**REPORT #707**

## TAX SECTION

# New York State Bar Association

REPORT ON PROPOSED SECTION 367(a) AND (b) REGULATIONS

## Table of Contents

Cover Letter: ..... i
I. Introduction ..... 1
II. Summary of Comments and Recommendations ..... 4
III. Detailed Comments and Recommendations ..... 14
A. Section 1.367(a)-3 ..... 14
Summary of Regulation ..... 14
Comments ..... 19
1. General/Transfers to Certain CFCs ..... 19
2. 351/"B" Reorganization Overlap ..... 21
3. Indirect Transfers ..... 25
4. Active Trade or Business and Same-Country Exceptions for Stock and Securities ..... 28
5. Deemed Dispositions ..... 32
6. Technical Comments ..... 33
B. Section 1.367(a)-8 ..... 33
Summary of Regulation ..... 33
1. Time and Measure of Income Inclusion, Appropriateness of Interest Charge and the Offset Rule ..... 37
2. Ratable Disposition of Transferred Property ..... 40
3. Partial Dispositions ..... 41
4. Reasonable Cause. ..... 41
5. Effective Date ..... 41
C. Section 1.367(b)-1 ..... 42
Summary of Regulation ..... 42
Comments ..... 43
1. Scope of Regulations ..... 43
2. Elections ..... 44
3. Notice Requirement ..... 44
D. Section 1.367(b)-2 ..... 45
Summary of Regulation ..... 45
Comments ..... 47

1. Definitions. ....................................................47
2. Foreign Currency Rules ............................................48
3. Technical Comment .................................................51
E. Section 1.367(b)-3 ....................................................51
Summary of Regulation ..................................................51
Comments ...............................................................55
1. General ...........................................................55
2. Currency Exchange Gain and Loss on Capital..........................59
3. Same-Country Dividend Treatment......................................60
4. Technical Comment ...................................................60
F. Section 1.367(b)-4 ....................................................61
Summary of Regulation....................................................61
Comments ...............................................................63
G. Section 1.367(b)-5 ....................................................65
Summary of Regulation ..................................................65
Comments ...............................................................69
1. General ...........................................................69
2. Gain Recognition Election ..........................................70
3. Definition of Pre-distribution Amount...............................70
4. Technical Rules for Non-Pro Rata Distributions......................72
5. Special Earnings and Profits Rules..................................72
H. Section 1.367(b)-6 ....................................................72

Tax Report #707

**TAX SECTION**

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January 24, 1992

The Honorable Fred T. Goldberg, Jr.
Commissioner of Internal Revenue
1111 Constitution Avenue, N.W.
Washington, D.C. 20024

Dear Commissioner Goldberg:

I enclose our report on the proposed section 367(a) and (b) regulations. The principal author of the report is Philip R. West.

As detailed in the report, we believe the proposed regulations are a substantial improvement over the temporary regulations which they would replace. We recommend, however, a number of changes.

In particular, we recommend that if gain is triggered by a disposition of transferred stock following an outbound transfer under section 367(a), the amount recognized by the initial transferor should be included in income in the year of the subsequent disposition, not in the year of the initial transfer. As in the case of a deferred intercompany transaction under the consolidated return rules, no interest charge or amended return would be required.

With respect to the proposed regulations under section 367(b), we recommend abandonment of the mandatory gain recognition rule for less-than-10% exchanging U.S. shareholders participating in inbound asset transfers. We also recommend alternatives to the gain recognition election for non-exchanging shareholders in certain section 355 transactions.

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The report makes numerous other substantive and technical comments.

We would be pleased to discuss the report and its recommendations with you or your staff.

Very truly yours,

James M. Peaslee
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Enclosure

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Tax Report #707

# NEW YORK STATE BAR ASSOCIATION TAX SECTION

# REPORT ON PROPOSED SECTION 367(a) AND (b) REGULATIONS

NEW YORK STATE BAR ASSOCIATION TAX SECTION

# Report on Proposed Section 367(a) and (b) Regulations[1]

This report comments on regulations proposed on August 23, 1991, under sections 367(a) and (b) of the Code (the "Proposed Regulations"). The Proposed Regulations would modify and replace the current regulations under section 367(a) to the extent that they address transfers of stock and securities. The Proposed Regulations would replace entirely the current regulations under section 367(b), except for certain transitional purposes.

## I. Introduction

Sections 367(a) and (b) prescribe special rules affecting non-recognition transactions involving foreign corporations whose status as corporations is required for non-recognition treatment.[2] Section 367(a) applies to "outbound" transactions. Section 367(a)(1) generally provides that foreign corporations acquiring property from U.S. persons will not be treated as corporations for purposes of determining the

[1] This report was prepared by an Ad Hoc Committee chaired by Stanley I. Rubenfeld and Esta E. Stecher and composed of Leo Arnaboldi, Reuven Avi-Yonah, Robert Feinschreiber, Arnold J. Fries, Deborah J. Jacobs, Pinchas Mendelson, Stanislaus S. Mroczkowski, Kevin Rowe, Rene C. Schlag, Lawrence E. Shoenthal and Philip R. West. The report was drafted by Philip R. West. Helpful comments were received from Peter Canellos, Kevin Clancy, John A. Corry, John B. Duncan, Alfred C. Groff, J. Roger Mentz, James M. Peaslee, Michael L. Schler, David Sicular and Henry N. Winters.

[2] Section 367(a) applies to outbound exchanges described in section 332, 351, 354, 356 or 361. (Although section 367(a) literally applies to section 332 exchanges, section 367(e)(2) overrides section 367(a) with respect to such exchanges.) Section 367(b) applies to inbound and foreign-to-foreign exchanges described in those sections as well as exchanges described in section 355.

applicability of the enumerated non-recognition provisions (the "367(a) Recognition Rule"). Section 367(b) applies to "inbound" and "foreign-to-foreign" transactions. Section 367(b)(1) generally provides that foreign corporations will be treated as corporations with respect to transactions that are not described in section 367(a)(1). Both sections 367(a) and (b) are subject to exceptions to the extent provided in regulations.

The Treasury has promulgated temporary regulations (the "Temporary Regulations") under sections 367(a) and (b).[3] Pursuant to authority granted by section 367(a),[4] the Temporary Regulations provide several exceptions to the 367(a) Recognition Rule. For example, gain realized on the transfer of stock or securities in a transaction described in section 367(a)

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[3] T.D. 8087 (May 16, 1986) (section 367(a)); T.D. 7530 (Dec. 27, 1977) and T.D. 7646 (Oct. 2, 1979) (section 367(b)). The Temporary Regulations were amended in T.D. 7863 (Dec. 23, 1982), T.D. 8087, supra, T.D. 8243 (March 3, 1989) and T.D. 8280 (Jan. 12, 1990).

[4] "[Section 367(a)(1)] shall not apply to the transfer of any property which the Secretary, in order to carry out the purposes of this subsection, designates by regulation." Code S 367(a)(6). The Temporary Regulations under section 367(a) are also issued under the authority of section 7805. T.D. 8087, supra. It has been suggested that the Temporary Regulations under section 367(a) relating to the transfer of stock and securities are issued under the authority of section 367(a)(3) (presumably in conjunction with the general authority of section 7805) and that, therefore, all transfers governed by such regulations are subject to the limitation in section 367(a)(5). It would seem clear that because the Proposed Regulations do not contain an active trade or business exception for stock and securities transfers, section 367(a)(3) cannot provide a basis for the Proposed Regulations. Therefore, and because the general rule of section 367(a)(2) is not incorporated in the Proposed Regulations, the limitation in section 367(a)(5) would appear to be inapplicable to transfers governed by the Proposed Regulations. It would be helpful if the Proposed Regulations so stated. If, as we recommend at Section III(A)(4) below, the active trade or business exceptions for stock and securities transfers are retained, the Proposed Regulations should state that they are not promulated under the authority of section 367(a)(2) or 367(a)(3), and section 367(a)(5) does not apply to stock and securities transfers, except with respect to transfers described in section 367(a)(2) or 367(a)(3).

is recognized in only specified circumstances. In Notice 87-85,[5] issued on December 16, 1987, the I.R.S. modified the Temporary Regulations relating to stock and security transfers. The Proposed Regulations generally codify Notice 87-85.

Pursuant to authority granted by section 367(b),[6] the Temporary Regulations provide an elaborate set of rules governing the circumstances under which a foreign corporation will be considered to be a corporation in connection with certain non-recognition exchanges not described in section 367(a). These rules require income inclusions measured by various amounts and attribution of earnings and profits and other accounts from transferred stock to stock received in a reorganization. The Proposed Regulations generally simplify the inclusion rules and eliminate the attribution rules.

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[5] 1987-2 C.B. 395.

[6] Section 367(b)(1) prescribes a general rule allowing non-recognition "except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes." Section 367(b)(2) provides further that:

> The regulations prescribed pursuant to paragraph (1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing --
>
> (A) the circumstances under which --
>
> (i) gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both, or
>
> (ii) gain or other amounts may be deferred for inclusion on the gross income of a shareholder (or his successor in interest) at a later date, and
>
> (B) the extent to which adjustments shall be made to earnings and profits, basis of stock or securities, and basis of assets.

The section 367(b) Temporary Regulations are also issued under the authority of section 7805. T.D. 7646, supra.

A summary of our comments and recommendations on the Proposed Regulations is set forth in the following section. Our detailed comments and recommendations then follow, organized by regulation section.

## II. Summary of Comments and Recommendations

We believe that the Proposed Regulations are a substantial improvement over the Temporary Regulations. The Proposed Regulations simplify Temporary Regulations that are generally complex and, in some respects, are extraordinarily so. Moreover, where the Proposed Regulations reach results that are adverse to taxpayers, they generally do so to address legitimate concerns of the Treasury. We are encouraged that the preamble to the Proposed Regulations expressly seeks comments on several controversial points. We also found useful the preamble's discussion of the broad policy goals of the Proposed Regulations.

We believe, however, that in several instances the Proposed Regulations reach results that are inappropriate. Among these are (i) the treatment of outbound transfers of domestic stock to foreign corporations more-than-50% owned by any U.S. person,[7] (ii) removal of the active trade or business and same-country exceptions to section 367(a)(1) insofar as such exceptions apply to stock or securities,[8] (iii) the consequences of triggering a gain recognition agreement,[9](iv)the mandatory gain recognition rule for less-than-10% exchanging shareholders that are U.S. persons participating in inbound asset transfers[10]

[7] See infra Section III(A)(1).

[8] See infra Section III(A)(5).

[9] See infra Section III(B)(1).

[10] See infra Section III(E)(1)(b).

and (v) the gain recognition election for non-exchanging shareholders in certain section 355 transactions.[11] A summary of our recommendations is as follows:

1. Transfers to Certain CFCs. Notice 87-85 contains a flat rule providing that no outbound transfer of domestic stock by a single U.S. transferor that owns more than 50% of the transferee foreign corporation immediately after the transaction will qualify for non-recognition treatment. The Temporary Regulations contain exceptions to this rule.[12] The Proposed Regulations are as restrictive, if not more restrictive than the Notice.[13] We do not understand why all outbound transfers of domestic stock by greater-than-5% shareholders should be taxable solely because a single U.S. person owns, possibly through attribution, more than 50% of the transferee after the transaction. An appropriate gain recognition agreement would protect against avoidance of tax. Accordingly, we disagree with the per se rule of the Proposed Regulations.

2. "Indirect" Transfers. The Temporary Regulations characterize certain transfers of the stock or assets of domestic corporations as "indirect" outbound stock[14] transfers.

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[11] See infra Section III(G)(2).

[12] See, e.g., Temp. Reg. § 1.367(a)-3T(c)(2) (active trade or business exception).

[13] The Proposed Regulations deny non-recognition treatment if any U.S. person owns more than 50% of the transferee foreign corporation. Prop. Reg. § 1.367(a)-3(b)(3). It is unclear whether the use of the word "person" rather than "transferor" is intended to change the rule of the Notice. It is also unclear whether there is any situation in which this change would make a difference.

[14] Temp. Reg. § 1.367(a)-1T(c)(2) through (7).

Specifically, the Temporary Regulations state that such transfers "include" triangular type A, B and C reorganizations involving domestic targets where the shareholders of such targets receive stock of a foreign parent of the acquiring corporation.[15] The Proposed Regulations expand this rule to include triangular type b and C reorganizations where the target is a foreign corporation.[16] The Proposed Regulations also re-characterize other transactions as indirect outbound stock transfers. For example, a section 351 transfer of assets by a U.S. person to a foreign corporation that transfers the assets to a second corporation that is 80% owned by the foreign corporation is characterized as an indirect transfer of the stock of the second corporation to the foreign corporation.[17]

We do not object to these changes, but recommend a clarification regarding the use of the word "include" in the Temporary Regulations. The Proposed Regulations should state that transactions subject to the Temporary Regulations, and not the Proposed Regulations, will be treated as indirect transfers subject to section 367(a) only if they are explicitly described in the Temporary Regulations. That is, although the Temporary Regulations may be interpreted to apply to transactions such as the "double drop-down" described in the previous paragraph, they should not be so interpreted. If abuse is a concern, the Proposed Regulations could contain an effective date of August 26, 1991 with respect to this provision. Alternatively, the Proposed

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[15] Temp. Reg. § 1.367(a)-1T(c)(1), (2).

[16] Prop. Reg. § 1.367(a)-3(d)(1)(i) through (iv).

[17] Prop. Reg. § 1.367(a)-3(d)(1)(iv).

