corporations, up to the amount of the losses subject to recapture.

2. TCJA

As in the Camp Bill, section 91, enacted by the TCJA, is in the portion of the Act establishing the participation exemption system.[36]

A proposal for section 91 was included in the initial House Ways & Means Committee's version of the Bill.[37] Consistent with the Camp Bill, the House Bill introduced a participation

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31 Tax Reform Act of 2014, H.R. 1, 113th Cong. (2014) [hereinafter Camp Bill].

32 Section 4001 of the Camp Bill.

33 Section 4211 of the Camp Bill.

34 The related Congressional reports and the Joint Committee on Taxation summary of the Camp Bill do not provide anything beyond the text of the provision.

35 Title IV, PARTICIPATION EXEMPTION SYSTEM FOR THE TAXATION OF FOREIGN INCOME, Subtitle A, of the Camp Bill. Other provisions included in that Part were (i) the participation exemption itself, (ii) basis adjustments to deny losses attributable to the participation exemption, (iii) transition tax, and (iv) making permanent section 954(c)(6).

36 Section 14102(d) (which includes section 91) is included in Subtitle D (International Tax Provisions), Part I (Outbound Transactions), Subpart A (Establishment of Participation Exemption System for Taxation of Foreign Income).

37 Section 4003, Tax Cuts and Jobs Act, H.R. 1, 115th Cong. (2017) (as introduced November 2, 2017 by

exemption and would have retained section 367(a)(3) in its entirety. However, section 91 would have applied by taxing the recaptured losses immediately instead of over time as the participation exemption benefits were claimed.

The Senate's Bill repealed the active trade or business exception (and, with it, section 367(a)(3)(C)) and reintroduced the Camp Bill's approach of spreading section 91 taxation over time by denying the benefit of the participation exemption of section 245A for all dividends from foreign corporations up to the section 91 income.

The final Bill, after the reconciliation process, retained the Senate repeal of section 367(a)(3) and rejected the Senate's proposal to spread the recognition of section 91 income over time.

C. Incorporation of Foreign Branches Post-TCJA

The TCJA altered the tax consequences and considerations relevant to the incorporation of foreign branches in meaningful ways.

First, following the repeal of section 367(a)(3), the transfer of assets of a foreign branch is nearly always fully taxable, with exceptions only for (i) intangibles that qualify for section 367(d) (which, post-TCJA, now clearly include goodwill and going concern value),[38] and (ii) stock and securities that qualify for the exceptions in section 367(a)(2) and Treasury regulations section 1.367(a)-3.

Second, for all taxpayers other than those subject to section 91 (*e.g.*, individuals, U.S. corporations that are not United States shareholders of the transferee foreign corporation or that do not transfer substantially all of the assets of the foreign branch), there is no recapture of branch losses, whether incurred before or after the enactment of the TCJA, for the few assets that are still eligible for non-recognition treatment.

Third, a domestic corporation that has recognized net losses from a foreign branch after December 31, 2017 will recapture those losses as U.S. source income if it transfers "substantially all" the assets of the foreign branch to a specified foreign corporation (within the meaning of section 245A) with respect to which such domestic corporation is a United States shareholder (as

Chairman Brady).

[38] Prior to the TCJA, the IRS believed that goodwill, workforce-in-place, going concern value and similar intangible sources of value were within the definition of intangible (then found in section 936(h)(3)(B)). Taxpayers had successfully challenged this position. *See, e.g., Veritas v. Commissioner*, 133 T.C. No. 14 (December 10, 2009) (holding that goodwill and going concern value were not included in definition of intangible for section 367(d) purposes); *Amazon v. Commissioner*, 148 T.C. No. 8 (2017) (same). These rulings were part of the reason for explicitly adding goodwill and going concern value in the definition of intangible under section 367(d)(4)(F). *See* Joint Committee on Taxation, "General Explanation Of Public Law 115-97" (JCS-1-18) [hereinafter "Bluebook"] at 387.

defined under section 951).[39] We refer to a domestic corporation making such a transfer as "the section 91 U.S. corporation."

Fourth, while the loss recapture rules apply only to section 91 U.S. corporations, they apply to *any* transfer, so they are not limited to a transaction that would otherwise qualify for nonrecognition treatment (*e.g.*, incorporation of a branch that is eligible for section 351 treatment) but would apply also to a taxable sale of assets.

Fifth, upon a transfer subject to section 91, a section 91 U.S. corporation is required to include in income the net losses from a foreign branch in excess of the gain recognized in the transaction, regardless of the built-in gain in, or the fair market value of, the property transferred.

Finally, unlike former section 367(a)(3)(C), section 91 does not include a specific grant of regulatory authority (except for basis issues).

D. Purpose of Section 91

Section 91 is linked intrinsically to the participation exemption established by the TCJA. As noted in Part III.B.2 above, the section was enacted in the section of the TCJA that establishes the participation exemption. In addition, section 91 applies only to transferors that are eligible for the participation exemption with respect to the transferee foreign corporation (*i.e.*, the transferor must be a domestic corporation; the transferee must be a "specified foreign corporation (as defined in section 245A) and the transferor must be a United States shareholder with respect to the transferee foreign corporation).

The legislative history contains little further detail, however, on the rationale for section 91. The House Ways and Means Committee Report on the Bill that became the TCJA provides the following explanation in the section titled "Reasons for Change:"

> [T]axpayers may wish to arbitrage the application of the participation exemption system to foreign subsidiaries but not foreign branches. Specifically, a taxpayer may deduct losses from a foreign branch operation against U.S. taxable income and then incorporate that branch once it becomes profitable. Present law provides an array of loss recapture rules to address such a fact pattern, but those rules generally rely on the worldwide system of taxation to recapture losses in excess of built-in gains by taxing future earnings when repatriated. Instead of only recapturing such losses upon later repatriation of earning, the Committee wishes to recapture the U.S. tax benefits of these losses immediately upon the incorporation of a foreign branch that has generated losses. This is so that the repatriation of foreign earnings will not carry negative tax consequences thereby discouraging such repatriation, which is one of the reasons for moving to a participation exemption system of taxation.[40]

[39] Pre-2018 losses are recaptured only to the extent of gain in the assets. We discuss this special rule in Part IV.E.2, below.

[40] H. Rept. 115-409, "Report of the Committee on Ways and Means, House of Representatives on H.R. 1

The Senate Finance Committee explanation of the Bill as it was being discussed in the Senate contains a similar discussion with only minor changes.[41] There is no further statement in the Conference Committee Report or the Bluebook.

We note that the "Reasons for Change" statement appears to include at least four assumptions relating to the purpose of section 91, but the application of section 91 does not depend on those assumptions being true:

- *First*, incorporations of foreign branches can be motivated by the domestic corporation's intentional use of tax arbitrage.

  While there is certainly an advantage to incorporating in a post-TCJA world, not all the transactions covered by section 91 are motivated by tax arbitrage. For example, a U.S. bank may be required by a local foreign regulator to incorporate its foreign branch. (Indeed, an increasing number of countries impose additional restrictions on banking branches and otherwise encourage (or mandate) that banking operations be operated in subsidiary form.)[42] Similarly, a U.S. corporation may want to IPO its foreign operations and may therefore need to contribute them to an entity that can be publicly-traded (most of which are per se corporations).

  In addition, because a 10% relationship between the transferor and the transferee is sufficient to trigger the application of section 91, the U.S. corporation may not have control over the form of the transfer. That could be the case for instance if a domestic corporation wants to combine some of its foreign operations with the larger operations of a foreign corporation and the foreign corporation does not agree that the combined entity will be a flow-through entity for U.S. tax purposes (*e.g*., because of BEPS-related concerns over the use of hybrids).

Together with Dissenting and Additional Views" at 373.

41 Sen. Fin. Comm. "Explanation of the Bill" at 356 (November 30, 2017).

42 *See* International Monetary Fund, "Subsidiaries or Branches: Does One Size Fit All?" at 6 fn.2 (March 7, 2011) (available at https://www.imf.org/external/pubs/ft/sdn/2011/sdn1104.pdf) ("Some host countries (e.g., Brazil, Mexico, and New Zealand) encourage, or require, subsidiarization of local business units."); *id.* 11 (giving examples of jurisdictions that provide restrictions on business operations maintained in branch form, "These requirements typically either restrict business operations (e.g., restrictions on branches of foreign banks accepting deposits, as in Croatia and Mexico), ensure equal treatment of host country depositors in an event of insolvency of the parent company (e.g., Croatia and Poland), or require a more burdensome approval process by the home supervisor to open a branch.") *See also* Organization for Economic Cooperation and Development, "The Conditions for Establishment of Subsidiaries and Branches in the Provision of Banking Services by Non-Resident Institutions" at 3 (available at https://www.oecd.org/daf/fin/financial-markets/Conditions-for-establishment-in-the-provision-of-banking-services.pdf) ("While branching by non-resident banks remains a widely available option, a number of countries have applied certain safeguards to ensure the safety of depositors or to prevent deposit insurance from being activated for a branch. In particular, the financial and governance requirements that are now being imposed, while the same or equivalent to domestic banks, may limit the attractiveness of branching going forward.").

- *Second*, the foreign corporation will be profitable in the future.

  However, section 91 does not condition its application upon the foreign corporate transferee generating profits from the foreign branch assets.

- *Third*, the future earnings from the foreign corporation would not be taxable by the United States.

  That is, it assumes that income from the foreign subsidiary will be eligible for the participation exemption with respect to the transferring corporation and that the foreign corporation will not be a controlled foreign corporation (a "**CFC**") whose income is subject to tax under subpart F, or section 951A ("**GILTI**") for the transferring corporation. There is also no exception from section 91 recapture for situations where the taxpayer would not in fact qualify for a section 245A deduction because of a short holding period or the existence of a hybrid instrument.

- *Fourth*, taxing the income on incorporation avoids creating an incentive not to repatriate the future earnings of the business.

  This is consistent with the House's version of the Bill (which would have taxed the section 91 income at the time of the transfer) but is at odds with the Senate's proposal since that proposal would have deferred taxation of the section 91 income until the taxpayer received dividends that would otherwise qualify for section 245A.

Based on these committee statements and the history of the branch loss recapture rules described in this Part III, it seems that the goals of section 91 generally include some combination of the following:

- A codification of former Revenue Ruling 80-163 and a version of the "tax benefit" principle pursuant to which the U.S. tax system must be able to reverse a prior tax benefit by taxing at least the amount of losses claimed by the section 91 U.S. corporation with respect to the branch before potentially losing the right to tax future revenues from the incorporated branch; and

- A toll charge or deterrent, meant to discourage U.S. corporations from operating loss-generating enterprises in pass-through form (or, if they do so, to discourage them from incorporating those operations later on), since section 91 requires not only immediate recapture of prior losses regardless of the profitability of the operations, but also treats the income as U.S. source (even though the losses that are being recaptured would have been treated as foreign source loss).

E. Comparative Experience: The U.K.

Finally, it may be helpful to note that the United Kingdom faced a similar issue in 2010 when it allowed U.K. corporations to elect to have their foreign branches qualify for the territorial tax system. A branch loss recapture rule applied in this context, albeit with key differences from section 91. First, the U.K. rules look back only to the six years that precede the year in which the election takes effect; and second, similar to the Camp Bill and the Senate's proposal, they do not impose an immediate tax but instead deny the benefit of territoriality until the profits from the branch are equal to the net losses accumulated during the prior six years. In addition, the loss recapture can be "streamed" to apply only to the territory which incurs the loss or can apply against all profits from all branches, and all foreign tax credit carryforwards with respect to the branches are lost once the election is made.[43]

IV. DISCUSSION AND RECOMMENDATIONS

A. Foreign Branch

1. Definition of "Foreign Branch"

Section 91 applies to the transfer of assets of a "*foreign branch*." The statute does not define what a foreign branch is, but refers instead to "a foreign branch (within the meaning of section 367(a)(3)(C), as in effect before the date of the enactment of the Tax Cuts and Jobs Act)." Prior to its repeal, section 367(a)(3)(C) used the term "foreign branch" but did not define it; the term was, however, defined in the 367(a)(3)(C) Regulations (which have remained unchanged in this respect since promulgated in 1986).[44] We assume therefore that the reference to a foreign branch "within the meaning of section 367(a)(3)(C)" de facto codifies the definition that was found in the 367(a)(3)(C) Regulations.

The 367(a)(3)(C) Regulations define a branch as an "integral business operation carried on by a U.S. person outside the United States" and provide that whether activities constitute a foreign branch must be "determined under all the facts and circumstances."[45] Some nonexclusive indicia of branch status are listed, including maintenance of a separate set of books and records and the existence of an office or other fixed place of business used by employees of the U.S. person in carrying out activities outside the United States. The regulations further deem activities to

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43 *See* HM Revenue and Customs, *Corporate Tax Reform: Delivering a More Competitive System* Part IIIB (Nov. 29, 2010).

It is noteworthy that the election into the branch exemption regime operates by calculating a hypothetical amount of losses over the 6-year look-back period as if the branches had been operated as separate entities (*i.e.*, in corporate form) during that time. Additionally, the 6-year lookback rule operates essentially as a *de minimis* rule, since losses over a specified amount are not limited by this lookback period. *Id.* at 91.

44 Treas. Reg. § 1.367(a)-6T(g)(1).

45 Treas. Reg. § 1.367(a)-6T(g)(1).

constitute a foreign branch when those activities constitute a permanent establishment for treaty purposes.[46]

While the text of section 91 appears to leave little room for changing the definition of "branch" for purposes of section 91, it is worth noting that, post-TCJA, a number of rules in the Code and Treasury regulations address "foreign branches," or the income of a foreign branch, each with its own definition of what constitutes a foreign branch:

- Section 904(d)(1)(B), enacted by the TCJA, creates a separate section 904 basket for "foreign branch income," which is defined as the business profits of the taxpayer which are attributable to one or more qualified business units (as defined in section 989) in one or more foreign countries.[47] Looking at the definition of qualified business unit together with the proposed regulations (issued in December 2018) under section 904, a "foreign branch" would be defined as (A) any (i) separate and clearly identified unit of a trade or business that maintains separate books and records, or (ii) partnership, trust or estate, that (B) conducts a "trade or business" outside the United States. In addition, the rules presume that activities carried out outside the United States that constitute a permanent establishment (under the terms of an income tax treaty between the United States and the country in which such activities are conducted) are a trade or business outside the United States.[48]

- Section 1503(d) (which limits the use of DCLs), defines DCLs as losses of separate units which are defined as (i) an interest in a hybrid entity (*i.e.*, a flow-through entity for U.S. federal income tax purposes that is subject to foreign income tax at the entity level on its worldwide income or on a residence basis), *and* (ii) a foreign branch. For that purpose, a foreign branch is defined as a business operation outside the United States that, if carried on by a U.S. person, would constitute a foreign branch under the 367(a)(3)(C) Regulations.[49] However, the rules go on to exclude from that definition any business operation that (i) is not carried on indirectly through a hybrid entity or a transparent entity, (ii) is conducted in a country with which the United States has a tax treaty, and (iii) is not treated as a permanent establishment under that treaty (and is not otherwise subject to tax on a net basis under that treaty).

