DEVELOPMENTS IN THE APPLICATION OF SECTION 367(a) TO TRANSFERS OF PROPERTY TO FOREIGN CORPORATIONS

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The Senate Finance Committee Staff Report recommended several changes in the rules governing transfers of appreciated property outside the United States, under section 367 of the Code. These structural recommendations were addressed in the Tax Reform Act of 1984, enacted almost three months after our conference.

Mr. Pugh traces the history of section 367 and details the important changes in that provision and the impact it will have on so-called "outbound" transactions.

Professor Gann's presentation deals with two major abuses in the foreign area covered by the Senate Finance Committee Staff Report. The bulk of her paper, however, deals with the concept of deferral in our international tax system, where earnings and profits are not taxed until actually brought back to the United States. She devotes much of her comments to the complex areas of foreign personal holding companies and the controlled foreign corporation provisions. Most of these changes were adopted by Congress outside the structural reform recommended by the Senate staff report.

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RICHARD C. PUGH*

INTRODUCTION

The Tax Reform Act of 1984[1] contained some important changes in I.R.C. section 367(a), which deals with outbound transactions involving transfers of property to foreign corporations. Prior to the 1984 changes, section 367(a) provided that if a U.S. person transfers property to a foreign corporation, a gain that was realized on the transaction would be tax-free under one of certain specified non-recognition-of-gain provisions only if a ruling were obtained to the effect that the transfer was not in pursuance of a plan having federal income tax avoidance as one of its principal purposes. Although section 367 was extensively amended in 1976, the Treasury and apparently the Congress continued to be dissatisfied with the way section 367(a) and the ruling requirement were functioning. As a result, in 1984 the Congress has again enacted a major overhaul.

As a background, it would be useful to summarize the situation before the 1976 changes.

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1. Tax Reform Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

Section 367(a) Prior to the Tax Reform Act of 1976 Changes

Prior to the changes of 1976, in order to avoid recognition of gain in every case in which a foreign cor-poration was a party to what would otherwise have qualified as a tax-free reorganization, liquidation, or transfer of property to a foreign corporate transferee, it was necessary to obtain a ruling from the I.R.S. prior to the transaction to the effect that the transaction was not in pursuance of "a plan having as one of its principal purposes the avoidance of Federal income taxes."

Although section 367 was originally aimed at preventing tax-free transfers by U.S. taxpayers of appreciated property to foreign corporations that could then sell the property free of U.S. tax, it applied to a broad spectrum of transactions involving transfers both into and out of the United States and, as a result of the enactment of subpart F in 1962, to a variety of transactions involving only foreign corporations.

Although the section 367 statutory standard for the issuance of rulings was a subjective one, the I.R.S. normally issued favorable rulings only if the proposed transaction complied with various objective standards embodied in the Revenue Procedure 68-23 "367 Guidelines" and only if the taxpayer agreed to bear the tax (pay the "toll charge") on the gain realized on the transfer of certain assets ("tainted assets").[2]

Prior to the enactment of the Tax Reform Act of 1976,[3] it was generally believed that there was no workable mechanism for judicial review of an adverse ruling or a ruling with unacceptable conditions.[4]

1976 Changes

The centerpiece of the changes in section 367(a) enacted in the Tax Reform Act of 1976 was the drawing of a distinction between (1) so-called "outbound" transactions defined as transfers of property (other than stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization) by a U.S. person to a foreign corporation in connection with exchanges described in sections 332, 351, 354, 355, 356, or 361, which were covered by section 367(a), and (2) all other "non-outbound" transactions, which were covered by section 367(b).

2. Rev. Proc. 68-23, 1968-1 C.B. 821; *modified by* Rev. Proc. 77-17, 1971-1 C.B. 577; *amplified by* Rev. Proc. 76-20, 1976-1 C.B. 560 *and* Rev. Proc. 80-14, 1980-1 C.B. 617.

3. Tax Reform Act of 1976, 94-455, 90 Stat. 1525 (1976).

4. *But see* Gerli & Co. v. Commissioner, 688 F.2d 691 (2d Cir. 1982).

Outbound transactions remained subject to a ruling requirement, except to the extent that regulations otherwise provided, but the ruling could be requested within 183 days after the beginning of the transfer and the issuance of an adverse ruling, a failure to rule and the conditions attached to an otherwise favorable ruling were subject to review in a declaratory judgment proceeding in the Tax Court pursuant to I.R.C. section 7477. Although section 367(a)(2) contemplated the issuance of regulations that would obviate the ruling requirement with respect to certain outbound transactions, no such regulations were promulgated, and the I.R.S. generally continued to follow the pre-1976 367 Guidelines.

Non-outbound transactions did not require a ruling and were subject to temporary regulations.[5]

With respect to outbound transactions, the I.R.S. took the formal position that when the specific 367 Guidelines were not met, a presumption of tax avoidance resulted, but that under Rev. Proc. 68-23, section 2.02, the taxpayer could overcome this presumption by establishing to the satisfaction of the I.R.S. that, based upon the particular facts and circumstances, a favorable ruling should have been issued because the transaction was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. The I.R.S. stated that "the intent of Section 2.02 . . . is that the facts and circumstances must be compelling and significant in order to satisfy the [I.R.S.] that the exchange involved no principal tax avoidance purpose."[6] In practice, the taxpayer was rarely able to rebut the presumption to the satisfaction of the Service.

Although the Service traditionally tended to apply the 367 Guidelines literally and inflexibly, a number of decisions of the Tax Court imposed on the I.R.S. a more flexible application of the 367 Guidelines and, when a principal tax avoidance purpose was absent, precluded the imposition of a toll charge altogether. Significantly, in *Dittler Bros., Inc. v. Commissioner*,[7] the Tax Court interpreted the "principal purpose" reference in the section 367 statutory test as a purpose "first in rank, authority, importance or degree," and it adopted the rule that the denial of a favorable ruling would be overturned if it were not based on "substantial evidence."[8] The other

5. Treas. Reg. § 7.367(b)(1)-(b)(13) (1977).
6. I.R.S. Letter Ruling 8334017 (May 19, 1983).
7. Dittler Bros., Inc. v. Commissioner, 72 T.C. 896 (1979), *aff'd mem.*, 642 F.2d 1211 (5th Cir. 1981).
8. *Id.* at 915.

cases in which the Tax Court rejected the Service's refusal to rule are *Kaiser Aluminum Chemical Corp.*[9] and *Hershey Foods Corp.*[10] On a number of occasions in the wake of these decisions, the I.R.S. adopted a more liberal position after the taxpayer protested an initial adverse ruling and requested higher level administrative review by the Office of the Associate Chief Counsel (Technical).

Treatment of Outbound Transactions Prior to Enactment of the 1984 Changes

Outbound Asset Transfers

There are three basic types of transactions involving transfer of assets to a foreign corporation ("outbound asset transfer") that have been assimilated for purposes of the 367 Guidelines.

The Section 351 Transaction

The transfer of properties to a foreign corporation that is controlled (within the meaning of I.R.C. section 368(c)) by the transferors immediately after the transfer.[11]

The Type-C Acquisitive Reorganization

The acquisition of substantially all of the properties of a U.S. corporation (which normally must then liquidate) by a foreign corporation in exchange for stock of the latter.[12]

The Section 332 Liquidation

The liquidation of a U.S. corporation into a foreign parent corporation that controls it within the meaning of I.R.C. section 368(c).[13]

Ruling Requirements for Outbound Asset Transfers

Under the 367 Guidelines a ruling would "ordinarily" be issued (1) if assets were to be used by the foreign corporation transferee in the active conduct of a trade or business in a foreign country and (2) if that trade or business had a need for substantial investment in fixed assets or would be engaged in the purchase and sale abroad of manufactured goods.[14] Despite the latter requirements, the I.R.S. ruled favorably with respect to incorporation of a foreign branch involved in a service business in which the only fixed assets were lease-

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9. Kaiser Aluminum Chemical Corp. v. Commissioner, 76 T.C. 325 (1981).
10. Hershey Foods Corp. v. Commissioner, 76 T.C. 312, *appeal dismissed*, 642 F.2d 1211 (5th Cir. 1981).
11. Rev. Proc. 68-23, § 3.02(i).
12. Rev. Proc. 68-23, § 3.03(1).
13. Rev. Proc. 68-23, § 3.01(2).
14. Rev. Proc. 68-23, § 3.02(1).

hold improvements, furniture, and fixtures.[15]

Toll Charge Requirement

A favorable ruling would ordinarily not be issued if one or more types of "tainted" assets were transferred to a foreign corporation unless the taxpayer agreed to include in its gross income for its taxable year in which the transfer occurred an appropriate amount to reflect realization of income or gain in respect of the tainted assets.[16]

Identification of Tainted Assets — Sections 3.02(1)(a) and (b) of the 367 Guidelines

Tainted assets are listed in sections 3.02(1)(a) and 3.02(1)(b) of the 367 Guidelines and relatively little flexibility has been demonstrated by the I.R.S. in applying them in accordance with their literal terms. The following are the more important categories of tainted assets.