Regulations should state that no inference is to be drawn there from regarding whether a transaction subject to the Temporary Regulations, and not the Proposed Regulations, is an indirect outbound stock transfer.

3. Active Trade or Business and Same-Country Exceptions. The Proposed Regulations eliminate the Temporary Regulations' active trade or business exceptions for transfers of stock and securities. Among those eliminated exceptions is one[18] for a stock constituting an operating asset under the principles of the Kaiser Aluminum case.[19] We recommend that these exceptions be retained and expanded so that they are governed by the rules generally applicable to assets transferred in connection with the active conduct of a trade or business outside the U.S., and not the rules applicable to stock and securities transfers. Thus, no gain recognition agreement should be required.

The Proposed Regulations also eliminate the Temporary Regulations' “same-country” exception to the 367(a) Recognition Rule. We believe that the exception for same-country transfers should be retained.

4. Time and Measure of Gain Under Gain Recognition Agreements. The Temporary Regulations[20] and the Proposed Regulations[21] state that if a gain recognition agreement is triggered, the measure of the gain will be the gain realized but unrecognized at the time of the initial transfer, and such

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18 Temp. Reg. § 1.367(a)-3T(e)(2).

19 Kaiser Aluminum Chemical Corp. v. C.I.R., 76 T.C. 325 (1981).

20 Temp. Reg. § 1.367(a)-3T(g)(3)(i).

21 Prop. Reg. § 1.367(a)-8(b)(2).

recognized gain will be included in income on an amended return for the year of the initial transfer. Interest is imposed with respect to any resulting underpayment of tax.

We agree that gain recognized by the initial transferor upon the triggering of a gain recognition agreement should be measured by the amount of the gain realized but not recognized on the initial transfer. We recommend, however, that the gain be taken into account in the year of the subsequent disposition, as in the case of a deferred intercompany transaction. This would eliminate both the interest charge and the amended return requirement.

5. The “Offset” Rule. The Temporary[22] and Proposed[23] Regulations governing outbound stock and securities transfers may be interpreted to require that an NOL be available in the year of the income inclusion for it to be usable. For example, if a U.S. transferor transfers stock to a foreign corporation in year one and the foreign corporation sells the stock in year five, an NOL arising in year one could offset the gain included by the U.S. transferor in year one, but an NOL arising in year two arguably could not. We recommend that the regulation be clarified to foreclose this interpretation. We do not see any compelling policy reason why the general NOL carryover and carry-back rules should not be available to taxpayers.[24]

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22 Temp. Reg. § 1.367(a)-3T(g)(3)(i). The Temporary Regulations apply the same rule to credits, but not capital losses.

23 Prop. Reg. § 1.367(a)-8(b)(2)(v). The Proposed Regulations apply to credits and capital losses, as well as NOLs.

24 If the previous recommendation (deferred gain treatment) is adopted, the offset rule would not be relevant.

6. The "Fungibility" Rule. Unlike the Temporary Regulations, the Proposed Regulations provide that where a transferee of shares subject to a gain recognition agreement sells any such stock or stock fungible therewith, the sale is deemed made out of the shares subject to the gain recognition agreement in at least the same proportion that the shares sold bear to the total of the shares sold and those retained.[25]

In general, we think that taxpayers should be able to designate which shares they want to dispose of, as they are able to do under the general tax rules relating to dispositions of stock[26], but we recognize that abuses are possible in limited circumstances. For example, if a U.S. transferor owned all of the stock of a corporation and transferred that stock to a foreign corporation in a section 351 transaction, the transferred corporation could then issue new stock that would dilute to a de minimis value the transferred stock and the transferee could sell the new stock while retaining the transferred stock. The fungibility rule is not limited to these potential abuses, however, and the potential abuses do not warrant such a drastic deviation from the generally applicable rule.

7. Effective Date (Section 367(a)). Prop. Reg. §§ 1.367(a)-3 and -8 contain rules relating to outbound transfers of stock or securities. In general, the rules relating to gain recognition agreements are in Prop. Reg. § 1.367(a)-8, although special rules relating to transfers of stock or securities are in Prop. Reg. § 1.367(a)-3. Prop. Reg. § 1.367(a)-8 contains a new reasonable cause exception to the "denial of non-recognition treatment" sanction for failure to enter into or comply with the

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[25] Prop. Reg. § 1.367(a)-8(b)(2)(iii).

[26] Reg. § 10l2-1(c).

terms of a gain recognition agreement.[27] Prop. Reg. § 1.367(a)-3 is electively retroactive to December 16, 1987, the date of Notice 87-85,[28] while Prop. Reg. § 1.367(a)-8 is not retroactive.[29]

Retroactive application of only one portion of interrelated rules adds confusion and complexity to the tax law. Moreover, retroactive reasonable cause relief is desirable. Therefore, taxpayers should be able to elect retroactive application of Prop. Reg. § 1.367(a)-8.

8. Certain Definitions. The Temporary Regulations define "all earnings and profits amount" by reference to amounts "attributable to the stock of the foreign corporation exchanged under the principles of section 1246 or 1248 (whichever is applicable) and the regulations under that[30] section." The Proposed Regulations define "all earnings and profits amount" to include earnings and profits attributable to periods when the foreign corporation was not a CFC.[31] Moreover, this change is effective for exchanges that occur on or after August 26, 1991.[32] We do not object to this change. We recommend, however, that it be effective with the rest of the section 367(b) rules, i.e., 30 days after the regulations are finalized.

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[27] Prop. Reg. § 1.367(a)-8(h)(2).

[28] Prop. Reg. § 1.367(a)-3(f).

[29] Prop. Reg. § 1.367(a)-8(1).

[30] Temp. Reg. § 7.367(b)-2(f).

[31] Prop. Reg. § 1.367(b)-2(d)(3).

[32] Prop. Reg. § 1.367(b)-2(d)(4).

The Temporary Regulations define “United States shareholder” as a person who satisfies the ownership requirement of section 1248(a)(2) or 1248(c)(2).[33] The Proposed Regulations define the term without regard to whether the foreign corporation in which such United States shareholder owns stock is a CFC.[34] We do not object to this change.

9. Section 985 Adjustments in Section 367(b) Transactions. Under the Proposed Regulations, the adjustments described in Reg. § 1.985-5T must be made on the occurrence of a transaction described in section 381(a) in which the acquiring corporation has a functional currency different from that of the acquired corporation.[35] These adjustments generally require that gain or loss be taken into account with respect to section 988 transactions and, in certain circumstances, that the acquired corporation re-compute its net capital and profits in a new functional currency. We recommend that these rules be applicable only where the qualified business (“QBU”) that is transferred changes its functional currency in connection with the transaction.

10. Mandatory Gain Recognition by Certain Exchanging Shareholders. Under the Proposed Regulations relating to inbound asset transfers subject to section 367(b), less-than-10% exchanging shareholders that are U.S. persons must recognize gain, but not loss, on inbound asset transactions.[36] Thus, for example, gain, but not loss, is recognized by a U.S. person owning less than 101 of the stock of a foreign corporation that

[33] Temp. Reg. § 7.367(b)-2(b).

[34] Prop. Reg. § 1.367(b)-3(b)(1).

[35] Prop. Reg. § 1.367(b)-2(k).

[36] Prop. Reg. § 1.367(b)-3(c).

transfers or is deemed to transfer all its assets to a domestic corporation in exchange for stock of the domestic corporation that is distributed in liquidation of the foreign corporation in a transaction otherwise qualifying as a type C or type F reorganization.

We recommend against this rule. It unnecessarily discriminates against small shareholders.

In any event, if the final regulations require that such shareholders recognize gain, they should also allow recognition of losses realized on the exchange where the shareholders would otherwise be entitled to such losses. In the case of an inbound liquidation, for example, such shareholders would be entitled to recognize their losses in the absence of section 367. There is no reason why section 367 should change this result.

11. Foreign Currency Gain and Loss on Capital. With respect to inbound asset transfers subject to section 367(b) (such as liquidations of foreign subsidiaries), the Proposed Regulations[37] follow regulations under section 987 that take into account foreign currency gain or loss on capital in certain circumstances.[38] The theory behind this inclusion is that foreign currency gain increases the basis of assets transferred into the U.S. when that basis is recomputed in U.S. dollars. Unless this increased basis is taxed, it improperly decreases any gain when those assets are later sold. Foreign currency loss has the opposite effect. We recommend that instead of requiring that an exchanging shareholder include an amount in income, the final

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[37] Prop. Reg. § 1.367(b)-3(b)(2)(ii).

[38] See Prop. Reg. § 1.987-1,-2,-3; Reg. S 1.987-5.

regulations should require the acquiring corporation to adjust the basis of the assets it acquires in the transaction.

12. Section 355 Transactions. The Proposed Regulations provide for tax at the corporate level on distributions to individuals of foreign stock by domestic corporations, even where the transaction otherwise qualifies as a tax-free distribution under section 355. We recommend against this result.

The Proposed Regulations allow any non-exchanging shareholder in a non-pro rata section 355 distribution by a CFC to elect to treat the entire transaction as taxable.[39] For example, if a CFC distributes the stock of a subsidiary to Shareholder A in a transaction described in section 355, Shareholder B can elect to cause the subsidiary not to be treated as a corporation. Presumably, this election is provided to mitigate the harsh consequences of the Proposed Regulations which provide that, absent such an election, the non-distributee shareholder must include in income the section 1248 amount attributable to its indirect interest in the distributed subsidiary.[40]

We recommend instead a rule requiring such a shareholder to add the section 1248 amount attributable to such indirect interest to its section 1248 amount with respect to the stock of the distributing corporation. Alternatively, the final regulations could provide an election under which such a shareholder may elect to recognize all or a portion of the gain inherent in its stock in the distributing corporation.

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[39] Prop. Reg. § 1.367(b)-5(d)(3)(ii).

[40] Prop. Reg. § 1.367(b)-5(d)(2).

13. Effective Date (Section 367(b)). We believe that the Proposed Regulations under section 367(b) substantially simplify the Temporary Regulations on the same subject. There is no apparent reason why taxpayers should not be allowed to utilize the simplified rules as of the earliest possible time. Therefore, we recommend that taxpayers be able to elect to apply the Proposed Regulations under section 367(b), and not the Temporary Regulations, to exchanges that occur on or after August 26, 1991.

## III. Detailed Comments and Recommendations

### A. Section 1.367(a)-3

#### Summary of Regulation

Notice 87-85 simplified the Temporary Regulations relating to the circumstances under which an outbound transfer of stock or securities subject to section 367(a) would be respected as a non-recognition transaction. In general, Prop. Reg. § 1.367(a)-3 is consistent with Notice 87-85.

The Proposed Regulations distinguish among three categories of U.S. transferors of stock or securities that are potentially subject to section 367(a). Transferors in the first category will never be denied non-recognition treatment. Transferors in this category are those who own (directly, indirectly and constructively) less than 5% (by vote and value) of the transferee foreign corporation immediately after the transaction.[41]

Transferors in the second category will always be denied non-recognition treatment. Transferors in this category are those (other than those in the first category) who transfer stock or

[41] Prop. Reg. § 1.367(a)-3(b)(1)(i). Abroad exception is also provided for certain deemed transfers under section 83. See Prop. Reg. § 1.367(a)-3(e).

securities of a domestic corporation in a transaction in which a single U.S. person owns (directly, indirectly or constructively) more than 50% (by vote or value) of the transferee foreign corporation immediately after the transaction.[42] For this purpose, a U.S. person includes, with respect to any corporation, all members of its affiliated group within the meaning of section 1504(a), but without regard to section 1504(b).[43]

Transferors in the third category are all transferors not in either of the first two categories. Transferors in the third category will not be denied non-recognition treatment under section 367(a) if they enter into a gain recognition agreement.[44]

The Proposed Regulations distinguish between two subcategories of transferors in the third category. Transferors in the first subcategory must enter into five-year gain recognition agreements. Transferors in the first subcategory are those who transfer stock or securities in a transaction in which all U.S. transferors own (directly, indirectly and constructively) less them 50% (by vote and value) of the transferee foreign corporation immediately after the

[42] Prop. Reg. § 1.367(a)-3(b)(3). For example, if A owns 52%, B through K each owns 4% and L owns 8% of the stock of a domestic corporation which is transferred to a newly organized foreign corporation in a transaction described in section 351, A and L will be denied non-recognition treatment and B through K will be accorded non-recognition treatment, in each case without regard to whether a gain recognition agreement has been entered into. Under a literal application of the rule, this would be the result even if A were a foreign corporation, as long as it owned 80% of the stock of a domestic subsidiary and even if the subsidiary owned no stock of the transferee corporation.

[43] Id.

[44] Prop. Reg. § 1.367(a)-3(b)(1)(ii).

transaction.[45] Transferors must affirmatively establish that the condition in the immediately preceding sentence has been met.[46]

Transferors in the second subcategory must enter into ten-year gain recognition agreements. Transferors in the second subcategory are those who transfer stock or securities in a transaction in which all U.S. transferors own (directly, indirectly and constructively) 50% or more (by vote or value) of the transferee foreign corporation immediately after the transaction.[47]

The Proposed Regulations do not adopt the provisions of the Temporary Regulations that create exceptions to the general gain recognition rule of section 367(a) for transfers of stock or securities constituting operating assets, transfers of stock or securities in connection with the consolidation of an integrated business and same-country transfers.[48]

The Proposed Regulations alter the rules governing transfers of foreign stock or securities to foreign corporations described in section 368(a)(1)(B). The Temporary Regulations apply only section 367(b) to such transfers, even when the

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45 Prop. Reg. § 1.367(a)-3(b)(2).