- The regulations under section 909 (which apply to splitter arrangements where foreign taxes are separated from their related income) target certain partnership inter-branch splitter arrangements. For this purpose,

46 *Id*.

47 Section 904(d)(2)(J).

48 Treas. Reg. § 1.989(a)-1(b) and Prop. Treas. Reg. § 1.904-4(f)(3)(iii). As mentioned, the foreign derived intangible income rules incorporate the definition by reference.

49 Treas. Reg. § 1.1503(d)-1(b)(3).

a branch is not defined except that the rules indicate that it includes a disregarded entity.[50]

- Post-TCJA, IRS Form 8858 needs to be filed for a foreign branch as well. The instruction indicates "[a foreign branch] is defined in Regulations section 1.367(a)-6T(g). *For purposes of filing a Form 8858*, [a foreign branch] *also* includes a qualified business unit (QBU) defined in Regulations section 1.989(a)-1(b)(2)(ii)."[51]

Each of these rules has different policies and goals. Different definitions could therefore be acceptable as a policy matter. In addition, because the existence of a foreign branch is adverse to the taxpayer in each of these rules, there would seem to be limited incentives for a taxpayer to try to take advantage of the differences in such definitions.

However, the multiplication of definitions does not appear to serve a clear purpose. The DCL rules and the section 91 rules have very different policy goals. The DCL rules prevent a domestic corporation from utilizing the same loss in both the United States and a foreign country whereas section 91 prevents a taxpayer from getting a U.S. tax benefit from operating a branch and then incorporating it. Yet they both use the same definition from the 367(a)(3)(C) Regulations (with the DCL regulations carving out from the foreign branch definition activities that do not result in a permanent establishment). On the other hand, the section 91 definition differs from the definition in the proposed regulations under section 904(d). Section 91 refers to an "integral business operation carried on by a U.S. person outside the United States" while the proposed regulations under section 904 refer to a "trade or business outside of the United States." Are those meant to have different scopes?[52]

Because the varying definitions create administrative complexity, compliance burdens, uncertainty and possibility for unintended results we recommend that consideration be given to harmonizing the definition of "foreign branches" in these sections. To the extent Treasury and the IRS believe that different definitions should apply, we recommend that the guidance explain how and why these terms are different. If, however, a harmonized definition would be acceptable then the same basic definition could apply albeit with explicit exceptions or additions, as relevant, similar to the approach of the DCL regulations with respect to the definition of foreign branch under the 367(a)(3)(C) Regulations. Alternatively (or in addition), consideration should be given

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50 Treas. Reg. § 1.909-2(b)(4) which refers to Treas. Reg. § 1.704-1(b)(4)(viii)(d)(3) (revised as of April 1, 2011).

51 U.S. Department of the Treasury, I.R.S., INSTRUCTIONS FOR FORM 8858 (Rev. December, 2018), https://www.irs.gov/pub/irs-pdf/i8858.pdf (emphasis added).

52 The instructions to IRS Form 8858 appear to take the position that these definitions may possibly differ. However, no specific details or analysis is provided in the instruction or other publications

to adding a presumption in the regulations that a branch for section 91 purposes is a branch for section 904(d) purposes (and vice versa).

2. Whether Stock or Securities Are Branch Assets

The statute and legislative history are silent on whether stock or securities can form part of a foreign branch. The other provisions of the Code that refer to foreign branches take a variety of approaches on this issue.

Thus, the regulations proposed in December 2018 with respect to the new section 904(d) "foreign branch income" basket would not attribute income from stock to the foreign branch income basket except to the extent the stock is dealer property.[53] The section 987 regulations would include in the QBU's income any income from stock that is reflected on the books and records of an eligible QBU, but only if the owner of the QBU owns less than 10% of the applicable corporation.[54] The DCL regulations, on the other hand, include in the income of the applicable "separate unit" (including a foreign branch) all income from the stock owned by such separate unit (as well as any income relating to such stock, such as a subpart F income inclusions).[55] Former section 367(a)(3)(C) would not have applied to a transfer of stock or securities that would qualify for nonrecognition treatment under Treasury regulation section 1.367(a)-3.

No answer here is particularly favorable to the taxpayer or the government. On the one hand, excluding stock and securities from the foreign branch's assets would increase the likelihood that the branch had incurred a loss and would also increase the likelihood that the "substantially all" requirement triggering loss recapture is satisfied. On the other hand, it would also mean that a transfer of stock or securities to a foreign corporation would never be treated as a section 91 transfer.

On balance, we think that stock or securities should be included only if they form an integral part of the business operation carried on by the branch. The mere fact that the branch owns the stock or securities or reflects income from these stock or securities on its books and records should not be determinative—otherwise, there would be an incentive to "stuff" foreign branches with stock or securities (to reduce branch losses and prevent the "substantially all" requirement from being met upon a branch incorporation). The rules that apply to determine whether stock or securities are attributable to the U.S. trade or business of a non-U.S. person may be a good analogy.[56]

B. Substantially All

Once it has been established that the taxpayer has a foreign branch, section 91 is triggered only if "substantially all" of the foreign branch's assets are transferred to a specified foreign corporation. There is no requirement that the business be continued by the foreign corporation,

53 Prop. Treas. Reg. § 1.904-4(f)(2)(iii).

54 Treas. Reg. § 1.987-2(b)(2)(i).

55 Treas. Reg. § 1.503(d)-5(c)(4)(iv).

56 Treas. Reg. § 1.864-4.

the key is that ownership of "substantially all" of the assets of the foreign branch pass to the foreign corporation. This is a new requirement because former section 367(a)(3)(C) applied to the transfer of any asset from a foreign branch (but had far less draconian results than section 91 since the amount of recapture was limited to the built-in gain in the asset).

The Code and Regulations use "substantially all" as a threshold in many places,[57] some of which have developed bright-line tests,[58] and others of which rely on a more qualitative analysis. An initial question is whether one of these other bodies of law should be incorporated by reference (and, if so, which one), so that existing guidelines would apply for purposes of section 91. There is no guidance in the statutory text or the legislative history.

We believe that numerical guidelines should not be used, but rather a qualitative analysis should apply, and that the "substantially all" rules of section 368 would serve as the best analogy.[59] The section 91 rules intend to capture situations where a U.S. corporation incorporates a business previously conducted in branch form, similar to section 368's goal of tracking whether a sufficient amount of assets has been transferred to constitute the continuation of a business and therefore qualify for reorganization treatment. In addition, "substantially all" in the context of section 368

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57 *See*, *for example*, Treas. Reg. § 1.367(a)-8(j)(2) (gain recognition agreement regulations); Sections 368(a)(1)(C), (2)(D), (2)(E), Treas. Reg. § 1.368-2(b)(2) (reorganizations); Section 7874(a)(2)(B)(i) (inversions); Treas. Reg. § 1.469-2(f)(5)(ii) (determination of passive activity losses); Treas. Reg. § 1.1502-75(d)(2) (a downstream merger does not terminate the existence of a consolidated group where the affiliated group members succeed to and become the owners of "substantially all" of the assets of the former parent). *See also* Prop. Treas. Reg. §§ 1.1400Z2(d)-1(c)(5) (applying 90 percent threshold for determining whether qualification as qualified opportunity zone business for "substantially all of the QOF's holding period for the stock" is satisfied); Prop. Treas. Reg. § 1.1400Z2(d)-1(c)(6) (70 percent used as bright line test for determining whether "substantially all" of a of a trade or business's tangible property is in a qualified opportunity zone).

58 For example, in the asset reorganization context, for advance ruling purposes, the IRS has defined "substantially all" as at least 70 percent of gross assets and at least 90 percent of net assets. Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Proc. 86-42, 1986-2 C.B. 722. Courts have typically been more likely to apply a facts and circumstances analysis. *See, e.g.*, *Smothers v. United States*, 642 F.2d 894, 900 (5th Cir. 1981) (criticizing the use of percentages when analyzing whether the "substantially all" standard was met); John D. McDonald, Stewart R. Lipeles, and Matthew S. Jenner, Gain Recognition Agreements: When does "Substantial" become "Substantially All"?, 91 TAXES 5, 8 (2013) (surveying cases where courts applied a facts and circumstances analysis to the "substantially all" standard in the context of section 368 reorganizations); Bittker & Eustice: Federal Income Taxation of Corporations & Shareholders, ¶ 12.26 "Transfer of Assets to a Controlled Corporation (Type D Reorganization)," fn 638 (surveying cases).

59 *Cf.* McDonald, Lipeles, and Jenner, *supra* note 58, at 7-8 (arguing that the section 368 "substantially all" standard should be applied in the gain recognition agreement context). *But see* Jeff Maydew and Julia Skubis Weber, Foreign Branch Incorporations After the TCJA, TAX NOTES 1871, 1878-80 (2018) at 1880 ("it would likely be best if Treasury prescribed a bright-line threshold for when substantially all of a branch's assets are transferred" for the purposes of section 91).

In the context of transition tax under section 965, Treasury and the IRS recently declined to provide a bright line test for the "substantially all" requirement of the acceleration event and triggering event rules. The preamble to those regulations notes: "The phrase ''substantially all'' is used in various Code provisions and in Regulations, and often is determined based on all of the facts and circumstances and not providing the bright-line definition is consistent with this general approach." (T.D. 9846, 2019-09 I.R.B. 583).

is a relatively clear and well-established test with a robust body of judicial and administrative authorities.

Because of the "cliff effect" that results from the transfer of "substantially all" of the assets of the foreign branch, we would also recommend guidance regarding aggregating, disaggregating, or disregarding transactions in contexts where the purpose of the structuring of the transactions is improper avoidance of the application of section 91. Thus, there should be rules addressing:

- Stuffing transactions to prevent artificially increasing the assets of a foreign branch.

- Creeping transfers of branch assets such that transfers over time to a specified foreign corporation are aggregated in considering whether substantially all of the assets have been transferred.

- Aggregation principles to prevent a taxpayer from contributing the assets of a foreign branch to multiple foreign corporations (including whether aggregation should apply in that case only if the foreign corporations use substantially all of the foreign branch's historic assets as part of an integrated business).

- Onshoring and offshoring of assets to prevent a taxpayer from "onshoring" the operations of its foreign branch and subsequently transferring such assets to a foreign corporation.

The 367(a)(3)(C) Regulations included an anti-abuse rule which addressed onshoring and offshoring transactions.[60] Under that rule if "(1) a U.S. person transfers property of a foreign branch to a domestic corporation for a principal purpose of avoiding the effect of this section, and (2) the domestic corporation thereafter transfers the property of the foreign branch to a foreign corporation" then the U.S. person was treated as having transferred the property of the branch directly to the foreign corporation. The rules established a rebuttable presumption that any such transfers that occurred within a two year period had tax avoidance as a principal purpose.

We believe it would be appropriate to adopt a similar principal purpose test for transactions that could be undertaken to avoid meeting the "substantially all" test. As in the 367(a)(3)(C) Regulations, a rebuttable presumption of abuse should apply for onshoring and offshoring transactions that take place within a two-year period.

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60 Treas. Reg. § 1.367(a)-6T(h). Since the application of former section 367(a)(3)(C) did not depend on the transfer of "substantially all" the assets, the other categories enumerated in the text were not relevant.

C. Transfer and Transferors

1. Definition of "Transfer"

(a) *In General*

The operational trigger for the application of section 91 is the occurrence of a "*transfer*." There is no single definition of "transfer" under the Code, and section 91 does not define the term. While in many cases it will be obvious whether and when a transfer has occurred (for example, a one-time contribution or sale of property to a foreign corporation), in other cases, it may not be clear. Guiding principles will be helpful.

In the absence of any specific guidance in the statute or legislative history, a transfer would seem to refer broadly to all shifts of tax ownership following general tax principles, regardless of the form of transfer, the tax treatment of the transfer, the consideration received (if any),[61] and whether the transferee takes legal title.[62] In fact, section 91 applies even if the transferor was paid in full in cash such that the net asset value of the transferee foreign corporation stays the same. What matters is the transfer of the benefits and burdens of ownership of the assets.

Given the policies underlying section 91, should a transfer also include a transfer from a U.S. corporation to a specified foreign corporation of the right to the income produced by the assets?

In some contexts in the Code, the concept of transfer does capture transactions where legal and beneficial ownership remains with the owner of the property but another party is granted a right of use. Thus, under former section 1551 (which denied the benefit of graduated corporate income tax rates to corporations created through "transfers" of property among related entities), a bona fide lease constituted a transfer (and thus the lessee was potentially subject to section 1551) because "lease of the facilities effected a passage to the subsidiary of the use, possession, and control over the economic benefits to be derived from such facilities."[63] Similarly, in the transfer

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[61] A transfer would seem to include any contribution to capital of a foreign corporation (whether shares are actually received or merely deemed to be received). *See, e.g.*, section 367(c)(2) (contribution of property to a more than 80% owned foreign contribution is deemed to be a transfer in exchange for CFC's stock with a fair market value equal to that of the property); *Lessinger v. Commissioner*, 63 AFTR 2d 89-1055, 89-1058 (2d Cir.) (Mar. 29, 1989) ("[T]he exchange requirements of section 351 are met where a sole stockholder transfers property to a wholly-owned corporation even though no stock or securities are issued therefor. Issuance of new stock in this situation would be a meaningless gesture."); Rev. Rul. 64-155, 1964-1 C.B. 138 (transfer of property by domestic corporation to wholly-owned subsidiary that is not actually in exchange for shares is deemed to be in exchange for stock).