Ordinary Income Assets

(1) Property described in I.R.C. section 1221(1) (inventory or other property held for sale to customers) or I.R.C. section 1221(3) (copyrights, literary, musical or artistic compositions, etc.).[17]
(2) Property, such as accounts receivable or installment obligations, in respect of which income has been earned, unless the income attributable to such property has been or will be included in the gross income of the transferor for Federal income tax purposes.[18]

Stock or Securities

The only explicit exceptions to the treatment of stock or securities as tainted have been (1) the so-called "single-country exception" and (2) the transfer of stock of a foreign corporation to another foreign corporation in exchange for its voting stock that qualifies as a Type-B reorganization. In the case of the latter transaction, section 351 and the Type-B reorganization overlap. Initially the Government's position was that the transaction had to be treated as an outbound section 351 transfer; in 1983 this was reversed, and prior to the effective date of the 1984 changes, the transaction was treated as a

15. I.R.S. Letter Ruling 8331093 (May 3, 1983).
16. Rev. Proc. 68-23, § 3.02(1)(d).
17. Rev. Proc. 68-23, § 3.02(1)(a)(i).
18. Rev. Proc. 68-23, § 3.02(1)(a)(ii).

non-outbound transaction.[19]

Under the single-country exception, a favorable ruling would normally be issued with respect to transfers of stock of a foreign corporation when (1) immediately after the exchange that corporation is controlled (under I.R.C. section 368(c)) by the transferee foreign corporation, (2) the foreign corporation of which the stock is transferred and the transferee foreign corporation are organized under the laws of the same foreign country and the former has a substantial part of its assets used in its trade or business located in that country, and (3) the transferee foreign corporation is controlled (within the meaning of I.R.C. section 954(d)(3)) by a person or persons who immediately prior to such exchange controlled the foreign corporation the stock of which is transferred. This exception is based on I.R.C. section 954(c)(4)(A).

The Type-B reorganization exception is much more expansive than, and it virtually swallows up, the more restrictive single-country exception. The latter might be invoked if a section 351 transaction, which met its requirements, failed to qualify as a Type-B reorganization, *e.g.*, because boot is involved. As a result of the Type-B reorganization exception, a U.S. corporation could, prior to the 1984 changes, transfer "control" of foreign operating corporations to a foreign holding company organized in a tax haven without obtaining a ruling or paying a toll charge.

The Service attempted for years to treat stock or securities as tainted *per se*, subject only to the two exemptions noted above. Its position was rejected by the Tax Court, however, in *Kaiser Aluminum Chemical Corp. v. Commissioner*[20] in which the the U.S. taxpayer (through a wholly-owned U.S. subsidiary) transferred a 4% stock interest in an Australian company ("QAL," which processed bauxite into alumina solely for its shareholders at cost under take or pay arrangements) to another Australian company ("Comalco," which held a bauxite development lease and in which the U.S. taxpayer owned a 45% interest). The Court held that Kaiser's 4% stock interest in QAL, which carried with it the right to an additional 4% of the alumina produced by QAL and needed by the transferee joint venture company, was more like a direct interest in producing assets than an interest in "stock" and that the ruling should not have been denied on the ground that tainted stock was transferred.[21]

The Service's acquiescence in the result of *Kaiser* seemed to signal the dawning of a less rigid approach.[22] In the Letter Ruling, follow-

19. Treas. Reg. § 7.367(b)-4 (1977).
20. Kaiser Aluminum Chemical Corp. v. Commissioner, 76 T.C. 325 (1981), *acq. in result* 1982-2 C.B. 1.
21. *Id.* at 345.
22. *See* I.R.S. Letter Ruling 8313099 (December 29, 1982).

ing a protest, the Service agreed to permit transfer by a U.S. petroleum company to a wholly owned foreign corporation of a 50% interest in a foreign joint venture corporation owning a refinery along with substantially all the properties of the transferor in a Type-C reorganization. The Service concluded that the transfer of the 50% interest in the refining corporation, which was 50% owned by a foreign joint venture partner, could proceed without a toll charge since the arrangement between the two 50% shareholders was "basically one of operating a joint venture to process products that are vital components of their respective business and is in essential respects . . . quite similar to the arrangement in *Kaiser*." There were other cases in which favorable rulings have been issued after taxpayers have protested an initial unfavorable ruling,[23] however, the standard reflected in *Kaiser* remained quite restrictive and difficult to administer.

Intangibles

Under the 367 Guidelines, transfers of intangibles were treated as tainted in four situations set forth in Rev. Proc. 63-23, sections 3.02(1)(b)(i), 3.02(1)(a)(iv), 3.02(1)(b)(iii), and 3.02(1)(b)(iv). The intangible Guidelines were aimed principally at imposing a toll charge on (1) the transfer of income-producing intangibles to a foreign corporation organized in a country in which there would be little or no tax on the income from sale or licensing of the intangibles and (2) the transfer of intangibles to a foreign corporation that would use them in connection with a U.S. trade or business or in connection with goods to be manufactured, sold, or consumed in the United States.

Transfers of foreign rights to patents, trademarks, and know-how for use in connection with a foreign manufacturing business would normally be accorded a favorable ruling without a toll charge.

Partnership Interests

Proposed Treasury Regulation section 1.367(a)-1(b)(3) provides that a transfer of property by a partnership to a foreign corporation is treated as an indirect transfer by each partner of the portion of each partnership asset attributable to his partnership interest. The

23. *E.g.*, I.R.S. Letter Ruling 8150082 (Sept. 17, 1981)(after protest, favorable ruling issued in I.R.S. Letter Ruling 8301076 (Oct. 5, 1982)); I.R.S. Letter Ruling 8307031 (Nov. 15, 1982).

proposed regulations do not deal with transfer of partnership interests themselves and do not distinguish between general and limited partnerships.

Transfer of a general partnership interest to a foreign corporation has been treated as a transfer of the partner's proportionate share of the underlying assets.[24]

Transfer of a limited partnership interest to a foreign corporation has been treated as the transfer of a tainted asset analogous to stock.[25]

Oil and Gas Interests

Outbound transfers of working or operating interests normally received favorable rulings. When the transfer involved a nonoperating interest, the I.R.S. imposed a toll charge tax on its appreciation.[26]

Foreign Branch Losses

In Rev. Rul. 78-201,[27] the I.R.S. announced a flat rule that required recapture of previously deducted losses incurred by a foreign branch upon its incorporation. This was amplified in a series of subsequent rulings.[28]

The I.R.S. rule was that when foreign business assets were transferred by a U.S. taxpayer to a foreign corporation in a section 351 exchange, a favorable ruling would be issued only if the total net loss for all taxable years generated by that business was included in the taxable income of the U.S. taxpayer as foreign-source income. The amount of foreign loss recapture was reduced by the amount of branch loss included in an overall loss to the extent such loss had been separately recaptured under I.R.C. section 904(f), and in Rev. Rul. 82-146,[29] the I.R.S. reversed its prior position[30] and held that recapture was limited to gain realized. Therefore, the I.R.S. position prior to the 1984 changes appeared to be that recapture was limited to the lesser of (1) gain realized and (2) the cumulative branch loss reduced by the amount of that loss previously recaptured under section 904(f).

In *Hershey Foods Corp. v. Commissioner*,[31] the Tax Court re-

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24. I.R.S. Letter Ruling 8040070 (July 11, 1980).
25. I.R.S. Letter Ruling 8145034 (Aug. 11, 1981).
26. I.R.S. Letter Ruling 8323020 (March 4, 1983).
27. Rev. Rul. 78-201, 1978-1 C.B. 91.
28. Rev. Rul. 80-246, 1980-2 C.B. 125; Rev. Rul. 80-247, 1980-2 C.B. 127; Rev. Rul. 80-293, 1980-2 C.B. 128; Rev. Rul. 81-82, 1981-1 C.B. 127; Rev. Rul. 81-89, 1981-1 C.B. 129; Rev. Rul. 82-146, 1982-2 C.B. 84.
29. 1982-2 C.B. 84.
30. Rev. Rul. 80-163, 1980-1 C.B. 78.
31. Hershey Foods Corp. v. Commissioner, 76 T.C. 312, *appeal dismissed*, 642 F.2d 1211 (5th Cir. 1981).

jected the Service's 367 recapture rule, holding that it could not coexist with I.R.C. section 904(f), which was held to be the sole mechanism Congress enacted to deal with "recapture" of foreign losses.

The U.S. Solicitor General rejected the I.R.S. recommendation that the *Hershey* decision be prosecuted. The I.R.S. nonetheless apparently concluded that the Supreme Court decision on the application of the tax benefit rule in *Hillsboro National Bank v. Commissioner* and *U.S. v. Bliss Dairy, Inc.*,[32] provided a basis for sustaining loss recapture on a tax benefit theory, and it persisted in applying the rule announced in Rev. Rul. 78-201.

Creation of U.S. Branch

When a going U.S. business is transferred to a foreign corporation, the business may be continued as a U.S. branch by the foreign corporation. It is arguable that it is inappropriate to impose a toll charge since the business will continue to be subject to U.S. taxation and, if necessary, a closing agreement could be used to protect U.S. taxing jurisdiction against a transfer of assets abroad. A toll charge on difficult-to-value intangibles used by the U.S. branch could be particularly burdensome.

However, the Service's position prior to the 1984 changes went far beyond imposing a toll charge on "tainted" assets. For example, it refused to rule favorably with respect to the liquidation of two wholly owned U.S. sales subsidiaries into a foreign corporation that would continue the sales operations in the United States through a branch on the ground that 367 Guideline section 3.02(1) specifically required that the transferred assets be used in the active conduct of a trade or business in a *foreign country*. This violation of the 367 Guidelines gave rise to a presumption of tax avoidance that the taxpayer could successfully rebut only by showing good business reasons and foreign tax advantages that resulted from the liquidation. When a taxpayer failed to carry this burden, the ruling was refused.[33]

Use of Closing Agreements

The Service regularly refused to enter into closing agreements in outbound transactions covered by I.R.C. section 367(a), citing a variety of reasons, most of which centered on administrative and en-

32. Hillsboro Nat'l Bank v. Commissioner, *decided with* U.S. v. Bliss Dairy, Inc. 460 U.S. 370 (1983).
33. I.R.S. Letter Ruling 8334013 (May 18, 1983).

forcement difficulties.[34]

Acquisitions of the Stock of a U.S. Corporation by a Foreign Corporation or Assets or Stock of a U.S. Corporation by a U.S. Subsidiary of a Foreign Corporation

The following transactions have been regarded as outbound in nature and have been assimilated for purposes of the 367 Guidelines:
(1) Acquisition of stock of a U.S. corporation for stock of a foreign corporation — direct Type-B reorganization;
(2) Acquisition of stock of a U.S. corporation for stock of a foreign corporation through a reverse subsidiary merger of a new U.S. subsidiary of the foreign corporation into the target corporation under I.R.C. section 368(a)(2)(E);
(3) Acquisition of a U.S. corporation for stock of a foreign corporation through a direct subsidiary merger of the target corporation into a U.S. subsidiary of the foreign corporation under I.R.C. section 368(a)(2)(D);[35]
(4) Acquisition of substantially all of the properties of a U.S. corporation by a U.S. subsidiary of a foreign parent corporation in exchange for stock of the latter in a triangular Type-C reorganization; and
(5) Acquisition of stock of a U.S. corporation by a U.S. subsidiary of a foreign corporation for stock of the latter in a triangular Type-B reorganization.