46 Id.

47 Prop. Reg. § 1.367(a)-3(b)(3).

See Temp. Reg. SS 1.367(a)-3T(c)(2), -3T(d)(2), (3). The Proposed Regulations also do not adopt an “anti-abuse” rule contained in the Temporary Regulations and continued in Notice 87-85. That rule provides that no exception to section 367(a) will apply to the transfer of stock of a foreign corporation in which the U.S. transferor is a “United States shareholder” unless the U.S. transferor receives in exchange stock in a CFC as to which the U.S. transferor is a United States shareholder immediately after the transfer. (The Temporary Regulations define United States shareholder by reference to section 951(b); the Notice defines the term by reference to sections 1248(a)(2) and (c)(2).)

transfers are also described in section 351.[49] The Proposed Regulations apply section 367(a) to such transfers and, to the extent that the transferee is respected as a corporation under that section, they also apply section 367(b).[50]

A gain recognition agreement entered into under the Proposed Regulations will be triggered if the transferee foreign corporation disposes of the transferred stock or securities.[51] Generally, the transferee foreign corporation is deemed to dispose of the transferred stock or securities if the transferred corporation disposes of "substantially all" of its assets (within the meaning of section 368(a)(1)(C)) in a taxable transaction.[52] Under the Temporary Regulations, the gain recognition agreement is triggered if the transferred corporation disposes of a "substantial portion" of its assets.[53] Under the Proposed Regulations, the gain recognition agreement will not be triggered and will instead terminate upon the disposition (a "termination disposition") by the transferred corporation of substantially all of its assets in a taxable transaction if the transferred corporation is a domestic corporation that was 80% owned immediately prior to the transfer by another domestic corporation.[54]

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[49] Temp. Reg. § 7.367(b)-4(b).

[50] Prop. Reg. § 1.367(b)-4(e), Example 5.

[51] Prop. Reg. § 1.367(a)-8(b)(2).

[52] Prop. Reg. § 1.367(a)-3(c)(3). Similarly, a disposition of substantially all of the assets of a subsidiary of the transferred corporation will be treated as a disposition of the stock of such subsidiary. A parallel rule applies down a chain of subsidiaries. Id.

[53] Temp. Reg. § 1.367(a)-3T(g)(3)(iii).

[54] Prop. Reg. § 1.367(a)-3(c)(5).

Under the Proposed Regulations, if the transferred corporation disposes of substantially all of its assets in a nontaxable transaction such as a type C reorganization, the gain recognition agreement will not be triggered if the initial transferor enters into a new gain recognition agreement.[55] The new agreement requires that the initial transferor recognize gain in the event that, prior to the expiration of the term of the original gain recognition agreement, either (i) the initial transferee foreign corporation disposes of the interest received in exchange for the transferred property (other than in another non-recognition transaction), (ii) the subsequent transferee disposes of the transferred property (other than in another non-recognition transaction) or (iii) there is "any other disposition that has the effect of an indirect disposition of the transferred property."[56] If a transferor is required to enter into a new gain recognition agreement, it must certify to the I.R.S. that arrangements have been made to ensure that it will be informed of any subsequent disposition of property that would trigger gain recognition under the agreement.[57]

The Temporary Regulations characterize certain transfers of the stock or assets of domestic corporations as "indirect" outbound stock transfers[58]. The Temporary Regulations state that such transfers "include" triangular type A, B and C reorganizations involving domestic targets where the shareholders

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[55] Prop. Reg. § 1.367(a)-3(c)(4). The new agreement is similar to one that, under the Proposed Regulations (which are substantially the same in this respect as the Temporary Regulations), a U.S. transferor may enter into to prevent gain recognition when the transferee foreign corporation disposes of transferred stock or securities in a nontaxable transaction. See Prop. Reg. § 1.367(a)-8(e).

[56] Prop. Reg. § 1.367(a)-8(e)(3).

[57] Prop. Reg. § 1.367(a)-8(e)(4).

[58] Temp. Reg. § 1.367(a)-1T(c)(2) through (7).

of such targets receive stock of a foreign parent of the acquiring corporation.[59] The Proposed Regulations expand this rule to include triangular type B and C reorganizations where the target is a foreign corporation.[60] The Proposed Regulations also re-characterize other transactions as indirect outbound stock transfers. For example, an exchange by a U.S. person of stock or securities of a corporation for voting stock or securities of a foreign acquiring corporation in a reorganization described in sections 368(a)(1)(C) and (a)(2)(C) will be characterized as an indirect transfer of the stock of the corporation to which the assets are transferred under section 368(a)(2)(C).[61] Moreover, a section 351 transfer of assets by a U.S. person to a foreign corporation which transfers the assets to a second corporation that is 80% owned by the foreign corporation will be characterized as an indirect transfer of the stock of the second corporation to the foreign corporation.[62]

Comments

1. General/Transfers to Certain CFCs. We applaud the simplification of Notice 87-85 that is incorporated in the Proposed Regulations. We also endorse the liberalization of certain rules in the Notice and Proposed Regulations. For example, under the Temporary Regulations, if all U.S. transferors owned more than 50% of the transferee foreign corporation's stock immediately after the transaction, even though no one transferor owned more than 50% of such stock, no transferor could obtain

[59] Temp. Reg. § 1.367(a)-1T(c)(1), (2).

[60] Prop. Reg. § 1.367(a)-3(d)(1)(i) through (iv).

[61] Prop. Reg. § 1.367(a)-3(d)(1)(v).

[62] Prop. Reg. § 1.367(a)-3(d)(1)(vi).

non-recognition treatment on the basis allow deferral.[63] We agree with the provisions of the Proposed Regulations that change this result.[64]

We also agree with the decision to abandon in the Proposed Regulations the “anti-abuse” rule referred to in footnote 48 above. In the context of section 367(a), it is unclear what policy objective is served by such a rule.

We do not agree with the Proposed Regulations' retention of the second “anti-abuse” rule of Notice 87-85, which may have been expanded[65] in the Proposed Regulations.[66] That rule provides that no exception to section 367(a) will apply (other than with respect to a less-than-5% shareholder) if a single U.S. person owns more than 50% of the transferee foreign corporation immediately after the transfer of a domestic corporation's stock or securities. This rule may be intended to prevent avoidance of section 367(a) in situations perceived to be so fraught with the potential for abuse that they should not even be eligible to use the I.R.S.'s first line of defense against tax avoidance -- the gain recognition agreement. The rule may also have been intended to prevent deconsolidation of subsidiaries through interposition of foreign affiliates between the subsidiaries and their parents.

In the typical case, a U.S. transferor that owns more than 50% of a transferee foreign corporation will recognize income under Subpart F on a disposition of the transferred stock or securities by the transferee corporation. Further, Congress

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[63] Temp. Reg. § 1.367(a)-3T(c)(3), (c)(4), (d)(4), (d)(5).

[64] Prop. Reg. § 1.367(a)-3(b)(3).

[65] See note 13, supra.

[66] Prop. Reg. § 1.367(a)-3(b)(3).

enacted section 904(i) (applicable to tax years beginning after July 10, 1989) to prevent deconsolidation abuses. We believe that this case should not be subjected to harsher rules than cases in which U.S. ownership is lower or more dispersed and we recommend elimination of the rule.[67]

The Proposed Regulations provide that, if a transferor cannot determine whether all U.S. transferors own less than 50% of the foreign transferee corporation, such transferors will be deemed not to own less than 50% of such 68 corporation.[68] In making this determination, all transferors, including transferors owning less than 5% of the transferee's stock, must be counted. Because of the applicability of the attribution rules, we believe that it will be extremely difficult in certain cases to determine the level of U.S. ownership of the transferee corporation. Therefore, we recommend that the final regulations contain no constructive ownership rules for stock owned by less-than-5% shareholders (subject to an anti-abuse rule if appropriate).

2. 351/”B” Reorganization Overlap. The history of the tax treatment of transfers of foreign stock or securities in transactions described in both sections 351 and 368(a)(1)(B) is tortuous. The legislative history of the Tax Reform Act of 1976 (“TRA 76”), which created the first statutory distinction between outbound transactions and inbound and “foreign-to-foreign” transactions, indicates that a primary purpose of distinguishing between section 367(a) and section 367(b) transactions was to distinguish a group of transactions (those subject to section

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[67] It has been suggested that the automatic gain recognition rule might not apply to transferors other than the greater than-50% transferor. See Kingson, The New Theory and Practice of Section 367, 69 Taxes 1008, 1009 n.7 (Dec., 1991). If this is the intention of the Proposed Regulations they should be clarified to so state.

[68] Prop. Reg. § 1.367(a)-3(b)(2).

367(b)) the tax effects of which could be prescribed without the necessity of case-by-case tax avoidance determinations.[69] Congress believed that the tax consequences of inbound non-recognition transfers could be prescribed by generally applicable rules.[70] Congress also believed that foreign-to-foreign non-recognition transactions generally should be tax-free as long as the tax attributes of a U.S. shareholder's portion of a CFC's previously untaxed earnings were preserved to such shareholder.[71]

TRA 76 endorsed the view, however, that outbound transfers (those subject to section 367(a)) presented the potential for the permanent avoidance of tax on the appreciation of the transferred assets.[72] Therefore, outbound transfers were taxable unless the I.R.S. determined that they did not have tax avoidance as one of their principal purposes.

With respect to transfers beginning after October 9, 1975, TRA 76 excluded from the reach of section 367(a), i.e., no ruling was required with respect to, transfers of “stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization”.[73] Thus, foreign-to-foreign type B reorganizations were not subject to section 367(a). The relevant legislative history states that “[for] these

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69 H.R. Rep't No. 94-658, 94th Cong., 1st Sess., 241 (1975) (“TRA 76 House Report”); S. Rep’t No. 94-938, 94th Cong., 2d Sess., 263 (1976) (“TRA 76 Senate Report”).

70 TRA 76 House Report at 245; TRA 76 Senate Report at 268.

71 TRA 76 House Report at 245; TRA 76 Senate Report at 268.

72 TRA 76 House Report at 242; TRA 76 Senate Report at 264.

73 Pub. L. No. 94-455 § 1042(a).

exclusively foreign transactions, it is anticipated that regulations will provide for no immediate U.S. tax liability”.[74]

In 1977, proposed regulations, promulgated under section 367(b), recognized that foreign-to-foreign type B reorganizations might also be described in section 351 and as a result could be governed by section 367(a) as well as section 367(b).[75] In that event, the proposed regulations concluded, section 351 would prevail and the transaction would be subject to section 367(a).[76] In 1982, the 1977 proposed regulations were promulgated as temporary regulations and modified to treat 351/B transfers of foreign stock to foreign transferees as governed solely by section 367(b).[77]

The Deficit Reduction Act of 1984 (“DEFRA”) deleted the above-quoted provision of TRA 76 excluding type B reorganizations from section 367(a) and added in its place section 367(a)(2).[78] Section 367(a)(2) states that “[except] to the extent provided in regulations, [the 367(a) Recognition Rule] shall not apply to the

[74] TRA 76 House Report at 246; TRA 76 Senate Report at 268-69.

[75] T.D. 7530, supra. In its 1978 report on those proposed regulations, a committee of the Tax Section took the position that such transactions should be governed solely by section 367(b). See N.Y.S. Bar Ass'n Tax Section, Report on the Proposed Regulations Under Section 367, 34 Tax L. Rev. 83 (1978). The committee believed that the requirements of the section 367(b) regulations provided adequate protection of the U.S. taxing jurisdiction applicable to any type B reorganization where the U.S. transferor controls the acquiring CFC after the exchange. Id. at 110-114. The committee also stated that to treat the transaction as governed by section 367(a) would create an erroneous distinction between a typical type B reorganization that is described in section 351 and a type B reorganization that is described in section 351 and recast as a type C reorganization in accordance with the principles of Revenue Ruling 78-130, 1978-1 C.B. 114.

[76] Prop. Reg. § 7.367(b)-4(b) (prior to amendment by T.D. 7863, supra).

[77] T.D. 7863, supra.

[78] Pub. L. No. 98-369, § 131(a).

transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization”.[79] The Conference Committee rejected a Senate-sponsored provision that would treat 351/B transactions solely as section 351 exchanges governed by section 367(a) and not section 367(b).[80] Instead, the Conference report states that “the conferees expect that, in developing regulations, the Secretary will carefully consider whether there are cases where the transfer should be treated as a section 351 exchange”.[81]

The Proposed Regulations apply both sections 367(a) and 367(b) to every type B reorganization involving a transfer of a foreign corporation's stock to another foreign corporation by a U.S. transferor. We do not object to the position taken in the Proposed Regulations.[82]

A transfer of stock from a U.S. person to a foreign corporation that is described in section 368(a)(1)(B) is literally an outbound transfer of stock. If section 367(a) did

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79 Code § 367(a)(2) (emphasis added).

80 Id. Compare S. Print No. 98-169, 98th Cong., 2d Sess., 365 (1984) (“DEFRA Senate Report”) with H. Rep. Rep't No. 98-861, 98th Cong., 2d Sess., 955 (1984) (“DEFRA Conference Report”). In its 1985 report on the 1984 amendments, a committee of the Tax Section reiterated the position taken in the 1978 report, that 351/B transactions should be governed solely by section 367(b). This position was based on the 1978 rationale of the committee, particularly the desirability of not establishing different consequences for type B reorganizations and essentially equivalent transactions qualifying as type C reorganizations. See N.Y.S. Bar Ass'n Tax Section, Report on Section 367 as Revised by The Tax Reform Act of 1984 22-23 (Feb. 7, 1985) (unpublished manuscript).