[62] The Code and Treasury regulations treat certain events as transfers. *See, e.g.*, Treas. Reg. § 1.987-2(c) (providing rules regarding a transfer to a section 987 QBU); Treas. Reg. § 1.679-3(a) (defining transfer as "a direct, indirect, or constructive transfer" for purposes of determining whether a U.S. person has transferred property to a foreign trust); Section 1253(b)(3) (defining transfer as including "the renewal of a franchise, trademark, or trade name" for purposes of determining whether there has been a sale of a franchise, trademark or trade name). We note that there are other sections of the Code and regulations confirming that a transfer is a transfer even if it qualifies as a tax-free reorganization or incorporation. (*Cf.* Treas. Reg. §§ 1.1551-1(g)(2) and (3).)

[63] Rev. Rul. 57-202, 1957-1 C.B. 297. *See also Perfection Foods, Inc.*, TC Memo 1965-15 (A subsidiary's use

pricing context, entering into a "qualified cost-sharing arrangement" within the meaning of Treasury regulations section 1.482-7 may sometimes be viewed as a transfer for purposes of section 482.[64]

In both those cases, however, the owner of the property retains tax ownership and, in fact, remains taxable on the income from the property. The income from the assets is not transferred to another person. As a result, we do not believe that section 91 should apply in these situations. Indeed, regulations which applied to former section 367(a)(3)(C) clarified that qualified cost sharing arrangements did not constitute a transfer for purposes of section 367. We believe that the same principle should apply here.[65]

(b) *Intangible Property*

An interesting question arises with respect to whether the license of intangible property should qualify as a transfer for section 91 purposes (and, if so, under what circumstances). While there are frequently real economic differences between a license of intangible property and an outright transfer,[66] the right answer in the context of intangible property is less clear than for leases of tangible property, because the Code often treats a transaction that would clearly qualify as a transfer for section 91 purposes (*e.g.*, a section 351 contribution) as economically similar to a license. Under section 367(d), when a U.S. person transfers an intangible (as defined in section 367(d)(4)) to a foreign corporation the transfer can qualify for nonrecognition treatment but the transferor must treat the transfer as a sale of the property and include in income over time (during each year of the useful life of the property) an amount commensurate with the income attributable to the intangible. Because the Code thus generally treats the transfer of an intangible to a foreign corporation in a non-recognition transaction similar to the licensing of the intangible to such foreign corporation, the question arises as to whether the application of section 91 should depend on the form of the transaction through which a section 367(d) intangible is made available to such foreign corporation (*i.e.*, whether it is formally licensed, or recharacterized as similar to a license under section 367(d)). In cases where a substantial portion of the assets of a foreign branch consist of intangible property, this question will be especially significant, since the choice to license or to shift ownership of an intangible may have little practical impact on the operation of the branch

of the offices and personnel of its parent, for which the subsidiary paid and deducted rent, was a lease and therefore a transfer, notwithstanding that there was no written or oral agreement entitling the subsidiary to the use of the space).

64 *Compare Altera v. Commissioner*, No. 16-70496, 16-70497, at 26 (9th Cir. 2019), ("When parties enter into a QCSA, they are *transferring* future distribution rights to intangibles, albeit intangibles that have yet to be developed.") (emphasis in original), *with id.* at 63 ("Again, Treasury never explained why QCSAs in which controlled parties share costs to develop intangibles would constitute "transfers" of intangibles sufficient to trigger the commensurate with income standard in the first place.").

65 Treas. Reg. § 1.367(a)-1(d)(3).

66 In particular, where the benefits and burdens of ownership generally remain with the lessor/licensor, and the lessor/licensor remains taxable on the payments made on the lease/license, the reasons discussed above for not treating a lease of tangible property as a transfer are applicable in the context of a license of intangible property as well.

but—depending on the definition of "transfer" for section 91 purposes—could have significant tax consequences. Consider the following examples:

> **<u>Example 1</u>**: US Corporation operates a branch in Country Y. The branch has accumulated losses over the years. The value of the branch's assets is attributable: (i) 50% to tangible property, and (ii) 50% to section 367(d) intangible property. In 2022, US Corporation transfers all the tangible property to its wholly-owned foreign corporation (CFC) and licenses the intangible property to CFC under a long-term license.
>
> **<u>Example 2</u>**: Same facts as example 1, except that the value of the branch is attributable (i) 3% to tangible property, and (ii) 97% to the section 367(d) intangible property.

Should these transfers be subject to section 91?

In Example 1, because there is no fundamental difference from a U.S. federal income tax perspective between licensing the intangible and transferring it to CFC, and because the tangible property which will be potentially sheltered from current taxation post-transfer is significant, it may be appropriate to treat the intangible as having been "transferred" to the foreign corporation, and thus, since all of the branch's assets have been transferred for section 91 to apply. By contrast, in Example 2, where most of the branch's assets are intangible property and thus the U.S. corporation will continue to be subject to tax currently on most of the income from the former branch's assets, a transfer of tangible property could be seen as too insubstantial, when compared with the other assets of the branch, to warrant the application of section 91.

We have considered whether a "principal purpose" anti-abuse test would be appropriate in this context but, given the flexibility that a taxpayer has to retain tax ownership of an intangible while making the use of the intangible available through a license, such a test might not be useful:[67] Every license would be problematic and the application of the test would turn on whether tax considerations were taken into account in structuring the transaction. Alternatively, a facts and circumstances test would be very difficult to administer in practice and create significant uncertainty for the IRS and the taxpayers.

In the absence of legislative history or statutory guidance on the appropriate treatment of licenses of intangible property in this context, we discuss below the relative merits of three alternative approaches. We note that in all cases where a license of intangible property would be

[67] *See* Postlewaite, Cameron & Kittle-Kamp: Federal Income Taxation of Intellectual Properties & Intangible Assets, ¶ 1.05[2][a] "Disposition by License;" Charles E. Hodges, II and Lynn E. Fowler, Tax Considerations of Acquiring Intellectual Property, 121 J. TAX'N 157, 158-59 (2014); and Harsha Reddy, Intellectual Property: Exploitation and Disposition, 558-2nd BNA Tax Portfolios (2017).

considered a "transfer" there may be a need for further coordination between the section 91 income and the licensing income to avoid double taxation of the transferor.[68]

(i) Approach A: A License is Never a Transfer

This first approach would conclude that a license of intangible property that is respected as such under general tax law principles[69] is not a transfer for purposes of section 91. Accordingly, when testing whether "substantially all" of a foreign branch's assets have been transferred to a foreign corporation in Examples 1 and 2, the property that the U.S. corporation licensed to the transferee corporation would be included in the denominator but not the numerator. As such, the transfers in Example 1 and 2 would presumably not be subject to section 91 (because only 50% of the foreign branch's assets have been transferred in Example 1, and 3% in Example 2).

This approach may have the advantage of being more aligned with the structure of the statute: Section 91 appears to contemplate dispositions of ownership of property (rather than merely of rights to property). Section 91(e) contemplates an increase in basis in the property (which is commonly the result of a taxable disposition of ownership, but not of a license) and section 91(c) refers to the "amount of gain recognized by the taxpayer on account of the transfer" (suggesting the transfer can give rise to gain, which is not the case for a license).

However, a concern with this approach is that taxpayers may be able to easily structure transactions in such a way that avoids section 91 altogether, by licensing intangible property on terms that nevertheless allow the licensee corporation benefits of the property that are substantially similar to those it would enjoy if it owned the intangible outright. Because the economic benefits to both licensor and licensee may not be meaningfully different from those had the intangible property been contributed or sold outright, and the tax consequences may also be nearly the same (if section 367(d) applies license-like treatment to the transfer), treating them differently based on the form of the transaction might present an inappropriate planning opportunity for taxpayers to obtain tax advantages that are not based on genuine economic differences.

(ii) Approach B: A Long-Term License is a Transfer

This second approach would treat long-term licenses of intangible property as transfers for purposes of section 91. This approach would thus effectively include the licensed property in both the numerator and denominator of the fraction used for determining whether the substantially all test has been met. As such, the transfers described in Examples 1 and 2 would be subject to section 91 because 100% of the foreign branch's assets would be treated as transferred to the foreign corporation.

A benefit of this approach is that it minimizes the planning opportunity discussed above by making the application of section 91 independent of the form of the transaction, and thus more

68 By analogy, *see* Part IV.H, below which discusses the coordination of section 367(d) and section 91.

69 *See supra* note 67.

closely aligns with the way the Code treats nonrecognition transfers of intangible property under section 367(d).

However, in cases where the licensor retains significant benefits and burdens of ownership of the intangible, and will remain taxable both on the royalty stream and potentially on future income generated by the intangible directly, it would not seem appropriate for the license to be a transfer for purposes of section 91. For that reason, if this approach were adopted, certain licenses should nevertheless not appropriately be transfers for purposes of section 91 (for example, because the duration of the license is short enough to leave the licensor with an appreciable amount of residual value in the intangible property after it expired). We recognize that treating some licenses and not others as transfers for section 91 purposes may introduce additional uncertainty to the already qualitative substantially all test but treating a short-term license as a transfer would be unduly harsh.

(iii) Approach C: Licensed Property is Ignored

A third approach is to ignore property that is licensed for purposes of determining whether the substantially all test is met. Thus, intangible property that is licensed to a foreign corporation (to which tangible property of the branch has been transferred) would be excluded from both the numerator and denominator.

This approach has the advantage of keeping the analysis neutral with respect to licenses of intangible property (and making the planning opportunities described above ineffective). It has the disadvantage, however, of potentially placing too much emphasis on transfers of tangible property in situations where only a small amount of tangible property is transferred. For example, in Example 2, where the tangible property represents only 3% of the value of the foreign branch's assets, ignoring the intangible property that is licensed to the foreign corporation could result in the application of section 91 turning on the transfer of a relatively insignificant asset, which would seem inappropriate.

For that reason, if this approach is adopted, a *de minimis* rule may be necessary to prevent the inappropriate application of section 91. This test could provide that the licensed property is not ignored (and that a license is *not* treated as a transfer) if the value of the foreign branch's assets that are transferred to the foreign corporation is small compared to the aggregate assets of the foreign branch including the intangible (or, conversely, when the intangible property constitutes too great a portion of the assets of the foreign branch).

2. "After Such Transfer"

Section 91 applies to a transfer when the domestic corporation transferor is a United States shareholder with respect to the transferee foreign corporation "after such transfer." By contrast, the 2018 instructions to IRS Form 1120 (when providing examples of "Line 10. Other Income") refer to the rule as applying "when substantially all the assets of a foreign branch are transferred to a foreign corporation with respect to which the corporation was a United States shareholder *immediately* after the transfer."[70] Similarly, IRS Form 926 when assessing whether a section 91

[70] U.S. Department of the Treasury, I.R.S., INSTRUCTIONS FOR FORM 1120, (Jan 16, 2019),

transfer may have happened asks: "[i]mmediately after the transfer, was the domestic corporation a U.S. shareholder with respect to the transferee foreign corporation?"[71]

While the legislative history does not provide guidance on the intended meaning of "after such transfer," we believe that it refers to a broader time period than the phrase "immediately after." Even in the context of section 351 exchanges (which is one type of transfer that could be subject to section 91), Treasury regulations interpret the statute's reference to "immediately after the exchange" to mean a broader period of time if there are multiple exchanges and certain conditions are met.[72]

Accordingly, we suggest that section 91's reference to "after the transfer" be interpreted in regulations to mean after the last of any "series of related transactions" (and that IRS Form 926, its instructions, and the instructions to IRS Form 1120 be revised to reflect this).[73] This would capture "conduit-type" transactions or similar indirect transfers that are part of a plan,[74] as well as avoid triggering the application of section 91 in situations where the required ownership is not in fact met when looking at the substance of the transaction (*e.g.*, a U.S. corporation that incorporates a business as part of a plan to dispose of the shares of such corporation).

3. "United States Shareholder" as the "Transferor"

In order for section 91 to apply the transferring domestic corporation must be a "United States shareholder" with respect to the transferee foreign corporation after the transfer.

The definition of United States shareholder under section 951(b) of the Code incorporates attribution rules. Accordingly, a transferor need not be an actual shareholder of the foreign transferee corporation in order for section 91 to apply to the transfer. This result seems appropriate when the transferor is a "United States shareholder" as a result of "indirect" or "constructive" ownership where the transferor or a related U.S. party would be eligible for the benefits of section 245A with respect to the transferee foreign corporation; but if the transferor is a United States

https://www.irs.gov/pub/irs-pdf/i1120.pdf (emphasis added).

71 U.S. Department of the Treasury, I.R.S., FORM 926, (Nov. 2018), https://www.irs.gov/pub/irs-pdf/f926.pdf. . *See also* the instructions to the form, U.S. Department of the Treasury, I.R.S., INSTRUCTIONS FOR FORM 926, 5 (Nov. 2018) https://www.irs.gov/pub/irs-pdf/i926.pdf

72 Section 351(a). In the context of section 351 transactions, the regulations under section 351 provide that "[t]he phrase 'immediately after the exchange' does not necessarily require simultaneous exchanges by two or more persons, but comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement proceeds with an expedition consistent with orderly procedure." Treas. Reg. § 1.351-1(a)(1). *See also Marsan Realty Grp.*, T.C. Memo 1963-297 (Oct 29, 1963) (allowing nonrecognition treatment where it was "clear that [a transferor] was in the transaction from the start [and] was obligated to [the corporation, but who waited 8 months to contribute cash] due to mere procrastination.").

73 Such guidance could also illustrate creeping dispositions discussed in Part IV.B, above.

74 *Cf.* Treas. Reg. §§ 1.679-3(c)(5), (d) (giving examples of indirect and constructive transfers by U.S. persons to foreign trusts, including: a U.S. person guarantees a borrowing by a foreign trust that is not otherwise creditworthy, a U.S. person transfers money to a domestic trust which later becomes a foreign trust, a U.S. person deposits money in a bank which then lends to a foreign trust, a U.S. person transfers property to a third-party creditor in satisfaction of (or assumes the liability of satisfying) a foreign trust's obligation).

shareholder only as a result of "downstream" constructive ownership rules, the application of section 91 seems less appropriate.

