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INTERNATIONAL TAX FREE EXCHANGES: THE STRUCTURE OF I.R.C. SECTION 367

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INTRODUCTION

For half a century tax practitioners have been troubled by section 367 of the Internal Revenue Code[1] (Code). Section 367 provides rules for determining the applicability of various nonrecognition provisions of subchapter C to certain exchanges involving foreign corporations. Early concerns stemmed from the dearth of authoritative interpretation, but the complex rules confuse current analysts as well. A study of the legislative history in conjunction with analysis of the rulings and regulations does, however, reveal some basic recurring themes of section 367. This Article undertakes to trace the development of those themes and to illustrate their application to a variety of transactions. The present work does not pretend to account for every transaction within the scope of section 367. Its ambitions instead are to unravel the mystery of the statute by illuminating the rationale behind these recurring themes and to give examples of particular parts of section 367 that illustrate its relation to other sections of the Code.

LEGISLATIVE HISTORY

Before the enactment of the Revenue Act of 1932 the nonrecognition provisions of the Code applied equally to domestic and foreign corporations.[2] As a result, United States taxpayers could avoid recognition of gain and thus taxation by transferring appreciated property to foreign corporations. Congress realized the need to prevent such overt tax avoidance:

> Taxpayers having large unrealized profits in securities may transfer such securities to corporations organized in countries im-

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[1] I.R.C. § 367 (1954) (amended 1976).

[2] *E.g.*, Crosby-Wirth Sales Book Co. v. Comm'r of Internal Revenue, 19 B.T.A. 1074 (1930).

posing no tax upon the sale of capital assets. Then, by subsequent sale of these assets in the foreign country, the entire tax upon the capital gain is avoided. For example, A, an American citizen, owns 100,000 shares of stock in corporation X, which originally cost him $1,000,000 but now has a market value of $10,000,000. Instead of selling the stock outright, A organizes a corporation under the laws of Canada to which he transfers the 100,000 shares of stock in exchange for the entire capital stock of the Canadian company. This transaction is a nontaxable exchange. The Canadian corporation sells the stock of corporation X for $10,000,000 in cash. The latter transaction is exempt from tax under the Canadian law and is not taxable as United States income under present law. The Canadian corporation organizes corporation Y under the laws of the United States and transfers the $10,000,000 cash received upon the sale of corporation X's stock in exchange for the entire capital stock of Y. The Canadian corporation then distributes the stock of Y to A in connection with the reorganization. By this series of transactions, A has had the stock of X converted into cash and now has it in complete control.[3]

Congress intended the Revenue Act of 1932 to prevent this type of tax avoidance,[4] and enacted section 112(k),[5] the predecessor of section 367. Certain transactions involving foreign corporations were withdrawn from the operation of the nonrecognition provisions by stating that "for the purposes of determining gain, the foreign corporation shall not be considered as a corporation" unless the Commissioner had determined that tax avoidance was not a principal purpose behind the transaction.[6] This determination could be made only in the form of an advance ruling issued by the Treasury Department.

It has been difficult to detail the meaning of the statute,[7] as Congressional commentary,[8] Treasury Department interpretation,[9]

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[3] H.R. REP. NO. 708, 72d Cong., 1st Sess. 20 (1932); S. REP. NO. 665, 72d Cong., 1st Sess. 26 (1932).

[4] *Id. See also* R. RHOADES, INCOME TAXATION OF FOREIGN RELATED TRANSACTIONS 7-14 (1979); Siegel, *Section 367 of the Internal Revenue Code and its Relationship to the Taxation of Certain Transactions Involving Foreign Corporations*, 22 FED. B.J. 109, 111 (1962).

[5] Revenue Act of 1932, Pub. L. No. 72-154, § 112(k), 47 Stat. 198 (1932).

[6] *Id.*

[7] McDonald, *Section 367 - A Modern Day Janus*, 64 COLUM. L. REV. 1012 (1964).

[8] When section 112(i) of the Internal Revenue Code of 1939 was enacted, the original Congressional comments in the House and Senate Reports of the Revenue Act of 1932 were not amplified. *See* H.R. REP. NO. 855, 76th Cong., 1st Sess. 20 (1939). Moreover, when section 112(i) of the 1939 Code became section 367 of the 1954 Code, the Committee Reports indicate no major change in Congressional intent. H.R. REP. NO. 1337, 83d Cong., 2d Sess. A131 (1954) *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4025; S. REP. NO. 1622, 83d Cong., 2d Sess. 272 (1954) *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621.

[9] McDonald, *supra* note 7, at 1014.

and judicial analysis have been markedly absent.[10] By the early 1960's, however, a theme was clear in the application of section 367 by the Internal Revenue Service. "Tax avoidance," as used in the statute, referred not only to the circumvention of taxation by transfer of appreciated property outside United States tax jurisdiction, but also to the repatriation by a domestic parent corporation of accumulated earnings and profits of its foreign subsidiary in a nontaxable liquidation or reorganization of the foreign subsidiary. When significant accumulated earnings and profits were to be transferred in, the Commissioner generally refused to issue a favorable ruling.[11]

Despite the Service's interpretation of "tax avoidance," a United States person still could repatriate accumulated earnings and profits at favorable capital gains rates. Had the foreign corporation distributed dividends of such amounts to its domestic shareholders, the dividends would have been subject to ordinary income treatment; however, section 367 applied only to various nonrecognition provisions of subchapter C of the Code. Thus, the domestic shareholder could sidestep the statute by selling, liquidating or redeeming his stock in the foreign corporation. Because these transactions required the recognition of gain, they did not come within the purview of section 367 and capital gains rates normally applied.[12] To the extent that the value of the stock sold represented earnings and profits accumulated in the foreign subsidiary, the taxpayer effectively converted ordinary income into capital gains.[13]

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> [Section 367] says . . . that for purposes of determining gain, the foreign corporation 'shall not be considered as a corporation.' The meaning of that quoted phrase is totally obscure and should have been analyzed by the first cases that dealt with section 367's forerunner. It was not. Indeed, as of this writing, no case has adequately attempted to walk through the maze of what happens when a corporation is not a corporation.

R. RHOADES, *supra* note 4, at 7-14.

[11]

> Theoretically it is also possible to bring earnings accumulated by a foreign corporation back to the United States without payment of income tax through the use of a tax-free reorganization (under sec. 368) or through the use of a tax-free liquidation (under sec. 332). However, to do so the Commissoner of Internal Revenue must give clearance by determining in advance that the transaction "is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." Generally the Commissioner has been unwilling to grant such approval where there is an appreciable amount of earnings and profits accumulated in a foreign corporation.

