Exchanges Involving Foreign Corporations: The Logic and Rationale of Section 367

Vikram A. Gosain

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VIKRAM A. GOSAIN*

Introduction

Section 367 of the Internal Revenue Code[1] (Code), which provides rules for determining when various nonrecognition provisions of subchapter C shall apply to certain exchanges involving foreign corporations, has troubled tax practitioners for half a century. While initial concerns stemmed from the dearth of published authority, current confusion results from the complexity of present rules. A study of the legislative history in conjunction with an analysis of the rulings and regulations, however, sheds light on a few basic themes that reappear throughout the body of law. This article undertakes to trace the development of those themes as well as to illustrate their application to a variety of exchanges. While the present work makes no pretense of accounting for every transaction within the scope of Section 367, its ambition is to unravel the mystery of the statute by underscoring the rationale behind the recurring themes.

Legislative History

Before the enactment of the Revenue Act of 1932 the nonrecognition provisions of the Code applied equally to both domestic as well as foreign corporations.[2] As a result, U.S. taxpayers could avoid taxes by transferring appreciated property to foreign corporations without the recognition of gain. Congress was cognizant of the need to prevent such overt tax avoidance:

> Taxpayers having large unrealized profits in securities may transfer such securities to corporations organized in countries imposing no tax upon the sale of capi-

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*Mr. Gosain practices law in California.

[1]All code section references are to the Internal Revenue Code of 1954, as amended, unless otherwise specified.

[2]Crosby-Wirth Sales Book Company v. Commissioner of Internal Revenue, 19 B.T.A. 1074 (1930).

> tal 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]

Congressional intent in the passage of the Revenue Act of 1932 was to prevent this kind of tax avoidance.[4] Consequently, the legislature enacted Section 112(k),[5] the predecessor to Section 367, which withdrew certain transactions involving foreign corporations 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. This determination could be made only in the form of an advance ruling issued by the Treasury.[6]

The meaning of the statute has been difficult to decipher since the date of its enactment.[7] For the major span of the history of the law, there has been a marked absence of commentary by Congress,[8] interpretation by the Treasury,[9] and analysis by the judiciary.[10] In the early part of the 1960s, however, an additional trend had become clear in the service's application of Section 367. "Tax avoidance," as used in the statute, referred not only to the circumvention of taxes by the transfer of appreciated property outside

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[3]H. R. Rep. No. 708, 72d Cong., 1st Sess. 20 (1932); S. Rep. No. 665, 72d Cong., 1st Sess. 26–27 (1932).

[4]*Id. See also* 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); RHOADES, TAXATION OF FOREIGN RELATED TRANSACTIONS 7–14 (1979).

[5]Revenue Act of 1932, ch. 209, § 112(k), 47 Stat. 198.

[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. 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 that no major change of Congressional intent took place. H. R. Rep. No. 1137, 83d Cong., 2nd Sess. A131 (1954); S. Rep. No. 1622, 83d Cong., 2d Sess. 272 (1954).

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

[10]"[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." RHOADES, *supra* note 4.

of U.S. 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. When significant amounts of earnings and profits had been accumulated, the commissioner generally would refuse to issue a favorable ruling.[11]

Despite the service's interpretation of "tax avoidance," a U.S. citizen could still repatriate accumulated earnings and profits at capital gains rates (which, had the foreign corporation distributed dividends of such amounts to its domestic shareholders, would have been subject to ordinary income treatment). Since Section 367 applied only to various nonrecognition provisions of subchapter C of the Code, the domestic shareholder could sidestep the statute by selling, liquidating or redeeming its stock in the foreign corporation. Because these transactions required the recognition of gain, they did not come within the purview of Section 367. Furthermore, capital gains rates normally would prevail.[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]

One of the legislative purposes behind the passage of the Revenue Act of 1962 was to eliminate such repatriation of earnings and profits.[14] Hence, Section 1248 was enacted to provide that when a U.S. shareholder[15] enters into certain sales, exchanges or redemptions of stock in a controlled foreign corporation (CFC),[16] the surrendering shareholder includes in income as a dividend the 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 retrospect, the first thirty years of the history of Section 367 observed the evolution of two applications of "tax avoidance." First, the avoidance

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[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 Section 368) or through the use of a tax-free liquidation (under Section 332). However, to do so the Commissioner 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., 2nd. Sess. 480 (1962); S. Rep. No. 1881, 87th Cong., 2nd. Sess. 813 (1962).

[12] *Id.*

[13] *Id.*

[14] *Id.*

[15] Section 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."

[16] Section 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."