Under the 367 Guidelines, a favorable ruling has normally been granted with respect to the foregoing transactions provided that (1) immediately after the exchange, the stockholders of the acquired U.S. corporation do not own directly or indirectly more than 50% of the total combined voting power of the acquiring foreign corporation and (2) the assets of the acquired corporation do not consist principally of stock or securities.[36] It would appear that for purposes of this rule, stock of securities should encompass portfolio investments but not direct investments in operating subsidiaries.

PROPOSED CHANGES UNDER NEW ACT

The Tax Reform Act of 1984 Changes

Concerns of the Treasury and the Congress

Basic legislative changes were presaged in the Finance Committee Staff Report on Reform and Simplification of the Income Taxation

34. *See, e.g.,* I.R.S. Letter Ruling 7924028 (March 14, 1979).
35. I.R.S. Letter Ruling 8113123 (Jan. 5, 1981).
36. Rev. Proc. 68-23, § 3.03(1)(d). For application of the Rev. Proc., *see, e.g.,* I.R.S. Letter Ruling 8303064 (Oct. 20, 1982).

of Corporations,[37] which stated as follows with respect to I.R.C. section 367(a):

> The Internal Revenue Service has encountered difficulty in administering section 367(a), primarily due to the definition ascribed by the Tax Court to the term "principal purpose" test of section 367(a) in *Dittler Bros., Inc. v. Commissioner*. In that case the Tax Court referred to a "principal" purpose as being a purpose "first in rank, authority, importance or degree." The implication of the case, therefore, was that a tax avoidance purpose for a transfer must be greater in importance than any business purpose before section 367(a) will apply. In light of the decision in the *Dittler* case, and the subsequent cases which were similarly decided against the Government, the Internal Revenue Service has shown some reluctance to litigate cases involving the type of tax avoidance that was intended to be prevented by the application of section 367(a). . . .
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> Section 367(a) could be amended in various ways to assure that it will operate in the future to accomplish its original purpose of preventing the avoidance of Federal income taxes by the transfer of appreciated property outside the U.S. taxing jurisdiction. One alternative would be simply to lessen the Government's burden of proof by substituting the present "principal" purpose test of section 367(a) with a more expansive "significant" or "material" purpose test. A second alternative would be to eliminate the subjective test altogether and instead institute an effects test, whereunder an automatic toll would be imposed with respect to transfers of certain "tainted" assets. Regardless of which alternative or combination of alternatives might be adopted, special attention must be directed to particularly complex problems associated with the transfers of stock and securities and other intangibles.[38]
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> The problem perceived by the Treasury and the Congress with respect to intangible marketing and manufacturing assets, such as trademarks, trade names, patents, and technological know-how, centered on the fact that the taxpayer could develop such assets in the United States, deducting the costs thereof against U.S.-source income, and could then under the existing 367 Guidelines transfer these intangibles to a foreign corporation for use in connection with its foreign manufacturing and marketing operations. The tension was particularly acute in the case of manufacturing intangibles. The U.S. taxpayer benefits from important U.S. tax incentives to the conduct of research and development in the United States. Research or experimental expenditures are currently deductible. A tax credit for 25% of certain incremental research expenses is available. Under temporary legislation enacted in 1981, all research and experimental expenditures for U.S. activities reduce U.S.-source but not foreign-source income for purposes of the section 904 limitation on foreign tax credits. This enables many U.S. businesses to credit a larger portion of their foreign tax burdens than would be possible under the normal rules that would require an appropriate portion of those expenditures to be allocated against foreign-source income.
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> If the research expenditures resulted in valuable patents or technological know-how, the U.S. taxpayer could transfer the foreign rights to a wholly owned manufacturing and marketing corporation abroad, and if the intangibles were to be used in connection with a foreign manufacturing busi-

37. STAFF OF THE SENATE COMM. ON FINANCE, 98TH CONG., 2D SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORTIONS: A PRELIMINARY REPORT (Comm. Print 1983) [hereinafter cited as SFC REPORT].
38. SFC REPORT, *supra* note 37, at 53, 80-81 (footnotes omitted).

ness the products of which will be sold abroad, under the existing 367 Guidelines, a favorable ruling would be issued without a toll charge. If the foreign corporation is set up in a low-tax or a tax-holiday jurisdiction, such as Ireland, there would be little or no foreign tax on the income generated by the intangibles, and U.S. tax would be deferred until the earnings were distributed as dividends to the U.S. corporations.

The situation was similar to the issue presented by the transfer of marketing and manufacturing intangibles to possessions corporations. The effective exemptions from U.S. and Puerto Rican income taxes have encouraged U.S. corporations to maximize the income of corporations qualifying for the section 931 exemptions and its successor, the section 936 credit. They do this by transferring to qualifying corporations manufacturing and marketing intangibles, such as patents, know-how, and trademarks, tax-free under section 351 and thereafter taking the position that all the income generated by these intangibles qualifies for the section 931 exemption or the section 936 credit.

The I.R.S., concerned that the costs of the R and D that produced the patents and know-how and the advertising and other expenses that gave value to the trademarks have been deducted for U.S. tax purposes, takes the position that income attributable to manufacturing and marketing intangibles acquired by a possessions corporation tax-free from a related party in a section 351 exchange can be allocated to such party under section 482.

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA)[39] provided a legislative resolution with respect to 936 possessions corporations. This called for treating income attributable to intangible manufacturing and marketing assets, owned or licensed by a 936 corporation, as income of its U.S. shareholders. This income is ineligible for the 936 credit unless the 936 corporation opts out of this treatment by electing to have only specified income attributable to intangible property qualify for the credit under either of two options: (1) a cost-sharing arrangement or (2) a fifty-fifty profit split. Broadly speaking, under the cost-sharing election, by making an appropriate cost-sharing payment, a 936 corporation will continue to receive a section 936 credit with respect to income attributable to certain manufacturing and marketing intangibles, while under the profit-split election, 50% of the combined taxable income of the 936 corporation and its U.S. affiliates from manufacture and sale will qualify for the credit. Since under each of these elections a portion of the 936 corporation's intangible property income will qualify for the 936 credit, 936 corporations with substantial intangibles income normally opt out and thereby shelter part of their intangible property income from tax.

TEFRA also provided that any transfer of manufacturing and marketing intangibles by a 936 corporation to a foreign corporation would be taxable. Intangibles of a possessions corporation thus became irrefutably tainted for purposes of section 367.

Summary of the 1984 Changes in Section 367(a)

The fundamental changes enacted in the Tax Reform Act of 1984 included elimination of the requirement of an I.R.S. ruling for outbound transfers and repeal of the declaratory judgment procedure of section 7477. Instead of the ruling mechanism, the new section 367(a) contains a general rule of taxability for outbound transfers of property from a U.S. person to a foreign corporation described in

39. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97-248, 96 Stat. 324 (1982).

sections 332, 351, 354, 355, 356, or 361. Under this rule, the foreign corporation will not be deemed to be a "corporation" for purposes of determining recognized gain on the transaction.[40]

The general rule of taxability is made subject to certain exceptions. The exceptions, together with the general rule, codify many aspects of the prior treatment of outbound transfers as reflected in the statute prior to the 1984 changes and in the 367 Guidelines; but some important modifications have been introduced.

The principal exception to the rule of taxability encompasses transfers of property to be used in the active conduct of a foreign trade or business. Subject to the toll charge requirements and special rules for manufacturing and marketing intangibles discussed below, transfers of property to a foreign trade or business are to be tax-free.

A toll charge is imposed on transfers of certain tainted assets, as well as on the incorporation of foreign loss branches. With some significant exceptions the assets treated as tainted under the proposed rules are the same as those so treated under the existing 367 Guidelines.

One addition made by the 1984 changes is a new set of highly important toll charge rules which are included for the transfer of manufacturing and marketing intangibles to foreign corporations.

Another potentially important change is that new section 367(a), in effect, adds section 336 to the non-recognition provisions referred to in section 367(a) by providing that in the case of any distribution described in section 336 by a domestic corporation to a person who is not a U.S. entity, to the extent provided in regulations, gain shall be recognized "under principles similar to the principles of this section." Thus, to the extent provided in future regulations, any liquidation of a U.S. corporation with foreign shareholders would be potentially covered by section 367(a), not merely liquidation of an 80% owned U.S. subsidiary into its foreign parent corporation under section 332. Unless and until regulations are promulgated, however, only the section 332 liquidation can be subjected to toll changes.

Since I.R.C. section 336(a) continues to provide that a liquidating distribution of appreciated property to U.S. persons who are shareholders of a U.S. corporation is normally tax-free to the distributing corporation, imposing tax on the distributing corporation, if the distributee is a foreign person, would appear to violate the non-discrimination provisions of a number of the U.S. double taxation treaties.