H.R. REP. NO. 1447, 87th Cong., 2d Sess. 76 (1962). S. REP. NO. 1881, 87th Cong., 2d Sess. 107 (1962), *reprinted in* [1962] U.S. CODE CONG. & AD. NEWS 3304.

[12] *Id.* at 3411.

[13] *Id.* at 3411-12.

One of the legislative purposes in the passage of the Revenue Act of 1962 was to eliminate this repatriation of earnings and profits as capital gains.[14] Hence, section 1248 of the Code was enacted to provide that when a United States shareholder enters into certain sales,[15] exchanges or redemptions of stock in a controlled foreign corporation (CFC),[16] the surrendering shareholder must include in income as a dividend that portion of post-1962 earnings and profits of the foreign corporation accumulated while the shareholder held the stock during a period in which the corporation was a CFC.[17]

In the first thirty years under section 367, two applications of the "tax avoidance" interpretation emerged. First, the avoidance of capital gains tax by the transfer of specified appreciated property to a foreign corporation was proscribed. Second, the tax-free repatriation of earnings and profits accumulated in foreign subsidiaries was prohibited. However, it was often difficult for a taxpayer to determine when the Service would consider a specific transaction to be "tax avoidance."[18] Combined with the advance ruling requirement, this uncertainty had harsh consequences for unsuspecting taxpayers who otherwise might have structured an exchange in which tax avoidance was not considered a principal purpose.[19] To resolve this uncertainty, the Internal Revenue Service published guidelines (Guidelines) in 1968 providing objective tests for determining whether a favorable ruling would be granted in a specific transaction.[20] The Guidelines required inclusion in income of gain derived from specific items, such amounts constituting

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[14] *Id.* at 3304.

[15] I.R.C. § 951(b) defines "United States shareholder" as:

> with respect to any foreign corporation, a United States person (as defined in section 957(d)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation.

I.R.C. § 951(b).

[16] I.R.C. § 957(a) defines "controlled foreign corporation" as:

> any foreign corporation of which more than 50 percent of the total combined voting power of all classes of stock entitled to vote is owned (within the meaning of section 958(a)), or is considered as owned by applying the rules of ownership of section 958(b), by United States shareholders on any day during the taxable year of such foreign corporation.

I.R.C. § 957(a).

[17] I.R.C. § 1248(a).

[18] Beimfohr, *Tax-Free Exchanges With a Foreign Corporation: Section 367; the Guidelines Analyzed*, 28 N.Y.U. INST. ON FED. TAX. 455, 458 (1970).

[19] Sitrick, *Section 367 and Tax Avoidance: An Analysis of the Section 367 Guidelines*, 25 TAX. L. REV. 429, 430 (1970).

[20] Rev. Proc. 68-23, 1968-1 C.B. 821 [hereinafter cited as GUIDELINES].

the section 367 "toll" charge if the taxpayer desired a favorable ruling with respect to certain exchanges.[21]

Despite publication of the Guidelines, four problems developed in the application of section 367 and the related provisions of section 1248. First, the advance ruling requirement caused undue delay for taxpayers who engaged in transactions with no tax avoidance purpose. Second, where a foreign corporation was involved in an exchange without the knowledge of its domestic shareholders, a transaction otherwise tax-free could become taxable if no request for a ruling had been made. Third, the Guidelines required current payment of the toll charge even though the tax avoidance categorization existed only prospectively. Fourth, recipients of an adverse decision from the Commissioner had no forum for appeal.[22]

With the Tax Reform Act of 1976 Congress sought to ameliorate these difficulties.[23] The Act amended section 367 to establish separate rules for two different groups of transactions. First, section 367(a) stated rules for the transfer of property *from* the United States. The obvious statutory objective was the prevention of untaxed removal of appreciated stock or assets from United States tax jurisdiction. While prior to 1976 nonrecognition provisions of section 367 applied only if a favorable ruling had been granted, the act eliminated the requirement that the ruling be obtained prior to the exchange.[24] Moreover, the Code was amended to entitle a taxpayer to judicial review of adverse determinations by the Treasury Department.[25]

Second, section 367(b) established independent treatment for other transfers, including transfers into the United States and others exclusively foreign, in order to preserve the taxation of accumulated earnings and profits of CFC's.[26] Furthermore, the subsection provided that Treasury Regulations (rather than determinations by the Commissioner) were to govern the treatment of an exchange within its scope.[27]

THE MECHANICS OF SECTION 367

OUTBOUND TRANSACTIONS

Section 367(a) applies to direct, indirect or constructive transfers

[21] S. REP. NO. 94-938, 94th Cong., 2d Sess. 262 (1976), *reprinted in* [1976] U.S. CODE CONG. & AD. NEWS 3439, 3692, 3693.

[22] *Id.* at 262, 263. *See also* H.R. REP. NO. 94-658, 94th Cong., 1st Sess. 240, 241 (1975).

[23] The Tax Reform Act of 1976, Pub. L. No. 94-455, § 1042, 90 Stat. 1634 (1976).

[24] I.R.C. § 367(a)(1).

[25] *Id.* § 7477.

[26] S. REP. NO. 94-938, *supra* note 21, at 264.

[27] I.R.C. § 367(b).

of property (other than stock or securities of a foreign corporation which is a party to the exchange or reorganization) by a United States person to a foreign corporation in connection with any exchange described in sections 332, 351, 354, 355, 356, or 361.[28]

Direct transfers include the following exchanges:

1) The liquidation of a domestic subsidiary into its foreign parent.[29]
2) The transfer of property by a United States person to a foreign corporation which the transferor controls immediately after the exchange.[30]
3) A corporate reorganization in which a domestic corporation transfers assets to a foreign corporation.[31]
4) A corporate reorganization in which a domestic shareholder transfers stock to a foreign corporation.[32]

Indirect transfers include the following "triangular" and "reverse triangular" reorganizations:

1) A corporate reorganization described in section 368(a)(1)(C) where a domestic corporation transfers assets to a domestic subsidiary of a foreign parent in exchange for the parent's stock.[33]
2) A corporate reorganization described in sections 368(a)(1)(A) and 368(a)(2)(D) or (E), where a domestic corporation is merged into another domestic corporation and a United States person who is an exchanging shareholder receives stock of a foreign parent.[34]

Constructive transfers encompass two types of transactions.[35]

1) The revocation by a domestic parent of a section 1504(d) contiguous foreign country election to treat its wholly owned Mexican or Canadian subsidiary as a domestic corporation.[36]
2) The transfer of property by a foreign partnership, foreign trust or foreign estate in which a United States person has an interest, to a foreign corporation, on account of which transfer the United States person realizes gain.[37]

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[28] Treas. Reg. § 7.367(a)-1(b)(3)(i), T.D. 7530, 1978-1 C. B. 92 (approved Dec. 27, 1977 and published as temporary regulations which were simultaneously designated as proposed regulations).