[17] Section 1248(a).

of capital gains tax by the transfer of specified appreciated property to a foreign corporation was proscribed. Second, despite the fact that the original House and Senate reports were silent on this matter, the tax-free repatriation of earnings and profits accumulated in foreign subsidiaries was prohibited. Nevertheless, when the service would consider tax avoidance to be present in a specific transaction was frequently difficult for a taxpayer to determine.[18] This uncertainty, combined with the advance ruling requirement, resulted in harsh consequences to unsuspecting taxpayers who otherwise would have structured an exchange so that tax avoidance was not considered a principal purpose.[19] To alleviate this problem, the service published guidelines (Guidelines) in 1968 that provided objective tests for determining whether favorable rulings would be granted in specific transactions.[20] The Guidelines stated that if the taxpayer wanted to receive a favorable ruling with respect to certain exchanges, gain on specific items must be included in income (such amounts constituting the Section 367 toll charge).[21]

Despite the publication of the Guidelines, problems developed in the application of Section 367 and the related provisions of Section 1248. First, the advance ruling requirement resulted in undue delay for taxpayers who engaged in business transactions where no tax avoidance purpose was present. Second, where a foreign corporation was involved in an exchange without the knowledge of its domestic shareholders (and, thus, no ruling request was made), a transaction that otherwise was tax free became taxable. Third, the Guidelines required present payment of the toll charge even though only future potential for tax avoidance existed. Fourth, no mechanism was available for meaningful judicial review of an adverse decision by the commissioner.[22]

Section 1042 of the Tax Reform Act of 1976 represented a congressional effort to ameliorate the aforementioned difficulties.[23] The act amended Section 367 to establish separate rules for two different groups of transactions. First, Section 367(a) stated the rules for transfers of property from the United States. The statutory objective, of course, was to prevent the removal of appreciated stock or assets from U.S. tax jurisdiction. While the nonrecognition provisions of the Code applied only if a favorable ruling had been granted, the act eliminated the requirement that it be obtained prior to the exchange.[24] Moreover, the amendment added Section 7477 to

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[18]Beimfohr, *Tax-Free Exchanges with a Foreign Corporation: Section 367; the Guidelines Analyzed*, 28th ANN. N.Y.U. INST. 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]Revenue Procedure 68-23, 1968-1 C.B. 821 (hereinafter cited as Guidelines).

[21]S. Rep. No. 94-938, 94th Cong., 2d Sess. 262 (1976).

[22]*Id. See also* H. R. Rep. No. 94-658, 94th Cong., 1st Sess. 932 (1975).

[23]The Tax Reform Act of 1976, Section 1042, Pub. L. No. 94-455, 90 Stat. 1520 (1976).

[24]Section 367(a)(1).

the Code, which entitled the taxpayer to judicial review of adverse determinations by the Treasury.[25]

Second, Section 367(b) established independent treatment for other transfers, including transfers into the United States and those which were exclusively foreign. The statutory purpose of this subsection was to preserve the taxation of accumulated earnings and profits of CFCs.[26] Furthermore, the subsection stated that Treasury regulations (rather than the commissioner's determination) were to govern the treatment of an exchange within its scope.[27] The complexity of the regulations, revenue rulings, and revenue procedures that have been published in relation to Section 367 warrants an explanation of the mechanics of the law.

Section 367(a): Transfers of Property from the United States

Section 367(a) applies to direct, indirect or constructive transfers of property (other than stock or securities of a foreign corporation which is a party to the exchange or reorganization) by a U.S. person to a foreign corporation in connection with any exchange described in Section 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 U.S. 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 United States stock to a foreign corporation.[32]

Indirect transfers apply to 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]

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[25]Section 7477.

[26]S. Rep. 94–938, *supra* note 11, at 264.

[27]Section 367(b).

[28]Treas. Reg. § 7.367(a)-1(b)3. Unless otherwise indicated, all references to section numbers that are preceded by a number followed by a decimal point are references to Treasury Regulations.

[29]Section 332.

[30]Section 351.

[31]Section 361.

[32]Sections 354, 355 and 356.

[33]Section 7.367(a)-1(b)(3)(ii).