> **<u>Example 3</u>**: A, a U.S. individual, owns 100% of each of FC1 and US1. US1 has a foreign branch. US1 sells the branch to FC1 for cash. US1 is a United States shareholder of FC1 within the meaning of section 951(b) (by virtue of "downstream attribution" to US1 of the FC1 shares owned by A).[75]

In this example, US1 appears to be subject to section 91, even though US1 does not own any shares in FC1 and A, as an individual, is not eligible for section 245A; instead, all the returns to A from A's shareholding in FC1 are subject to full U.S. taxation (and even ignoring section 245A, a higher tax burden than a domestic corporate shareholder, since A would not be eligible for the GILTI deduction of section 250).[76] There is a question about whether this is an appropriate result and what policy would justify taxing US1 on the transfer in this example.

On the one hand, it may be appropriate for section 91 to apply. The statutory wording would support such a reading, and it may be that the application of section 91 should not depend on the availability of a section 245A deduction. Post-TCJA, section 245A may not have significant value for many transferring domestic corporations that are clearly within the scope of section 91. Thus, if a domestic corporate transferor transfers the assets of a foreign branch to a CFC of which it is a United States shareholder, such transferor may be subject to significant taxation going forward (in respect of subpart F income or GILTI) on account of its indirect ownership of the former branch's assets and yet section 91 will clearly apply.

On the other hand, applying section 91 in this context would seem at odds with the stated purpose of section 91. Section 91 was enacted specifically as a backstop to section 245A. As discussed in Part III.D, above, the section of the TCJA which enacted section 91 is in subpart A of the TCJA: "Establishment of Participation Exemption System for Taxation of Foreign Income." The legislative history explains the enactment of section 91 by saying that "taxpayers may wish to arbitrage the application of the participation exemption system to foreign subsidiaries but not foreign branches." Finally, section 91 applies only to transferors who, but for the constructive ownership issue identified in this Part IV.C.3, have the potential to qualify for the participation exemption with respect to the transferee foreign corporation. The transferor must be a domestic corporation, the transferee must be a "specified foreign corporation (as defined in section 245A)"

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[75] Section 958(b) (defining ownership of stock for purposes of the definition of United States shareholder in section 951(b) by reference to section 318(a)(3)(C) (corporation is deemed to own stock owned by its majority shareholder)).

[76] It is possible that A could make an election under section 962 to be taxed as a domestic corporation for purposes of section 951(a). Treasury and the IRS have proposed regulations providing that individuals who make a section 962 election would be eligible for the deduction under section 250 (and the corresponding reduced rate on GILTI). *See* Prop. Treas. Reg. § 1.962-1(b)(3). However, any actual distribution of earnings from the CFC to the United States shareholder may result in additional taxes for A (section 962(d); Treas. Reg. § 1.962-3(a); section 951A(f)(1)(A), Treas. Reg. § 1.951A-5(b)(1) (GILTI inclusion amount is treated as an amount included under section 951(a)(1)(A) for purposes of applying section 962)).

and the transferor must be a United States shareholder with respect to the transferee foreign corporation.

If Treasury and the IRS believe that section 91 should apply in Example 3, we believe the regulations should provide an example to make clear to taxpayers how section 91 will apply in the context where the transferring corporation is a United States shareholder solely as a result of downstream attribution.

However, if Treasury and the IRS believe this is not an appropriate result, we believe that regulations should clarify that section 91 does not apply to situations where (i) the transferring corporation is a United States shareholder by virtue of downstream attribution, and (ii) the shareholder of the transferee foreign corporation whose ownership is attributed to the transferring corporation does not qualify for the benefit of section 245A and is not a foreign person whose income from the transferee foreign corporation is not subject to U.S. tax. If Treasury and the IRS have concerns as to whether they have sufficient authority under section 7805 to do this, we recommend that technical corrections be sought.[77]

4. Transfers and Partnerships

Section 91 does not state whether an aggregate or entity approach applies to partnerships. The Code, case law, and Treasury regulations section 1.701-2(e), however, support treating a partnership as an aggregate when doing so would carry out the purpose of an otherwise applicable provision of the Code.[78]

When a partnership that has a significant domestic corporate partner transfers its foreign branch to a foreign corporation with respect to which the corporate partner is a United States

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77 By analogy, in the context of section 965, Treasury and the IRS have used their authority to limit the application of the downstream attribution rules of section 958(b) in certain cases. Treas. Reg. § 1.965-1(f)(45)(ii). However, this exception in the section 965 regulations addressed a narrow case (downstream attribution to partnerships due to *de minimis* ownership in such partnership) and the preamble to those regulations indicates that the exception was provided "to limit the administrative and compliance difficulties associated with determining whether a foreign corporation is a specified foreign corporation solely by reason of downward attribution of its stock under section 318(a)(3)(A) from a partner to a partnership when the partner has only a de minimis interest in the partnership." (T.D. 9846, 2019-09 IRB 583).

78 *Cf.* HR Conf. Rep. No. 2543, 83d Cong., 2d Sess. 59 (1954) (stating that a partnership need not be treated as an entity outside of subchapter K "if the concept of the partnership as a collection of individuals is more appropriate for such provisions"); *Holiday Village Shopping Center v. United States*, 5 Cl. Ct. 566, 570 (1984) ("Congress has not committed itself to the entity theory for all partnership tax purposes; and the proper inquiry is not whether a partnership is an entity or an aggregate for purposes of applying the internal revenue laws generally, but rather which is the more appropriate and more consistent with Congressional intent with respect to the operation of the particular provision of the Internal Revenue Code at issue."); Treas. Reg. § 1.701-2; and Notice of Proposed Rulemaking, *Guidance under Section 958 and Section 951A*, (REG-101828-19, 84 FR 29114), pt. II (June 21, 2019) (citing provisions of the Code where the aggregate theory applies to partnerships).

Treas. Reg. § 1.701-2(e)(2) prescribes entity treatment where (i) the provision of the Code prescribes the treatment of the partnership as an entity (in whole or in part) and (ii) that treatment and the ultimate tax results, taking into account all the relevant facts and circumstances, are clearly contemplated by that provision. These conditions are not met here since section 91 is silent.

shareholder, is the transfer subject to section 91? Similarly, assuming all the other conditions are met, and a partnership owns a foreign branch, is the transfer *of* a partnership interest that represents "substantially all" of the foreign branch's assets to a specified foreign corporation subject to section 91?

We believe that aggregate treatment is appropriate in both cases. First, aggregate treatment generally applies to transfers subject to section 367(a) (and applied to section 367(a)(3)(C) prior to its elimination). That is, transfers by a partnership are treated as transfers by partners and transfers of partnership interests are treated as transfers of the partnership's assets.[79] While section 91 differs from former section 367(a)(3)(C), the two sections have the same policy at their core and the same fundamental goal. Section 91 is the successor to section 367(a)(3)(C) and refers to section 367(a)(3)(C). Thus, the same considerations favoring aggregate treatment under former section 367(a)(3)(C) are likely to pertain to section 91. Second, treating a partnership as an entity would unduly reduce the scope of section 91. Except for "true branches" which have to be owned by a U.S. corporation for regulatory or other purposes, most taxpayers would be able to avoid the application of section 91 by operating foreign branches through partnerships.

In turn, when a domestic corporation is subject to section 91 by virtue of being a partner in a partnership, the income that is subject to recapture should be limited to the amount of losses actually allocated to the domestic corporation with respect to the applicable foreign branch (assuming for this purpose that the specific allocation is respected as having substantial economic effect or being in accordance with such partner's interest in the partnership). Consistent with section 91's recapture purpose, a partner should not be taxed on an amount that exceeds the benefit it derived from the branch.[80]

Finally, we considered whether a transfer of assets to a partnership should be considered as a transfer to the other partners (and thus potentially be subject to section 91 if one of the partners is a specified foreign corporation with respect to the transferor).

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79 Treas. Reg. § 1.367(a)-1T(c)(3).

The aggregate rules of Treas. Reg. § 1.367(a)-1T(c)(3), treating both domestic and foreign partnerships as aggregates of their partners for purposes of section 367(a)(3)(C), should apply for section 91 purposes notwithstanding Treas. Reg. § 1.367(a)-6T(g)(1) (or the incorporation by reference of those regulations in the section 91 context), which created a degree of ambiguity about branches of partnerships. Because section 367(a)(3)(C) applied to non-recognition transactions involving any U.S. person (such as a domestic partnership or a U.S. partner in a domestic or foreign partnership), Treas. Reg. § 1.367(a)-6T(g)(1) says that "any U.S. person may be treated as having a foreign branch for purposes of this section, whether that person is a corporation, *partnership*, trust, estate, or individual." (emphasis added). This provision, arguably, by negative implication, suggests that foreign partnerships cannot have foreign branches, particularly given the fact that in Rev. Rul. 80-293, *supra* note 74, the IRS ruled that a foreign partnership could have a foreign branch for Rev. Rul. 78-201 purposes. *See, e.g.*, Robert J. Staffaroni, *Partnerships: Aggregate vs. Entity and U.S. International Taxation*, 49 Tax Law. 55, 99-100 (1995) ("Temporary Regulations section 1.367(a)-6T(g)(1) confuses the issue somewhat by stating that a domestic partnership may be treated as having a foreign branch. There should instead be a reference to the aggregate rule of Temporary Regulations section l.367(a)-1T(c)(3) and a statement that a foreign branch of a partnership, whether domestic or foreign, is imputed to its U.S. partners").

80 *Cf.* Revenue Ruling 80-293, 1980-2 C.B. 128 which predates section 367 (partner who was not allocated loss

> **<u>Example 4</u>**: US1 operates a branch in Country X with accumulated post-2018 losses. US1 and its wholly-owned Country X subsidiary (CFC1) decide to consolidate their operations through a Country X partnership (PRS). US1 contributes the branch to PRS and CFC1 contributes other assets. US1 owns 20% of PRS and CFC1 own 80% of PRS. No special allocations are made and so CFC1 now has an indirect ownership of 80% of the branch on account of its interest in PRS.

US1 has economically exchanged what could arguably constitute "substantially all" of the branch's assets in exchange for a 20% participation in the assets contributed by CFC1—economically, this is not dissimilar to a sale to CFC1 of 80% of the branch assets in exchange for other assets—a transaction that clearly would be subject to section 91.

However, we do not believe that section 91 should apply to this transaction, as there has been no transfer *to* CFC1, and US1 remains fully taxable on its income from the partnership. We note that section 721(c) and the regulations thereunder apply to preserve the taxation of the built-in gain in the branch's assets. Further, the "anti-mixing bowl" rules of sections 704 and 737, as well as the disguised sale rules of section 707, would already monitor whether a transaction should be treated as a sale of property to CFC1.

D. Calculating The TLA

Section 91(b) defines the TLA as the excess (if any) of (i) "the sum of losses which were incurred by the foreign branch after December 31, 2017, and before the transfer, and with respect to which a deduction was allowed to the taxpayer," over (ii) "the sum of any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer, and any amount which is recognized under section 904(f)(3) on account of the transfer." With the exception of the reference to post-2017 losses as opposed to all losses, this language is identical to former section 367(a)(3)(C). The section 91 income is then computed by subtracting from the TLA the amount of any gain recognized by the taxpayer on account of the transfer.[81]

In light of the similarities between the statutory language of section 91 and former section 367(a)(3)(C), we assume that the guidance under section 91 will adopt the principles of the 367(a)(3)(C) Regulations in measuring the TLA. As discussed in Part III.A.2, above, those regulations provided a series of steps for computing the amount of losses required to be recaptured under section 367(a)(3)(C). The starting point was the calculation of the total amount of ordinary and capital losses deducted by the transferred branch in previous years. Then these amounts were reduced by expired losses (expired ordinary losses reducing the total amount of ordinary losses; expired capital losses reducing the total amount of capital losses). Then the remaining amounts were reduced to reflect expired foreign tax credits, and similar reductions were made to reflect

isn't subject to loss recapture upon a foreign partnership's incorporation of its business).

[81] Section 91(c).

expired investment credits. The goal of this system was to require loss recapture only for deductions in respect of which the taxpayer received an actual tax benefit.

We believe that these principles should generally continue to apply and recommend that they be implemented in the guidance under section 91. In addition, this section of the Report discusses specific issues relating to the measurement of the TLA.

1. Measuring Branch Losses

The first step under the definition of TLA in section 91 is to determine the amount of losses that should be treated as having been incurred or realized by the foreign branch. This is not a new question. The 367(a)(3)(C) Regulations described previously deducted losses simply as those losses "that were realized by the foreign branch,"[82] without further explanation. The only guidance was a field service advice from 1998, but the facts involved in that field service advice were unique.[83] This issue takes a renewed importance in a post-TCJA world. As discussed, it is easier in many ways to have a section 91 event than a recapture under former section 367(a)(3)(C). In addition, the amount of the branch loss recapture can be much larger under section 91 than under former section 367(a)(3)(C).

As discussed in Part IV.A.1, above, several provisions in the Code and the regulations (particularly post-TCJA) address the income of the foreign branch of a U.S. person, although the goals of these provisions are not uniform.[84] A primary purpose of the branch loss recapture rules of section 91 is to identify and deny the *U.S.* tax benefit that the domestic corporation derived from the branch. Put another way, if the business had always operated in corporate form, what losses would not have been incurred by the U.S. taxpayer *for U.S. tax purposes*?

Other provisions seek instead to measure the amount of taxable income that is subject to foreign tax in order to align the U.S. and foreign taxation of income to avoid double taxation (or double non-taxation) in the foreign tax credit context or to avoid arbitrage (for example, in the

82 Treas. Reg. § 1.367(a)-6T(d)(1).

83 F.S.A. 3217 (June 25, 1998). In the FSA, various members of an affiliated group filing a consolidated return had no U.S. operations but conducted exploration activities in foreign branches. Each of these U.S. affiliates operated in only one foreign country and with only one foreign branch. Foreign expenses were generally funded with intercompany loans to the affiliates with the foreign branches. Interest expense on such loans was deducted in computing the taxable loss of each affiliate (and the consolidated taxable income of the affiliated group). Because the consolidated group contained other assets that generated U.S. source income, a portion of the interest expense was U.S. source under section 864(e) and Treas. Reg. § 1.861-11T (which allocates interest expense based on an apportionment fraction that applies as if all members of the group were a single corporation). Thus, even though all of the assets of a foreign branch were located outside of the United States, a portion of the interest expense on the intercompany loans (and presumably, although this is not said in the FSA, the interest expense booked in the foreign branch) was apportioned to U.S. source income. When the taxpayer decided to incorporate one of these foreign branches, it claimed that former section 367(a)(3)(C) applied only to foreign source losses and thus did not capture the portion of the interest expense that was U.S. source. The IRS disagreed.