[29] I.R.C. § 332.

[30] *Id.* § 351.

[31] *Id.* § 361.

[32] *Id.* §§ 354-356.

[33] Treas. Reg. § 7.367(a)-1(b)(3)(ii).

[34] *Id.*

[35] While the Treasury Regulations do not use the term "constructive transfers" to refer to these transactions, the Tax Section of the New York State Bar Association has so addressed such exchanges. TAX SECTION, NEW YORK STATE BAR ASSOCIATION, *Report on the Proposed Regulations Under Section 367*, 34 TAX. L. REV. 83, 92 (1978). [hereinafter cited as Tax Section Report].

[36] Treas. Reg. § 7.367(a)-1(b)(3)(iv).

[37] Treas. Reg. § 7.367(a)-1(b)(3)(iii).

For the purpose of determining whether gain is recognized on a section 367(a) exchange, a foreign corporation shall not be considered a corporation unless the taxpayer satisfies the Commissioner that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes. A ruling request must be filed within 183 days after the beginning of the transfer.[38] In considering ruling requests, the Commissioner has relied principally on the Guidelines.[39] Despite the Tax Reform Act of 1976 amendments to section 367, the 1968 Guidelines will be followed by the Internal Revenue Service until superceded.[40]

In a section 351 exchange, a transfer of appreciated property to a foreign corporation, the Guidelines classify property transferred in two broad categories. The first category, referred to as "tainted" property,[41] consists of those assets for the transfer of which a favorable ruling will not be issued. There are eight classes of "tainted" property:

> 1) Property which would be included in the inventory of the transferor, or property held by the transferor primarily for sale to customers in the ordinary course of his trade or business (or other property described in section 1221(1)) as well as copyrights, literary, musical or artistic compositions held by the transferor whose personal efforts created such property (or other property described in section 1221(3)).
> 2) Property, such as accounts receivable or installment obligations, for which income has been earned but not included in the transferor's gross income.
> 3) Stock or securities. An exception exists for stock or securities of a foreign corporation where: 1) the transferee foreign corporation controls (immediately after the exchange) at least 80% of the voting power of the foreign corporation whose stock or securities are transferred, and 2) the persons who owned more than 50% of the voting stock of the transferor corporation (immediately before the exchange) now control at least 50% of the transferee corporation. Both the transferee corporation and the corporation the stock of which is transferred must be created or organized under the laws of the same foreign country, and a substantial portion of the assets of the transferor corporation must be located in such foreign country.
> 4) Property to be transferred under circumstances which make it reasonable to believe that sale or other disposition by the

[38] I.R.C. § 367(a)(1).
[39] GUIDELINES, *supra* note 20.
[40] Rev. Proc. 77-5, 1977-1 C. B. 536.
[41] TAX MNGM'T (BNA) 57-5th, at A-41 [hereinafter cited as 57-5th].

transferee foreign corporation is one of the principal purposes of the transfer of the property.
5) Property for which the transferor is a lessor or licensor, unless the transferee foreign corporation is the lessee or licensee.
6) Property which, although not subject to an existing lease or license, is transferred under circumstances that make it reasonable to believe it will be leased or licensed by the transferee after the transfer.
7) Domestic patents, trademarks, and similar intangibles to be used in connection with either the conduct of a trade or business in the United States or the manufacture of goods for sale or consumption in the United States.
8) Foreign patents, trademarks and similar intangibles to be used in connection with the sale of goods manufactured in the United States.[42]

Upon the transfer of "tainted" property in a section 351 exchange, the transferor shall include in income an amount reflecting the realized income or gain. The character of the gain shall be determined as though the property had been transferred by the United States person in a taxable exchange. Furthermore, the transferee corporation shall make appropriate adjustments in the basis of such property as it receives.

The second category of property to which the Guidelines refer in connection with section 351 exchanges comprises all other assets, or "non-tainted" property.[43] The transferor will receive a favorable ruling on the transfer of "non-tainted" assets where the transferee is to apply them to the active conduct of a trade or business in any foreign country and will either have a need for substantial investment in fixed assets in such business or be engaged in the purchase and sale abroad of manufactured goods.[44]

In a corporate reorganization where assets or stock of a domestic corporation are acquired by a foreign corporation,[45] a favorable ruling by the Service depends on the percentage of foreign corporate stock received in exchange by the United States transferor. A favorable ruling generally will be issued if the transferor owns 50% or less of the voting power of the foreign corporation, unless the assets of the acquired United States corporation consist principally of stock or securities.[46] If the shareholders of the acquired

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[42] GUIDELINES, *supra* note 20, § 3.02(1).
[43] 57-5th, *supra* note 41, at A-47.
[44] GUIDELINES, *supra* note 20, § 3.02(1).
[45] *See supra* notes 31-34 and accompanying text.
[46] The Guidelines speak only of stock acquisitions of domestic corporations and are silent as to the remaining forms of corporate reorganizations. GUIDELINES, *supra* note 20,

United States corporation own more than 50% but less than 80% of the voting power of the foreign corporation, the Guidelines are silent on whether a favorable ruling will issue. Apparently the decisions of the Service are made on analysis of the facts and circumstances of each case.[47] If the transferor owns 80% or more of the voting power of the foreign corporation, the reorganization also qualifies as a section 351 exchange of assets or stock. Accordingly, the Service applies the Guideline standards that are relevant to such transfers.[48]

In a section 332 liquidation of a domestic subsidiary into its foreign parent,[49] the Guidelines provide that the parent will be considered a corporation if the subsidiary includes in income any gain realized on the distribution of assets that would be considered "tainted" if transferred to a controlled corporation in a section 351 exchange. The character of income and adjustments in basis are determined as if the subsidiary had transferred assets to the parent in a taxable exchange.[50]

SECTION 367(b): OTHER TRANSFERS

Section 367(b) applies to an exchange of stock in a foreign corporation by any transaction described in sections 332, 351, 354, 355, 356, or 361 where there is no section 367(a)(1) property transferred.[51] Such exchanges include the following transactions:

(1) The liquidation of a foreign subsidiary into its foreign or domestic parent.[52]
(2) The transfer of foreign stock by one foreign corporation to another foreign corporation that the transferor controls immediately after the exchange.[53]
(3) A corporate reorganization in which a foreign corporation transfers assets to either a domestic or foreign corporation.[54]
(4) A corporate reorganization in which a United States shareholder exchanges stock of a foreign corporation.[55]

Section 367(b) states that in a relevant exchange, "a foreign cor-

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§ 3.03(1)(d). The Service, however, usually has applied similar rules to such reorganizations. 57-5th, *supra* note 41, at A-34.