[34]*Id.*

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 U.S. person has an interest, to a foreign corporation, on account of which transfer the U.S. person realizes gain.[37]

If Section 367(a) applies to the transfer, for the purpose of determining whether gain is recognized on the exchange, a foreign corporation shall not be considered a corporation unless it is established to the satisfaction of 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. The absence of a tax avoidance purpose must be demonstrated in a ruling request filed within 183 days after the beginning of the transfer.[38]

In deciding upon a ruling request, the commissioner has relied on the Guidelines.[39] Despite the amendments to Section 367 made by the Tax Reform Act of 1976, the Guidelines shall be followed by the service until they are superseded.[40]

In a Section 351 exchange,[41] the Guidelines classify property transferred to a foreign corporation into two broad categories. The first category, referred to as "tainted" property,[42] consists of those assets for which a favorable ruling will not be issued. Eight classes of "tainted" property existed:

(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)).[43]

(2) Property, such as accounts receivable or installment obligations, for which income has been earned but not included in the transferor's gross income.[44]

(3) Stock or securities. An exception exists for stock or securities of a foreign corporation where the transferee foreign corporation controls (immediately after the exchange) at least 80 percent of the voting power of the foreign corporation whose stock or securities is transferred and at least 50 percent of the voting stock

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[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]Section 7.367(a)–1(b)(3)(iv).

[37]Section 7.367(a)–1(b)(3)(iii).

[38]Section 367(a)(1).

[39]Guidelines, *supra* note 20.

[40]Revenue Procedure 77–5, 1977–1 C.B. 536.

[41]*See* text accompanying note 30, *supra*.

[42]Tax Management Portfolio, 57–5th, A–41.

[43]Section 3.02(1)(a)(i) of the Guidelines, *supra* note 20.

[44]*Id.* at § 3.02(1)(a)(ii).

of the transferee corporation is controlled by the persons who owned more than 50 percent of the voting stock (immediately before the exchange) of the corporation whose stock is transferred. Moreover, both the transferee corporation and the corporation whose stock is transferred must be created or organized under the laws of the same foreign country. Finally, a substantial part of the assets of the corporation whose stock is transferred must be located in such foreign country.[45]

(4) Property to be transferred under circumstances which make it reasonable to believe that its sale or other disposition by the transferee foreign corporation is one of the principal purposes of its transfer.[46]

(5) Property for which the transferor is a lessor or licensor, unless the transferee foreign corporation is the lessee or licensee.[47]

(6) Property, though not subject to an existing lease or license, transferred under circumstances which make it reasonable to believe that it will be leased or licensed by the transferee after the transfer.[48]

(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 manufacturer of goods for sale or consumption in the United States.[49]

(8) Foreign patents, trademarks and similar intangibles to be used in connection with the sale of goods manufactured in the United States.[50]

Upon the transfer of "tainted" property in a Section 351 exchange the transferor shall include in income an amount to reflect realization of income or gain. The character of the gain shall be determined as if the property were transferred by the U.S. person in a taxable exchange. Furthermore, the transferee corporation shall make appropriate adjustments in basis to the property it receives.

The second category of property which the Guidelines refer to in connection with Section 351 exchanges comprises all other assets, or "non-tainted" property.[51] The transferor will receive a favorable ruling on the transfer of "non-tainted" assets where the transferee is to devote them to the active conduct of a trade or business in any foreign country and either it will have a need for substantial investment in fixed assets in such business or it will be engaged in the purchase and sale abroad of manufactured goods.[52]

In a corporate reorganization[53] where assets or stock of a domestic corporation are acquired by a foreign corporation, whether the service issues a favorable ruling depends on the percentage of foreign corporate stock received in exchange by the U.S. transferor. A favorable ruling generally will be issued if the transferor owns 50 percent or less of the voting power of the foreign corporation, unless the assets of the acquired U.S. corporation

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[45]*Id.* at § 3.02(1)(a)(iii)(B).
[46]*Id.* at § 3.02(1)(a)(iv).
[47]*Id.* at § 3.02(1)(b)(i).
[48]*Id.* at § 3.02(1)(b)(ii).
[49]*Id.* at § 3.02(1)(b)(iii).
[50]*Id.* at § 3.02(1)(b)(iv).
[51]57-5th, *supra* note 42.
[52]Section 3.02(1) of the Guidelines, *supra* note 20.
[53]*See* text accompanying notes 31, 32, 33 and 34, *supra*.

consist principally of stock or securities.[54] If the shareholders of the acquired U.S. corporation own more than 50 percent but less than 80 percent of the voting power of the foreign corporation, the Guidelines are silent as to whether a favorable ruling will be granted. Apparently the decision of the service is based on a case-by-case analysis of the facts and circumstances.[55] If the transferor owns 80 percent 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 Guidelines standards that are relevant to such transfers.[56]

In a Section 332 liquidation of a domestic subsidiary into its foreign parent,[57] the Guidelines provide that the parent will be considered a corporation if the subsidiary includes in income any gain or income 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 transferred assets to the parent in a taxable exchange.[58]

Section 367(b): Other Transfers

Section 367(b) applies to an exchange of stock in a foreign corporation in any transaction described in Section 332, 351, 354, 355, 356, or 361 where there is no transfer of property described in Section 367(a)(1).[59] Such exchanges include the following transactions:

(1) The liquidation of a foreign subsidiary into its foreign or domestic parent.[60]

(2) The transfer of foreign stock by one foreign corporation to another foreign corporation which the transferor controls immediately after the exchange.[61]

(3) A corporate reorganization in which a foreign corporation transfers assets to either a domestic or foreign corporation.[62]

(4) A corporate reorganization in which a United States shareholder exchanges stock of a foreign corporation.[63]

Section 367(b) states that in a relevant exchange, "a foreign corporation shall be considered to be a corporation except to the extent provided in the regulations prescribed by the Secretary."[64] The temporary regulations presently in effect provide for either current or deferred inclusion in income

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[54]The Guidelines speak only of stock acquisitions of domestic corporations and are silent as to the remaining forms of corporate reorganizations. Section 3.03(1)(d) of the Guidelines. The service, however, usually has applied similar rules to such reorganizations. 57–5th, *supra* note 42, A-34.

[55]57–5th, *supra* note 42, A-35.

[56]*See* text accompanying notes 41 through 52, *supra*.

[57]*See* text accompanying note 29, *supra*.

[58]Section 3.01(2) of the Guidelines, *supra*, note 20.

[59]Section 367(b).

[60]Section 7.367(b)–5.

[61]Section 7.367(b)–8.

[62]Sections 7.367(b)–7, 7.367(b)–9.

[63]Sections 7.367(b)–7; 7.367(b)–9; 7.367(b)–10.

[64]Section 367(b).

of gain realized.[65] Hence, the concern becomes one of weaving through the intricacies of the Treasury's promulgation. While such an undertaking appears formidable at first blush, a careful analysis of key transactions unveils the foundation upon which the logical framework of the regulations is constructed.

Current Inclusion

Sections 367 and 1248 assert U.S. tax jurisdiction only to the extent that the taxpayer is a U.S. shareholder of a CFC. To recall, the legislative objective is to preserve dividend tax treatment with respect to a U.S. shareholder's interest in the accumulated earnings and profits of a CFC. Consequently, if a U.S. shareholder either directly repatriates the CFC earnings or exchanges the CFC stock in return for stock as to which he is not a U.S. shareholder (over which sections 367 and 1248 confer no tax jurisdiction), then immediate dividend inclusion in income is required to prevent the conversion of ordinary income into capital gains.[66] The regulations provide for the mechanism of income inclusion.

The complete liquidation of a foreign subsidiary: A domestic parent currently must pay a toll charge upon the complete liquidation of a foreign subsidiary, in order for the subsidiary to be considered a corporation.[67] The toll charge results in an 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 stock of the foreign corporation exchanged.[68] Since the parent includes these amounts in income as a dividend,[69] any foreign taxes paid by the subsidiary upon such earnings qualify for deemed paid foreign tax credit treatment.[70] If the parent does not pay the toll charge, the subsidiary will not be considered to be a corporation. Hence, the nonrecognition rules of Section 332 will fail to protect the parent. Consequently, Section 1248 will apply to treat the parent's gain realized, to the extent of the subsidiary's post-1962 earnings and profits, as a dividend. Despite the recognition of gain, the normal carryover basis rules shall still apply.[71]

In the liquidation of a foreign subsidiary by a foreign parent, a foreign corporation will be treated as a corporation.[72]

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[65] Section 367(b)(2)(A).

[66] An exception to this would be if a closing agreement, which tracks the realized gain, is entered into with the commissioner.

[67] Section 7.367(b)–5.

[68] Section 7.367(b)–2(f).

[69] Section 7.367(b)–3(b).

[70] TAX SECTION REPORT, *supra* note 35, at 116.

[71] Section 7.367(b)–5.

[72] Section 7.367(b)–5(c).

The exchange of first-tier CFC stock for non-CFC stock: If a U.S. shareholder exchanges stock in a CFC in return for stock as to which he is not a U.S. 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 U.S. shareholder), the exchanging person shall include in income the Section 1248 amount attributable to the stock exchanged, to the extent of gain realized.[73] 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.[74]

Example: U.S. 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 percent of the stock of foreign corporation X in a type B reorganization,[75] realizing gain of $200. Since A is not a U.S. shareholder of X, corporations F and X will be considered to be corporations only if A includes $150 in income as a dividend.