84 *See* Part IV.A.1, above.

DCL rules, which measure a taxpayer's ability to use losses or deductions that exist for U.S. and non-U.S. tax purposes to reduce taxable income in multiple jurisdictions).[85]

This divergence of goals would argue for different measurement methods for section 91 and the other provisions which measure branch income. There are two countervailing considerations however.

First, in many ways the question posed by the section 91 measurement of losses is impossible to answer. It presumes an alternate reality where the taxpayer would likely have structured its activities very differently if its foreign operations were in a foreign corporation. This is particularly relevant for true branches where the lack of juridical separation between the branch and the head office and the limited implications of "transactions" between the branch and the head office dictate a conduct which is very different from that of a parent and its subsidiaries. Thus, the rules can only reach an approximate result and the guidance should therefore focus on both avoiding unfair results for the taxpayer and preventing avoidance of section 91 (*e.g.*, stuffing transactions to artificially increase the foreign branch's income or incurring expenses at the domestic corporation level to fund the foreign branch's activities).

Second, administrative complexity is clearly a disadvantage to the proliferation of methods. Requiring taxpayers to use different methods for different purposes raises the cost and difficulty both for taxpayers to comply with the rules and for the IRS to administer them.

There are at least four potential methods to consider:

- *Books and Records*. Where books and records are kept, the books and records could serve as the starting point for determining the amount of losses realized by the branch for section 91 purposes. IRS Form 8858 already requires U.S. persons that are tax owners of a foreign disregarded entity or that operate a foreign branch to report annually their income from such entity or operations. The form adopts a books and records approach.[86]

  Reliance on books and records could be simpler than any other approach and would in general follow the approach taken in the context of section 987.[87] It would however put an undue emphasis on form and would therefore allow a taxpayer to artificially reduce the amount of expenses or losses attributable to the branch (*e.g.*,

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85 *But see* the preamble to the recently proposed regulations under section 1503(d) which indicates that Treasury is studying issues relating to expenses that are regarded for local tax purposes but disregarded for U.S. tax purposes (REG 104352-18, 83 FR 67612 (Dec. 28, 2018)).

86 *See* Schedule H, lines 1 and 7 of IRS Form 8858. IRS Form 8858 also includes in Schedule I reporting for any transfer subject to section 91 as well as the amount of TLA. When computing the TLA, the instructions to the form do not however refer to past Schedule H reporting for the branch but instead restate the formulas found in section 91.

87 Treas. Reg. § 1.987-2(b)(1).

by incurring expenses for the benefit of the branch at the level of the U.S. corporation).

In the field service advice mentioned above, the IRS appears to have adopted a strict "books and records" approach for former section 367(a)(3)(C). In that case, however (i) the facts of the field service advice were so specific (*i.e*., a U.S. corporation with no assets other than a foreign branch) that this may not reflect a general approach, and (ii) part of the reasoning for the IRS's conclusion seems to have been that former section 367(a)(3)(C) predated the specific expense allocation rules for consolidated groups under section 864(e) (which of course is not the case for section 91).[88]

- <u>*Modified Books and Records*</u>. This is the approach of the proposed regulations under section 904(d) for the foreign branch income basket (as well as the proposed regulations for the section 250 foreign derived intangible income deduction).[89] It would take into account generally the *income* recorded in the books and records (with some modifications) but then apply section 861 principles to allocate *deductions.*

  A particular issue in implementing the modified books and records approach would be how to handle transactions between a foreign branch and the head office (or other branches) that are otherwise disregarded for U.S. tax purposes. Under the proposed section 904 regulations, when measuring the income of a branch, disregarded transactions are generally taken into account, with the important exception of interest and interest equivalent payments.[90] We have previously recommended in our report on these regulations that such payments also be taken into account.[91]

  Because a goal of section 91 is to deny the actual tax benefit that resulted from the use of the branch as opposed to a foreign subsidiary, it would be logical to take into account items from otherwise disregarded transactions such as transactions between the branch and the head office (or between multiple branches) in determining the TLA: these transactions would have been regarded had the branch operated as a foreign corporation from the outset. It would be artificial for instance to treat a branch as loss-making solely because some of its income is derived from transactions with its U.S. corporate owner. We note however, that, in the context of true branches, where the form of transactions between the branch and the head office (*e.g.*, distribution/contribution or loan) often have little independent

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88 *See supra* note 83.

89 Prop. Treas. Reg. §1.904-4(f)(2)(vi) and Prop. Treas. Reg. §1.250(b)-1(c)(11).

90 *See* Prop. Treas. Reg. § 1.904-4(f)(2)(vi)(A). *See also* Prop. Treas. Reg. § 1.951A-2(c)(6)(vi)-*Example* (respecting disregarded payment between branches for purposes of calculating separate tentative gross tested income items based on disregarded payments of interest shown on books and records of QBUs).

91 New York State Bar Association Tax Section Report No. 1408, Report on the Proposed Foreign Tax Credit Regulations (February 5, 2019), 34-35.

significance or legal implications,[92] this could put an undue emphasis on the form of the transaction and may still not produce an accurate result.

- <u>*Authorized OECD/treaty approach ("AOA")*</u>. The OECD Model Tax Convention and the U.S. Model Tax Treaty provide an approach for determining how to attribute profits to a permanent establishment. This approach would be available for countries with which the United States has a tax treaty (so it would not necessarily always be available for a taxpayer's foreign branches).

  The approach seeks to determine "the profits [the branch] might be expected to make, in particular in its dealings with other parts of the enterprise if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions, taking into account the functions performed, assets used and risks assumed by the enterprise through the [branch] and through the other parts of the enterprise."[93] The primary focus of this approach, then, is on determining which activities that give rise to risk of loss are undertaken by the branch as opposed to being undertaken by the head office.

  One benefit of this approach is that, as more countries adopt the AOA approach, there is an increased likelihood that the jurisdiction of the branch allocates profits and losses in a way that would match the allocation for section 91 purposes. On the other hand, parity in treatment is less of a goal in the section 91 context, since the focus is on the tax benefit that the *U.S. tax system* granted to the taxpayer as a result of the use of a branch rather than a corporation. Another benefit is that this approach focuses on the actual operations of the foreign branch to derive the income or loss of the branch. In a context where it is not possible to determine the true

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92 For example, while a true branch will frequently have accounts on its books and records showing amounts "due to" or "due from" its head office (signifying that funds were made available by the head office to the branch, or vice versa, respectively), many regulators express a preference for scrutinizing a local branch's worldwide liquidity and relations with the regulator in the jurisdiction of the branch's head office, rather than an emphasis on the branch's standalone liquidity. *See, e.g.*, Bank of England, Prudential Regulatory Authority, Supervisory Statement: "International banks: the Prudential Regulation Authority's approach to branch authorisation and supervision" at 14 (March 2018) ("[T]he PRA's general approach to branch authorisation and supervision . . . is anchored by an assessment of a range of factors including the degree of equivalence of the home state supervisor's regulatory regime and . . . include[s] whether the *whole firm* meets the PRA's Threshold Conditions [for obtaining and maintaining a U.K. license, which include having adequate financial resources].") (emphasis added). This is in contrast to the prior rules imposed by the PRA, which required branches of non-U.K banks to maintain specific liquidity resources in the branch, rather than the consolidated liquidity information required now. *See* Bank of England, Prudential Regulatory Authority, Policy Statement "CRD IV: Liquidity" at 12 (June 2015) (available at https://www.bankofengland.co.uk/-/media/boe/files/prudential-regulation/policy-statement/2015/ps1115).

93 *See* OECD (2017), *Model Tax Convention on Income and on Capital: Condensed Version 2017*, Art. Para. 2, OECD Publishing, http://dx.doi.org/10.1787/mtc_cond-2017-en; U.S. Model Income Tax Convention of 2016, Art. 7 para.2.

benefit generated by the branch, this functional approach may best approximate a fair result.

- *Section 864/882 model*. Section 882 and the regulations thereunder provide rules for allocating and apportioning income and expense between a foreign corporation's U.S. trade or business and its other operations. A similar approach could be taken in the context of section 91. There is at least one precedent for this approach in the context of the DCL regulations for "true branches" that do not maintain books and records.[94]

  We have discussed the relative benefits of this approach and the modified books and records approach in our prior reports on the proposed section 904(d) regulations and the section 250 foreign derived intangible income deduction.[95]

We do not favor a strict books and records method because it seems to be prone to manipulation. As between the three other approaches, ultimately, whichever method is chosen will only produce a "rough justice" result—as noted earlier, in many ways it is not possible to know what tax benefits would *not* have been realized by the U.S. corporation (and what structuring would have been used by the taxpayer) if the foreign operations had been conducted through a foreign corporation from the start. Accordingly, in order to reduce the enormous complexity that would result from having a taxpayer maintain different sets of U.S. tax measurements of the income from its foreign branch, we recommend that Treasury and the IRS coordinate the guidance on section 904(d) with the guidance on section 91 such that the approach that is ultimately chosen for the section 904(d) foreign branch income basket apply also to measure section 91 losses, with appropriate adjustments (*e.g.*, our discussion of stock and securities in Part IV.A.2, and measurement on a branch-by-branch basis as opposed to across all branches for section 904 purposes).

Finally, because section 91 seeks to recapture losses from past years (for which there may be limited information), it will be important to be able to refer to a measure of income already reported for other purposes instead of having to create measurements *ex post*. Accordingly, regardless of the approach that is chosen to measure branch losses, we recommend that the IRS require a U.S. corporation with a foreign branch to report on an annual basis the amount of income or loss attributable to such branch for purposes of section 91. This could be done by updating IRS Form 8858 for instance.

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94 Treas. Reg. § 1.1503(d)-5(c)(2)(i).

95 New York State Bar Association Tax Section Report No. 1408, Report on the Proposed Foreign Tax Credit Regulations (Feb. 5, 2019), 31-33; New York State Bar Association Tax Section Report No. 1399, Report on Foreign Derived Intangible Income (Sep. 4, 2018), 6-7; and New York State Bar Association Tax Section Report No. 1416, Report on Proposed Regulations under Section 250 (Foreign Derived Intangible Income) (May 6, 2019), 5-7. *See also* New York State Bar Association Tax Section Report No. 1411, Report on Proposed Regulations Under Sections 267A, 245A(e), and 1503(d) (Feb. 26, 2019), 92-95 (discussing whether items reflected on a disregarded entity's books and records should be regarded for certain purposes).

2. Unused Net Operating Losses

As noted, we believe that the TLA should be measured following the principles of the 367(a)(3)(C) Regulations. However, a modification may be needed in respect of unused net operating losses.

In the pre-TCJA world, because the transferor remained able to use losses of a branch that gave rise to net operating losses, those losses were included in the calculation of the branch losses that could be recaptured. Indeed, under the 367(a)(3)(C) Regulations the recapture amount was only reduced by expired losses. The taxpayer was then free to use its available net operating losses to offset the income recaptured pursuant to former section 367(a)(3)(C) or any other income.

However, post-TCJA, section 172(a)(2) limits utilization of a net operating loss carryforward to 80% of taxable income for the taxable year. Accordingly, a section 91 U.S. corporation could be required by section 91 to take into income a loss even if this loss has not, in fact, been used and may not be fully available to offset such income.

> **Example 5**: USP, a domestic corporation, has a branch operating a business (B) in country X and no other sources of income or deduction. In Year 1, B generated $100 of net losses. Because USP has no income or gain for such year, USP has a net operating loss of $100. At the beginning of Year 2, USP transfers B to its wholly owned foreign corporation.

In this example, USP has had no tax benefit from the use of the foreign branch. Yet, the approach of the 367(a)(3)(C) Regulations post-TCJA would imply a section 91 income inclusion of $100 in year 2, even though the taxpayer is only able to use $80 of its net operating losses to offset the section 91 income inclusion, resulting in net taxable income of $20 for year 2 and a carryforward net operating loss of $20.

Because of this potential mismatch, we would recommend that consideration be given to reducing the TLA by the amount of any unused and unexpired net operating losses or capital losses resulting from the foreign branch that were incurred prior to the year of the transfer. The taxpayer in return would waive the right to use such losses.[96] We believe Treasury and the IRS have authority to provide such guidance. In defining the TLA, section 91 refers to the losses "with respect to which a deduction *was* allowed to the taxpayer."[97] A net operating loss has not yet been "allowed" prior to its use under section 172(a).[98]

We acknowledge that this proposal may result in some complexity in tracing the net operating losses. The 367(a)(3)(C) Regulations already provided for tracing rules[99] but

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96 For this purpose, the unused NOL that is attributable to the foreign branch for a given year would be measured as the lesser of (a) the NOL incurred by the foreign branch in that year (as measured under section 91), and (b) the taxpayer's unused NOL attributable to that same tax year under section 172(b).

97 Emphasis added.

98 The first few words of section 172(a) are "There shall be *allowed* as a deduction for the taxable year an amount equal to the lesser" (emphasis added).

99 Treas. Reg. § 1.367(a)-6T(d)(2)(ii).

presumably tracing would become more relevant than when it applied only to expired net operating losses.

3. Reduction by Taxable Income

Section 91 provides that the TLA will be reduced by "any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer."[100] This matches the wording of former section 367(a)(3)(C). However, the 367(a)(3)(C) Regulations also allowed taxpayers that incurred losses *after* the foreign branch had generated income to reduce the losses by the prior years' income.[101]

The 367(a)(3)(C) Regulations and Treasury Decisions promulgating them do not explain the reason for this reduction of losses for previously generated income, but we note that at the time the regulations were issued, operating losses could be carried back against income from prior years (with limitations).[102] Because after the TCJA, taxpayers can no longer carry back ordinary net operating losses,[103] such reduction of losses for previously generated income may no longer be appropriate as a policy matter. However, because taxpayers can still carryback capital losses in certain circumstances,[104] we recommend that consideration be given to a limited reduction of capital losses for previously incurred capital gain.

E. Reduction by Gain

1. In General

Once the TLA has been computed, the section 91 income is the TLA reduced by the section 91(c) amount, which is the "amount of gain recognized by the taxpayer on account of the transfer" (other than the OFL recapture, since that amount is already carved out from the definition of TLA under section 91(b)(2)(B)).