[47] 57-5th, *supra* note 41, at A-35.

[48] *See supra* notes 41-52 and accompanying text.

[49] *See supra* note 29 and accompanying text.

[50] GUIDELINES, *supra* note 20, § 3.01(2).

[51] I.R.C. § 367(b).

[52] Treas. Reg. § 7.367(b)-5.

[53] *Id.* § 7.367(b)-8.

[54] *Id.* §§ 7.367(b)-7, 7.367(b)-9.

[55] *Id.* §§ 7.367(b)-7, 7.367(b)-9, 7.367(b)-10.

poration shall be considered to be a corporation except to the extent provided in the regulations prescribed by the Secretary."[56] The temporary regulations now in effect allow either current or deferred treatment of gain realized as income.[57]

CURRENT INCLUSION

Sections 367 and 1248 assert United States tax jurisdiction only to the extent that the taxpayer is a United States shareholder of a CFC. As noted above, the legislative objective is to preserve dividend tax treatment of a United States shareholder's interest in the accumulated earnings and profits of the CFC. Consequently, if a United States shareholder either directly repatriates the CFC earnings or exchanges the CFC stock in return for stock as to which he is not a United States shareholder (over which sections 367 and 1248 confer no tax jurisdiction), immediate dividend inclusion in income is required to prevent the conversion of ordinary income into capital gain.[58] The regulations provide the mechanisms discussed below for income inclusion.

COMPLETE LIQUIDATION OF A FOREIGN SUBSIDIARY

A domestic parent currently must pay a toll charge upon the complete liquidation of a foreign subsidiary if the subsidiary is to be considered a corporation for nonrecognition purposes.[59] The toll charge results in the inclusion in the parent's gross income of "the all earnings and profits amount" attributable to its stock in the subsidiary. The all earnings and profits amount is the earnings and profits for all taxable years (without distinction between pre-1963 and post-1962 earnings and profits) attributable to the exchanged stock of the foreign corporation.[60] Because the parent includes these amounts in income as a dividend,[61] any foreign taxes upon such earnings paid by the subsidiary qualify for "deemed-paid" foreign tax credit treatment.[62] If the parent does not pay the toll charge, the subsidiary will not be considered a corporation and the nonrecognition rules of section 332 will not protect

[56] I.R.C. § 367(b)(1).
[57] *Id.* § 367(b)(2)(A).
[58] An exception to treatment would occur if a closing agreement, which tracks the realized gain, is entered into with the Commissioner.
[59] Treas. Reg. § 7.367(b)-5.
[60] *Id.* § 7.367(b)-2(f).
[61] *Id.* § 7.367(b)-3(b).
[62] Tax Section Report, *supra* note 35, at 116.

the parent. As a result, section 1248 will apply to the parent's gain realized, treating it as a dividend to the extent of the subsidiary's post-1962 earnings and profits. Despite recognition of gain, the normal carryover basis rules still will apply.[63] In its liquidation by a foreign parent, a foreign subsidiary will be treated as a corporation.[64]

EXCHANGE OF FIRST-TIER CFC STOCK FOR NON-CFC STOCK

If a United States shareholder exchanges stock in a CFC in return for stock as to which he is not a United States shareholder (either stock of a domestic corporation, stock of a foreign corporation which is not a CFC, or stock of a CFC as to which the exchanging person is not a United States shareholder), the exchanging person shall include as income the section 1248 amount attributable to the stock exchanged, to the extent of gain realized.[65] The section 1248 amount, applicable only to an exchange of stock in a first-tier subsidiary, refers to the earnings and profits of the foreign corporation which would have been attributable to the stock exchanged, had it been sold.[66]

EXAMPLE: United States shareholder *A* owns all the stock of foreign corporation *F*, a first-tier CFC formed after 1962. *F* has earnings and profits of $150. *A* exchanges all the stock of *F* for 5% of the stock of foreign corporation *X* in a type-B reorganization,[67] realizing gain of $200. Since *A* is not a United States shareholder of *X*, corporations *F* and *X* will be considered to be corporations only if *A* includes $150 in income as a dividend.

EXCHANGE OF SECOND-TIER CFC STOCK FOR NON-CFC STOCK

If a United States shareholder in a CFC exchanges stock of a second-tier CFC in return for stock as to which he is not a United States shareholder, the 1248(c)(2) amount is added to the earnings and profits of the first-tier CFC.[68] The 1248(c)(2) amount refers to the earnings and profits which would have been attributable under section 1248(c)(2) to the stock of the foreign corporation exchanged, including stock in other lower-tier corporations.[69] Moreover, if all

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[63] Treas. Reg. § 7.367(b)-5(b).
[64] *Id.* § 7.367(b)-5(c).
[65] *Id.* § 7.367(b)-7(c)(1)(i).
[66] *Id.* § 7.367(b)-2(d).
[67] I.R.C. § 368(a)(1)(B).
[68] Treas. Reg. § 7.367(b)-7(c)(1)(ii).
[69] *Id.* § 7.367(b)-2(e).

United States shareholders of the exchanging CFC properly consent to treat the amount added to its earnings and profits as a dividend, such corporation's basis in stock received shall be increased by the amount of the dividend.[70]

EXAMPLE: *F*, a CFC as to which *A* is the sole United States shareholder, owns all the stock of *G*, a second-tier CFC formed after 1962. *G* has earnings and profits of $100. *F* exchanges all the *G* stock in return for 5% of the stock of *X*, a foreign corporation as to which *A* is not a United States shareholder. *F* must add $100 to its earnings and profits. If *A* properly consents to treat the $100 as a dividend, *F*'s basis in the *X* stock received will be stepped-up by a corresponding amount.

DEFERRED INCLUSION

If a United States shareholder exchanges CFC stock for other CFC stock as to which he maintains similar status, sections 367 and 1248 confer United States tax jurisdiction. As to the exchanging shareholder, the regulations preserve the tax characteristics of the CFC the stock of which is exchanged by attributing its earnings and profits to the CFC stock received. Thus, the attribution rules allow deferral of realized gain without permitting the repatriation of ordinary income at capital gains rates. The deferral rules provide that certain adjustments will be made to the earnings, profits, and basis levels of the CFC's involved in the reorganization.