The exchange of second-tier CFC stock for non-CFC stock: If a CFC as to which there is a U.S. shareholder exchanges stock of a second-tier CFC in return for stock as to which the U.S. shareholder of the exchanging CFC no longer maintains such status, then the 1248(c)(2) amount is added to the earnings and profits of the first-tier CFC.[76] 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.[77] Moreover, if all U.S. 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.[78]

Example: F, a CFC as to which A is the sole U.S. 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 percent of the stock of X, a foreign corporation as to which A is not a U.S. 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 U.S. shareholder exchanges CFC stock in return for other CFC stock as to which he maintains similar status, sections 367 and 1248 confer U.S. tax jurisdiction with the respect to that person over the CFC stock received. In reference to the exchanging shareholder, the regulations preserve the tax

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[73] Section 7.367(b)–7(c)(1)(i).
[74] Section 7.367(b)–2(d).
[75] Section 368(a)(1)(B).
[76] Section 7.367(b)–7(c)(1)(ii).
[77] Section 7.367(b)–2(e).
[78] Section 7.367(b)–7(c)(1)(iii).

characteristics of the CFC whose stock is exchanged by attributing its earnings and profits to the CFC stock received in the exchange. Thus, the attribution rules allow for deferral of realized gain without permitting the repatriation of ordinary income at capital gains rates. The deferral rules provide for adjustments to earnings and profits and basis of the CFCs involved in the reorganization.

Earnings and Profits Adjustments

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 U.S. 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 whose stock is exchanged.[79] The all earnings and profits amount means the pre-1963 earnings and profits of the CFC whose stock is exchanged.[80] These amounts are then attributed to the CFC stock received by the exchanging shareholder.[81]

Furthermore, the CFC whose stock is received "inherits" the earnings and profits of the CFC whose stock is exchanged.[82] The regulations specify the mechanism of inheritance: the earnings and profits of the CFC whose stock is received are increased by the earnings and profits of the CFC whose stock is exchanged and any of its lower-tier corporations.[83] Correspondingly, the earnings and profits of the CFC whose stock is exchanged and any of its lower-tier corporations are reduced by a like amount.[84]

Example: United States shareholder A owns all the stock of F, a first-tier CFC formed after 1962. F has $125 of E&P. In a type B reorganization A exchanges all the F stock for 20 percent of the stock of G, a CFC as to which A becomes a U.S. 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 Adjustments and Elections

The regulations provide for two levels of basis adjustments. The first level applies to basis in stock of lower-tier foreign corporations of the CFC whose stock is exchanged. These adjustments are relevant regardless of the form of the acquisition, whether it be a nontriangular asset reorganization on the one hand, or a type B or triangular exchange on the other hand. An additional set of adjustments exists exclusively for triangular and type B exchanges. Hence, a triangular acquisition where the CFC whose stock is exchanged has lower-tier foreign corporations, brings into play both levels

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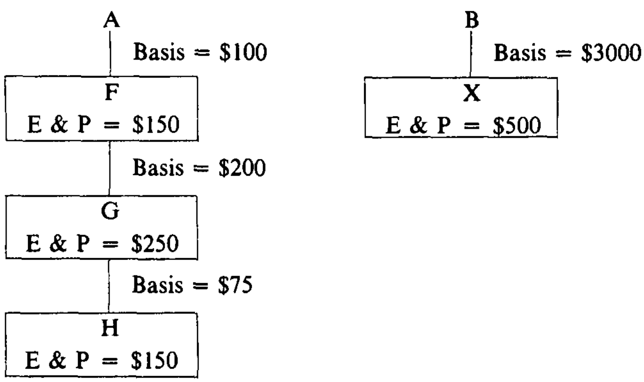
[79] Section 7.367(b)–2(g).
[80] Section 7.367(b)–2(f).
[81] Section 7.367(b)–9(b)(1).
[82] TAX SECTION REPORT, *supra*, note 35, at 132.
[83] Section 7.367(b)–9(c).
[84] Section 7.367(b)–9(d).

of basis adjustments. These adjustments take place only if appropriate elections are made.

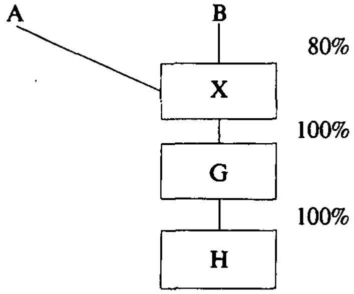
Adjustments in basis of lower-tier foreign corporations of the CFC whose stock is exchanged are made with respect to the lower-tier corporation's immediate shareholder.[85] If the requisite consent dividend election occurs, the basis in each such lower-tier corporation, in the hands of its immediate shareholder, is increased by the amount of that company's post-1962 earnings and profits which are inherited by the CFC whose stock is received in the exchange.[86] These earnings and profits are deemed distributed as a dividend, through any intervening corporation, to the CFC whose stock is exchanged.[87] Basis adjustments regarding pre-1963 earnings and profits require no election.[88] Such amounts, however, are not treated as dividends.[89] To illustrate the application of only this level of basis adjustments (without involving the additional adjustment that may accompany a type B or triangular exchange), a nontriangular asset reorganization serves as fruitful.