Gain recognition is generally preferable to section 91 recapture, in that both parties receive fair market value basis. As discussed below, section 91 recapture might not have the same

[100] Section 91(b)(2)(A).

[101] Treas. Reg. § 1.367(a)-6T(e)(2).

[102] Section 172(b)(1), prior to amendment by the TCJA, had allowed operating losses to be carried back to each of the two prior taxable years.

[103] As amended by section 13302(b)(1)(A) of the TCJA, section 172(b)(1) does not allow carryback of net operating losses, except for certain farming losses and losses of property and casualty insurance companies.

[104] Section 1212.

consequence. Further, gain recognition is preferable because section 91 recapture income is U.S. source, whereas gain may be foreign source (and thus able to be reduced by foreign tax credits).

The implication is that—in situations where the transfer of an asset may otherwise qualify for tax-free treatment (*i.e.*, intangible or stock or securities)—the taxpayer may well be incentivized to choose gain recognition over section 91 recapture.

In addition, since recaptured OFL would also reduce the TLA, if a transfer would result in section 91 income then a taxpayer that has an OFL would also be incentivized to ensure that the transaction results in a recapture of OFL in order also to reduce the taxpayer's OFL balance.

2. Pre-2018 Losses

(a) *Does the Form of the Transaction Matter*?

The TCJA contains a transition rule that is not included in section 91: "The amount of gain taken into account under section 91(c) of the Internal Revenue Code of 1986, as added by this subsection, shall be reduced by the amount of gain which would be recognized under section 367(a)(3)(C) … with respect to losses incurred before January 1, 2018."[105]

Because the TLA is reduced by the section 91(c) amount (*i.e.*, gain recognized as described in section 91(c)), reducing the section 91(c) amount has the effect of increasing section 91 income. Because this rule is not in the Code, we recommend that regulations expressly include the transition rule (to avoid oversights) as well as provide guidance regarding its application.

The Bluebook provides the following illustration of the transition rule:

> U.S. multinational corporation ("**U.S. Parent**"), a calendar year taxpayer, incorporates its branch located in country X ("**Incorporated Country X Branch**") on December 31, 2018. Incorporated Country X Branch recognized $150 of losses during calendar year 2018 for which U.S. Parent took a deduction. On December 31, 2018, Incorporated Country X Branch has tangible assets with built-in gain of $100, and U.S. Parent recognizes that $100 of gain under section 367(a)(1). Under section 91(a), U.S. Parent includes $50 in gross income ($150 of losses, reduced by $100 section 91(c) reduction amount, which in this case is the amount of gain recognized under section 367(a)(1)). However, if, for example, Incorporated Country X Branch also had $75 of pre-2018 branch losses, the $100 section 91(c) reduction amount would be reduced by $75 to $25. In this case, U.S. Parent would include $125 in gross income ($150 of losses, reduced by the $25 section 91(c) reduction amount).[106]

While the purpose of the rule may be to maintain the ability to recapture pre-2018 losses despite the repeal of section 367(a)(3)(C), the effect of the rule is not necessarily to preserve the status quo with respect to pre-TCJA branch losses. The amount of the recapture depends on the

[105] Section 14102(d)(4) of TCJA.

[106] Bluebook, 354.

existence of post-2017 losses. In the example above, if Country X branch had not recognized losses of $150 during 2018, no pre-TCJA or post-TCJA loss would be recaptured (unless it consists of OFL). In addition, under former section 367(a)(3)(C) the recaptured loss would be foreign source. In the Bluebook's example, the $75 of pre-2018 losses would have been foreign source pre-TCJA but now increase U.S. Parent's section 91 income and thus are treated as U.S. source.

Furthermore, the statute's use of the hypothetical reference to the amount of "gain which would be recognized under section 367(a)(3)(C)" raises some questions as to its intended scope. Because former section 367(a)(3)(C) applied only to override nonrecognition treatment, it would not have required recognition of income on many transfers that nevertheless trigger section 91. For example, a taxable sale of a branch to a CFC would not have required loss recapture under section 367(a)(3)(C) because it would not be a nonrecognition exchange described in former section 367(a)(3), but such a transfer would nevertheless trigger section 91. A question is therefore whether the transition rule applies to losses which *could have* been recaptured under former section 367(a)(3)(C) (*i.e.*, it measures the quantum of the potential recapture as the lesser of net pre-2018 losses and the amount of built-in gain measured as of the transfer), or to losses which *would have* been recaptured if the applicable section 91 transfer had been analyzed under pre-TCJA principles. The example in the Bluebook does not resolve this issue because it deals with a transfer that could have qualified for former section 367(a)(3) treatment (a section 351 incorporation of a foreign business).

On the one hand, if the goal of the transition rule is to preserve the pre-TCJA law for pre-2018 losses, it would make sense to limit the application of this rule to transfers that would have been subject to section 367(a)(3)(C) recapture. On the other hand, this would be a somewhat contrived analysis (looking at a transaction under pre-TCJA principles that are not otherwise relevant to the transaction). Furthermore, this reading would mean that well-advised taxpayers would generally be able to avoid recapture of pre-2018 losses by structuring their transactions as taxable transfers under pre-TCJA section 367(a)(3), and would turn the transition rule into a trap for the unwary.

In the absence of guidance from the statute or legislative history, it would seem more logical to avoid such an artificial result and to require that the section 91(c) amount be reduced by any gain which *could* have been taxed under former section 367(a)(3)(C) (up to the amount of pre-2018 losses) regardless of the form of the transaction actually undertaken.

(b) *Ordering Rule*

In addition, when measuring the amount of the pre-2018 losses that should be recaptured there is a question as to whether post-2017 income of the foreign branch can be used to reduce the losses.

> **Example 6**: USCo, a U.S. corporation, has a branch in Country X that it has been operating since 2016. At the end of 2019, USCo transfers the branch's assets to a wholly-owned foreign corporation recognizing $100 of gain.
>
> Country X branch's net income/loss in 2016-2019 is as follows:

Year	Country X branch Income (loss)
2016	$(100)
2017	$(100)
2018	$150
2019	$(100)

Under section 91(b) the TLA would be $100, which is the loss incurred in 2019. The TLA cannot be reduced by the income generated in 2018, since the loss was incurred after the income was earned (see Part IV.D.3, above).

Under section 91(c), the TLA is reduced by the $100 of gain recognized on the transaction, but under the transition rule the gain itself is reduced (but not below zero) by the pre-2018 losses that would be recognized under former section 367(a)(3)(C) with respect to pre-2018 losses. As of December 31, 2017, there is $200 of pre-2018 losses. Should the gain reduction therefore be for the $200? Or should USCo be allowed to reduce the $200 loss by the $150 of income generated in 2018, such that the gain reduction should only be $50?

Under the first reading, USCo recognizes $100 of income under section 91 (TLA of $100 and no reduction for gain since the pre-2018 losses exceed the gain). Under the second reading, USCo recognizes $50 of income (TLA of $100 *minus* ($100 of gain *minus* $50 of gain reduction for pre-2018 losses)).

We believe that it would be appropriate to allow a foreign branch's post-2017 income that is not used to reduce the TLA to reduce pre-2018 losses to the extent the corporation would have been able to do so under the 367(a)(3)(C) Regulations.[107]

(c) *Non-Calendar Year Corporations*

Finally, the transition rules refer to losses incurred *prior to* January 1, 2018. For corporations with tax years that are not calendar years, the regulations will therefore need to provide an allocation mechanism for losses incurred in the 2017-2018 tax year between post-December 31, 2017 losses (that are included in the TLA) and pre-January 1, 2018 losses (that are only taken into account to reduce the gain under section 91(c)).

We recommend that the regulations apply the principles of section 382(d)(1) and Treasury regulations section 1.382-6 by analogy. These rules deal with a section 382 change of control that occurs in the middle of a tax year and provide for a ratable allocation of loss between the pre-and

[107] Treas. Reg. § 1.367(a)-6T(e)(2) ("The previously deducted losses shall be reduced by any taxable income of the foreign branch recognized through the close of the taxable year of the transfer, whether before or after any taxable year in which losses were incurred.").

post-change period or, at the taxpayer's election, allow for an allocation based on a closing of the books.

F. Basis Issues

1. Section 91(e)

Section 91(e) provides a grant of regulatory authority with respect to the basis consequences of section 91 recapture:

> Consistent with such regulations or other guidance as the Secretary shall prescribe, proper adjustments shall be made in the adjusted basis of the taxpayer's stock in the specified 10-percent owned foreign corporation to which the transfer is made, and in the transferee's adjusted basis in the property transferred, to reflect amounts included in gross income under this section.

The section thus suggests that Congress believed it would be proper, in at least some circumstances, for adjustments to be made *both* to the transferor's outside basis in the stock of the foreign corporation, as well as the transferee corporation's inside basis in the property transferred. However, neither the statute nor the legislative history elaborate as to what adjustments would be proper under what situations. Former section 367(a)(3)(C) did provide for an inside and outside basis adjustment,[108] but these authorities are not necessarily determinative since former section 367(a)(3)(C) denied tax-free treatment (and the normal implications as to inside and outside basis followed) whereas section 91 requires inclusion of the TLA (as reduced by gain under section 91(c)).

Because section 91 requires inclusion of income, we believe that the reference in the statute to "adjustments" is a reference only to increases in basis. That is, a taxpayer should not be required to reduce basis on account of an income inclusion. Accordingly, questions include (1) which basis should be increased, and (2) by how much should it be increased?

This section of the Report describes issues and possible approaches in the context of (i) transfers where the section 91 income is less than the built-in gain in the assets, which should be the case only if nonrecognition transfers (*i.e.*, transfers of intangibles or stock or securities) are involved, and then (ii) other transfers.

2. Section 91 Income is Less Than the Unrecognized Built-In Gain in Assets

> **Example 7**: USP, a domestic corporation, has a branch operating a business (B) in country X. B's only appreciated assets are intangibles with a fair market value (FMV) of $200, in which USP has a basis of $100.
>
> - In Year 1, B generated $20 of gross income (and cash) and its sole expense is salaries of $60. In order to pay B's employees, USP transfers $40 to B, which then uses the $20 of cash from its own operations and

[108] Treas. Reg. § 1.367(a)-6T(i) (references to Treas. Reg. § 1.367(a)-1T(b)(4)(ii) which shows inside and outside basis adjustment).

$40 from USP to pay salaries. Because B is a branch, the $40 injection is disregarded for U.S. tax purposes and does not affect USP's basis in B's assets. USP takes a deduction of $60 for the payment of salaries by B, resulting in a net loss for the year of $40 (*i.e.*, $20 of gross income less $60 of salaries).

- In Year 2, USP transfers B to a newly formed corporation (FC) that is wholly owned by USP.

- Taxation of incorporation: no gain is recognized since the intangibles will receive section 367(d) treatment. However, section 91(a) provides that USP takes into income the $40 of losses that had been deducted in Year 1 against USP's other income, so USP has $40 of income.

There are at least three approaches to deal with this situation:

Approach A: No adjustments. Under this approach, neither the transferor's outside basis in the stock of the foreign corporation, nor the transferee corporation's basis in the assets transferred, would be increased. In the case of a true economic loss (and where the transferred business may not in fact generate offsetting profits), denying both the transferor and transferee any benefit of that loss seems to us unduly harsh. This approach would also be inconsistent with the language of section 91(e), which refers to an adjustment in inside and outside basis.

Finally, this approach would put the transferor in a worse position than it would be had the business been operated as a corporation all along. If FC had conducted B as a corporation from the start then USP would have increased its basis in FC stock for the $40 that it contributed in Year 1 to FC to pay salaries. In addition, FC would have obtained the benefit of a $40 deduction. Since FC is a CFC, that deduction could have reduced USP's GILTI and/or subpart F income. In other words, USP would have (i) a basis in its shares of FC that is higher by $40, and (ii) would have realized a tax benefit that would have offset taxable income.

Approach B: Inside and outside adjustments. Under this approach, both the basis of the foreign corporation stock in the hands of the transferor *and* the foreign corporation's basis in the assets transferred would be increased. This approach comes closest to placing the transferor in the same position that it would have been in had the business been operated in corporate form all along. Of course this is rough justice—it may be that the $40 of deductions would have been more valuable to USP in year 1, or alternatively that the $40 increase in basis is more valuable to USP because it gives USP control over the use of the attribute. Post-TCJA, a loss of a CFC that is not used in a current year to offset subpart F income or GILTI has only limited value.[109]

Approach C: Increase outside basis. Because section 91 is not a gain recognition provision but a recapture provision, this approach would have the benefit of consistency with the treatment

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109 Treas. Reg. § 1.952-2(c)(5) (in determining taxable income of a foreign corporation, capital loss and net operating loss carryforwards are ignored). Subpart F income is limited to current year earnings and profits and, in some limited cases, prior year deficits can reduce such amount (section 951(c)(1)).

Similarly, for GILTI purposes, tested income refers to the definition of gross income under Treas. Reg. §

of nonrecognition transfers elsewhere in subchapter C. It would also have the benefit of ensuring that the basis (and potential loss or reduction in income) be available to the transferor corporation that incurred the section 91 income (as opposed to being allocated among other parties for instance).

Ultimately, however, we believe that denying an inside basis increase will in most cases be unduly harsh. First, the transferring corporation in the case of section 91 recapture has in fact incurred a real economic loss and the offsetting benefit that the transferring corporation could realize through an increase in outside basis may not be realized for a long time, if at all, and may have a different character (capital loss). Second, there is a strong connection between the section 91 income and the transferred assets. In many cases, basis in the assets generating the recaptured losses will have been reduced as a corollary to the transferring corporation taking the deductions now being recaptured (*e.g.*, if the prior year losses were due to depreciation deductions on a building), the assets will have diminished in value (*i.e.*, the transferring corporation will have suffered a real economic loss), or both. Finally, section 91(e) does indicate that there would be situations in which there could be proper adjustments to both inside *and* outside bases, and this approach of adjusting only outside basis would imply that inside basis would never be adjusted.

For the reasons discussed above, we would recommend Approach B, at least if the foreign corporation is a CFC after the section 91 transfer.