EARNINGS AND PROFITS AJUSTMENTS

The 1248 amount, the 1248(c)(2) amount, the additional earnings and profits amount, and the "all earnings and profits" amount are calculated with respect to each United States shareholder who retains such status in reference to the CFC stock received. The additional earnings and profits amount refers to the pre-1963 earnings and profits of the CFC the stock of which is exchanged.[71] The all earnings and profits amount includes both pre-1963 and post-1962 earnings and profits of the CFC the stock of which is exchanged.[72] These amounts are then attributed to the CFC stock received by the exchanging shareholder.[73]

Furthermore, the CFC the stock of which is received "inherits"

[70] *Id.* § 7.367(b)-7(c)(1)(iii).
[71] *Id.* § 7.367(b)-2(g).
[72] *Id.* § 7.367(b)-2(f).
[73] *Id.* § 7.367(b)-9(b)(1).

the earnings and profits of the CFC the stock of which is exchanged.[74] The earnings and profits of the CFC the stock of which is received are increased by the earnings and profits of the CFC (and any of its lower-tier corporations) the stock of which is exchanged.[75] Correspondingly, the earnings and profits of the CFC the stock of which is exchanged and any of its lower-tier corporations are reduced by a like amount.[76]

EXAMPLE: United States shareholder *A* owns all the stock of *F*, a first-tier CFC formed after 1962. *F* has $125 of earnings and profits. In a type-B reorganization *A* exchanges all the *F* stock for 20% of the stock of *G*, a CFC as to which *A* becomes a United States shareholder. One hundred and twenty-five dollars is attributed to the *G* stock owned by *A*. Also, *G* inherits the $125 earnings and profits amount of *F*. Finally, *F*'s earnings and profits are reduced by $125.

BASIS AJUSTMENTS AND ELECTIONS

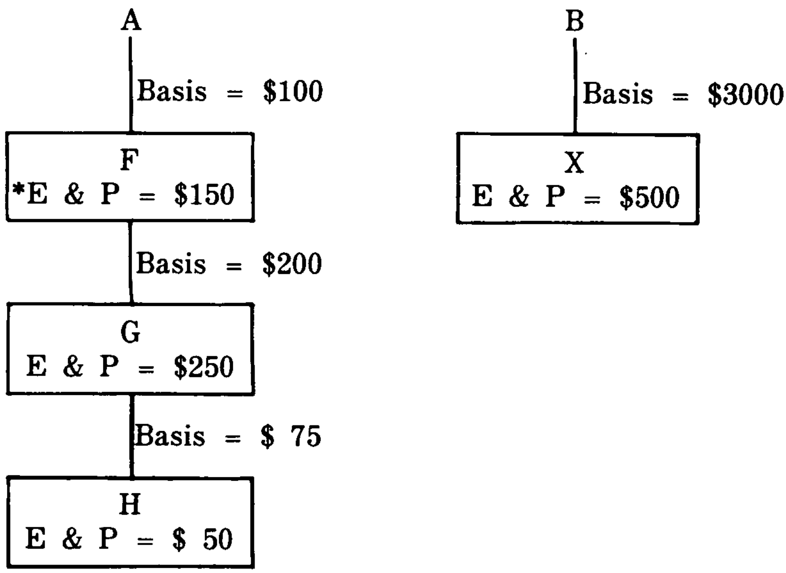
The regulations provide two levels of basis adjustment. The first applies to basis in stock of lower-tier foreign subsidiaries of the CFC the stock of which is exchanged. These adjustments are relevant regardless of the form of the acquisition, whether a non-triangular asset reorganization or a type-B (section 368(a)(1)(B)) exchange. An additional set of adjustments is provided exclusively for triangular and type-B exchanges. Hence, in a triangular acquisition where the CFC the stock of which is exchanged has lower-tier foreign corporations, both levels of basis adjustment apply. These adjustments are available only if appropriate elections are made.

On the level of lower-tier foreign corporations of the CFC the stock of which is exchanged, adjustments in basis are made with respect to the lower-tier corporation's immediate shareholder.[77] If the requisite consent dividend election is made, the basis in each such lower-tier corporation, in the hands of its immediate shareholder, is increased by the amount of that company's post-1962 earnings and profits that are inherited by the CFC the stock of which is received in the exchange.[78] These earnings and profits are deemed distributed as a dividend to the CFC the stock of which

[74] Tax Section Report, *supra* note 35, at 132.
[75] Treas. Reg. § 7.367(b)-9(c).
[76] *Id.* § 7.367(b)-9(d).
[77] *Id.* § 7.367(b)-9(e)(1).
[78] *Id.*

is exchanged,[79] through any intervening corporation. Basis adjustments regarding pre-1963 earnings and profits require no election;[80] however, such amounts are not treated as dividends.[81] A non-triangular asset reorganization illustrates the application of this level of basis adjustment without involving the additional adjustment that may accompany a type-B or triangular exchange.

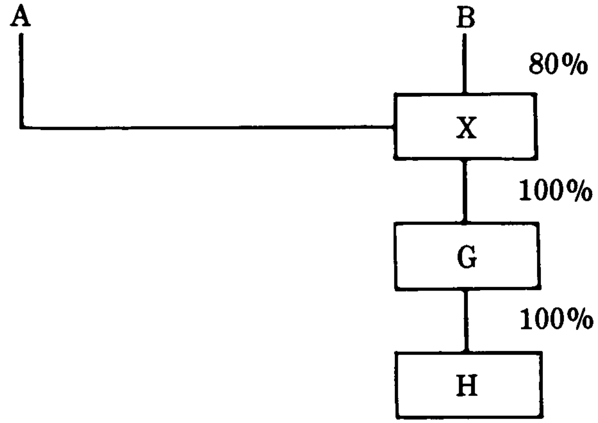
EXAMPLE: United States shareholder *A* owns all the stock of *F*, a first-tier CFC which holds all the stock of *G*, a second-tier CFC. *G*, in turn, owns all the stock of *H*, a third-tier CFC. United States shareholder *B* owns all the stock of CFC *X*. Each corporation was formed after 1962. A diagram of the corporation structure, including basis, earnings, and profits of the respective shareholders and corporations, appears as follows:



* E & P = earnings and profits

In the acquisition of *F* by *X* pursuant to a type-C reorganization,[82] *F* exchanges all its assets in return for 20% of the stock of *X*. Immediately thereafter *F* is liquidated and *A* becomes a United States shareholder of *X* upon the exchange of *F* stock for *X* stock. The following diagram illustrates the resulting chain of ownership:

[79] *Id.* § 7.367(b)-9(f)(1).
[80] *Id.* § 7.367(b)-9(e)(3).
[81] Tax Section Report, *supra* note 35, at 134.
[82] I.R.C. § 368(a)(1)(c).



Four hundred and fifty dollars (the total earnings and profits of *F*, *G*, and *H*) is attributed to the *X* stock received by *A* in the exchange. *X* inherits a similar amount, while the earnings and profits of *G* and *H* are reduced by $250 and $50, their respective contributions to *X*'s inheritance.

Assuming *A* makes the consent dividend election, *G*'s basis in *H* increases by $50 (*H*'s earnings and profits inherited by *X*), from $75 to $125. *X*'s basis in *G* increases by $300 (the total earnings and profits of *G* and *H* inherited by *X*), from the carryover basis of $200 to $500.