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 and earnings and profits of the respective shareholders and corporations, appear as follows:



In the acquisition of F by X pursuant to a type C reorganization,[90] F exchanges all its assets in return for 20 percent of the stock of X. Immediately thereafter F is liquidated and A becomes a U.S. shareholder of X upon the exchange of F stock for X stock. The following diagram illustrates the resulting chain of ownership:

[85] Section 7.367(b)-9(e)(1).
[86] Section 7.367(b)-9(e)(1).
[87] Section 7.367(b)-9(f)(1).
[88] Section 7.367(b)-9(e)(3).
[89] TAX SECTION REPORT, *supra*, note 35, at 134.
[90] Section 368(a)(1)(c).



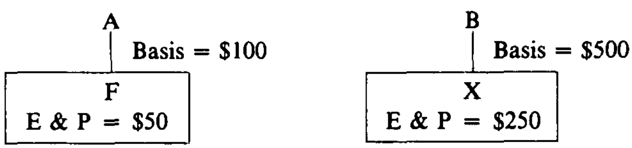
Four hundred and fifty dollars (the total earnings and profits of F, G, and H) is attributed to the X stock received by A in the exchange. X inherits a similar amount while the earnings and profits of G and H are reduced by $250 and $50, their respective contributions to X's inheritance.

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.

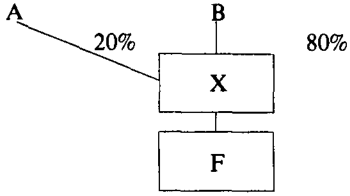
Type B and triangular reorganizations are exclusively provided with an additional set of basis elections. They apply to the basis of stock in lower-tier corporations (after the reorganization) of the corporations whose stock is received. In a type B reorganization, if the U.S. shareholders make the required consent dividend elections,[91] then the basis of stock of the corporation whose stock is exchanged (the acquired corporation) in the hands of the corporation whose stock is received (the acquiring corporation) is increased by the extent to which the latter inherits earnings and profits from the former, and any of its lower-tier corporations.[92]

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. Each corporation was formed after 1962. A diagram of the corporation 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 percent of the stock of X. The following chart illustrates the consequential chain of ownership:

[91] Section 7.367(b)-9(f)(2).
[92] Section 7.367(b)-9(e)(2).

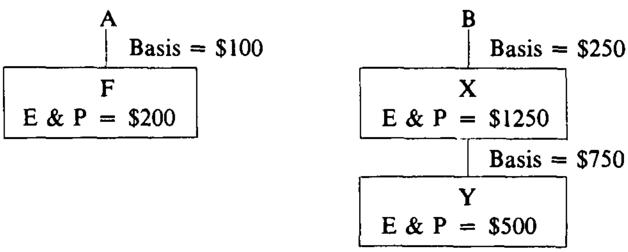


Fifty dollars (the E&P of F) is attributed to the X stock received by A in the exchange. X inherits a similar amount. The earnings and profits of F are reduced by $50, its contribution to X's inheritance.

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.

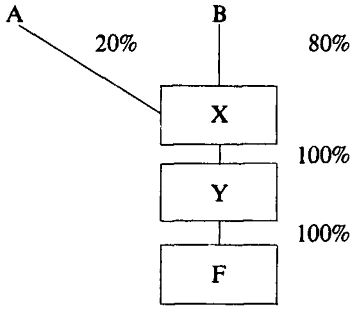
In a triangular reorganization, if the elections are properly made,[93] then the basis of stock of the corporation that acquires the corporation whose stock is exchanged, in the hands of the corporation whose stock is received, is increased by the extent to which the latter inherits earnings and profits from the corporation whose stock is exchanged.[94] In other words, the basis of stock of the acquiring corporation, in the hands of its parent, is increased by the earnings and profits the parent inherits from the acquired corporation.

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,[95] A exchanges all the F stock in return for 20 percent of the stock of X. The resulting chain of ownership is as follows:

[93] Section 7.367(b)-9(f)(2).
[94] Section 7.367(b)-9(e)(2).
[95] Sections 368(a)(1)(B) and 368(a)(2)(D).



Two hundred dollars (the E&P 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 is reduced by $200, its contribution to X's inheritance.