40. I.R.C. § 367(a)(1) (1982).

Among the apparent violations would be Art. 24(3) of the U.S.-French Income Tax Treaty, Art. 24(3) of the U.S.-Belgian Income Tax Treaty, and Art. 24(6) of the OECD Model Convention. It would also violate the U.S. Treasury's Proposed Model Income Tax Treaty, which states the anti-discrimination rule as follows:

> Enterprises of a Contracting State, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other Contracting State, shall not be subjected in the first mentioned State to any taxation or any requirement connected therewith which is other or more burdensome than the taxation and connected requirements to which other similar enterprises of the first-mentioned State are or may be subjected.[41]

Since there is no evidence of Congressional intent to override U.S. treaty obligations by the 1984 amendments to section 367(a), it may be hoped that regulations imposing tax on outbound liquidating distributions that would otherwise be tax-free under section 366(a) will exempt liquidations protected by treaty non-discrimination provisions.

The basic thrust of the amendments to section 367(a) is to eliminate the "principal purpose" test, with its emphasis on subjective elements, in favor of a more objective test of whether the assets will be used in the active conduct of a trade or business, buttressed by objective toll-charge rules requiring taxation in the case of transfer of specified tainted assets.

So that the IRS will be informed of outbound transfers covered by section 367(a), a new section 6038B is added to the Code to require U.S. persons involved to notify the I.R.S. of the existence of these transactions. U.S. taxpayers who fail to notify the I.R.S. and cannot show reasonable cause will pay a penalty equal to 25% of the gain realized. The statute of limitations for assessment with respect to recognized gain under section 367(a) will be extended until three years after notice is given to the I.R.S.

Active Conduct of a Foreign Trade or Business

Aside from toll charges for tainted assets and branch loss recapture, the touchstone of non-taxability under the new regime is whether the property is transferred for use in the active conduct of a foreign trade or business. Under new section 367(a)(3)(A), except as provided in regulations and in section 367(a)(3)(B), gain will not be recognized with respect to any property transferred for use by a foreign corporation in the active conduct of a trade or business outside of the United States. It is contemplated, however, that the regulations may require recognition of gain in cases of transfers of property

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41. U.S. Treasury's Proposed Model Income Tax Treaty, June 16, 1981, Art. 24(5).

for use in an active business abroad "involving the potential of tax avoidance."[42] Authority is also given to exempt transfers from tax by regulation.

No mention is made in the amended section 367(a) or the committee reports of the additional 367 Guideline requirements that the transferee have a need for substantial investment in fixed assets or be engaged in purchase and sale abroad of manufactured goods. These requirements may be expected to find their way into the regulations.

The Senate Finance Committee indicated it expects that:

> that, prior to January 1, 1985, the Secretary will issue regulations prescribing the standards to be used in determining whether property is transferred for use in the active conduct of a trade or business within the meaning of the bill. However, if the Secretary does not issue regulations before January 1, 1985, it is intended that taxpayers will continue to rely on the current I.R.S practice (as reflected in I.R.S. ruling policy) in determining the existence of an active trade or business.[43]

The Finance Committee also indicated that:

> [t]he committee believes that the activities engaged in by the corporation involved in the *Dittler* case did not constitute an active trade or business. [*Dittler* involved a transfer of manufacturing know-how in exchange for 50% of the stock of a Netherlands Antilles corporation which did not engage in manufacturing itself but had the manufacturing done by independent contractors.] Accordingly, under the new statutory standard (which does not look to tax avoidance), a transfer such as that in *Dittler* would be taxable. The Committee contemplates that, ordinarily, no gain will be recognized on the transfer of goodwill or going concern value for use in an active trade or business. Similarly, it is expected that regulations will provide that gain will not be recognized on transfers of marketing intangibles (such as trademarks or trade names) in appropriate cases.[44]

Tainted Assets Under New Section 367(a)

Like the 367 Guidelines, amended section 367(a) imposes a toll charge tax on the income realized on transfers of certain tainted assets that will be used in the active conduct of a foreign trade or business. Categories of tainted assets under the existing 367 Guidelines that remain tainted under new 367(a) include: (1) property described in paragraph (1) or (3) of section 1221 (relating to inventory and copyrights, etc.); (2) installment obligations, accounts receivable, or similar property; (3) property with respect to which the trans-

42. SENATE FINANCE COMM., 98TH CONG., 2D SESS., EXPLANATION OF THE DEFICIT REDUCTION TAX BILL OF 1984, 364 (Comm. Print 1984) [hereinafter cited as S. REP.].
43. *Id.* at 365.
44. S. REP., *supra* note 42, at 365 (footnotes omitted).

feror is a lessor at the time of the transfer, unless the transferee was the lessee; (4) assets of a foreign branch with cumulative losses; (5) intangible marketing and manufacturing assets, which, however, are treated under the 1984 amendments as tainted in every case and are subjected to special toll-charge rules.[45] The Joint Congressional Conference Committee also indicates that it intends regulations to be prescribed that will require recognition of gain on the transfer of depreciable assets used in the United States to the extent of depreciation deductions previously claimed by the taxpayer with respect to the transferred property. This would represent a significant change in existing law.[46] New section 367(a) departs from the 367 Guidelines' treatment of tainted assets in a number of significant respects.

Assets Dropped from Automatically Tainted Category

Stock and securities are no longer treated as assets that are tainted *per se*. New section 367(a) subjects transfers of stock and securities only to the general active trade or business test. The test will be met when stock or securities are "transferred under circumstances resembling those existing at the time of the transfer in the *Kaiser* case or under certain other limited circumstances."[47] The Senate Finance Committee further elaborates on the treatment of stock or securities as follows, "[g]enerally, additional circumstances which might place a transfer of stock within the exception include substantial ownership by the transferee in the corporation whose stock is transferred, and integration of the business activities of that corporation with the business activities of the transferee."[48]

The Finance Committee also suggests that use of closing agreements be provided for in regulations to police I.R.S. policies relating to stock or securities notwithstanding the administrative problems they pose:

> The Committee believes that the I.R.S. should set forth regulations whereby, where appropriate, the I.R.S. would not impose tax on the transfer of such stock, provided the transferor agrees that the stock will not be disposed of by the transferee (or any other person) for a substantial period of time following the year of the transfer. The transferor would be taxed on any income or gain from a disposition of the stock as if the disposition took place in the year of the original transfer at the fair market value of the stock at the time of the original transfer. Thus, interest would be added to the tax for the

45. I.R.C. § 367(a)(3)(b), (c) (1982).

46. JOINT CONGRESSIONAL CONFERENCE COMM., 98TH CONG., 2D SESS., REPORT ON H.R. 4170 (1984) [hereinafter cited as CONF. REP.].

47. H. R. REP. No. 432, Part 2., 98th Cong., 2d Sess., (1984) [hereinafter cited as H. REP.].

48. S. REP., *supra* note 42, at 365.

period from the initial transfer to the subsequent disposition.[49]

The Finance Committee also suggests that closing agreements be used to police I.R.S. policies relating to stock or securities notwithstanding the administrative problems they pose:

> The Committee understands that enforcement of such regulations could, in some cases, present problems. However, it believes that the burdens of enforcing compliance would not outweigh the benefits of regulations in many cases. To promote compliance, the I.R.S. might require in the regulations, for example, the transferor to certify annually for some period (*e.g.*, 15 years) following the transfer that the transferred property is still held by the transferee and to file annually a waiver of the statute of limitations on assessment. In addition, the I.R.S. might require that the transferor furnish sufficient security to ensure that any tax will be paid.
>
> In addition, the Committee anticipates that regulations will provide an exception for transfers of stock of foreign corporations to transferees organized in the same country as the corporation whose stock is transferred under principles similar to those now embodied in the I.R.S. guidelines.[50]

Although the Senate Finance Committee stated its view that when a transfer of stock to a foreign corporation could qualify either as a section 351 transfer and a Type-B reorganization, it should be treated as a section 351 transfer, thus reversing the rule of the existing regulations,[51] the Conference Committee took a more flexible view, stating merely that "the conferees expect that, in developing regulations, the Secretary will carefully consider whether there are cases where the transfer should be treated as a section 351 exchange."[52]

Two other categories of assets would lose their automatic "tainted" status - property whose sale by the transferee is a principal purpose of the transfer, and property likely to be leased or licensed by the transferee.

The House Committee noted:

> Generally, these assets will not be considered to be transferred for use in the active conduct of a trade or business. However, the Committee believes that the leasing of transferred tangible assets should not preclude tax-free treatment of the related exchange when the transferee is engaged in the active conduct of a leasing business involving such assets which will not be leased in the United States, and the transferee has a need for a substantial investment in the type of assets transferred.[53]

49. *Id.* at 365-66.
50. *Id.*
51. *Id.* at 365.
52. CONF. REP., *supra* note 46, at 953.
53. H. REP., *supra* note 47, at 1317.

Assets Added to the Automatically Tainted Category

Foreign currency and other property denominated in foreign currency (*e.g.*, installment obligations, accounts receivable and other obligations calling for payment in foreign currency) are classified as "tainted" assets. The Ways and Means Committee noted that taxation of gains attributable to exchange rate fluctuations was appropriate in light of the increased numbers of foreign currency transfers by U.S. business in recent years, and in light of the ready liquidity of foreign currency.[54]

Special Rule for Intangibles

New section 367(a) treats the transfer of intangibles separately from other section 367(a) transfers. The special rules are contained in a revised section 367(d), and they represent a significant departure from the treatment under prior law.

Under the existing 367 Guidelines, the Service requires only a one-time toll charge for transfer of intangibles in certain situations. But if the intangibles are to be used in an active manufacturing and marketing business abroad, a favorable ruling will issue without a toll charge.