81 DEFRA Conference Report at 955.

82 We note, however, that the dual applicability of sections 367(a) and 367(b) in 351/B overlap cases is potentially a trap for the unwary, since type B reorganization treatment is easily avoided. Thus, while the Proposed Regulations may be theoretically justifiable, they may have harsh consequences in a given case.

not apply to such a transfer, and such stock were subsequently sold, U.S. tax on gain attributable to the appreciation in such stock could be avoided completely, if the transferee foreign corporation were not a CFC, and partially, if indirect U.S. ownership of the transferred stock were diluted through ownership of the transferee foreign corporation.[83]

Therefore, a type B reorganization involving an outbound transfer of stock is no less an appropriate target for the objectives of section 367(a) than an outbound section 351 transfer that is not a type B reorganization. Both should be equally subject to its constraints.

3. Indirect Transfers. The Temporary Regulations provide that indirect or constructive outbound transfers of stock or securities "include" certain listed transactions (the "listed indirect transfers").[84] The listed indirect transfers are transfers of the stock or assets of domestic corporations to other domestic corporations in triangular type A. B and C reorganizations where the consideration for the transfer is stock of a foreign corporation in control of the acquiror.[85] For example, a listed indirect transfer occurs where substantially all of the assets of domestic corporation DC1 are transferred to domestic corporation DC2 in a transaction described in section 368(a)(1)(C), in exchange for stock of DC2's foreign parent which

[83] A transfer of foreign stock from a U.S. person to a foreign corporation that is described in section 368(a)(1)(B) is also a foreign-to-foreign transfer. If section 367(b) did not apply to such a transfer, section 1248 treatment could be avoided with respect to pre-transfer earnings where the U.S. transferor is a United States shareholder with respect to the transferred corporation but is not a United States shareholder with respect to the transferee foreign corporation.

[84] Temp. Reg. § 1.367(a)-1T(c)(1).

[85] Temp. Treas. Reg. § 1.367(a)-1T(c)(2).

is distributed to DC1's shareholders in exchange for their DC1 stock.

The Proposed Regulations continue to treat the listed indirect transfers as indirect outbound stock transfers.[86] The Proposed Regulations expand this rule to include triangular B and C reorganizations where the target is a foreign corporation.[87] Moreover, the Proposed Regulations treat two additional transactions as indirect outbound stock transfers (i) a U.S. person exchanging stock or securities of a corporation for voting stock or securities of a foreign acquiring corporation in a reorganization described in sections 368(a)(1)(C) and (a)(2)(C),[88] and (ii) a U.S. person transferring property to a foreign corporation in an exchange described in section 351, where such assets are, in connection with the same transaction, transferred to a second corporation controlled by the foreign corporation in one or more exchanges described in section 351.[89]

Expanding the list of transactions subject to section 367(a) brings into focus the following conflict. On the one hand, if section 367(a) could be avoided by the simple expedient of recasting the form of a transaction, section 367(a) would be a paper tiger. On the other hand, taxpayers should be able to enter into business-motivated transactions without the burdens imposed

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86 Prop. Reg. §§ 1.367(a)-3(d)(1)(i) through (iv). Prop. Reg. § 1.367(a) 3(d)(2)(iii) states that, with respect to an indirect transfer, a U.S. person includes in income gain in the year of disposition. Presumably, this reference should be to the year of the initial transfer.

87 Id.

88 Prop. Reg. § 1.367(a)-3(d)(1)(v).

89 Prop. Reg. § 1.367(a)-3(d)(1)(vi).

by a statute such as section 367(a) which is designed to prevent tax avoidance.[90]

This conflict may be resolved in one of two ways: with fine distinctions among cases to determine the extent of tax-avoidance motivation, or with a bright line rule. The Proposed Regulations have opted for the latter course. Although we believe that inequities will result in specific cases, we do not object to this decision.

We do, however, recommend a clarification. We do not believe that the indirect transfer rules of the Temporary Regulations should be interpreted to apply to any transactions that are not listed indirect transfers. Use of the word “include” by the Temporary Regulations, as described above, suggests that other transactions could be treated as indirect or constructive transfers. However, practitioners generally believe that, as is currently explicit with respect to foreign-to-foreign 351/B transactions, other foreign-to-foreign reorganizations are governed by section 367(b) and not section 367(a). Moreover, many practioners would be surprised to learn that consecutive section asset transactions have always been indirect stock transfers for these purposes.[91] Therefore, the final regulations should state that indirect outbound transfers of stock or securities that begin prior to the date that is 30 days after the Proposed Regulations become final will not be deemed taxable because of the absence of a gain recognition agreement unless they are listed indirect transfers. Alternatively, the date in the

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90 We do not agree with those who view as problematic per se the simultaneous application of sections 367(a) and (b). As we noted above, to the extent that a transaction is literally described in each section and poses the potential for tax avoidance towards which each section is aimed, that transaction is a legitimate object of each section.

91 Cf. Rev. Rul. 77-449, 1977-2 C.B. 110.

preceding sentence should be no earlier than August 26, 1991. As a further alternative, the Proposed Regulations should state that no inference is to be drawn there-from regarding whether a transaction subject to the Temporary Regulations, and not the Proposed Regulations, is an indirect outbound stock transfer.

4. Active Trade or Business and Same-Country Exceptions for Stock and Securities. In accordance with Notice 87-85, the Proposed Regulations do not incorporate from the Temporary Regulations three exceptions to the 367(a) Recognition Rule. Two of these relate to stock or securities used in the active conduct of a trade or business outside the U.S. (the “active trade or business” exceptions)[92] and one relates to the transfer of stock or securities of a corporation organized and doing business in one country to another corporation organized in the same country (the “same country” exception).[93] Because Prop. Reg. § 1.367(a)-3 states that it provides the sole basis upon which a transfer of stock or securities by a U.S. person to a foreign corporation may qualify for non-recognition treatment,[94] these deletions are significant modifications of the Temporary Regulations. We believe the deletions are inconsistent with the 1984 amendments to section 367(a) and are wrong as a matter of policy. Further, we believe that an expansion of the active trade or business exceptions is warranted.

The Temporary Regulations contain two tests for determining whether stock or securities are transferred for use in the active conduct of a trade or business outside the U.S. First, stock or securities transferred for use as an “operating

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92 Temp. Reg. §§ 1.367(a)-3T(c)(2), (d)(2).

93 Temp. Reg. § 1.367(a)-3T(d)(3).

94 Prop. Reg. § 1.367(a)-3(a).

asset” in a foreign business (i.e., because its ownership grants material rights to products produced by the transferred corporation) will be considered to be transferred for use in the active conduct of a trade or business outside the U.S.[95] Second, stock or securities will be considered transferred for use in the active conduct of a trade or business outside the U.S. if both the transferred and transferee corporations constitute an “integrated business” as defined in the regulations.[96]

Neither stock nor securities are included in the section 367(a)(3) list of “tainted” assets that cannot be transferred without the recognition of gain, even if transferred in connection with the active conduct of a trade or business outside the U.S.[97] Further, the legislative history to the 1984 amendments to section 367(a) indicates that the active trade or business exception was intended to apply to stock and securities.

The Conference Committee considering DEFRA substantially adopted the Senate version of the amendments to section 367(a).[98] The DEFRA Senate Report states, in relevant part, that “[certain] transfers of stock and securities by a U.S. person to a foreign corporation will fall within the active trade or business exception and will, therefore, be free of U.S. tax”.[99] To illustrate a case in which this rule will apply, the Senate

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95 Temp. Reg. § 1.367(a)-3T(e)(2).

96 Temp. Reg. § 1.367(a)-3T(e)(3).

97 Code § 367(a)(3)(B). Code section 367(a)(3)(B)(ii) does characterize certain obligations as “tainted”: installment obligations, accounts receivable and similar property.

98 See DEFRA Conference Report at 954-55.

99 DEFRA Senate Report at 365. See also Jt. Com. Tax'n, General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, 431 (1984).

Report cites Kaiser Aluminum Chemical Corp. v. C.I.R., supra.[100] The Senate Report goes on to state that regulations

> are also to specify additional circumstances under which outbound transfers of stock may fall within the active trade or business exception .... Generally, additional circumstances which might place a transfer of stock within the exception include substantial ownership by the transferee in the corporation whose stock is transferred, and integration of the business activities of that corporation with the business activities of the transferee.[101]

The deletion of the "operating asset" and "integrated business" exceptions from the Temporary Regulations is, therefore, inconsistent with the 1984 amendments to section 367(a). It is also, in our view, incorrect from a policy perspective.

We recognize that transfers of certain assets may be subject to greater scrutiny under section 367(a) because such assets are liquid, passive investments.[102] However, where it can be shown that the transferred stock or securities are being transferred to a foreign corporation for legitimate reasons relating to the active conduct of a trade or business, such stock and securities should be treated like other active business assets. To avoid the necessity for a factual inquiry in every case, the Temporary Regulations contain two tests, the "operating asset" and "integrated business" tests, to determine whether stock and securities are transferred for use in the active conduct of a trade or business outside the U.S. These two narrowly drawn tests create few burdens for the I.R.S. and should be retained.

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[100] DEFRA Senate Report at 365.

[101] Id.

[102] DEFRA Senate Report at 361.

Moreover, they should be expanded. Under the Temporary Regulations, even if a transfer of stock or securities is not immediately taxable because it is made in connection with the active conduct of a trade or business outside the U.S., the transferor must enter into a gain recognition agreement and recognize gain on a subsequent disposition of the stock or securities that violates the terms of the agreement.[103] In contrast, under the Temporary Regulations' general active trade or business exception applicable to assets other than stock or securities, if a subsequent disposition of the transferred assets is made and, under step-transaction principles, that disposition should be integrated with the initial transfer, then the active trade or business exception will not apply.[104] By negative implication, the exception will apply if the subsequent disposition cannot be "stepped together" with the initial transfer. A similar rule should be applied with respect to a transfer of stock or securities in connection with the active conduct of a trade or business outside the U.S. Therefore, we recommend that potential abuses that may arise in connection with the transfer of stock or securities under the active conduct of a trade of business test be monitored with the step transaction doctrine, and that the gain recognition agreement requirement not apply to such a transfer.

The Temporary Regulations provide another exception to the 367(a) Recognition Rule for certain transfers of stock or securities of a corporation organized and doing business in one country to another corporation organized in that country.[105] The legislative history of section 367(a) indicates that Congress

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[103] Temp. Reg. § 1.367(a)-3T(e)(1).

[104] Temp. Reg. § 1.367(a)-2T(c)(1).

[105] Temp. Reg. § 1.367(a)-3T(d)(3).

intended that regulations contain a same-country exception.[106] We believe the rule of the Temporary Regulations is narrow and appropriate and we see no reason for its deletion. Therefore, we recommend that it be retained.

5. Deemed Dispositions. With respect to the deemed disposition rules, we welcome the change in the Proposed Regulations that requires a disposition of “substantially all” of the transferred corporation's assets before a gain recognition agreement will be triggered. However, this rule is counter-productive to the effort to create bright line rules that are easier for taxpayers to comply with and for the I.R.S. to administer in that the Proposed Regulations fail to provide a safe harbor definition of “substantially all”. Instead, the Proposed Regulations simply state that a deemed disposition of a transferred corporation's stock occurs on “a disposition of substantially all (within the meaning of section 368(a)(1)(C)) of its assets.” We recommend that the final regulations specify that unless a corporation disposes of 90% of its net assets and 70% of its gross assets, no disposition of its stock will be deemed to have occurred.[107] We also recommend that if, as we assume, substantially all the assets need not be disposed of in one transaction for the deemed disposition rule to apply, the regulations provide a safe harbor so that unless the 90/70 threshold is met within, say, any two-year period, the deemed disposition rule will not apply.

[106] See DEFRA Senate Report at 366.

[107] See Rev. Proc. 77-37, § 7.05(3), 1977-2 C.B. 568.

We agree with the rule terminating the gain recognition agreement on a sale by a domestic transferred corporation of substantially all of its assets in any case in which it was 80% owned immediately before the transaction by another domestic corporation. This rule reflects the notion that if the inside gain is recognized, and that gain would (in the case of an affiliated group filing consolidated returns) increase the basis of the corporation's stock, application of section 367(a) is inappropriate. In line with this policy, consideration should be given to expanding the rule so that any disposition by a transferred corporation of substantially all of its assets would not be a deemed disposition of that corporation's stock that triggers gain recognition, as long as the disposition is fully subject to U.S. tax, including under subpart F, and the recognized inside gain is reflected in a U.S. person's stock basis.

6. Technical Comments. Example 6 of Prop. Reg. § 1.367(a)-3(d)(3) seems to imply that a transfer of 50% of a transferred corporation's assets is a transfer of substantially all of those assets, so that relief from the deemed disposition rule for non-recognition transactions is required. This implication should be changed. Also, the cross-reference in such relief provision (Prop. Reg. § 1.367(a)-3(c)(4)) to Prop. Reg. §§ 1.367(a)-8(d)(2) through (d)(4) should be to Prop. Reg. §§ 1.367(a)-8(e)(2) through (e)(4).

B. Section 1.367(a)-8

Summary of Regulation

This regulation addresses the contents and terms of the gain recognition agreement (except with respect to duration and deemed dispositions, as discussed above)[108] and the consequences of taxable and nontaxable dispositions (i) by the transferee foreign corporation of the transferred property and (ii) by the transferor of the transferee foreign corporation's stock.