Assuming the basis elections are made, X's basis in Y increases by $200 (the E&P of F inherited by X), from $750 to $950. Y's basis in F increases by $200 (the E&P 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 and basis adjustments at both the corporate and shareholder levels. For purposes of the Section 367 regulations, the terms "distributing corporation" and "controlled corporation" have the same meaning as in Section 355.[96]

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.[97] In making the allocation, regulation Section 1.312-10 shall not apply.[98] After the earnings and profits of each corporation in both the distributing and controlled groups, before the distribution, are calculated, the gross sum of such calculations are allocated between the two groups in proportion to the net fair market value of the assets of each group. When an allocation to a group is made, an increase to earnings and profits occurs only to the parent of such group.[99] A corresponding decrease to earnings and profits is made to the group from which such amounts are allocated. The decrease proportionately reduces the earnings and profits of each corporation in that group

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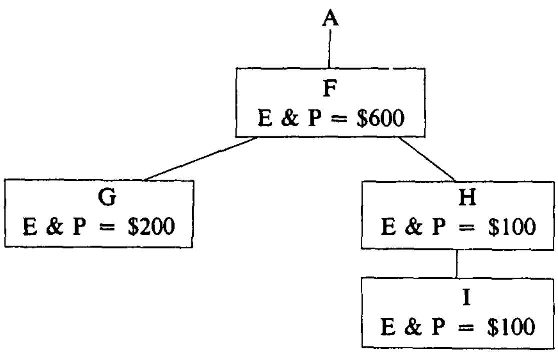
[96]Section 7.367(b)-10(a)..
[97]Section 7.367(b)-10(d)(4).
[98]Section 7.367(b)-10(d).
[99]Section 7.367(b)-10(d)(5)(i).

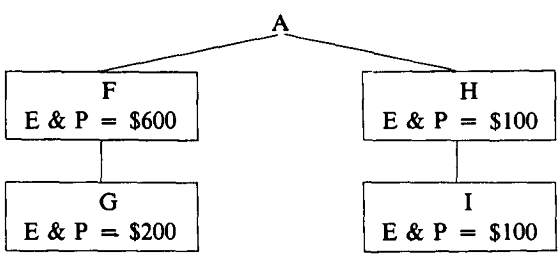
by the ratio which each member's earnings and profits prior to the allocation bears to the group's total earnings and profits prior to the allocation.

Furthermore, basis adjustments exist for each corporation in the group from which earnings and profits are allocated, if that corporation is not the parent of the group. 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 both that corporation as well as other members of the group which as to that corporation are lower-tier members.[100] Basis adjustments in reference to earnings and profits accumulated in taxable years beginning after 1962 take place only if all U.S. shareholders of the group from which the allocation is made invoke the required consent dividend election.[101] Basis adjustments in regards to earnings and profits incurred in taxable years beginning before 1963 shall be accounted for only to compute the all earnings and profits and additional earnings and profits amounts.

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:



[100] Section 7.367(b)-10(e)(1).
[101] Section 7.367(b)-10(f).

After the distribution, $300 is allocated from the F group to the H group, which results in each group having equal E&P of $500. The $300 allocation is made entirely to H, the parent of the controlled group, increasing H's E&P from $100 to $400. Correspondingly, a $300 reduction to the E&P of the F group occurs. The decrease, however, is prorated between F and G: F's E&P is reduced by $225 ($300 times $600/$800), from $600 to $375; G's E&P is reduced by $75 ($300 times $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 E&P allocated from G to H. If A fails to make the election, F's basis in G will remain the same as it was before the distribution.

Shareholder Level Adjustments

The objective of these regulations is to preserve U.S. tax jurisdiction over the U.S. shareholder of the distributing foreign corporation who exchanges stock of the distributing corporation in return for stock of the controlled corporation (or to preserve such jurisdiction over an exchanging CFC as to which there is a U.S. 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.[102]

Exchanging U.S. shareholder receives CFC stock: If a U.S. shareholder of a CFC that is a distributing corporation exchanges its stock in that corporation for controlled corporation stock in respect of which such exchanging person as a U.S. shareholder after the distribution, then the income deferral rules come into play. The rationale, of course, is obvious: since Sections 1248 and 367 confer tax jurisdiction upon the United States over the earnings and profits of the distributed CFC in reference to the exchanging shareholder, there is no need for immediate income inclusion. Hence, the regulations call merely for the attribution of the earnings and profits of the distributing corporation. Thus, the Section 1248 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 attributed to both those shares as well as the controlled corporation shares he receives. The amount attributed to a corporation's shares is the proportion that the value of the stock of that corporation bears to the value of all stock owned after the distribution.[103]

Example: United States shareholder A owns all the stock of F, a foreign corporation formed after 1962 with E&P 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 U.S. shareholder of both G as well as H. Moreover, the value of the F stock is $8,000 while that of the G stock is $2,000.

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[102]Section 367(c)(1).

[103]Section 7.367(b)–10(h)(2).