3. Other Transfers.

In most section 91 transfers, the section 91 income will exceed the unrecognized gain in the assets, because post-TCJA, most transfers of a foreign branch's assets will be taxable such that the transferee corporation should already have a fair market value basis in the assets before section 91 even applies. In these situations, the question becomes what basis adjustment should be made.[110]

Applying Approach B would create a built-in loss both in the transferor's basis in its shares of the transferee foreign corporation and in the transferee's basis in its assets. This could create a potential for inappropriate tax planning at either level or both levels. We would recommend that both inside and outside basis be increased by the amount of the section 91 income, but that the transferee corporation's inside basis should be limited to the fair market value of the assets.[111]

We have considered whether taxpayers should be given a choice similar to that provided by section 362(e)(2) in the context of section 351 transactions. Section 362(e)(2) provides the taxpayer with the choice between a built-in loss in the outside or inside basis. We do not believe such a choice would be appropriate here. First, allocating incremental inside basis (equal to the section 91 income) in excess of fair market value to the corporation's assets would create novel

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1.952-2 without modification for loss carryovers (Treas. Reg. § 1.951A-1(c)).

110 This issue could also present itself in a nonrecognition transfer where the section 91 income exceeds the built-in gain in the assets.

111 While the increase in the basis of the transferee corporation's stock does create a built-in loss, as described above in Part IV.F.2, this is related to a genuine economic loss and does not create the same potential for inappropriate tax planning.

and complex issues not addressed by basis allocation mechanisms used in other contexts. For instance, the section 1060 rules (which apply to allocate the consideration paid in certain asset acquisitions) allocate value to transferred assets only up to such assets' fair market value. There is no mechanism (or asset category) to allocate a built-in loss to, and so it is difficult to determine in which particular asset the corporation would have this excess basis. Second, permitting inside basis in excess of fair market value would have the potential of improperly shifting the benefit of losses among taxpayers if the transferring domestic corporation does not wholly own the transferee foreign corporation (whereas limiting the basis to the assets' fair market value puts them in the same position they would be in if the corporation had purchased the assets).

4. Cash Transfers

One final issue is what should be done in situations where section 91 applies even though no shares are issued to the transferring domestic corporation. As discussed in Part IV.C.1, above, section 91 does not require that the consideration for the transfer include equity. What matters is whether the transferring domestic corporation is a United States shareholder of the transferee corporation after the transfer.

> **Example 8**: same as example 7 above, except that USP sells B to FC for cash, and USP owns 50% of FC.

Since the section 91 recapture is caused by USP's existing ownership in FC, it would seem appropriate for USP's basis in its existing shares in FC to be increased by the section 91 income.[112]

G. Coordination With Other Loss Recapture Provisions

The OFL rules of section 904(f) and the DCL rules of section 1503(d) address branch losses and require specific coordination with section 91. The existing OFL and DCL regulations address their interaction with former section 367(a)(3)(C) and should be revised to refer to section 91. However, further coordination is needed.

1. Section 904(f)(3) and Section 91(d)

Under section 91(b)(2)(B), the TLA is reduced by any gain recognized under the OFL recapture rules of section 904(f)(3). The statute thus provides an ordering rule. However, as discussed below, we recommend further coordination in light of the sourcing rules of section 91(d).

Under section 904(f)(3), if a U.S. taxpayer disposes of property which has been used in a foreign trade or business, then the taxpayer is generally required to recognize as U.S. source

[112] Because section 91 requires only that the transferring domestic corporation be a United States shareholder of the transferee foreign corporation, it does not require a direct ownership link. Indirect and constructive ownership may suffice. Accordingly, the guidance will need also to address adjustment to basis in these cases.

income an amount equal to the lesser of its OFL and the gain in the property, regardless of most non-recognition provisions.

Section 91(d) treats the remainder of the branch losses (*i.e.*, the section 91 income) as U.S. source income. This sourcing rule was also in the Camp Bill (which would have also amended section 367(a)(3)(C) to treat the gain as U.S. source), but there is nothing in the TCJA legislative history or the Camp Bill history which explains the purpose of this sourcing rule.

The U.S. source treatment under section 91(d) seems particularly harsh as section 904(f)(3) is already designed to recapture foreign branch losses that have offset U.S. source income (because the OFL account is designed to measure the foreign source losses that did in fact reduce U.S. source income). In fact, as discussed in Part III.A.1, above, former section 367(a)(3)(C) was specifically enacted to address the situation where losses offset *foreign source* income and, prior to that, Revenue Ruling 80-163 (which, as discussed, was the first ruling to require a recapture of all foreign branch losses in excess of gain) characterized the recapture income as foreign source income. If the goal of section 91 is to recapture a past benefit granted by the U.S. tax system (under a "tax benefit" approach) then recapturing the income as foreign source income is sufficient. Doing so reverses the prior benefit because section 904(f)(3) has already applied to resource the portion of the prior losses that offset U.S. source income.[113]

> **Example 9**: US corporation P is formed in 2018. It operates (i) in the United States, (ii) a branch in country X, and (iii) a branch in country Y.
>
> On December 31, 2019, P contributes the assets of the country X branch to S, its newly formed, wholly owned country X subsidiary. At the time of incorporation there is no gain in the branch's assets.
>
> P's and its branches' net income and loss in past years have been as follows:

Year	U.S. source income	Country X branch	Country Y branch	Aggregate branches' income (loss)
2018	$100	$(100)	$200	$100
2019	$100	$(50)	$100	$50

- *OFL*: there is no OFL since P had net foreign source income in each year ($100 in 2018 and $50 in year 2).

113 Separately, coordination with the interest allocation rules of section 861 may be necessary. Under Treas. Reg. § 1.861-9T(g)(3), assets are characterized according to the source and type of the income that they generate, have generated, or may reasonably be expected to generate. The physical location of assets is not relevant to this determination. If the Section 91 income is U.S. source does this mean that part or all of the interest allocated to the branch's assets in the year of a section 91 transfer would become U.S. source? This would be an odd result.

- *Section 91 income*: The section 91 income is $150 (that is $100 (losses from 2018) plus $50 (losses from 2019)).

On incorporation, P recognizes $150 of section 91 income that is U.S. source, so in the aggregate, P would have $350 of U.S. source income, and $150 of foreign source income. If no deduction had been allowed for Country X's losses in the first place, then P would have had in the aggregate, $200 of U.S. source income and $300 of foreign source income.[114] Thus, it appears that section 91 puts the taxpayer in a worse position than if the losses had not been incurred at all.

It may be that Congress provided for U.S. source treatment of section 91 income out of concern that the amount of the OFL recapture under section 904(f)(3), as under former section

[114] This is because in 2018, it would have had $100 U.S. source income and $200 foreign source income, and in 2019, $100 U.S. source income and $100 foreign source income.

We have considered whether the $150 of outside basis increase under section 91(e) (see Part IV.F, above) could provide a remedy under the theory that the built-in loss in the shares of the Country X foreign subsidiary may translate into $150 of U.S. source capital loss in the future which would then rebalance the relative amount of U.S. source and foreign-source income. To illustrate: once the loss in the shares is recognized, ignoring character and timing mismatch, there would be an aggregate of $200 of U.S. source income ($100 from 2018 *plus* $100 from 2019 *plus* $150 of section 91 income *minus* $150 of capital loss) and $150 of foreign source income ($100 of aggregate branch income in 2018 *plus* $50 of aggregate branch income in 2019), and thus $350 of total income.

However, even ignoring the mismatch in character and timing and whether the capital loss can in fact be realized, we still do not believe that the taxpayer would be in the same position as if no deduction had ever been allowed for the Country X branch and the business. If the Country X business had been operated in a foreign corporation from the start, P would also have had $150 of built-in loss in the shares of the Country X foreign corporation on account of the capital contributions to the Country X foreign corporation so when that loss would be recognized, P would have $50 of U.S. source income ($100 in 2018 *plus* $100 in 2019 *minus* $150 of capital loss) and $300 of foreign source income ($200 of Country Y branch income in 2018 *plus* $100 of Country Y branch income in 2019), and $350 of total income.

367(a)(3)(C), is limited by gain in the property transferred, such that some of the losses that are recaptured under section 91 may in fact have offset U.S. source income.

> **<u>Example 10</u>**: US corporation P is formed in 2018. It operates (i) in the United States, and (ii) in country X through a branch. P has no foreign source income outside of the Country X branch.
>
> On December, 31, 2019, P contributes the assets of the Country X branch to S, its newly formed, wholly owned foreign subsidiary. At the time of incorporation there is no gain in the branch's assets.
>
> P's and the branch's income and loss in past years have been as follows:

Year	U.S. source income	Country X branch income (loss)
2018	$100	$(100)
2019	$100	$(100)

- *OFL:* At the end of 2019, P's OFL balance is $200 (that is $100 (losses from 2018) plus $100 (losses from 2019)).
- *Section 91 income*: The section 91 income is also $200 (that is $100 (losses from 2018) plus $100 (losses from 2019)).

Since there is no gain in the assets transferred, section 904(f)(3) will not apply to resource the OFL on incorporation.

Section 91 on the other hand will require recognition of $200 of section 91 income. Section 91 operates therefore in this fact pattern to recapture losses which have in fact offset U.S. source income.

However, if nothing further is done, then the OFL recapture rules will operate in 2019 or subsequent years to recapture an additional $200 of foreign source income as U.S. source income.[115] As a result, the very same $200 of losses generated by the Country X branch which

115 Presumably, absent any further coordinating rule, a taxpayer would obtain some relief if the taxpayer has an overall domestic loss ("**ODL**") under section 904(g), because then the lesser of such ODL and 50% of the taxpayer's U.S. source income for the year (including the section 91 income) would be recharacterized as foreign source income under section 904(g)(1). However, this relief only arises if the taxpayer has an ODL.

Furthermore, the recharacterization of the income as foreign source income would still generate the incorrect amount of foreign source as compared with U.S. source income. The ODL account reflects a taxpayer's *domestic* losses that have offset foreign source income. The TLA that exceeds the OFL amount that is recaptured under section 904(f)(3) will (assuming the gain limitation under section 904(f)(3) does not apply) generally equal the *foreign source* losses that have offset foreign source income (particularly if our recommendation to coordinate guidance on section 904(d) with section 91 in Part IV.D.1 is adopted such that the TLA can, by definition, include only foreign source deduction or loss).

offset $200 of U.S. source income will result in $400 of U.S. source income. In order to avoid this result, the OFL balance would have to be reduced by the section 91 income.

We would recommend a reduction in the taxpayer's OFL balance to the extent it is attributable to the branch losses which are recaptured under section 91. That is, in cases where the gain limitation of section 904(f)(3) applies to limit the amount of recapture under section 904(f)(3), the OFL balance should be reduced (but not below zero) by the section 91 income.

As to regulatory authority, neither section 91 nor section 904 has a specific grant of regulatory authority. Further, section 91(b)(2)(B) (in the definition of TLA) provides for a specific coordination of section 91 with section 904(f) (by reducing the amount of the TLA by the amount of gain recognized under section 904(f)(3), but this does not apply when, as in this example, there is no gain). This could be read to indicate that this was the only coordination that Congress intended, and that an additional coordination rule to prevent the duplication of U.S. source income on account of the overlap of section 91 and 904(f) was intentionally not provided by Congress.

On the other hand, the reference to section 904(f) in the definition of TLA is taken directly from former section 367(a)(3)(C). Former section 367(a)(3)(C) did not raise this coordination issue since it was also by definition limited to the gain in the asset. (Thus, pre-TCJA, in the situation described in Example 10 there would have been no OFL recapture and no branch loss recapture under former section 367(a)(3)(C)). Further, there is no indication in the legislative history that Congress considered the interplay of the new sourcing rules of section 91 and the OFL rules or otherwise intended to provide for such a harsh result. Furthermore, the proposed coordination would be narrow. It would not override the general result of section 91(d) or coordinate section 91 and the OFL rules for unrelated losses. Finally, section 7805(a) explicitly empowers Treasury to issue all "needful regulations" including "as may be necessary by reason of any alteration of law." Indeed, Treasury has already used such authority with respect to the changes enacted by the TCJA to address coordination issues.[116] However, if Treasury and the IRS are reluctant to promulgate such regulations here out of concerns of regulatory authority, then we recommend that a statutory amendment be sought.

Accordingly, if the TLA had never been incurred, the domestic corporation would have had more foreign source income and the same amount of ODL. Using the ODL mechanism of section 904(g)(1) to recharacterize the section 91 income as "foreign source income" would not put the taxpayer in the same position as if the TLA had not been incurred. If the TLA had not been incurred, the ODL would remain unchanged, whereas using the ODL mechanism to recharacterize the section 91 income as foreign source income would reduce the taxpayer's ODL account despite the fact that the TLA does not include domestic losses. The justification for this approach is not clear.

116 *See* Treas. Reg. 1.245A-5T and T.D. 9865, 2019-27 IRB 27 ("given the authority in section 245A(g) directing the Secretary to issue such regulations as are necessary or appropriate to carry out the provisions of section 245A, *and the authority under section 7805(a) to issue rules and regulations made necessary by reason of changes in the tax laws,* the temporary regulations under section 245A are designed to ensure that the section 245A deduction operates properly within the context of a closely coordinated set of rules and, as a result, is not available to eliminate the taxation of subpart F income and tested income in these limited circumstances") (emphasis added).

2. <u>Section 1503(d) and Section 91</u>

Under the existing DCL regulations, the amount of a domestic corporation's DCLs is reduced by the amount of any loss recaptured under section 367(a)(3)(C) (or the OFL recapture rules).[117] We recommend two revisions to the DCL regulations to coordinate the repeal of section 367(a)(3)(C) with section 91. First, DCLs should be reduced by the section 91 income. Second, a transfer that triggers a section 91 recapture should not constitute a "foreign use" or a "triggering event" under the DCL regulations.[118]

The DCL rules target the "double dipping" of losses (the DCLs) incurred by a separate unit (including a foreign branch) of a U.S. corporation. Thus, if the separate unit of a U.S. corporation incurs a DCL then the corporation must choose between (i) using such loss against its income from other sources (by making a "domestic use election") or (ii) using any portion of such loss against the income of one or more foreign persons, including foreign corporations that are owned by the U.S. corporation (the regulations refer to this as a "foreign use").[119] Once a domestic use election is made, the taxpayer must certify annually for the five tax years that follow the year in which the relevant DCL was incurred that such DCL has not been the subject of a triggering event.[120]

If a triggering event occurs with respect to a DCL for which a domestic use election has been made, then the taxpayer is required to recapture the entirety of such DCL (the "all or nothing" rule). The amount recaptured is treated as ordinary income and has the same source and character as, and falls within the same separate foreign tax credit categories to which, the items of deduction or loss composing the dual consolidated loss were allocated and apportioned.[121]

The DCL rules are both broader and narrower than the recapture rule of section 91. They are narrower because they focus on ordinary losses. A net capital loss of a separate unit (or combined separate unit, if there are multiple separate units in the same jurisdiction) does not generate a DCL.[122] Similarly, in the case of a transfer of assets, there is generally a triggering event only if as a result of the transfer a foreign person can, under U.S. or foreign tax law, obtain the benefit of the DCLs whereas the application of section 91 does not depend on the transfer of a tax benefit. On the other hand, the DCL rules are broader because they apply to a broader group of entities, not just foreign branches, but also hybrid entities (regardless of whether they operate a

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117 Treas. Reg. § 1.1503(d)-5(c)(4)(iii)(A).