In general, the contents of the gain recognition agreement under the Proposed Regulations are the same as under the Temporary Regulations. However, as described below, the Proposed Regulations expand the rules of the Temporary Regulations with respect to the consequences of various transfers under a gain recognition agreement.

In general, and consistent with the Temporary Regulations, if the transferee foreign corporation disposes of the transferred property in a taxable transaction, the gain recognition agreement is triggered.[109] If the property is disposed of in a non-recognition transfer, gain recognition is triggered unless a new gain recognition agreement is entered into similar to that described above in connection with a deemed disposition of substantially all of the transferred corporation's assets in a nontaxable transaction.[110]

In rules that supplement the Temporary Regulations, the Proposed Regulations generally provide that a transfer of the stock of the transferee foreign corporation in a taxable transaction will reduce the scope of the gain recognition agreement in proportion to the value of the transferee foreign corporation's stock that was transferred. A disposition of the stock of the transferee corporation in a non-recognition

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[108] See pages 17-23, supra.

[109] Prop. Reg. § 1.367(b)-8(b)(2).

[110] Prop. Reg. § 1.367(a)-8(e).

transaction will have no effect on the gain recognition agreement unless the transferor goes out of existence.[111] If the transferor goes out of existence, the gain recognition agreement will be triggered unless (i) sufficient assets are retained to meet any liability there-under, (ii) sufficient security is posted, (iii) the recipient of the stock of the transferee foreign corporation in the transaction pursuant to which the transferor goes out of existence enters into another gain recognition agreement and certain other requirements are met or (iv) a ruling is obtained.[112]

Perhaps the most significant portions of the regulations state that, on a triggering of the gain recognition agreement, the measure of tax is the gain realized but not recognized on the initial transfer, such gain is recognized in the year of the initial transfer, and an interest charge is imposed with respect to the deferred tax.[113]

The Proposed Regulations continue the rule of the Temporary Regulations relating to offsets, which may be interpreted to require that NOLs and credits be available in the year of the initial transfer if they are to offset any gain required to be recognized or any increase in tax with respect to that year.[114]

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[111] Prop. Reg. § 1.367(a)-8(b)(2)(iv).

[112] Prop. Reg. § 1.367(a)-8(f).

[113] Prop. Reg. §§ 1.367(a)-8(b)(2)(i), (ii) and (vi).

[114] Prop. Reg. § 1.367(a)-8(b)(2)(v).

The Proposed Regulations incorporate and expand on the rules in the Temporary Regulations with respect to partial dispositions by the transferee foreign corporation. As under the Temporary Regulations, if the transferee foreign corporation disposes of only a portion of the transferred property in a taxable transaction, the U.S. transferor recognizes a proportionate part of the deferred gain, measured by the relative fair market values of the property disposed of and retained.[115] In addition, the Proposed Regulations state that partial dispositions of the transferred property by the transferee foreign corporation will be deemed to be a disposition of no less than a ratable portion of the transferred property, where the transferee corporation owns additional shares or securities (other than those acquired in the section 367(a) transaction) at the time of the subsequent transfer (the "fungibility rule").[116]

The Proposed Regulations provide a reasonable cause exception to section 367(a)'s "denial of non-recognition treatment" sanction for a failure to timely enter into or comply with a gain recognition agreement.[117]

The effective date of the section is 30 days after it is published as a final regulation in the Federal Register.[118] There is no election, as may be made with respect to Prop. Reg. § 1.367(a)-3, to apply the regulation to transfers occurring on or after December 16, 1987 and before the date that is 30 days after the Proposed Regulations are finalized.[119]

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115 Prop. Reg. § 1.367(a)-8(b)(2)(iii).

116 Id.

117 Prop. Reg. § 1.367(a)-8(h)(2).

118 Prop. Reg. § 1.367(a)-8(1).

119 Compare Prop. Reg. § 1.367(a)-3(f).

Comments

1. Time and Measure of Income Inclusion, Appropriateness of Interest Charge and the Offset Rule. Congress replaced the ruling requirement for section 367(a) stock and securities transfers with a regime under which such transfers would be taxable only if they satisfied some objective standard deemed to be an indicator of tax avoidance.[120] Tax avoidance was determined to be present if there was a subsequent disposition of the acquired stock or securities within a prescribed period.[121] Thus, the subsequent disposition is only significant as a trigger for the conclusive presumption of tax avoidance, i.e., as a trigger for gain recognition, and we agree with the Proposed Regulations that gain from the subsequent disposition should not serve as a measure of the gain to be recognized under the gain recognition agreement. Rather, the gain included in a U.S. transferor's income on the triggering of a gain recognition agreement should be measured by the gain realized but not recognized on the initial transfer.

We also believe, however, that the Proposed Regulations should not impose an interest charge on deferred Gain[122] and should not require a U.S. transferor to amend its return for the year of the initial transfer. That is, the recognized gain should be included in income in the year of the subsequent disposition. The interest charge is punitive in the context of section 367(a),

[120] See DEFRA Senate Report at 365-66.

[121] Id.

[122] The legislative history to section 367(a) indicates that an interest charge would be imposed in an appropriate case. See id. We agree with the implication of the Proposed Regulations' request for comments on this point, that the reference to an “appropriate case” confirms that the issue is within the discretion of the Secretary.

the reach of which is broader than necessary to accomplish its goal. The amended return requirement adds unnecessary complexity. If the amended return requirement is retained, we recommend allowing the U.S. transferor to carry back losses to the year of the initial transfer.

The harsh application of the Proposed Regulations may be illustrated by two typical examples.

> Example 1. Domestic individual DI transfers its interest in foreign corporation FC1 to foreign corporation FC2 in exchange for 10% of FC2's stock. Simultaneously, domestic corporations DC1 and DC2 each transfer assets to FC2 in exchange for 45% of FC2's stock. DI enters into a ten-year gain recognition agreement. Nine years after the initial transfer, FC2 sells the stock of FC1 for legitimate business reasons unrelated to the initial transfer. Even though DI cannot prevent a subsequent sale by the transferee foreign corporation, the gain recognition agreement is triggered, and tax must be paid as if the initial transfer was taxable, along with non-deductible interest compounded daily for nine years. DI will, however, be permitted to increase its basis in its FC2 stock by the amount of gain required to be recognized. See Prop. Reg. § 1.367(a)-8(k)(2).
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> Example 2. In hopes of achieving business synergies, domestic corporation DC and foreign corporation FC1 each transfer large but only marginally profitable widget corporations of equal value to a foreign joint venture, FC2, in exchange for 50% of FC21s stock. DC enters into a ten-year gain recognition agreement. After four years it becomes apparent that the hoped-for synergies will never materialize. DC and FC1 agree to abandon the widget business and cause FC2 to sell out. A buyer is found, but the price is substantially below the value of the corporations four years earlier. In addition to its economic loss, DC must incur a tax and interest liability out of all proportion to any real gain that it has sustained in the transaction, and cannot use any of its NOL carry-backs that accrued after the year of the initial transfer. DC will increase its basis in the stock of FC2 by the gain recognized.

The Proposed Regulations and Notice 87-85 assume that certain outbound transfers are motivated by tax avoidance and separate the avoidance transactions from others based on whether a subsequent disposition has taken place within a prescribed time period. In fact, as the above examples demonstrate, many of the transfers that trigger gain recognition may not have a tax avoidance motive, but section 367(a) attempts to achieve "rough justice". In light of the fact that section 367(a) casts a bigger net than that needed to catch the tax avoidance transactions, we believe that the sanctions imposed in the final regulations should be less onerous than the rule set forth in the Proposed Regulations. In this context, an interest charge is punitive. Moreover, because such interest is not deductible by individuals, it imposes disproportionate burdens on similarly situated transferors. We recommend that it be eliminated. At the very least, the interest charge should only be applied where the transfer to the foreign corporation and the ensuing re-transfer by the foreign corporation have demonstrable tax-avoidance motivation.

Further, in the interest of simplification, the final regulations should not require amended returns. The consolidated return deferred intercompany transaction rules provide analogous precedent for including deferred gain in income in a later year without an interest charge that relates back to the year in which the deferred gain was realized.[123] While these rules could be distinguished on the basis that deferred gains are triggered to the extent of depreciation deductions to the purchasing member (which is a U.S. taxpayer),[124] we recommend this gain deferral/restoration approach in this context on simplicity and fairness grounds.

Finally, we see no policy justifying the offset rule. Although allowing carry-backs might create greater compliance burdens on taxpayers if the deferred gain is to be taken into

[123] Reg. § 1.1502-13.

[124] Reg. § 1.1502-13(d).

account in the year of the initial transfer, this is a burden taxpayers should have the option to bear.[125]

2. Ratable Disposition of Transferred Property. We also believe that the new fungibility rule of the Proposed Regulations lacks policy justification and should be removed. A taxpayer generally may specifically identify shares of stock to owned.[126] Section 367(a) is designed to prevent the transfer of appreciated assets outside the U.S. tax jurisdiction. Triggering gain recognition as a result of a sale by a transferee foreign corporation of shares that were not acquired in the section 367(a) transaction in no way advances the underlying policy of section 367(a).

We recognize that abuses are possible in limited circumstances. For example, if a U.S. transferor owned all of the stock of a corporation and transferred that stock to a foreign corporation in a section 351 transaction, the transferred corporation could then issue new stock, via a preferred stock dividend, for example, that would dilute to a de minimis value the transferred stock and the transferee could sell the new stock while retaining the transferred stock. The fungibility rule is not limited to these potential abuses, however, and the potential abuses do not warrant such a drastic deviation from the generally applicable rule.[127]

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125 Obviously, if the foregoing recommendation of this Section III(B)(1) for gain deferral/restoration is adopted, the offset rule would not be relevant.

126 Reg. § 1.10l2-1(c).

127 The fungibility rule could have particularly harsh consequences. For example, if a CFC transferee of 20 shares subject to a gain recognition agreement disposes of 20 old shares and retains the 20 new shares, gain would be recognized under this rule with respect to ten of the new shares and, under subpart F, with respect to all 20 of the old shares.

3. Partial Dispositions. Upon a partial disposition of the transferred property by the transferee foreign corporation, the Proposed Regulations base the amount of the gain recognized by the U.S. transferor on the relative fair market values of the assets retained and those transferred. The fair market value determination is apparently made at the time of the subsequent disposition. It is more logical to make the fair market value determination as of the time of the initial transfer, if that information is available. Therefore, transferors should compute the portion of the gain recognized in accordance with the relative fair market values, as of the time of the initial transfer, of the property disposed of and the property retained.

4. Reasonable Cause. We agree with the inclusion of a reasonable cause exception to the rules governing a taxpayer's failure to timely file or comply with the terms of a gain recognition agreement. We also think sensible the rules included in the Proposed Regulations describing the consequences of a disposition of stock in the transferee foreign corporation by the U.S. transferor.

5. Effective Date. We do not agree with the decision not to make Prop. Reg. § 1.367(a)-8 retroactive on an elective basis, to enable taxpayers that elect retroactive application of the substantive stock and securities transfer rules to comply with the Proposed Regulations relating to the terms and conditions of the gain recognition agreement. We see no reason to deny such a retroactive election, view the lack of such an election as adding complexity and view the reasonable cause exception of this section as an important procedural safeguard that should be available as soon as possible.

C. Section 1.367(b)-1

Summary of Regulation

The Temporary Regulations, in accord with the statute, apply section 367(b) only to exchanges in connection with which there is no transfer described in section 367(a).[128] The Proposed Regulations expand the scope of section 367(b) by providing, in pertinent part, that a

> section 367(b) exchange is any exchange described in section 332, 351, 354, 355, 356 or 361, with respect to which the status of a foreign corporation as a corporation is relevant. Notwithstanding the preceding sentence, a section 367(b) exchange does not include a transfer to the extent that the foreign corporation fails to be treated as a corporation by reason of section 367(a)(1).[129]

The Temporary Regulations provide the I.R.S. with discretion to determine whether the non-recognition rules apply if a taxpayer fails to comply with the section 367(b) regulations.[130] The Proposed Regulations eliminate this rule. Thus, if amounts are not included in income as prescribed by the Proposed Regulations, the relevant foreign corporation generally will not be treated as a corporation.

The Temporary Regulations require that notice be provided to the I.R.S. whenever gain or income is realized on account of any exchange to which section 367(b) applies by any person referred to in section 6012 (relating to the requirement to make returns of income).[131] The Proposed Regulations require

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128 Code § 367(b)(1); Temp. Reg. § 7.367(b)-1(a).

129 Prop. Reg. § 1.367(b)-1(a).

130 Temp. Reg. § 7.367(b)-1(b).

131 Temp. Reg. § 7.367(b)-1(c)(1).

that such notice be provided by any person who realizes income in a section 367(b) exchange.[132] The Proposed Regulations also eliminate on a prospective basis certain recordkeeping provisions, because the regulations dispense with the attribution regime that necessitates such recordkeeping.

Comments

1. Scope of Regulations. The Proposed Regulations under section 367(b) are promulgated under the authority of section 7805 and section 367(b).[133] They purport to apply to any of a number of different exchanges, except to the extent that the foreign corporation fails to be treated as a corporation by reason of section 367(a)(1).[134] Section 367(b)(1), however, defines its scope as follows: "any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in [section 367(a)(1)]". Thus, an obvious question exists as to whether the Proposed Regulations are valid to the extent that they apply section 367(b) to transactions that are described in section 367(a), either literally or because such transactions have been re-characterized as indirect outbound transfers and made subject to the rules of section 367(a) by the regulations there-under.

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[132] Prop. Reg. § 1.367(b)-1(c).