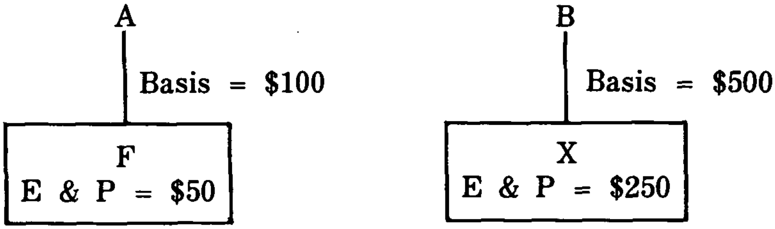
Assuming *A* makes no consent dividend elections, *G*'s basis in *H* stays at $75 and *X* takes a carryover basis in *G* of $200.

Only type-B and triangular reorganizations are provided an additional set of basis elections. These elections apply to the basis of stock in lower-tier corporations (after the reorganization) of the corporation the stock of which is received. In a type-B reorganization, if the United States shareholders make the required consent dividend elections,[83] the basis of stock of the corporation the stock of which is exchanged (the acquired corporation) is increased in the hands of the corporation the stock of which is received (the acquiring corporation) by the extent to which the acquiring corporation inherits earnings and profits from the acquired corporation and any of its lower-tier corporations.[84]

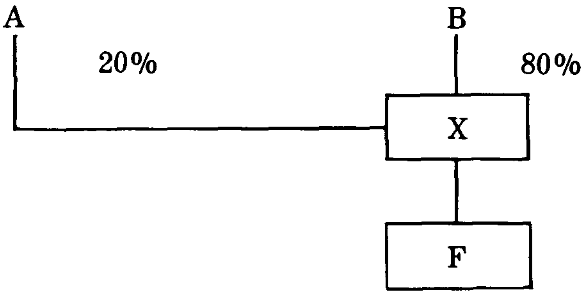
EXAMPLE: United States shareholder *A* owns all the stock of

[83] Treas. Reg. § 7.367(b)-9(f)(2).
[84] *Id.* § 7.367(b)-9(e)(2).

foreign corporation *F*. United States shareholder *B* owns all the stock of foreign corporation *X*. Each corporation was formed after 1962. A diagram of the corporate structure appears as follows:



In the acquisition of *F* by *X* pursuant to a type-B reorganization, *A* exchanges all the *F* stock in return for 20% of the stock of *X*. The following chart illustrates the consequential chain of ownership:



Fifty dollars (the earnings and profits of *F*) is attributed to the *X* stock received by *A* in the exchange. *X* inherits a similar amount. The earnings and profits of *F* are reduced by $50, its contribution to *X*'s inheritance.

Assuming the basis elections are made, *X*'s basis in *F* increases by $50 (the earnings and profits of *F* inherited by *X*), from the carryover basis of $100 to $150. Assuming no basis elections are made, *X* takes a $100 carryover basis in *F*.

In a triangular reorganization, properly made elections[85] increase the basis of stock of the acquiring corporation in the hands of its parent by the earnings and profits the parent inherits from the acquired corporation.[86]

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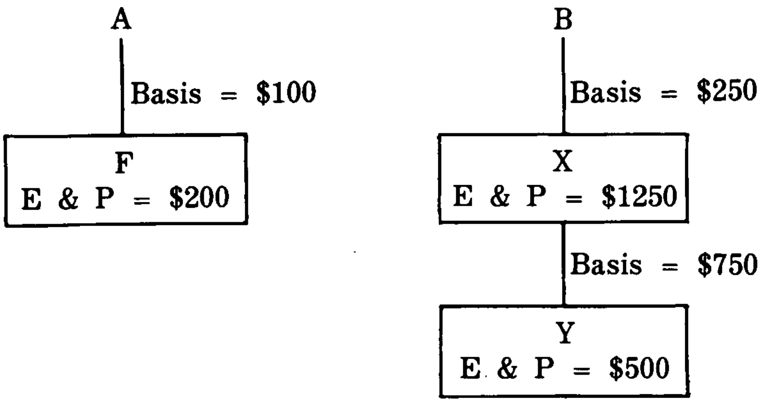
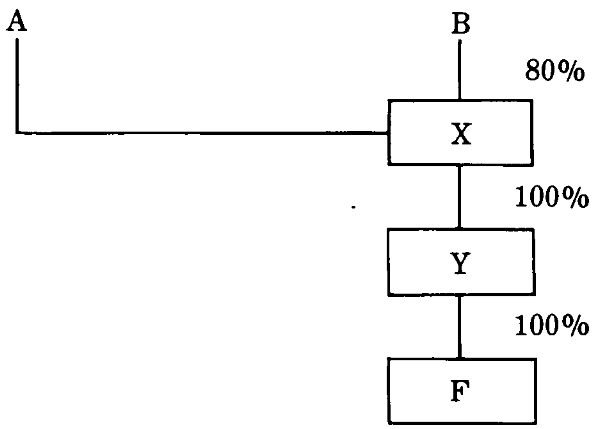
[85] *Id.* § 7.367(b)-9(f)(2).
[86] *Id.* § 7.367(b)-9(e)(2).

EXAMPLE: United States shareholder *A* owns all the stock of foreign corporation *F*. United States shareholder *B* owns all the stock of foreign corporation *X*, which in turn owns all the stock of foreign corporation *Y*. Each corporation was formed after 1962. The following diagram charts the corporate structure:



In the acquisition of *F* by *Y* pursuant to a triangular type-B reorganization,[87] *A* exchanges all the *F* stock in return for 20% of the stock of *X*. The resulting chain of ownership is as follows:



Two hundred dollars (the earnings and profits of *F*) is attributed to the *X* stock received by *A* in the exchange. *X* inherits a similar amount, while the earnings and profits of *F* are reduced by $200, its contribution to *X*'s inheritance.

[87] I.R.C. §§ 368(a)(1)(B), 368(a)(2)(C).

Assuming the basis elections are made, *X*'s basis in *Y* increases by $200 (the earnings and profits of *F* inherited by *X*), from $750 to $950. *Y*'s basis in *F* increases by $200 (the earnings and profits of *F* inherited by *X*) from the carryover basis of $100 to $300.

Assuming no basis elections are made, *X*'s basis in *Y* remains at $750. *Y* takes a $100 carryover basis in *F*.