118 Another question that may be worth addressing is whether the recaptured amount under section 91 should be considered to be income of the relevant combined separate unit or unrelated income. This may be relevant if the domestic corporation has a DCL for which it did not make a domestic use election. Since the section 91 income is a recapture of past losses generated by a branch (*i.e.*, a separate unit) it would seem logical that the section 91 income be deemed to be income of the combined separate unit (and thus that a taxpayer be allowed to use a DCL from such combined separate unit and for which no domestic use election has been made to offset such income). *Cf.* Treas. Reg. § 1.1503(d)-5(c)(4)(vi) which attributes DCL recapture income to the separate unit that incurred such DCL.

119 Treas. Reg. § 1.1503(d)-4 and 1.1503(d)-6(d).

120 Treas. Reg. § 1.1503(d)-6(g).

121 Treas. Reg. § 1.1503(d)-6(h)(5).

122 Treas. Reg. § 1.1503(d)-5(b)(2)(i) and Treas. Reg. § 1.1503(d)-5(c)(1)(ii).

branch) and dual resident corporations. The DCL rues also combine all the hybrid entities and branches of a domestic corporation in the same jurisdiction into one "combined separate unit,"[123] such that the DCL that a taxpayer has in a particular jurisdiction may include not only the losses generated by a particular branch but also losses generated by other entities or other branches that operate in the same jurisdiction. Finally, a triggering event or foreign use can occur independent of any transfer (*e.g.*, an election to file a foreign consolidated return with a foreign corporation, or the primary issuance of an interest in a hybrid entity to a foreign person).[124]

Both sets of rules may, however, apply to a transfer of the foreign branch's assets to a foreign corporation. For instance, the incorporation of a foreign branch is both a section 91 event and likely to be a "foreign use" and a per-se "triggering event" under the DCL rules, which may prevent a domestic use election or trigger the recapture of a DCL for which a domestic use election was made.[125] To the extent that section 91 applies, it will require the full recapture of all the net losses generated by the branch, an aspect that was not present in former section 367(a)(3)(C) (which limited the loss recapture to gain realized) and calls for further coordination with the DCL regulations.

Because section 91 will already deny the benefit of any loss claimed in the United States by the transferring U.S. corporation, there would be no possibility of "double dipping" for the loss realized by the foreign branch and there does not seem to be a policy reason to prevent the taxpayer from making a domestic use election with respect to its other, unrelated, losses from the combined separate unit to which the foreign branch belongs or to force the taxpayer to recapture other unrelated losses incurred by other members of the combined separate unit.[126]

When Treasury and the IRS last considered this question in connection with the issuance of the current DCL regulations,[127] they declined to depart from the "all or nothing rule" in light of the administrative complexities involved. We have recommended in our report on the proposed

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123 Treas. Reg. § 1.1503(d)-1(b)(4)(ii).

124 Treas. Reg. § 1.1503(d)-3(a); Treas. Reg. § 1.1503(d)-3(c)(4).

125 Treas. Reg. § 1.1503(d)-6(d)(1)(v) (requiring certification that there has not been a foreign use during the certification period), Treas. Reg. § 1.1503(d)-6(e)(1)(vi) (providing that conversion to a foreign corporation is a triggering event requiring DCL recapture).

126 This would be particularly true if Treasury and the IRS decide to adopt the strict "books and records" approach of the DCL regulations when measuring the TLA (See Part IV.D.1, above) since the foreign branch losses will be essentially the same as the DCL measurement of the branch losses. If the government instead follows our recommendation to apply the section 904(d) approach, it is possible that an item of deduction that is deemed incurred by a branch for foreign tax purposes and therefore by the separate unit for DCL purposes (based on the strict books and records approach of these rules) will be allocated to non-branch income for section 91 purposes. If so, that deduction would not be recaptured under section 91 (but would be under the DCL recapture rules). Nonetheless, we believe that the section 91 rules are uniquely tailored to recapture losses of a foreign branch for which the domestic transferring corporation obtained a benefit, and there would appear to be no reason to force additional recapture or prevent a domestic use election for unrelated losses. If Treasury and the IRS believe that that additional deduction should be limited then the regulations could require the recapture of that additional deduction under the DCL rules (or preclude such deduction to be the subject of a domestic use election) but we do not believe that the "all or nothing" approach of the DCL regulations should apply.

127 T.D. 9315, 2007-15 IRB 891.

regulations issued in December 2018 under section 267A, 245A and 1503(d) that the all or nothing approach be reconsidered in light of the willingness of Treasury and the IRS to follow an item-by-item approach in the anti-hybrid proposed regulations and that Treasury and the IRS redefine foreign use such that a partial use of a DCL results in only a partial foreign use (provided that appropriate evidentiary standards are met).[128]

If Treasury and the IRS do not follow that recommendation then given the complexities already involved in section 91 recapture, the purpose of section 91 to address branch losses specifically, and the recapture under section 91 of all the branch losses, it would seem appropriate to depart from the "all or nothing" rule at least in this context. Indeed, Treasury and the IRS have recently indicated their willingness to revisit certain policy decisions made in the DCL regulations in light of the changes introduced by the TCJA.[129]

H. Coordination of Section 91 and Section 367(d)

As discussed in Part IV.C.1, above, when a U.S. person transfers an intangible to a foreign corporation section 367(d) the transfer can qualify for nonrecognition treatment but the transferor must include in income over time (during each year of the useful life of the property) an amount commensurate with the income attributable to the intangible.

Under former section 367(a)(3), the transfer of an intangible as part of the assets of a foreign branch could be subject to section 367(a)(3)(C) recapture.[130] As a result, all or a portion of the built-in gain in an intangible could be taxed on the transfer of the intangible to the corporation. In such a case, regulations under section 367(d) provided that the gain recognized with respect to the intangible because of the application of former section 367(a)(3)(C) was credited against the income that was required to be recognized under section 367(d).[131] For this purpose, since former section 367(a)(3)(C) applied to all the property transferred (including the section 367(d) property), the rules provided an allocation mechanism. The gain recognized with respect to the intangible (which in turn reduced the section 367(d) income) was measured as the product of (a) the amount of loss that was recaptured (under former section 367(a)(3)(C) and/or section 904(f)) and (b) the ratio of built-in gain from the intangible property to built-in gain from all branch assets.

What should the rule be with respect to section 91? Because section 367(d) creates its own deemed transaction (*i.e.*, contribution of intangible in exchange for a stream of payments), it is difficult to analyze this question through the lens of the hypothetical alternative that we have used in other parts of this Report, namely, if the business had been conducted in corporate form from

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128 New York State Bar Association Tax Section Report No. 1411, Report on Proposed Regulations under Sections 267A, 245A(e) and 1503(d) (February 26, 2019), pages 98-99.

129 Thus, the preamble to the proposed regulations under section 1503(d) (*see supra* note 127) notes that Treasury and the IRS are studying transactions that do not currently raise DCL concerns but raise issues similar to the deduction/non-inclusion addressed by section 245A(e) and section 267A.

130 Treas. Reg. § 1.367(a)-6(c)(4).

131 Treas. Reg. § 1.367(d)-1(g)(3) (note that these regulations can still apply with respect to gain recaptured pursuant to the OFL recapture rules).

the start and the intangible property had been developed by the foreign corporation, there would have been no transfer subject to section 367(d), and thus no deemed royalty.

On the one hand, as discussed in Part III.C, above, section 367(d) operates separately from section 91. Section 91 does not require a recognition of gain but a recapture of past losses. Accordingly, one approach would be to deny the transferring corporation any adjustment to the section 367(d) income inclusion and to rely instead on the inside and outside basis adjustments discussed in Part IV.F to provide a tax attribute for the economic loss that has been recaptured by section 91.

On the other hand, if the purpose of section 91 is to ensure that the United States can tax an amount that is at least equal to the deductions claimed by the foreign branch, there is arguably no reason to further penalize the taxpayer by not reducing the stream of deemed royalty under section 367(d).[132] The section 367(d) payments, although treated as ordinary income and sourced in the same manner as royalty payments, are nevertheless the result of the requirement, imposed by section 367(d), that the transferor treat the exchange as a sale contingent on the productivity, use, or disposition of the intangible. The deemed payment stream under section 367(d) is a substitute for immediate gain recognition, which gain if recognized at the time of the transfer would have reduced the section 91 income.

Absent further coordination, if a taxpayer transfers substantially all of the assets of a foreign branch to a foreign corporation in a transaction subject to section 91, and some (or all) of the assets transferred are intangible property for these purposes, then both rules will apply. Section 91 will recapture losses that were presumably incurred in the development of the relevant assets giving rise to future income, in part motivated by policy concerns that the future income would not be subject to U.S. tax (and without any reduction for recognized gain on the intangible property since the transaction qualifies for nonrecognition under section 367(d)). Simultaneously, section 367(d) will require a deemed royalty stream to the transferor (also meant to ensure that future income from the intangible is subject to U.S. tax). Both of these measures are intended to ensure that the United States can tax at least a portion of the income generated by the intangible—applying both of them without coordination would ultimately subject the taxpayer to double taxation.

It is true that a similar argument could be made with respect to other sources of taxable income from transferee foreign corporations after a section 91 transfer (*e.g.*, full taxation of subpart F income or GILTI if the transferee foreign corporation is a CFC, or full taxation of dividends from transferee foreign corporations that do not qualify for the section 245A dividend). However, section 367(d) is more closely tied to section 91 as the transfer itself is the trigger for both section 367(d) and section 91.

Accordingly, we believe that a mechanism similar to the one that applied for former section 367(a)(3)(C) should apply with respect to section 91, and that the regulations under section 367(d)

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[132] *Cf.* Chief Counsel Advice 200610019. In that CCA, Chief Counsel noted that, on transfer of intellectual property to a foreign corporation in exchange for both non-qualified preferred stock and common stock, there should be some coordination to the recognition of gain under section 351(b) and the application of section 367(d) so that "the simultaneous application of §§ 351(b) and 367(d)) [did not] result[in] double tax [which would] not provide a proper result." The coordination rule adopted by Chief Counsel in that case was for section 367(d) to take precedence, and section 351(b) not to require gain recognition.

should be amended such that, if there is a transfer of a section 367(d) intangible as part of the transfer of assets of a foreign branch and such transfer would qualify for nonrecognition treatment under section 367(d), then (i) the portion of the section 91 income that is attributable to the intangible will be credited against the income that is required to be recognized under section 367(d), and (ii) no outside basis increase will be provided for such amount.

The section 91 income will need to be allocated between the intangible property that is transferred to the branch (and subject to section 367(d)) and the other property. Since section 91 does not use built-in gains as the base for taxing the transferor, and the section 91 income is in fact reduced by the gain recognized in the transfer, it would not seem appropriate to use for this purpose the built-in gain allocation ratio that was used under the coordination rules for former section 367(a)(3)(C). Rather, it would seem appropriate to allocate the section 91 income to the section 367(d) intangible based on the relative fair market value of the assets.

Second, post-repeal of section 367(a)(3), upon a transfer of tangible property and section 367(d) property, (i) the transfer of tangible property will result in the recognition of the built-in gain (which will in turn reduce the TLA), and (ii) the intangible property will not. Thus, if the section 91 income is allocated between the section 367(d) property and the other foreign branch property based only on their relative fair market value there may be an over-allocation of section 91 income to the non-section 367(d) property (*i.e.*, to the tangible property).

> **<u>Example 11</u>**: U.S. corporation (DC) starts a foreign branch in Country X in 2018. On January 1, 2021, it transfers the foreign branch's assets to a wholly-owned foreign subsidiary (FC) in a transaction which, but for the requirements of section 367, would qualify as a section 351 incorporation.
>
> At the time of the transfer, the TLA is $200. The foreign branch has (i) section 367(d) intangibles, that will be subject to section 367(d) treatment, with a value of $100 and $0 of basis, and (ii) other property with a value of $100 and $0 of basis.
>
> Upon the incorporation, $100 of gain is recognized, and the section 91 income is $100 (*i.e.*, TLA of $200 *minus* $100 of gain recognized). Section 367(d) applies to the $100 of intangible that have been transferred.

How should the section 91 income be allocated between the section 367(d) property and the non-section 367(d) property?

As noted, one approach would be to allocate the $100 of section 91 income based on relative fair market value (which here is equal for the two categories). Thus, $50 of section 91 income would be allocated to the section 367(d) property (and would reduce future section 367(d) income) and $50 would be allocated to the other property.

However that approach would over-allocate section 91 income to the non-section 367(d) property. Of the $200 of TLA, $150 of losses in total would be allocated to the non-section 367(d) property ($100 because of the gain recognition in the non-section 367(d) property, and $50 because of the allocation of section 91 income). By contrast, only $50 of the TLA would be allocated to the section 367(d) property, despite the fact that the section 367(d) property and the non-section 367(d) property had both the same fair market value and same amount of built-in gain.

Accordingly, we recommend that the section 91 income that is allocated to the section 367(d) property be equal to the product of (i) the TLA (*i.e.*, the section 91 income before any reduction for gain under section 91(c)) and (ii) the ratio of (x) the fair market value of the section 367(d) property, to (y) the fair market value of all of the foreign branch's assets that are transferred to the foreign corporation. The amount so allocated however would be capped at the amount of section 91 income.

Applying this formula to Example 11, the section 91 income that is allocated to the section 367(d) property, and thus that reduces future section 367(d) income, would be $100 (*i.e.*, $200 of TLA *multiplied* by the ratio of $100 of fair market value of section 367(d) property and $200 of fair market value of the branch's assets that were transferred to FC).