[133] INTL-054-91; INTL-178-86, par. 1.

[134] Prop. Reg. § 1.367(b)-1(a).

Although the regulatory authority of the Secretary under section 367(b) is broad, it is not unlimited. Section 367(b)(2) states what the regulations, at a minimum, should include, and does not circumscribe the Secretary's authority. Thus, the regulations may prescribe a broad range of rules. Each of those rules must, however, by the terms of section 367(b), address one or more transactions that are not described in section 367(a)(1). To the extent the Proposed Regulations do otherwise, we believe that they may be technically invalid.

We believe that this technical infirmity would not be fatal to the Proposed Regulations, however, if the rules that apply to transactions described in both sections 367(a) and (b) were promulgated under the authority of both sections 367(a) and (b), and not just under the authority of sections 7805 and 367(b), and we recommend that the rules be promulgated under such authority.

2. Elections. We agree with the determination to remove the discretion of the Commissioner to accord unconditional or conditional non-recognition treatment or deny non-recognition treatment to taxpayers that do not comply with the rules under section 367(b). This approach will give taxpayers more certainty as to the application of the rules. Our comments relating to the specific gain recognition elections that replace the implicit elections of the Temporary Regulations are contained in the sections below relating to those elections.

3. Notice Requirement. We question the change broadening the Temporary Regulations so that notice relating to section 367(b) transactions must be provided to the I.R.S. by any person who realizes income in a section 367(b) exchange. The removal of the reference to persons required to file tax returns

raises the question of whether notice is required from persons, such as certain foreign persons, who otherwise need not file tax returns. We recommend a clarification in the final regulations indicating that this is not the intention of the change. We recommend a further clarification that where a pass-through entity realizes income in a section 367(b) exchange, and the entity provides the required notice, the partners, beneficiaries and shareholders need not provide notice.

D. Section 1.367(b)-2

Summary of Regulation

The Temporary Regulations define the term "all earnings and profits amount" by reference to amounts "attributable to the stock of the foreign corporation exchanged under the principles of section 1246 or 1248 (whichever is applicable) and the regulations under that[135] section." The Proposed Regulations "clarify" that in determining the all earnings and profits amount attributable to a block of stock, the attribution principles of section 1248 are applied without regard to whether the earnings and profits were accumulated in pre-1963 taxable years and without regard to whether the foreign corporation was a CFC at any time within the 5-year period preceding the section 367(b) transaction.[136] This definition is effective for exchanges that occur on or after August 26, 1991.[137]

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135 Temp. Reg. § 7.367(b)-2(f).

136 Prop. Reg. § 1.367(b)-2(d)(3)(i).

137 Prop. Reg. § 1.367(b)-2(d)(4).

Rules are provided characterizing income inclusions as deemed dividends and detailing the consequences of such characterization.[138] Ordering rules are also provided that clarify the manner in which basis is determined by the exchanging shareholder and the transferee, and the extent to which boot is taxed.[139]

Consistent with the Temporary Regulations, the Proposed Regulations treat type F reorganizations as asset transfers.[140] The Proposed Regulations also treat certain foreign corporations electing or deemed to be treated as domestic corporations as transferring their assets in a type F reorganization.[141]

This section also addresses the application of the foreign currency rules to certain asset transfers.[142] In the case of a transaction described in section 381(a) (i.e., any asset transfer described in section 368(a)(1) or 332), in which the acquired corporation has a functional currency different from that of the acquiring corporation, the acquired corporation must make the adjustments described in Temp. Reg. § 1.985-5T.[143] With respect to any such transaction that is an inbound asset transfer described in section 332 or 368(a)(1)(C), (D) or (F) (i.e., any transaction to which Prop. Reg. § 1.367(b)-3 applies), the exchanging shareholder must also recognize exchange gain or loss

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[138] Prop. Reg. § 1.367(b)-2(e)(2).

[139] Prop. Reg. § 1.367(b)-2(e)(3).

[140] Prop. Reg. § 1.367(b)-2(f)(2).

[141] Prop. Reg. § 1.367(b)-2(g), (h) and (j).

[142] Prop. Reg. § 1.367(b)-2(k).

[143] Prop. Reg. § 1.367(b)-2(k)(1).

with respect to its capital investment in the acquired corporation.[144]

Finally, under this section, stock owned by foreign partnerships, estates and trusts (and, with respect to determining the tax treatment under Prop. Reg. § 1.367(b)-5 of a distributee of a foreign distributing corporation in a section 355 transaction, stock or securities owned by domestic partnerships, estates and trusts) is considered to be owned proportionately by their partners or beneficiaries under the principles of Reg. § 1.904-4(g)(1).[145]

Comments

1. Definitions.

The Proposed Regulations state that, in determining the all earnings and profits amount, the attribution principles of section 1248 apply without regard to whether the foreign corporation was a CFC at any time during the five years preceding the section 367(b) exchange and without regard to whether the earnings and profits of the foreign corporation were accumulated in post-1962 taxable years or while the corporation was a CFC. The preamble to the Proposed Regulations refers to this addition

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[144] Id.; Prop. Reg. § 1.367(b)-3(b)(2)(ii).

[145] Prop. Reg. § 1.367(b)-2(1).

as a revision "to clarify the scope of the term."[146]

While we do not object to this revision,[147] we disagree that it is a clarification of the Temporary Regulations. See, e.g., Letter Ruling 8924052 (Mar. 20, 1989) in which the I.R.S. concluded that the all earnings and profits amount does not include earnings and profits accumulated in a period in which the foreign acquired corporation was not a CFC. We believe that the interpretation of the Proposed Regulations is inconsistent with that of most practitioners. Therefore, since this interpretation represents more of a change than a clarification, we believe that it should be effective at the same time as the Proposed Regulations are generally effective.

2. Foreign Currency Rules. Each acquired corporation in a section 367(b) transaction that is described in section 381(a) must make the adjustments described in Temp. Reg. § 1.985-

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146 One point that is not clarified in the Proposed Regulations is whether the all earnings and profits amount includes earnings attributable to periods prior to the date on which a taxpayer acquired its stock. It appears from statements in the Proposed Regulations that the inclusion is limited to the earnings accumulated while the taxpayer held stock in the acquired corporation. See Prop. Reg. §§ 1.367(b)-2(d)(3)(i) (reference to "holding period"), -3(b)(2)(i)(B) Example 2(i) (reference to exchanging shareholder owning stock for entire duration of transferred corporation's existence). This result has also been suggested by a learned commentator. See Kingson, The Theory and Practice of Section 367, 37 N.Y.U. Inst. 22-1, 22-26 through 22-28 (1979). Moreover, policy would appear to favor the position that only repatriated earnings accumulated during a U.S. person's holding period should even arguably be subject to U.S. tax. The Proposed Regulations should resolve this ambiguity.

147 We do not agree with those who may object to the inclusion in a shareholder's income of earnings of a corporation under section 367(b) solely because the corporation is not a CFC. Section 367(b) inclusions serve a different function than subpart F inclusions. Because section 367(b)'s regulatory authority arguably does not allow for income inclusions by the acquiring corporation (unless it is also the exchanging shareholder, as in a liquidation) requiring an income inclusion by a shareholder even where the acquired corporation is not a CFC is a rational approach (subject to our comments below regarding small shareholders).

5T if the acquired corporation's functional currency differs from that of the acquiring corporation. As a result, the acquired corporation must take into account all exchange gain or loss attributable to section 988 transactions, as defined.[148]

Temp. Reg. § 1.985-5T requires certain adjustments when a taxpayer owning a branch changes its functional currency to one other than that of the branch.[149] Adjustments are also required for a branch of a taxpayer that is changing functional currencies.[150] Because section 367(b) transactions could fit into either category, the Proposed Regulations should state which of these, if either, they intend to incorporate.[151]

The Proposed Regulations also adopt and modify the rule of Temp. Reg. § 1.985-5T, which provides that a United States shareholder of a CFC changing its functional currency to the U.S. dollar must recognize foreign currency gain or loss with respect to previously taxed earnings and profits as if they were distributed immediately prior to the change in functional currency.[152] Under the Proposed Regulations, all exchanging shareholders required to include in income either the section 1248 amount or the all earnings and profits amount must recognize such gain or loss.[153] With respect to a CFC changing its

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148 Temp. Reg. § 1.985-5T (b). For this purpose, a section 988 transaction includes the entering into of a regulated futures contract or a non-equity option. Id. (reference to section 988(c)(1)).

149 Temp. Reg. § 1.985-5T(e)(4).

150 Temp. Reg. § 1.985-5T(d).

151 Although the objectives of the two rules seem the same, the former restates the acquired corporation's asset bases (less liabilities) in the acquiring corporation's functional currency, and the latter adjusts capital and earnings pools.

152 Temp. Reg. § 1.985-5T(e)(2).

153 Prop. Reg. § 1.367(b)-2(k)(2).

functional currency to the dollar, it appears that this is the appropriate result because it is the last time that the exchange gain or loss can be subject to U.S. tax. It is less clear, however, that this is the correct result in a case in which the section 367(b) transaction does not result in a change of functional currency for the QBU that is deemed to have made the distribution of previously taxed income. Therefore, we recommend that the rule requiring the recognition of exchange gain or loss on any income inclusion under section 367(b) be modified to apply only where the QBU whose earnings give rise to the inclusion changes its functional currency.

Moreover, under the Proposed Regulations, it appears that any exchange gain described in the preceding paragraph will not be eligible for the deferral rules[154] of section 481, and so will not be spread beyond the tax year in which is, in essence, an adjustment required by virtue of a change in accounting method[155] and, if so, question why section 481 should not be available.

Finally, Temp. Reg. § 1.985-5T states that a United States shareholder of a CFC will recognize exchange gain or loss attributable to the corporation's paid-in capital to the extent, if any, provided under section 367(b) or future final regulations under section 985.[156] The Proposed Regulation addressing the tax treatment of section 332 liquidations and inbound asset reorganizations requires that such gain with respect to capital

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[154] Prop. Reg. § 1.367(b)-2(k)(1); Temp. Reg. § 1.985-5T(e)(2).

[155] See H.R. Rep't No. 99-841, 99th Cong., 2d Sess., II-661 ("TRA 86 Conference Report") (choice of functional currency is a method of accounting that can be changed only with the consent of, and subject to such conditions as may be prescribed by, the Secretary).

[156] Temp. Reg. § 1.985-5T(e)(2).

be recognized in connection with the section 367(b) transactions to which it applies and for which no taxable election has been made.[157] Our comments on this rule are contained in section III(E) below.

3. Technical Comment. The example in Prop. Reg. § 1.367(b)-2(c) appears to disregard one aspect of the attribution rules under section 958. Under section 958(b)(2), if a corporation owns more than 50% of the voting stock of another corporation, it is considered to own all of such stock for purposes of attributing to it the ownership of stock owned by such other corporation. Applying this rule to the example would make FZ a CFC on January 1, 1992, not January 1, 1993, as stated in the example.

E. Section 1.367(b)-3

Summary of Regulation

Prop. Reg. § 1.367(b)-3 is the first of the three operative regulations under section 367(b). It applies to inbound section 332 liquidations and inbound asset reorganizations.[158] In general, this section requires the inclusion in income as a deemed dividend of the all earnings and profits amount by an exchanging shareholder that is either (i) a “United States shareholder” of the foreign acquired corporation or (ii) a foreign corporation with respect to which a United States person is either a “section 1248 shareholder” or a domestic corporation that meets the stock ownership requirements of section 902.[159] For this purpose, the Proposed Regulations modify the Temporary

[157] Prop. Reg. § 1.367(b)-3(b)(2)(ii).

[158] Prop. Reg. § 1.367(b)-3(a).

[159] Prop. Reg. § 1.367(b)-3(b)(1).

Regulations' definition of the term “United States shareholder”. Under this section of the Proposed Regulations, a “United States shareholder” is a U.S. person that owns 10% or more of the combined voting power of all classes of stock entitled to vote of the foreign corporation, without regard to whether such foreign corporation is a CFC.[160] Under the Temporary Regulations, a U.S. person is a United States shareholder only if the foreign corporation was a CFC at any time within the five-year period ending on the date of the section 367(b) transaction.[161]

The Proposed Regulations also change the rule with respect to exchanging shareholders that are not United States shareholders. Under the Proposed Regulations, an exchanging shareholder that is a U.S. person but not a United States shareholder must recognize any gain (but not loss) that it realizes with respect to the stock of the foreign acquired corporation.[162]

A “section 1248 shareholder” is any U.S. person that satisfies the ownership requirements of section 1248(a)(2) or (c)(2) with respect to a foreign corporation.[163] Presumably, the foreign corporation must be (or have been within the last five years) a CFC because, in defining United States shareholder, a contrary intent is stated explicitly.[164] Therefore, we assume that Prop. Reg. § 1.367(b)-3 will not apply to any inbound asset reorganization if the exchanging shareholder is a foreign corporation that is not (and was not) a CFC and has no 10%

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160 Id.

161 See Temp. Reg. § 7.367(b)-13, Example 14(f).

162 Prop. Reg. § 1.367(b)-3(c).

163 Prop. Reg. § 1.367(b)-2(b).

164 Prop. Reg. § 1.367(b)-3(b)(1).

domestic corporate shareholders.