Under new section 367(d), marketing and manufacturing intangibles, as defined in section 936(h)(3)(B), are treated as a special class of tainted asset and in every case the transferor will be treated as having sold the property in exchange for payments which are contingent upon the productivity, use, or disposition of such property and which reasonably reflect the amounts that would have been received (1) annually in the form of such payments over the useful life of such property or (2) in the case of a disposition following such transfer (whether direct or indirect) at the time of the disposition. I.R.C. section 367(d)(2)(B) calls for an appropriate reduction in the earnings and profits of the foreign corporation for the royalty-like payments deemed paid by the foreign corporation. The reference to direct or indirect disposition is intended to cover a disposition of either the transferred intangible by a transferee corporation or a disposition of the transferor's interest in the transferee corporation. The amount of income taxed upon such a disposition will depend on the value of the intangible at the time of the disposition.[55] The Senate Finance Committee noted that:

> [t]he bill contemplates that gain on a disposition of stock in a foreign-transferee corporation will be treated as being attributable, in part, to the transferred intangible (and, therefore, U.S. source income); similarly, upon a disposition of the intangible by the foreign-transferee corporation, the U.S.

54. *Id.*
55. CONF. REP., *supra* note 46, at 955.

transferor will be treated as receiving a payment with a U.S. source."[56]

Intangible property is defined in section 936(h)(3)(B) as any (1) patent, invention, formula, process, design, pattern, or know-how, (2) copyright, literary, musical, or artistic composition, (3) trademark, trade name, or brand name, (4) franchise, license, or contract, (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (6) any similar item, which property has substantial value independent of the services of any individual. It is unclear how the inclusion of trademark and trade names in this definition will be reconciled with the statement of the Senate Committee that "ordinarily, gain will be recognized on the transfer of good will or going concern value for use in an active trade or business" and that "[s]imilarly it is expected that regulations will provide that gain will not be recognized on transfers of marketing intangibles (such as trademarks and trade names) in appropriate cases."[57] The Conference Report does not dispel the confusion with its somewhat enigmatic statement that:

> [t]he conferees wish to clarify that, as under present law, gain will generally be recognized under section 367(a) on transfers of marketing intangibles (such as trademarks or trade names) for use in connection with a U.S. trade or business, or in connection with goods to be manufactured, sold, or consumed in the United States.[58]

This would seem to imply that, as under prior 367(a) policies, some transfers of marketing intangibles used abroad would not attract a toll charge.

Particularly important is the provision of section 367(d)(2)(C) that treats any income includable by the transferor under section 367(d) as ordinary income from sources within the United States.[59] This provision seems extraordinary in at least two respects. First, it reverses the normal source-of-income rule under which income from use of foreign patents, trademarks or foreign rights to use know-how is foreign-source.[60] As a result, if the foreign jurisdiction follows the lead of the United States and imposes a withholding tax on the constructive royalty deemed paid by the foreign transferee corporation on the theory that it is income from domestic sources, no foreign tax credit may be available for the withholding tax since there will be no foreign-source income produced by the transaction that could be in-

56. S. REP., *supra* note 42, at 368.
57. *Id.* at 365.
58. CONF. REP., *supra* note 46, at 955.
59. I.R.C. § 367(d)(2)(c) (1982).
60. I.R.C. § 862(a)(4) (1982).

cluded in the numerator of the section 904 foreign tax credit limitation fraction. Secondly, if the transfer of intangibles to the foreign corporation constitutes a transfer of all substantial rights to the property, the transaction, if held to be taxable, should be characterized as a sale and the gain should qualify for long-term capital gain treatment. This is assuming that the property qualifies as a capital or section 1231 asset and it has been held for more than six months. It may be noted that the Service's position for years has been that a transfer of intangibles to a foreign corporation will not qualify as a "transfer" of "property" for purposes of section 351 unless it constitutes a transfer of all substantial rights, *i.e.*, would qualify as a sale if the transaction were taxable. This position was rejected in *E.I. Du Pont de Nemours & Co.*,[61] but has never been abandoned by the I.R.S. It may now be abandoned since whether or not the transfer is of all substantial rights, if it qualifies under section 351, the gain will be ordinary income from U.S. sources.

The valuation problems inherent in determining what level of royalty income should be imputed are somewhat less difficult in most cases than those inherent in computing a one-time toll charge - but they remain formidable. The problem of determining a one-time toll charge will remain in the case of a disposition of the transferred intangible by the transferee corporation or of stock in the corporation. Also, the problem of determining useful lives of assets, such as know-how, a customer list or a brand name — a sampling of a very wide range of intangibles included in the section 936(h)(3)(B) definition — is imposing. The legislation may require a perpetual royalty in the case of good will, trademarks and other assets with indeterminate lives.

As a result of the draconian aspects of the new section 367(d) rules on intangibles, taxpayers may be expected to transfer intangibles to foreign corporations under actual license agreements in return for actual royalties rather than in section 351 transfers. Assuming that the actual royalties are fixed on an arm's length basis, this approach should exclude the transfers from section 367(a) and permit all royalties for foreign rights to marketing and manufacturing intangibles to be treated as foreign-source and licenses of all substantial rights to generate long-term capital gain royalties. In this connection, it is interesting to note that the Senate Finance Committee states:

> These special rules (including the sourcing rule) apply only to situations involving a transfer of the intangible property to a foreign corporation. In any case in which the I.R.S. determines that an adjustment under section 482 (relating to the allocation of income and deductions among taxpayers) is appropriate because a foreign corporation obtained the use of the intangi-

61. E.I. Du Pont de Nemours Co. v. Commissioner, 471 F.2d 1211 (1973).

ble property without sufficient compensation therefore, the special rule for transfers of intangibles will have no application to amounts included in the income of a U.S. taxpayer pursuant to such an adjustment. Thus, for example, the source of any adjustment to the income of a U.S. taxpayer under section 482 would be determined without regard to the sourcing rule in the bill.[62]

If the source of any royalty imputed under I.R.C. section 482 will be determined under normal source rules, it seems clear that the same will be true of any arm's length actual royalties paid by a foreign licensee corporation. Moreover, the reference to section 482 in the Senate Committee Report seems to imply that if actual royalties are set at less than arm's length levels in a license between related parties, the proper remedy will be for the I.R.S. to raise the royalty level under section 482, which would result in increased foreign-source income, rather than to contend that the transaction falls, in part, under section 351 with the result that U.S.-source royalties would be imputed under section 367(d).

If technological know-how is made available by a U.S. corporation to a foreign subsidiary controlled within the meaning of section 368(c) royalty-free under a bona fide cost-sharing agreement envisaged in Reg. Sec. 1.482(d)(4), the I.R.S. is precluded from imputing a royalty under section 482. Presumably no royalty-type toll charge should be imposed under section 367(a), but the statute and committee reports are silent on the point.

There appears to be a potential anomaly with respect to application of the new rule to intangibles in the context of an outbound transfer of intangibles in liquidation of a U.S. corporation to a foreign parent corporation under section 332 or to any other foreign shareholder under section 336. Treating the liquidating transferor of intangibles as receiving a royalty from the transferee(s) in this situation would not appear to make sense; the regulations may well call for a lump sum toll charge in this case even though the statute calls for a lump sum only if the transferee disposes of the intangible concerned.

At least insofar as manufacturing intangibles are concerned, there appears to be an overlap between the treatment of such intangibles in outbound transfers under section 367(a) and their asserted treatment by the I.R.S. under the tax benefit rule. The I.R.S. is now taking the position at least in some audits that the tax benefit rule requires that if patents, know-how, and other property (such as drawings) that embody the results of research and experimental ex-

62. S. REP., *supra* note 42, at 368.

penditures previously deducted under I.R.C. section 174 are disposed of in a sale, exchange, or distributed in liquidation, the previously-expensed amounts must be recaptured as ordinary income to the extent of the fair market value of the distributed property.

In I.R.S. Letter Ruling 8409009, November 23, 1983, the I.R.S. took the position that under the tax benefit rule, as expounded by the Supreme Court in *Hillsboro National Bank v. Commissioner*,[63] proceeds from the sale of patents and confidential know-how otherwise taxable as capital gain must be recharacterized as ordinary income to the extent of the deductions previously taken under section 174(a)(1) for research and experimental expenditures attributable to such patents and know-how. In a case now pending in the Tax Court, *Northern Telecom Inc.*,[64] the I.R.S. contends that, in connection with distribution of drawings, circuit boards, and parts lists embodying technological know-how in a section 334(b)(2) liquidation, recapture is required of amounts previously deducted under section 174 attributable to the distributed items of property to the extent of their fair market value. Although the amount of income recognized may differ under the tax benefit rule and the section 367(a) toll-charge rule, the income would be ordinary income from U.S. sources under either rule.

Toll Charge on the Incorporation of a U.S. Business' Foreign Branch with Previously Deducted Losses

New section 367(a)(3)(C) reverses the holding in the *Hershey* case,[65] and codifies generally and amends in some respects the Service's position that the U.S. transferor of foreign branch assets must recapture the previously deducted cumulative branch losses not recaptured under section 904(f) to the extent of its realized gain on the transfer.

The loss branch recapture rule is intended to operate — to the extent possible — independently of other rules imposing tax on transfers of appreciated property to foreign corporations. For example, assume that a taxpayer incorporates a foreign branch that has previously incurred $100 of deductible losses. None of the taxpayer's foreign losses previously reduced U.S. income. In connection with the incorporation of the loss branch, the U.S. transfer or transfers to the new foreign corporation (1) tainted assets (such as inventory) with $30 of built-in gain (excess of fair market value over basis) and (2) goodwill worth $90, with a basis of zero. The committee intends

63. Hillsboro Nat'l Bank v. Commissioner, *decided with* U.S. v. Bliss Dairy, Inc., 460 U.S. 370 (1983); *see also* text accompanying note 32.