A is required to make no income inclusion as a result of the distribution. Of F's $100 E&P amount, $80 is attributed to A's stock in F ($100 times $8,000/$10,000) and $20 to A's stock in G ($100 times $2,000/$10,000).

Exchanging U.S. shareholder receives non-CFC stock: If a United States shareholder of the CFC that is a distributing corporation 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 U.S. shareholder), then the income inclusion rules become operative. To the extent of gain realized, the exchanging shareholder includes in income the proportion of the Section 1248 amount of the predistribution stock in the distributing corporation that the value of the controlled corporation stock received bears to the value of all stock owned after the distribution.[104] The remaining Section 1248 amount is attributed to the distributing corporation stock owned by the exchanging shareholder after the distribution.[105]

Example: United States shareholder A owns all the stock of F, a foreign corporation formed after 1962 with E&P 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 times $2,000/$10,000). $80 is attributed to A's stock in F ($100 times $8,000/$10,000).

Exchanging CFC shareholder receives CFC stock: If a CFC as to which there is a U.S. shareholder exchanges stock in a distributing corporation in return for CFC stock as to which the U.S. shareholder retains similar status, the income deferral rules apply. Thus, the earnings and profits of the distributing corporation are attributed to both the exchanging foreign corporate shareholder's stock in that corporation as well as 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.[106] The amount attributed to the exchanging shareholder's stock in each corporation is the proportion that the value of the stock of that corporation bears to the value of all stock owned after the distribution.[107]

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 E&P 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 U.S.

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[104]Section 7.367(b)–10(i)(3)(i). If, however, the exchanging shareholder is a domestic corporation which receives stock of a controlled corporation that is also a domestic corporation, where 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). Section 7.367(b)–10(j).

[105]Section 7.367(b)–10(h)(2).

[106]Section 7.367(b)–10(g).

[107]Section 7.367(b)–10(h)(2).

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 E&P. Of G's $240 pre-distribution E&P, $180 is attributed to F's stock in G ($240 times $3,000/$4,000) and $60 is attributed to F's stock in H ($240 times $1,000/$4,000).

Exchanging CFC shareholder receives non-CFC stock: If a CFC as to which there is a U.S. shareholder exchanges stock in a distributing corporation for non-CFC stock (or CFC stock as to which the U.S. shareholder of the exchanging foreign corporation is no longer a U.S. shareholder), then the addition rule applies. The exchanging shareholder must add to its earnings and profits that portion of the predistribution Section 1248(c)(2) amount in the distributing corporation which 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.[108] This amount is considered a dividend to the exchanging shareholder only if all U.S. shareholders of the exchanging corporation make the appropriate consent dividend election.[109] If the election is made, then the exchanging foreign corporation's basis in the stock it receives in the exchange is increased by the amount added to the exchanging shareholder's earnings and profits.[110]

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 E&P 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 E&P of $60 ($240 times $1,000/$4,000). $180 is attributed to F's stock in G ($240 times $3,000/$4,000).

Moreover, if A makes the proper consent dividend election, the $60 added to F's E&P is treated as a dividend. F's basis in X is increased by $60. Alternatively, if A makes no consent dividend election, the $60 added to F's E&P is a nondividend increase and F receives no corresponding basis adjustment.

Conclusion

From preventing the avoidance of capital gains to curtailing the bail-out of earnings and profits, Section 367 has undergone an interesting metamorphosis in the past fifty years. The two subsections of the statute reflect this historical bifurcation. The legislative intent of subsection 367(a) is to eliminate the tax-free transfer and sale of appreciated assets outside of U.S. 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) is to inhibit the repatriation of CFC earnings and profits by U.S. shareholders. Thus,

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[108] Section 7.367(b)–10(i)(3)(ii)(A), (B).
[109] Section 7.367(b)–10(i)(3)(ii)(B), (C).
[110] Section 7.367(b)–7(c)(1)(iii).

Treasury regulations provide a comprehensive set of rules for determining the tax effect of such exchanges upon those shareholders.

The service's published interpretations, nevertheless, have been the subject of relentless criticism. The critics focus largely on the complexity of the regulations, reiterating platitudes such as "opaque provisions" or "obscure rules." Complexity, however, inheres in the nonrecognition sections of subchapter C. Those sections, in turn, lie at the heart of Section 367. The intricacy of the Code, accordingly, necessitates the complexity of these rules. A careful analysis of the law, on the other hand, leads to appreciation, if not admiration, of the sophisticated manner in which the regulatory network is pieced together. On balance, the draftsmen of the regulations deserve credit for successfully tackling the monumental task of examining exchanges involving foreign corporations with a view to unearthing those transactions motivated by tax avoidance.