SECTION 355: DIVISIVE REORGANIZATIONS

The regulations identify and provide special rules for transactions involving section 355 distributions. The rules specify earnings and profits, as well as basis adjustments at both the corporate and shareholder levels. For purposes of section 367 regulations, the terms "distributing corporation" and "controlled corporation" are defined as they are in section 355.[88]

CORPORATE LEVEL ADJUSTMENTS

At the corporate level, the object of the regulations is to provide for the allocation of earnings and profits between the "distributing group," defined as the distributing corporation and any corporations controlled by it after the distribution, and the "controlled group," defined as the controlled corporation(s) and any corporations controlled by them after distribution.[89] After the earnings and profits of each corporation in both the distributing and controlled groups are calculated, but before the distribution, the gross sum of such calculations is allocated between the two groups in proportion to the net fair market value of their respective assets. When an allocation to a group is made, an increase in earnings and profits is attributed only to the parent of the group.[90] A corresponding earnings and profits reduction is made for the group from which such amounts are allocated. The earnings and profits of each corporation in that group are decreased in proportion to the earnings and profits of each member prior to the allocation.

Furthermore, with the exception of the group parent corporation, basis adjustments are allowed for each corporation in the group from which earnings and profits are allocated. The basis of the stock in the hands of the corporation's immediate shareholder is increased by the amount of earnings and profits allocated from that corporation and other members of the group on a lower tier

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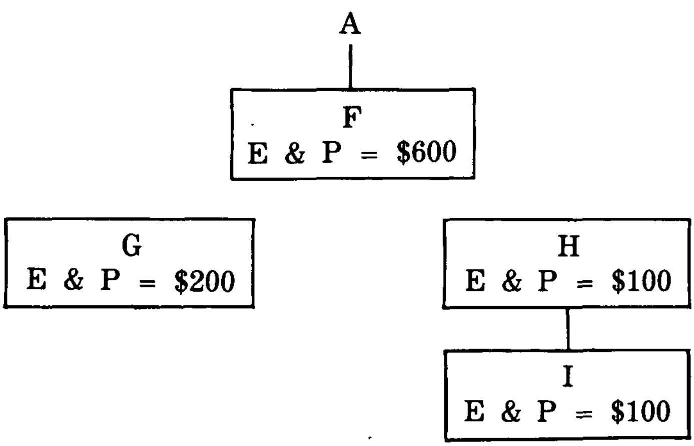
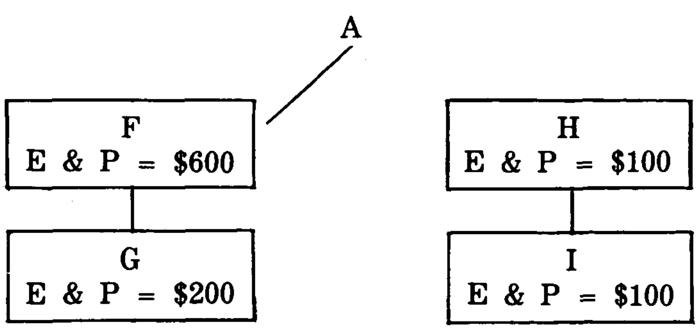
[88] Treas. Reg. § 7.367(b)-10(a).
[89] *Id.* § 7.367(b)-10(d)(4).
[90] *Id.* § 7.367(b)-10(d)(5)(i).

than that corporation.[91] In reference to earnings and profits accumulated in taxable years beginning after 1962, basis adjustments are made only if all United States shareholders of the group from which the allocation is made invoke the required consent dividend election.[92]

EXAMPLE: United States shareholder *A* owns all the stock of foreign corporation *F*. *F* owns all the stock of foreign corporations *G* and *H*. *H* owns all the stock of foreign corporation *I*. All corporations were formed after 1962. The corporate structure appears as follows:



Pursuant to a section 355 divisive reorganization, *F* distributes all the stock of *H* to *A*. After the distribution, the net fair market value of the assets of the *F* group (the distributing group) equals that of the *H* group (the controlled group). The resulting structure is as follows:



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[91] *Id.* § 7.367(b)-10(e)(1).
[92] *Id.* § 7.367(b)-10(f).

After the distribution, \$300 is allocated from the *F* group to the *H* group, giving each group equal earnings and profits of \$500. The \$300 allocation is made entirely to *H*, the parent of the controlled group, increasing *H*'s earnings and profits from \$100 to \$400. Correspondingly, a \$300 reduction in the earnings and profits of the *F* group occurs. The decrease, however, is prorated between *F* and *G*: *F*'s earnings and profits are reduced by \$225 (\$300 multiplied by \$600/\$800), from \$600 to \$375; *G*'s earnings and profits are reduced by \$75 (\$300 multiplied by \$200/\$800), from \$200 to \$125.

If *A* makes a consent dividend election, *F*'s basis in *G* will increase by \$75, the amount of the earnings and profits allocated from *G* to *H*. If *A* fails to make the election, *F*'s basis in *G* will remain the same as before the distribution.

SHAREHOLDER LEVEL ADJUSTMENTS

The objective of these regulations is to preserve United States tax jurisdiction over either the United States shareholder of the distributing foreign corporation who exchanges that stock for stock of the controlled corporation, or over an exchanging CFC as to which there is a United States shareholder. The concepts of attribution, inclusion and addition applicable to section 354 exchanges are relevant to the section 355 distributions as well. Moreover, for the purposes of section 367, any distribution described in section 355 shall be regarded as an exchange whether or not it is an exchange.[93]

Exchanging United States Shareholder Receives CFC Stock

When a United States shareholder of a distributing CFC exchanges its stock for controlled corporation stock of which the exchanging person is a United States shareholder after the distribution, the income deferral rules come into play. Because sections 1248 and 367 confer United States tax jurisdiction over the earnings and profits of the distributed CFC in reference to the exchanging shareholder, immediate income inclusion is unnecessary. The regulations merely require attribution of the earnings and profits of the distributing corporation. The section 1248 amount, the additional earnings and profits amount, and the all earnings and pro-

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[93] I.R.C. § 367(c)(1).

fits amount of the exchanging shareholder's shares in the distributing corporation are attributed both to those shares and to the shares of the controlled corporation he receives. The amount attributed to a particular corporation's shares is determined by the proportionate value of the stock of that corporation as compared to the value of all stock owned after the distribution.[94]

EXAMPLE: United States shareholder *A* owns all the stock of *F*, a foreign corporation formed after 1962 with earnings and profits of $100. *F*, which owns all the stock of foreign corporation *G*, distributes all the *G* shares to *A* in a section 355 reorganization. After the distribution, *A* is a United States shareholder of both *G* and *H*. Moreover, the value of the *F* stock is $8,000 while that of the *G* stock is $2,000.

A is not required to make an income inclusion as a result of the distribution. Of *F*'s $100 earnings and profits amount, $80 is attributed to *A*'s stock in *F* ($100 multiplied by $8,000/$10,000) and $20 to *A*'s stock in *G* ($100 multiplied by $2,000/$10,000).