64. Northern Telecom Inc. v. Commissioner, No. 28133-84 (T.C. filed 1984).

65. Hershey Foods Corp. v. Commissioner, 76 T.C. 312, *appeal dismissed*, 642 F.2d 1211 (5th Cir. 1981); *see also* text accompanying note 10.

imposition of tax on $120 — not $100 — in this case. If the goodwill in this example were worth $60 (rather than $90) the committee intends imposition of tax on $90.[66]

While the House bill calls for recapture only to the extent that branch losses were not previously treated as U.S.-source income for purposes of the section 904 limitation on the foreign tax credit under section 904(f) as a whole, the Senate bill calls for recapture of branch losses to the extent they exceed amounts recognized under section 904(f)(3) due to the section 367(a) transfer itself. Whereas under section 904(f)(1) an overall loss is "recaptured" only to the extent of treating, for foreign tax credit limitation purposes, 50% of what would otherwise be foreign-source income of the taxpayer as U.S.-source income (unless the taxpayer elects a higher percentage), under section 904(f)(3) 100% of the foreign-source gain is treated as U.S.-source upon a disposition of foreign business property. As an example in the Senate Committee report appears to confirm, this can result in recapture of branch losses that have previously been recaptured as U.S.-source income under section 904(f)(1).[67] The final text of section 367(a)(3)(C) adopts the Senate version and provides for recapture as foreign-source income to the transferor of gain realized to the extent that this cumulative branch loss exceeds "the amount which is recognized under section 904(f)(3) on account of transfer."

Assume that a U.S. corporation has a branch in foreign country A that incurs a foreign loss of $100 in year 1, while in years 2 and 3 it breaks even. Assume further that the U.S. corporation also had a branch in foreign country B that breaks even in year 1, earns $200 in year 2 and breaks even in year 3. The corporation has no other foreign-source income or loss during the years concerned. As a result of the overall foreign loss of $100 for year 1, and year 2 under section 904(f)(1), $100 of the country B branch income for year 2 is treated as U.S.-source and is excluded from the numerator of the section 904 foreign tax credit limitation fraction. In year 3, the country A branch is incorporated by means of a section 351 transfer of the branch assets to a foreign corporation when the fair market value of its assets is $150 while their basis is $25. No loss is "recaptured" (*i.e.*, treated as U.S.-source income for purposes of the foreign tax credit limitation) under 904(f)(3) on the disposition of the branch assets because the branch A losses had previously been recaptured in year 2 under section 904(f)(1). Taxpayer must, under

66. H. REP., *supra* note 47, at 1324.
67. S. REP., *supra* note 42, at 369.

section 367(a)(3)(C), include as income from foreign sources ($100) — the excess of the previously-deducted A branch losses over the amount ($0) subject to recharacterization as U.S.-source income under section 904(f)(3) even though there is no cumulative *overall* loss at the time. And yet, assuming that A branch lost $100 in year 1, and broke even in years 2 and 3, while B branch broke even in each of the 3 years, there would apparently be no recapture under section 367(a)(3)(C) at the time of incorporation of A branch, since the $100 cumulative loss of A branch would not exceed the amount ($100) recharacterized as U.S.-source income under 904(f)(3) upon the transfer of the country A branch assets to the foreign corporation.

Only the cumulative loss of a branch will be recaptured since a pre-incorporation loss is reduced by taxable income derived by the foreign branch in a taxable year after the year in which the loss was incurred and before the close of the taxable year of the transfer under section 367(a)(3)(C)(ii)(I). Thus, if, in the preceding example, A branch earned $100 and B branch lost $100 in year 2, there would be no recapture under section 367(a)(3)(C) because, notwithstanding the existence of an overall loss of $100 at the time of the incorporation of the country A branch in year 3, there is no cumulative loss in the country A branch. The overall loss, however, would trigger recharacterization of $100 of the gain on the incorporation under section 904(f)(3) as U.S.-source income for purposes of the section 904 limitation.

Therefore, it appears that whenever there is an overall foreign loss at time of incorporation of any foreign branch, gain realized to the extent of the overall loss will be recharacterized as U.S.-source income under section 904(f)(3) whether that loss is attributable to the country A branch, the country B branch, or both, but no recapture will be required under section 367(a)(3). Here the result may be loss of foreign tax credits. (Any overall loss that exceeds the gain realized will remain as overall foreign loss.) However, if there is no overall foreign loss, but there is a cumulative loss in the country A branch when it is incorporated, there will be recapture under section 367(a)(3)(C), but not under section 904(f). Here the result will be an increase in taxable foreign-source income, but normally no loss of foreign tax credits.

The characterization of the recognized gain as ordinary income or capital gain will turn on the character of the previously incurred loss and the gain will, in any event, be treated as income from foreign sources under section 367(a)(3)(C). The rule under which only cumulative losses of a branch will result in recapture and the gain will depend on the character of the prior loss will make it necessary to develop special ordering rules. For example, if a foreign country A branch has a cumulative ordinary loss of $500 and a cumulative capital loss of $200, how will subsequent ordinary income of $400 be treated? Will it offset the ordinary loss or will it offset proportionately the ordinary and the capital losses? Will a cumulative section 1231 loss of $200 be offset by a subsequent section 1231 gain of $200?

The Conference Committee indicates that upon incorporation of a loss branch with appreciated intangibles, the transfer of intangibles will be subject to the special rule for intangibles, not the branch loss rule.[68] Does this mean that if a foreign branch has a cumulative loss of $200 and manufacturing intangibles with a value of $200 and a basis of $50, only $50 of the loss will be recaptured as foreign-source income under the branch loss rule? If so, although the intangible toll charge rule normally calls for imputing a royalty, in this case it will apparently be necessary to determine the fair market value of the intangibles in order to identify how much gain will result in recapture under the branch loss rule and how much will be subject to the intangible asset toll-charge rules.

In all other respects, the Conference Committee indicated that it intends that the new provision be applied in a manner consistent with the Service's published rulings under existing law. Thus, for example, losses that result in gain recognition on incorporation include expenses directly related to a branch 's property that was not transferred but abandoned as worthless.[69] Similarly, in applying the statutory provision, the profits and losses of divisions that are separate business operations cannot be combined.[70] As under current law, the basis of transferred assets will be the same as the basis of the assets in the hands of the transferor immediately prior to the exchange, increased by the amount of gain recognized to the transferor on the exchange.[71]

Special Rule for Transfers of Partnership Interests

New section 367(a)(4) provides that, except as provided in regulations, a transfer of an interest in a partnership from a U.S. person to a foreign corporation will be treated as a transfer of that person's pro rata share of the assets of the partnership.

Although section 367(a)(4) does not distinguish between general

68. CONF. REP., *supra* note 46, at 956.
69. *See* Rev. Rul. 80-247, 1980-2 C.B. 127.
70. *See* Rev. Rul. 81-82, 1981-1 C.B. 127.
71. *See* Rev. Rul. 78-201, 1978-1 C.B. 91.

and limited partnerships, as have the Service's rulings, the Senate Finance Committee notes:

> Under regulations to be prescribed by the Secretary, this special rule will not apply to most transfers of limited partnership investments. Because limited partnership interests frequently represent passive, limited liability interests comparable to stock and securities, the Committee believes that limited partnership interests generally should be treated like stock and securities for section 367 purposes. Thus, a transfer of a limited partnership interest to a foreign corporation generally will fall within the active trade or business exception only under the limited circumstances in which a transfer of comparable stock or securities would do so.[72]

Creation of U.S. Branch

The rule under new section 367(a) that transfers of assets will be tax-free only if they are used in the active conduct of a trade or business *outside* the United States may arguably confirm the current I.R.S. policy against permitting a tax-free transfer of a business conducted in the United States to a foreign corporation.

On the other hand, the following statement of the Conference Committee seems to imply that certain transfers of a U.S. branch may be made to a foreign corporation without toll charge:

> Transfers of appreciated property of a domestic branch. — The conferees intend that regulations to be prescribed by the Secretary will require gain recognition on the transfer of assets that were used in the United States, to the extent of depreciation deductions previously claimed by the taxpayer with respect to the transferred property. This result is consistent with the treatment of transfers of property of a foreign branch that has operated at a loss . . . .[73]

There seems no persuasive policy against not permitting assets of a business being conducted in the United States to be transferred tax-free to a foreign corporation that will continue to carry on the business in the United States through a U.S. branch, subject to the imposition of toll charges on tainted assets (which will henceforth include depreciable assets to the extent gain reflects depreciation previously taken). If some policing mechanism is needed to avoid surreptitious transfers of the assets outside the United States by the transferee foreign corporation, the closing agreement mechanism, which has been endorsed by the Congress to police transfers of stock or securities to a foreign corporation, could also be utilized when assets are transferred to a U.S. branch of a foreign corporation.

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72. S. REP., *supra* note 42, at 367.
73. CONF. REP., *supra* note 46, at 955.

Elimination of Ruling Requirement and Declaratory Judgment Procedure

Noting that many taxpayers considered the ruling requirement burdensome and that the requirement has placed a steadily increasing demand on I.R.S. resources as outbound transfers have increased in number, the House Committee indicated that elimination of the principal purpose test renders the ruling requirement unnecessary. Outbound transfers can now proceed with no pre- or post- transaction clearance. The extent to which the transaction will be tax-free or will involve payment of a toll charge will be determined under the substantive rules contained in section 367(a) and the yet-to-be issued regulations.

Taxpayers seeking certainty of tax consequences will be free to seek discretionary rulings covering a proposed transaction. Eliminating the ruling requirement will not only free the taxpayer making an outbound transfer from having to incur the expense of seeking a ruling and the I.R.S. from the burden of processing it in straightforward cases, but it will enable the taxpayer to seek a private ruling before implementing any aspect of the transaction, while under prior law the transfer had to have commenced before the application for ruling could be filed.

The declaratory judgment procedure is repealed on the theory that elimination of the ruling requirement renders it superfluous. Under the amended section 367(a), therefore, the taxpayer will have the right to obtain judicial review only of whatever taxes may be eventually paid or asserted by the I.R.S. on audit to be payable under the new substantive 367(a) rules.