Amounts included in income as a deemed dividend under the general rule of this section will not qualify for the same country exception from the definition of foreign personal holding company income and thus will constitute subpart F income unless another exception applies.[165] The deemed dividend may, however, qualify for “look-through” treatment for purposes of apportioning income to baskets under the foreign tax credit limitation rules.[166]

Each exchanging shareholder in a transaction to which the section applies must recognize the exchange gain or loss with respect to its capital account in the foreign acquired corporation.[167] The Proposed Regulations reserve on the method of computation of a shareholder's capital account. Exchange loss recognized cannot exceed the amount included in income as a deemed dividend.[168] Thus, exchange gain or loss is recognized even if the acquired assets are used in a QBU that has the same functional currency it had before the transaction. The apparent regulatory purpose is to require the exchanging shareholder to pay for the portion of the previously untaxed repatriated basis attributable to currency rate fluctuation at the same time that it pays for the previously untaxed earnings and the rest of the previously untaxed repatriated basis.

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165 Prop. Reg. § 1.367(b)-3(b)(2)(i).

166 Id.

167 Prop. Reg. § 1.367(b)-3(b)(2)(ii).

168 Id.

This section provides for an election that may be made by an exchanging shareholder to recognize the gain (but not loss) that it realizes on the exchange.[169] Such an election will be useful to a shareholder with less gain inherent in its stock than earnings attributable thereto, including a shareholder with built-in loss stock. To the extent that the all earnings and profits amount with respect to such exchanging shareholder exceeds the gain recognized by such shareholder, certain tax attributes of the acquired corporation to which the domestic acquiring corporation would otherwise succeed are reduced.[170] The relevant tax attributes are, in the order required to be reduced, NOL carryovers, capital loss carryovers and basis.[171]

Because a domestic corporation will only succeed to a foreign corporation's NOL carryovers to the extent they relate to effectively connected income,[172] the basis reduction is likely to be the most significant of these reductions. This section lists, in order of priority, those assets the basis of which must be reduced as follows: first, tangible depreciable or depletable assets, according to their class lives (beginning with the shortest class life first); second, other non-inventory tangible assets; third, intangible assets that are amortizable; and fourth, the remaining assets of the foreign acquired corporation that are acquired by the domestic acquiring corporation.[173] If the amount to be allocated in any category is less than the aggregate

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169 Prop. Reg. § 1.367(b)-3(b)(2)(iii).

170 Prop. Reg. § 1.367(b)-3(b)(2)(iii)(A).

171 Prop. Reg. § 1.367(b)-3(b)(2)(iii)(A)(1), (2) and (3).

172 Rev. Rul. 72-421, 1972-2 C.B. 166.

173 Prop. Reg. § 1.367(b)-3(b)(2)(iii)(A)(3).

basis in that category, the taxpayer may choose the assets in the category to which the basis reduction will apply.[174]

Unused foreign tax credits allowable to the foreign acquired corporation under section 906[175] carry over to the domestic acquiring corporation, but such domestic corporation succeeds to no other foreign taxes paid or incurred by the acquired corporation.[176] Therefore, if foreign taxes are paid by the foreign corporation with respect to income that is not effectively connected with the conduct of a trade or business in the U.S. and is not an element of the all earnings and profits amount included in income, such taxes will not be creditable.

Comments

1. General. A comparison of Prop. Reg. § 1.367(b)-3 with the Temporary Regulations relating to the same types of transactions reveals that the Proposed Regulations are in some respects less onerous for taxpayers, but in more respects are materially more onerous.

Prop. Reg. § 1.367(b)-3 does not apply to inbound stock reorganizations. Therefore, such reorganizations are subject to the general rule of section 367(b) that the foreign acquired corporation will be treated as a corporation for purposes of determining the applicability of the reorganization provisions.

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174 Id.

175 Section 906 provides a foreign tax credit to foreign corporations and nonresident alien individuals to the extent they pay foreign taxes on effectively connected income.

176 Prop. Reg. § 1.367(b)-3(d).

We agree that inbound stock reorganizations should be respected as non-recognition transactions; because no earnings or assets (other than the stock of the transferred corporation) are being moved into domestic corporate solution, there is no potential to avoid tax on the repatriation of previously untaxed inside earnings or basis.

The Proposed Regulations treat taxpayers more harshly than the Temporary Regulations and, in our view, more harshly than is appropriate, in several situations. Consider the following examples:

> Example 3. Domestic corporation DC1 owns 10%, and unrelated foreign corporation FC1 owns 90%, of the outstanding stock of foreign corporation FC2. FC2 transfers all its assets to domestic corporation DC2 in a type C reorganization. Under the Temporary Regulations, DC1 would not include an amount in income because DC1 would not be a United States shareholder unless FC2 were a CFC (and thus, the special rules of Temp. Reg. § 7.367(b)-7 would not apply). Under the Proposed Regulations, DC1 must include in income the all earnings and profits amount attributable to its stock.

> Example 4. Domestic corporation DC1 owns 60%, and numerous domestic and foreign persons, none of whom owns over .1%, own the other 40%, of the outstanding stock of foreign corporation FC. FC transfers all its assets to domestic corporation DC2 in a type C reorganization. Under the Temporary Regulations, FC would be treated as a corporation with respect to the minority shareholders, because they are not United States shareholders, and DC1 would include the section 1248 amount attributable to its stock in accordance with Temp. Reg. § 7.367(b)-7(c)(1)(i). Under the Proposed Regulations, the domestic minority shareholders must recognize gain (but not loss) with respect to the exchange and DC1 must include in income the all earnings and profits amount attributable to its stock.

The differing tax treatment under the Proposed Regulations results from two rules. First, the Proposed Regulations expand the definition of United States shareholder to encompass shareholders owning stock in foreign corporations that are not CFCs. Second, exchanging U.S. persons that are small shareholders are denied the benefit of non-recognition treatment under the Proposed Regulations.

a. Definition of United States Shareholder. The regulatory goal here is to prevent a domestic acquiring corporation from succeeding to previously untaxed earnings or basis of a foreign acquired corporation. This goal may not be appropriate in all cases to which this section is applicable. Example 3 is most closely analogous to a direct foreign investment in the U.S. which would not be taxable at all. Arguably, the portion of U.S. investment that is repatriated, rather than invested anew in the U.S., is so small as to not warrant subjecting the transaction to tax.

However, consistent with the views stated above at Section III(D)(1), we believe that the inclusion in a U.S. person's income of the repatriated earnings of a corporation owned by such person is a rational approach. Therefore, we do not object to this change.

b. Mandatory Gain Recognition by Small Exchanging Shareholders That Are U.S. Persons. Under the Temporary Regulations, the domestic minority shareholders in Example 4 are entitled to treat the transaction as a reorganization without any immediate income inclusion. Under the Proposed Regulations, however, the domestic minority shareholders would be denied the benefit of non-recognition treatment.

We recognize that a significant gap in the coverage of section 367(b) results from the failure to include less-than-10% shareholders in the group of persons that must include in income the all earnings and profit amount. And we agree that such shareholders may not be able to obtain from the acquired or acquiring corporations the information necessary to compute the all earnings and profits amount attributable to their stock and corporations may not be able to acquire from such shareholders information necessary to adjust tax attributes as may be required under the gain recognition election of this section.

However, shareholder-level gain may bear no relation to the all earnings and profits amount which the rules should be designed to capture. This imprecision strengthens the case that, as a policy matter, small shareholders otherwise qualifying for non-recognition treatment should not be denied such treatment by section 367(b). In our view, such shareholders are not logical persons to penalize for any tax benefits accruing to the acquiring domestic corporation.[177] Therefore, we recommend that the final regulations provide non-recognition treatment for small exchanging shareholders even if larger shareholders must include income currently. At a minimum, the Proposed Regulations should afford exchanging U.S. shareholders the opportunity to make the converse of the election provided by Prop. Reg. § 1.367(b)-3(b)(2)(iii), to include in income the all earnings and profits amount in lieu of recognizing gain on the stock exchanged.

Finally, if small exchanging shareholders must recognize gain, they should be permitted to recognize losses where they would otherwise be entitled to such losses. For example, in the case of an inbound liquidation, such shareholders

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[177] One manifestation of the rule's inequity may be illustrated by the following example: A U.K. plc in financial distress owns two assets: stock of a U.S. corporation and stock of a U.K. corporation. Plc plans to sell the stock of U.K. Co. and use the proceeds to pay creditors. It will then domesticate through a "D" reorganization (in accordance with Revenue Ruling 57-465) in which it is deemed to transfer substantially all of its assets (consisting solely of the stock of U.S. Co.) to U.S. Co. in exchange for U.S. Co. stock and then liquidate. Suppose that a substantial number of Plc's shareholders are U.S. less-than-10% shareholders and that Plc has a cumulative deficit in earnings. It seems illogical to tax the U.S. investors on gain when (1) there is no asset with any basis (much less a basis increased by earnings) being transferred into the U.S. (other than stock of U.S. Co. which does not become an asset of U.S. Co.) and (2) Plc is demonstrably bereft of earnings and profits.

would be entitled to recognize losses in the absence of section 367.[178] There is no apparent reason why section 367 should change this result.

2. Currency Exchange Gain and Loss on Capital. Generally, the Proposed Regulations attempt to apply recently proposed rules governing the termination of a QBU branch to certain inbound section 367(b) transactions. These proposed regulations under section 987 provide that a taxpayer must recognize currency gain or loss attributable to a QBU branch's capital when the QBU branch terminates and treat as terminations of QBU branches inbound liquidations and section 367(b) transactions in which a U.S. shareholder must include in income an all earnings and profits amount.[179]

We agree with the general notion that adjustments to reflect foreign currency fluctuations should be made with respect to the investments of U.S. shareholders after inbound liquidations or asset reorganization. However, because any potential abuse relates to the repatriation of untaxed basis, and not earnings, we think that it is more appropriate to reflect foreign currency gain or loss in the basis of the assets of the acquired corporation that are transferred to the acquiring domestic corporation than to require an income inclusion.

[178] Code § 331.

[179] Prop. Reg. § 1.987-2, -3(b).

If the final regulations do not replace the proposed rule with a rule requiring basis adjustments, the final regulations should state that the source of foreign currency gain or loss with respect to capital is determined by reference to the earnings of the foreign acquired corporation. This would appear to be required by section 987 and its legislative history.[180]

Moreover, in accordance with our previous comments, foreign exchange loss should not be limited by the all earnings and profits amount included in income with respect to shareholders that can recognize losses absent section 367.

3. Same-Country Dividend Treatment. The Proposed Regulations state that an inclusion by a foreign corporation of the all earnings and profits amount as a deemed dividend does not qualify for same-country dividend treatment under subpart F, apparently even if an actual dividend from the same earnings would have so qualified. We see no reason to treat deemed dividends more adversely in this regard than actual dividends, especially where a well-advised taxpayer could cause the same country dividend to be paid prior to the inbound transfer, and recommend that this rule be changed.

4. Technical Comment. There is an apparent inconsistency in the rules governing the taxable exchange election. The Proposed Regulations state that the exchanging shareholders make the taxable exchange election by reporting the exchange in a manner consistent therewith.[181] If they do so, it is not clear that section 381 would apply.

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180 See Code § 987(3)(B), TRA 86 Conference Report at II-675.

181 Prop. Reg. § 1.367(b)-3(b)(2)(iii)(A).

The regulations require, however, that NOLs and capital loss carryovers “to which the domestic acquiring corporation would otherwise succeed under section 381(a) ...” must be reduced.[182] This apparent inconsistency should be clarified.

F. Section 1.367(b)-4

Summary of Regulation

Prop. Reg. § 1.367(b)-4 applies to foreign-to-foreign reorganizations and foreign-to-foreign section 351 transactions.[183] It is relatively straightforward and greatly simplifies the Temporary Regulations that address the same transactions. In general, exchanging shareholders in transactions to which this section applies must include in income as a deemed dividend the section 1248 amount with respect to their stock if the transaction satisfies one of two tests.[184]

The first test is met if, immediately before the exchange, a U.S. person is a section 1248 shareholder with respect to the foreign acquired corporation (or, where the exchanging shareholder is a foreign corporation, with respect to such foreign corporation and the foreign acquired corporation) and, immediately after the exchange, such U.S. person is not a section 1248 shareholder of the corporation the stock of which is received in the exchange, the foreign acquiring corporation (in the case of transactions other than B reorganizations) or the foreign acquired corporation (in the case of B reorganizations).[185]

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182 Prop. Reg. § 1.367(b)-3(b)(2)(iii)(A)(1), (2).

183 Prop. Reg. § 1.367(b)-4(a).

184 Prop. Reg. § 1.367(b)-4(b).

185 Prop. Reg. § 1.367(b)-4(b)(1).

The second test is met if (i) the exchanging shareholder receives preferred stock (other than fully participating preferred) in exchange for common stock or, in the discretion of the District Director, receives tracking stock, (ii) immediately after the exchange, a domestic corporation owns a sufficient amount of the voting stock of the foreign acquiring corporation to qualify for the indirect foreign tax credit with respect to a distribution from such corporation and (iii) the foreign acquired corporation and the foreign acquiring corporation are not members of the same affiliated group (determined as if the affiliation requirement were 50% instead of 80% and without regard to the exclusion for foreign corporations).[186]

The deemed dividend included in income under this regulation automatically qualifies for the same-country exception to foreign personal holding company income and, as such, is not Subpart F income if included by an exchanging shareholder that is a foreign corporation.[187]

If income is not required to be recognized under these rules, earnings and profits to which the foreign acquiring corporation succeeds under section 381 are deemed to have been accumulated by the acquiring corporation in the same years in which they were accumulated by the acquired corporation and the exchanging shareholder is deemed to have owned stock in the acquiring corporation for the same period during which it owned stock in the acquired corporation.[188]

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[186] Prop. Reg. § 1.367(b)-4(b)(2).