Exchanging United States Shareholder Receives Non-CFC Stock

When a United States shareholder of the distributing CFC exchanges such corporation's stock for that of a controlled corporation which is not a CFC (or CFC stock as to which the exchanging shareholder is not a United States shareholder), the income inclusion rules become operative. To the extent of gain realized, the exchanging shareholder includes in income a proportion of the section 1248 amount of the predistribution stock in the distributing corporation. That proportion is determined by the value of the controlled corporation stock received in relation to the value of all stock owned after the distribution.[95] The remaining section 1248 amount is attributed to the distributing corporation stock owned by the exchanging shareholder after the distribution.[96]

EXAMPLE: United States shareholder *A* owns all the stock of

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[94] Treas. Reg. § 7.367(b)-10(h)(2).

[95] *Id.* § 7.367(b)-10(i)(3)(i). If, however, the exchanging shareholder is a domestic corporation that receives stock of a domestic controlled corporation, and such controlled corporation acquired the assets of the foreign distributing corporation pursuant to a type-D reorganization, then gain to the exchanging shareholder is calculated with respect to its all earnings and profits amount in the distributing corporation (rather than the section 1248 amount). *Id.* § 7.367(b)-10(j).

[96] *Id.* § 7.367(b)-10(h)(2).

F, a foreign corporation formed after 1962 with earnings and profits of $100. *F*, which owns all the stock of domestic corporation *X* distributes all the *X* shares to *A* in a section 355 transaction. After the distribution the value of the *F* stock is $8,000 while that of the *X* stock is $2,000. *A* includes $20 in income as a result of the exchange ($100 multiplied by $2,000/$10,000). Eighty dollars is attributed to *A*'s stock in *F* ($100 multiplied by $8,000/$10,000).

Exchanging CFC Shareholder Receives CFC Stock

If a CFC as to which there is a United States shareholder exchanges stock in a distributing corporation for CFC stock in which the United States shareholder has an interest, the income deferral rules apply. Thus, the earnings and profits of the distributing corporation are attributed both to the foreign corporate shareholder's stock in the exchanging corporation and to the controlled corporation stock received in the exchange. Accordingly, the section 1248(c)(2) amount, the additional earnings and profits amount, and the all earnings and profits amount of the exchanging shareholder's shares in the distributing corporation are calculated.[97] The amount attributed to the exchanging shareholder's stock in each corporation is the proportionate value of that corporation's stock to the value of all stock owned after distribution.[98]

EXAMPLE: United States shareholder *A* owns all the stock of foreign corporation *F*. *F* owns all the stock of foreign corporation *G*, a CFC formed after 1962 with earnings and profits of $240. *G*, which owns all the stock of foreign corporation *H*, distributes all the *H* shares to *F* in a section 355 transaction. After the distribution, *A* is a United States shareholder of *H*. Furthermore, the value of the *G* stock is $3,000 while that of the *H* stock is $1,000.

F makes no addition to its earnings and profits. Of *G*'s $240 predistribution earnings and profits, $180 is attributed to *F*'s stock in *G* ($240 multiplied by $3,000/$4,000) and $60 is attributed to *F*'s stock in *H* ($240 multiplied by $1,000/$4,000).

Exchanging CFC Shareholder Receives Non-CFC Stock

When a CFC with a United States shareholder exchanges stock in a distributing corporation for non-CFC stock (or CFC stock as

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[97] *Id.* § 7.367(b)-10(g).
[98] *Id.* § 7.367(b)-10(h)(2).

to which the United States shareholder of the exchanging foreign corporation is no longer a United States shareholder), the addition rule applies. The exchanging shareholder must add to its earnings and profits a portion of the pre-distribution section 1248(c)(2) amount in the distributing corporation. The portion is that which reflects the relation the value of the stock received in the exchange bears to the value of all the stock of the distributing and controlled corporations owned after the distribution.[99] This amount is considered a dividend to the exchanging shareholder only if all United States shareholders of the exchanging corporation make the appropriate consent dividend election.[100] If the election is made, the exchanging foreign corporation's basis in the stock received in the exchange is increased by the amount added to the exchanging shareholder's earnings and profits.[101]

EXAMPLE: United States shareholder *A* owns all the stock of foreign corporation *F*. *F* owns all the stock of foreign corporation *G*, a CFC formed after 1962 with earnings and profits of $240. *G*, which owns all the stock of domestic corporation *X*, distributes all the *X* shares to *F* in a section 355 transaction. After the distribution, the value of the *G* stock is $3,000 while that of the *X* stock is $1,000.

F makes an addition to its earnings and profits of $60 ($240 multiplied by $1,000/$4,000). One hundred and eighty dollars is attributed to *F*'s stock in *G* ($240 multiplied by $3,000/$4,000).

Moreover, if *A* makes the proper consent dividend election, the $60 added to *F*'s earnings and profits is treated as dividend. *F*'s basis in *X* is increased by $60. Alternatively, if *A* makes no consent dividend election, the $60 added to *F*'s earnings and profits is a non-dividend increase and *F* receives no corresponding basis adjustment.

CONCLUSION

From preventing the avoidance of capital gains to curtailing the removal of earnings and profits from United States tax jurisdiction, section 367 has undergone a metamorphosis in the past fifty years. The two subsections of the statute reflect this historical transition. The legislative intent behind subsection 367(a) was to

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[99] *Id.* § 7.367(b)-10(i)(3)(ii)(A) & (B).
[100] *Id.* § 7.367(b)-10(i)(3)(ii)(B) & (C).
[101] *Id.* § 7.367(b)-7(c)(1)(iii).

eliminate the tax-free transfer and sale of appreciated assets outside United States tax jurisdiction. Hence, certain nonrecognition provisions of subchapter C will apply only if the Service rules that tax avoidance is not a principal purpose of the transfer. The statutory objective of subsection 367(b) was to inhibit the repatriation of CFC earnings and profits by United States shareholders. Treasury regulations thus provide a comprehensive set of rules for determining the tax effect of such exchanges upon those shareholders.

Nevertheless, the published interpretations by the Internal Revenue Service have been the object of relentless criticism. The critics focus primarily on the complexity of the regulations, characterizing them as opaque and obscure. Complexity, however, endures in the nonrecognition sections of subchapter C. Those sections lie at the heart of section 367 and the intricacy of the Code makes these complex rules necessary. A careful analysis of the law, however, leads to an appreciation of the sophisticated manner in which this regulatory network is constructed. On balance, the draftsmen of the regulations deserve credit for successfully tackling the monumental task of regulating exchanges involving foreign corporations in order to unearth those transactions carried out principally for tax avoidance purposes.