Conforming Amendments to Sections 1491-94

Under sections 1491-94, an excise tax generally applies to transfers of property, whether otherwise tax-free or taxable, by U.S. persons (including corporations and partnerships) to foreign corporations, foreign partnerships, and foreign estates and trusts. However, in the case of transfers of property to foreign corporations, the tax applies only to property treated as paid-in surplus or as a contribution to capital.

The excise tax is equal to 35% of the transferor's gain that is not recognized at the time of the transfer. But to the extent the transferor immediately recognizes gain on the transfer, the amount against which the excise tax is applied is reduced.

A transferor may elect to treat a transfer otherwise subject to the excise tax as a sale or exchange of the property transferred and to recognize as gain (but not loss) in the year of the transfer the excess of the fair market value of the property over the transferor's adjusted basis for determining gain on the property as stated in I.R.C. section 1057. To the extent that gain is recognized in the year of the transfer pursuant to this election, the transfer is not subject to the excise tax, and normal rules will apply to increase the transferred property's basis to the transferee by the amount of gain recognized.

The 1984 legislation amended I.R.C. section 1492 to provide that the excise tax will not apply to a transfer that is not described in section 367 but with respect to which the taxpayer elects (before the transfer) the application of principles similar to the principles of section 367. Conforming amendments have been made in the provisions governing abatement and refund of excise tax. Regulations implementing these changes will be promulgated.

Effective Date

The amendments are to apply to any transfer or exchange after December 31, 1984, in taxable years ending after such date, unless it is described in a request for ruling filed under section 367(a), 1492(2), or 1494(b) before March 1, 1984.

A special transitional rule was provided for transfers of intangibles described in section 936(h)(3)(B) after June 6, 1984 and prior to January 1, 1985, under which such transfers were treated as having been made pursuant to a plan having as one of its principal purposes the avoidance of Federal income tax unless a waiver is granted by the Service.

Conclusion

The 1984 amendments to I.R.C. section 367(a) represent a fundamental revamping of the rules relating to outbound transfers of property. Enormous scope has been left to the Treasury to flesh out by regulation the skeletal legislative changes. For example, the Treasury has been authorized by regulation to add to the list of tainted assets set forth in I.R.C. section 367(a)(3)(B), to exempt assets on the list from taxation and to elaborate on what is meant by use of property in the active conduct of a trade or business outside the United States. In addition, extensive rules relating to incorporation of loss branches and transfers of manufacturing and marketing intangibles will have to be promulgated. Until these rules are issued, at least in proposed form, a meaningful appraisal of the new regime will be impossible. A few generalizations, however, can be ventured even before the regulations are available.

A clear improvement will be the elimination of the requirement for a ruling in all cases, including those of garden variety. Avoiding the expenses of preparing and processing ruling requests in routine situations will result in significant savings to taxpayers and the I.R.S. Counterbalancing this will be the disadvantage represented by the inability to taxpayers who seek a private ruling to have an I.R.S. refusal to rule or an unfair application of the regulations reviewed until the issue is eventually raised on audit.

The new rules imposing toll charges on constructive royalties with respect to section 351 transfers of manufacturing and marketing intangibles will almost certainly lead taxpayers to effect transfers of foreign rights to intangibles to controlled foreign licensees through taxable licenses rather than through section 351 transfers. The result of using taxable licenses will be that actual royalty payments will qualify as foreign-source ordinary income or, in appropriate cases, foreign-source long-term capital gain, which will often increase the section 904 limitation on the foreign tax credit and increase the amount of creditable foreign income taxes. This will nearly always be preferable to accepting the imputation of royalties under section 367(d) that will invariably be characterized as U.S.-source ordinary income.[74]

With respect to the new provisions on incorporation of loss branches, it seems quite doubtful whether the complexity mandated by the new rules reversing the *Hershey* case, will prove to be justified by the revenue produced or abuses prevented.

The new rules clearly give the Treasury an opportunity to take a fresh look at the whole subject of taxing out-bound transfers. It is to be hoped that the drafters of the regulations will not feel themselves compelled to carry forward under the new statutory scheme the unduly inflexible 367 Guidelines of Rev. Proc. 68-23 and that they will heed the suggestions in the 1984 committee reports that resort should be had to the use of closing agreements and other methods of avoiding the imposition of toll charges, the effect of which is to inhibit international reorganizations motivated by business objectives.

74. Hershey Foods Corp. v. Commissioner, 76 T.C. 312, *appeal dismissed*, 642 F. 2d. 1211 (5th Cir. 1981); *see also* text accompanying note 10.

MISCELLANEOUS FOREIGN PROVISIONS

PAMELA B. GANN*

The Senate Finance Committee report[1] was, I believe, the underlying document with respect to which this particular program was planned. Respecting international issues, however, I recall it only covered three different topics. These included decontrol of controlled foreign corporations, section 367 matters which Dick mentioned, and a reference to section 341(f) elections in the context of foreign collapsible corporations. These three items are addressed in the specific legislation which the House and the Senate passed.

The only substantial changes made to the structure of the international tax system, however, are the 367 provisions. The other two provisions mentioned in the Senate Finance Committee report, along with a large number of additional provisions included in those bills, really have nothing to do with the fundamental structure of our international tax system. Rather they deal primarily with a handful of cases raising certain issues regarding well-publicized types of transactions. By these transactions, taxpayers were, arguably, successfully avoiding many of the anti-this-and-that rules contained in the international tax area.

The topics I will be addressing (since Dick has already discussed the 367 issues) are the other two items that were in the Senate Finance Committee report. But I don't think this topic will be nearly as entertaining as some of yesterday's or today's topics. One reason that many of you have enjoyed this conference, I think, is because it is so much like being in law school. You talk about what the world

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1. STAFF OF SENATE COMM. ON FINANCE, 98TH CONG., 1ST SESS., THE REFORM AND SIMPLIFICATION OF THE INCOME TAXATION OF CORPORATIONS 95 (Comm. Print 1983).

ought to be and not what the world is. I am going to have to talk today about what the world is about to be within the next few days.

Turning to the anti-this-and-that rules involved in the international tax structure, I begin my outline with a brief summary of some of those particular rules. Once you have made it over the 367 hurdles Dick talked about, and have successfully set up your foreign corporation, then the earnings and profits (E & P) of that corporation are, under the general rule, not taxed in the United States. That is, we have the concept of deferral in our international tax system. Those E & P are not taxed until they actually are brought back into the United States, typically in the form of dividend distributions.

Rather than eliminating that system totally, as many would advocate, what we have adopted is a half-way house. (It might be more interesting to shift over and talk about what we ought to do about that.) What we have is deferral subject to what were thought to be the major abuses in the area. The two systems that are primarily addressed to that are the foreign personal holding company provisions and the controlled foreign corporation (CFC) provisions. In each of those cases, if you have income in the form of foreign personal holding company income, or if you have certain types of income earned by the CFC, you lose deferral and it is taxed upstream to the U.S. shareholders of those entities.[2]

In doing tax planning in the United States, there have been some well-publicized examples of circumventing those particular provisions. That is primarily the type of tax regime to which these changes are addressed.

I want to talk about the last thing in my outline first. At the end I take up the problem with respect to stapled entities. This is a scheme to get around the CFC rules. Under those particular rules, you have a CFC if greater than 50% of the voting power is in the hands of "U.S. shareholders" and in turn those U.S. shareholders each own at least 10% of the stock. Therefore, a CFC is not only U.S. controlled, but it is a closely-held corporation. The scheme to get around those particular provisions is to use stapled entities whereby the U.S. parent corporation, rather than directly owning the stock of the foreign subsidiary, staples the foreign stock onto the domestic stock which is widely held. Those two types of stock, by being stapled, must be transferred in tandem. Thus, you do not have independent rights to transferability for the U.S. corporation and the foreign corporation.

The bill in both Houses would eliminate this particular technique by stating to the extent you have stapled entities, the foreign entity will be treated, for purposes of our Code, as a domestic corporation.[3]

2. I.R.C. §§ 552-57, 951-64 (1982).
3. I.R.C. § 269B, *added by* the Tax Reform Act of 1984, Pub. L. No. 98-369, §

Therefore, you obviously lose all deferral, not merely what you were attempting to do, which was to get rid of your subpart F income. There is a modest out: to the extent you are stapled, you may elect back into the CFC structure.[4] That election puts you back to the place where you would be if you were merely operating as a foreign subsidiary of the U.S. corporation. So, you are not stuck with the worse situation. There are also delayed effective dates so that you can plan to get rid of the whole structure, or, alternatively, you may elect to be deemed to be a foreign subsidiary of a parent company and then pick up the normal CFC rules.

There are also some specialized subrules. Since it says you will be deemed to be a domestic corporation, will you be a domestic corporation for all purposes? For example, it says no for consolidated tax return purposes; you are still a foreign corporation.[5] With respect to treaties there is a treaty exception.[6] This particular provision states that if you are stapled with a foreign corporation which is in a treaty country, (*i.e.*, one with which we have a bilateral income tax treaty) and you are protected by the permanent establishment (PE) rules of that particular treaty (that is, if you are foreign, the United States only taxes you on your business profits associated with a PE in the United States), you will continue to be protected by that particular treaty provision until the treaty itself is changed or Congress changes its mind and gets rid of that particular exception. So if you are stapled in a treaty country under this particular bill, you would be protected under that particular PE provision.[7]

Now I want to go back to the foreign personal holding company provisions. The foreign personal holding company is one regime, but foreign personal holding company income is also subpart F income of the subpart F regime.[8] So there can be an overlap of those particular provisions. The overlap has been solved in the past by stating when there is an overlap, the foreign personal holding company provisions will override.[9] It would seem to me that anybody dealing with an anti-tax haven would have gone exactly the other way; and that is

136, 98 Stat. 494, 669 (1984).