[187] Prop. Reg. § 1.367(b)-4(c).

[188] Prop. Reg. § 1.367(b)-4(d).

Comments

Evaluation of this regulation is assisted by a brief examination of the regulatory purpose. If a U.S. person that would have been subject to section 1248 on the disposition of stock in a corporation can avoid that section by acquiring in a reorganization an interest in another corporation, the disposition of which would not be subject to section 1248, that section’s objectives would be circumvented. One objective of section 367(b) is to prevent the avoidance of section 1248. Currently, the Temporary Regulations under section 367(b) also attempt to preserve a U.S. person's allocable share of a foreign corporation's earnings and profits and foreign tax attributes when an interest in that corporation is transferred in a non-recognition exchange.[189]

Generally, the Temporary Regulations accomplish these goals by requiring maintenance of section 1248 and earnings and profits accounts with respect to stock in the acquiring corporation to which an amount has been attributed in the section 367(b) transaction.[190] These accounts generally insure that exchanging shareholders (i) do not have the same earnings taken into account under section 1248 a second time when they sell their acquiring corporation stock, (ii) are accorded dividend treatment on the receipt of distributions from the acquiring corporation attributable to earnings and profits of the acquired corporation and (iii) obtain credit for a commensurate amount of the acquired foreign corporation's foreign taxes for future use as foreign tax credits.

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189 Temp. Reg. § 7.367(b)-7(c)(1)(ii), -9.

190 Id.

Maintenance of these accounts is extraordinarily complex, especially in tiered CFC settings. It also creates significant anomalies that arguably outweigh the benefits they are intended to confer.[191]

For these reasons, the Proposed Regulations abandon the maintenance of such accounts with one exception: with respect to a transaction in which exchanging shareholders are not required to recognize income under the general rule, subsequent transfers of the acquiring corporation's stock will be analyzed under section 1248 and section 367(b) as if the earnings and profits to which the acquiring corporation succeeds under section 381 are deemed to have been accumulated by such corporation in the same years in which they were accumulated by the foreign acquired corporation and the exchanging shareholder is deemed to have owned stock in the foreign acquiring corporation for the same period during which it owned stock in the foreign acquiring corporation for the same period during which it owned stock in the acquired corporation.[192] Thus, on subsequent dispositions of (but not distributions with respect to) the acquiring corporation's stock, exchanging shareholders are given the detriment (or benefit) of section 1248 to the same extent as if their stock in the acquired corporation[193] had been sold.

We agree with the decision to eliminate in most cases the attribution rules of the Temporary Regulations. The abuses at

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[191] For a discussion of these complexities, see, generally, Dolan and Horowitz, Reorganizations of Foreign Corporations under Section 367(b): Issues and Recommendations, 38 Tax L. Rev. 321 (1983)

[192] Prop. Reg. § 1.367(b)-4(d).

[193] We assume that the necessary corollary is that this rule applies for purposes of section 902 as well. A statement to that effect would be helpful.

which they are aimed (avoidance of dividend income and transferring of foreign tax credits to shareholders that did not "earn" them) are not of sufficient importance to warrant the complexity of the Temporary Regulations. And we agree that where, as in the case of the above-mentioned limited rule insuring that subsequent transfers are accorded their share of previous earnings, a rule can be applied without too much complexity that furthers the goal of giving each shareholder its correct amount of tax attributes, such a rule should be adopted. In short, we think that this section of the Proposed Regulations is a vast improvement over the Temporary Regulations covering the same subject.

### G. Section 1.367(b)-5

#### Summary of Regulation

Prop. Reg. § 1.367(b)-5 addresses distributions described in section 355 to which section 367(b) applies. The rules of this section are as follows.

If the distributing corporation is domestic and the controlled corporation is foreign, the status of the controlled corporation as a corporation depends on whether the distributee is an individual or a corporation.[194] Generally, stock owned by partnerships, estates or trusts is treated as owned proportionately by the partners and beneficiaries.[195]

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[194] Prop. Reg. § 1.367(b)-5(b). In either event, the distributing corporation will have to apply section 1248(f), as modified by Notice 87-64 1987-2 C.B. 375.

[195] Prop. Reg. § 1.367(b)-2(1).

If the distributee is an individual, the distributing corporation must recognize gain under section 311(b) with respect to the distribution (although the distributee is not required by the Proposed Regulations to recognize income under section 301 or 302).[196] If the distributee is a corporation, no such gain or income will be recognized under section 367(b).[197] However, if the distributee is foreign, section 367(e) may require that the distributing corporation recognize such gain.[198]

If the distributing corporation is foreign, but is not a CFC, no gain or income is recognized on the distribution. If the distributing corporation is a CFC, a section 1248 amount will be required to be taken into account to the extent that the distributee shareholder's section 1248 amount after the distribution is less than it was before the distribution, with respect to either the distributing or the controlled corporation.[199]

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196 Prop. Reg. § 1.367(b)-5(b)(2).

197 Prop. Reg. § 1.367(b)-5(b)(1). The distributee must be treated as an individual unless the distributing corporation has reason to know that the distributee is a corporation. Prop. Reg. S 1.367(b)-5(b).

198 It is unclear what the result is if some distributees are individuals and others are corporations. The Proposed Regulations should clarify this point.

199 Prop. Reg. § 1.367(b)-5(c), (d).

In cases in which the section 1248 amount is taken into account, it is taken into account differently depending on whether the distribution is pro rata or non-pro rata. If the distribution is non-pro rata, any reduction in the section 1248 amount by virtue of the distribution, with respect to either the distributing or the controlled corporation, is included as a deemed dividend in the distributee's income.[200] For this purpose, unless a taxable distribution election as described below is made, the term “distributee” includes all persons owning stock of the distributing corporation immediately after the transaction.[201]

If the distribution is pro rata, any such reduction reduces the basis of the distributee in the stock of such corporation (but not below zero). Such distributee includes in income as a deemed dividend any excess of such section. 1248 amount over such basis.[202]

With respect to non-pro rata distributions, (i) the deemed dividend is treated as paid out of the earnings and profits of the relevant member of the distributing or controlled group to which the difference is attributable and (ii) if a distribute owns no stock in either the distributing or controlled corporation, its section 1248 amount with respect thereto is zero.[203]

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[200] Prop. Reg. § 1.367(b)-5(d). If the distributee is a foreign person, it is treated as a U.S. person for purposes of determining the pre-distribution section 1248 amount, but not for purposes of determining if any lower-tier corporation is a CFC. Prop. Reg. § 1.367(b)-5(e).

[201] Prop. Reg. § 1.367(b)-5(d)(3)(i). For clarity, the quoted language should read “distributees with respect to such stock.”

[202] Prop. Reg. § 1.367(b)-5(c).

[203] Prop. Reg. § 1.367(b)-5(d)(2).

Also, and most significantly, in the case of a non-pro rata distribution, a shareholder of the distributing corporation required to include an amount in income under the foregoing rules that neither receives stock in the controlled corporation nor exchanges stock in the distributing corporation may elect to treat the distributing and controlled corporations[204] as not corporations so as to cause the recognition of gain, but not loss, by all persons affected by the taxable status of the transaction.[205]

Special rules are provided for computing earnings and profits in certain cases. In the case of a type D reorganization preceding a section 355 transaction subject to these rules, earnings and profits are allocated between a foreign transferor and the transferee in accordance with the relative adjusted bases, net of liabilities, of the assets retained by the transferor and the assets transferred.[206] This should be contrasted with Reg. § l.312-10(a), which generally provides that such allocation shall be made in accordance with fair market values. Also, under the Proposed Regulations, Reg. § l.312-10(b) does not apply in the case of a foreign distributing corporation, so that no earnings and profits reallocation is made for “non-type D” section 355 transactions.[207]

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[204] It is not entirely clear what the Proposed Regulations intend the consequences to be if the distributing corporation is not treated as a corporation.

[205] Prop. Reg. § 1.367(b)-5(d)(3)(ii).

[206] Prop. Reg. § 1.367(b)-5(f)(1)(i). Notwithstanding this rule, if a transferee makes the election described in Reg. S 1.884-2T(d)(4), earnings and profits are allocated in a manner consistent with such section, including the use of gross adjusted bases for the allocation instead of net adjusted bases. Prop. Reg. § 1.367(b)-5(f)(1)(ii).

[207] Prop. Reg. § 1.367(b)-5(f)(2).

Comments

1. General. The committee considered whether the general approach taken by the Proposed Regulations is an improvement over the Temporary Regulations. Some members favored an approach more like that of the Temporary Regulations, which attribute section 1248 amounts rather than force current inclusion of such amounts in income, at least in cases where both the distributing and the controlled corporations are CFCs and the total U.S. shareholder ownership of both corporations is not reduced. Others questioned why non-pro rata distributions should be subjected to more adverse treatment than pro rata distributions. Still others questioned why a corporate-level tax should be imposed on a distribution by a domestic corporation to an individual in a transaction that otherwise qualifies under section 355.

The consensus view was that simplification of the rules was a more important goal than a theoretically more correct approach that was practically beyond administrability. However, it was not deemed to be overly burdensome to administer, and policy was deemed to favor, a system in which there is no adverse section 367 consequence to a domestic-to-domestic distribution of a foreign corporation to an individual that otherwise qualifies under section 355. Therefore, although we agree in large measure with the general thrust of this section, we recommend an exception for this transaction.[208]

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[208] The preamble to the Proposed Regulations explains the different treatment for distributions of domestic stock by pointing out that in the case of such distributions, the controlled corporation's earnings and profits would have been subject to United States corporate tax jurisdiction when earned. We view section 355 as primarily addressing the tax liability of the distributing corporation and its shareholders, however, and do not view the stated reason as a sufficient basis for the rule.

2. Gain Recognition Election. The committee views the gain recognition election that may be made by a non-exchanging shareholder in a non-pro rata section 355 distribution as highly inequitable. Although we understand the plight of a non-exchanging shareholder forced to include an amount in income on a transaction where it has received no distribution, it is hardly an answer to provide that shareholder with the option of determining the tax effects to all other parties to the transaction.

One approach the final regulations might take instead would be to require that such a shareholder add the reduction in its section 1248 amount attributable to its indirect interest in the controlled corporation to its section 1248 amount with respect to the first-tier stock it retains.[209] Alternatively, the non-distributee shareholder might be given an election either to include in income the reduction in section 1248 amount or to recognize the gain in its stock. In any event, we recommend against the election in the Proposed Regulations, even if the non-exchanging shareholder's predicament must be tolerated as a necessary by-product of the shift in approach from a section 1248 amount attribution regime to a current inclusion regime.

3. Definition of Pre-distribution Amount. In the case of a distribution in which the distributee is a foreign corporation, such corporation is deemed to be a U.S. person for purposes of determining whether it has a pre-distribution amount, i.e., a section 1248 amount prior to the distribution.[210] Such

[209] We recognize that this might not produce a theoretically perfect result where, for example, the section 1248 amount's gain limitation reduces or eliminates the attributed section 1248 amount upon a subsequent disposition of the first-tier stock. We view this as a better solution, however, than the Proposed Regulations' gain recognition election.

[210] Prop. Reg. § 1.367(b)-5(e).

corporation is also deemed to be a U.S. person for purposes of determining whether it has a section 1248 amount after the distribution.[211] Thus, a foreign corporate distributee may have a reduction in its section 1248 amount and may be required to include an amount in income. If this rule is to be adopted, a rule similar to that included in Prop. Reg. § 1.367(b)-4(c) should be included in Prop. Reg. § 1.367(b)-5. That is, the resulting income inclusion should be eligible for exclusion from foreign personal holding company income as a same-country dividend.

There is also a technical error in the definition of predistribution amount. That amount is measured with respect to the distributing corporation as if the distributee sold all of its stock in the distributing corporation immediately prior to the distribution, but only to the extent of the amount that would be included in income by the distributee as a dividend attributable to (i) the distributing corporation and any corporations controlled by it immediately prior to the distribution or (ii) the controlled corporation and any corporations controlled by it immediately prior to the distribution, as the case may be.[212] Technically, “the distributing corporation and any corporations controlled by it immediately prior to the distribution” includes the controlled corporation and any corporations controlled by it immediately prior to the distribution. Thus, the controlled group is erroneously double counted.

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[211] Id.

[212] Id.

4. Technical Rules for Non-Pro Rata Distributions. The Proposed Regulations treat a deemed dividend as paid out of the earnings and profits of the relevant member of the distributing or controlled group to which the difference is attributable. We believe that this rule is incorrectly applied in the result in Example 1 of Prop. Reg. § 1.367(b)-5.

5. Special Earnings and Profits Rules. In a type D reorganization prior to a section 355 distribution, earnings and profits are allocated in accordance with net bases of assets. The regulations should clarify how this allocation is made when, on a net basis, the distributing corporation has a negative basis but the controlled corporation has a positive basis.

## H. Section 1.367(b)-6

Prop. Reg. § 1.367(b)-6 prescribes effective dates for the other sections of the Proposed Regulations under section 367(b). In general, except for certain transitional purposes, those regulations are effective for exchanges that occur on or after the date that is 30 days after the Proposed Regulations are published as final regulations in the Federal Register.

We believe that the Proposed Regulations under section 367(b) substantially simplify the Temporary Regulations on the same subject. There is no apparent reason why taxpayers should not be allowed to utilize the simplified rules as of the earliest possible time. Therefore, we recommend that taxpayers be able to elect to apply the Proposed Regulations under section 367(b), and not the Temporary Regulations, to exchanges that occur on or after August 26, 1991.