4. Tax Reform Act of 1984, Pub. L. No. 98-369, § 136, 98 Stat. 494, 669 (1984).

5. *See* H.R. REP. No. 432, pt. 2, 98th Cong., 1st Sess., 1546 (1984) [hereinafter cited as H.R. REP.].

6. Tax Reform Act of 1984, Pub. L. No. 98-369, § 136(c)(5), 98 Stat. 494, 671 (1984).

7. *See* H.R. REP., *supra* note 5, at 1546.

8. I.R.C. §§ 952(a)(2), 954(a)(1) (1982).

9. I.R.C. § 951(d) (1982).

exactly what this bill does. It changes that particular rule to provide when you are in a situation where both regimes apply, the larger regime applies; meaning the subpart F rules take precedent over the foreign personal holding company rules.[10]

There are some other modest changes to the foreign personal holding company provisions regarding attribution and the utilization of tiers of foreign personal holding companies, which I will not discuss.

Now to section 1248. It is also part of this anti-tax haven regime. Once you cross the 367 hurdle, the 482 hurdles, and the subpart F hurdles, you have deferral. Then, if you could sell the stock in those particular foreign corporations you would never have the operating income of the foreign entity taxed by the United States. You would have the United States jurisdictional application to capital gains with respect to the sale of that particular stock. That is eliminated with respect to 10% shareholders of the CFC under section 1248. When stock of that CFC is disposed of by a 10% or greater shareholder, then the gain is converted into a dividend distribution to the extent of the E & P which are attributable to the time period when you owned that stock. That is the general rule.

With respect to dispositions of stock which are covered by section 1248, it covers not only regular sales or exchange transactions but it covers imputed sales or exchange transactions such as a shareholder's stock being liquidated under section 331. It also overrides the *General Utilities*[11] rule (we've seen a lot of that), in this area as well. Under section 1248(f), it is a corporate U.S. shareholder who owns the foreign corporation and the corporate U.S. shareholder distributes the stock of the foreign corporation under section 311 or section 336 or sells it in a section 337 transaction where it would not normally have recognition of any gain. It will have gain recognized to the extent of its pro-rata share of E & P; if gain is in excess of that, it is to that extent still a protected *General Utilities* transaction.

One of the things that was mentioned in the Finance Committee report is the so-called McDermott transaction (named after the entity which did it), which was a technique to decontrol your foreign corporation and be outside these particular 1248 rules. McDermott is a U.S. parent corporation. Therefore, if it sells the stock it would be under section 1248; it must not distribute the stock under section 311, section 336 or sell it in a liquidation transaction, or it would be caught by the section 1248(f) provision. McDermott had its foreign subsidiary exchange foreign subsidiary stock for parent company stock, thereby revising the ownership so that the old parent was now

10. *Id.*

11. General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935).

the foreign subsidiary and the old subsidiary becomes the parent. The old subsidiary is now widely held, and it is no longer a controlled CFC. McDermott then argued that by this particular transaction it now had no problem with historical E & P nor prospectively with any E & P under the anti-tax haven regime.

These bills would eliminate that technique by deeming such a transfer or transaction to be as if the subsidiary issues its stock to the parent and then the parent distributes the stock in redemption of its shareholders under section 311. Since it is a section 311 distribution, section 1248(f) applies in that the parent has a taxable event to the extent of the undistributed E & P that are in the foreign corporation.

Two other changes are also made in section 1248. All section 1248 transactions are with respect to stock — you sell it, you exchange it, you distribute it out and so on. But it relates to the measurement of E & P inside the entity. Yet, actually there has been no distribution of E & P in these particular transactions. This is similar to a sale of section 306 stock when there has not been an actual distribution of the E & P which is nevertheless taxed as ordinary income under section 306. The question came up as to whether the E & P should be reduced because it has been taxed, or somehow classified as previously taxed E & P. The Service first took the position, "no" (because there was no technical distribution, I suppose) and then it withdrew that particular revenue ruling, leaving it an uncertain issue. However, under these anti-tax haven schemes, once the outside shareholder has been taxed you have accomplished your purpose. Although it does not technically reduce the E & P account, the possibility that those E & P will later taint other transactions or actual distributions should be eliminated by throwing them under section 959. This section provides that all income which has previously been taxed under the subpart F regime is treated as previously taxed income; therefore, actual distributions sourced into that particular pocket of E & P are not taxed again.

Now I'd like to talk about off-shore commodity funds which are a combination of a lot of these particular provisions in the sense that we are getting around all of them at one particular point in time. Example 7 gives you the illustration of an off-shore commodity fund. An investment advisor sets up a foreign corporation X which in turn sets up a foreign subsidiary Y. X is going to issue its stock so that it is widely held; therefore, X is not a CFC. Y then engages in commodities transactions in the United States but in a manner so that it is technically not operating a trade or business in the United States and, therefore, it is outside the U.S. taxing jurisdiction. You may then pay dividends up to X, and X will not be taxed in the United States on those dividends because they are foreign-source. Also, X argues that it is not subject to the accumulated earnings tax because that tax does not apply to foreign-source income. Shareholders of X are not taxed because X is a widely held foreign corporation not covered by the subpart F rules, the foreign personal holding company rules, nor the section 1248 rules. Finally, X argues that it is outside of section 1246, which applies to investment companies, because commodities were not picked up by that particular section.

The bills would change Example 2 if the income is sourced in the United States. If it then is distributed upstream as a dividend, it will keep its source as U.S. income and therefore the accumulated earnings tax will apply. Item 4 amends section 1246 to pick up commodities. If you sell stock in one of these particular off-shore commodity funds you would then have to be taxed on the ordinary income reflected in the sales transaction.[12]

Next I want to put together a few of the provisions that relate to another type of calculation in the international tax area which planners frequently try to manipulate — that is, the numerator (*i.e.*, what is foreign-source income) in the section 904 credit limitation.

An easy way to eliminate U.S.-source income is as follows: when you're on a boat, steer straight out to the 3-mile limit, stay outside of it for as long as you can and then come back into the other U.S. port. The bill modifies the old rule (that if you were operating ships, vessels, and so on outside the 3-mile limit, you were generating foreign-source income) to state that if you originate in a U.S. port and you end up in a U.S. port then no matter where you steer the vessel it is going to be deemed U.S.-source income.[13]

Another sourcing problem with respect to factoring income is dealt with at the very beginning of the outline. The simplest example is where you have a parent corporation owning a CFC to which the parent corporation sells its receivables at a discount. The CFC then collects the receivables and has income on the spread. Taxpayers argue that this particular transaction skirts all of the anti-tax haven provisions, as well as the discount being foreign-source income. If, however, the receivables had been collected by the U.S. parent they would have been U.S.-source income.

These particular bills make modifications, making sure that both the anti-tax haven regime applies to these particular transactions, and that, to the extent the receivables are those of the U.S. corpo-

12. I.R.C. § 1246 (1982).
13. *Id.*

rate parent or its U.S. affiliates, it will be deemed to be U.S.-source income for purposes of the section 904 credit limitation. What it does under the anti-tax haven regime, in the simplest case, is as follows: the sale of the receivables to the CFC, which brings money back into the United States, will be deemed to be a U.S. investment property under section 959. To the extent that it is an increase in investments in U.S. property and there are E & P in the CFC, the tax under section 951 will be triggered. Second, when the receivable has been collected, the foreign personal holding company provisions are separately amended to say that the discount income, when collected by the CFC, is foreign personal holding company income;[14] therefore, it will be taxed back to the U.S. parent under subpart F provisions as well. Third, for purposes of the credit limitation, this discount income is going to be deemed to be U.S.-source income because it was the U.S. corporation's receivables which were being factored in this particular case.[15] Obviously, if you are factoring non-U.S. receivables they will continue to be foreign-source. This has an impact under both the anti-tax haven rules and the section 904 credit limitation.

Finally, Dick mentioned the Netherlands Antilles finance subsidiaries. As you know, some of our possessions wanted to become finance subsidiaries as well. The Treasury Department has tried to prevent that by issuing proposed regulations under the sourcing rules.[16] These particular bills modify the withholding tax rules to the effect that if interest or dividends or other passive income is being paid from the United States to, say a Guam corporation which is owned by foreign investors, our 30% U.S. withholding tax will be applied in that particular case. If that income is going to the Guam corporation in situations where it is owned by Guam or U.S. persons, it will not trigger that particular anti-tax haven rule.[17]

14. I.R.C. § 864(d)(2)(A) *added by* the Tax Reform Act of 1984, Pub. L. No. 98-369, § 123, 98 Stat 494, 645 (1984).
15. I.R.C. § 864(d)(1) *added by* the Tax Reform Act of 1984, Pub. L. No. 98-369, § 123, 98 Stat 494, 645 (1984), 861(a)(1) (1982).
16. *See* Treas. Reg. 4a.861-1 (1982) (temporary regulation).
17. I.R.C. § 881(b) (1982).

APPENDIX A
MISCELLANEOUS FOREIGN PROVISIONS

PAMELA B. GANN

I. *General*
   A. *Table of Abbreviations*

1.	e&p	earnings and profits
2.	CFC	controlled foreign corporation
3.	FPHC	foreign personal holding company
4.	P	a U.S. parent corporation
5.	H.R. Rep. 432, pt. 2	House Comm. on Ways & Means, Tax Reform Act of 1984, Supplemental Report on H.R. 4170, H.R. Rep. 432, pt. 2, 98th Cong., 2d Sess. (1984).
6.	DRA of 1984	Deficit Reduction Act of 1984
7.	Conf. Comm. Statement	Joint Explanatory Statement of the Committee of Conference, 130 Cong. Rec. H6576 - 6763 (daily ed. June 22, 1984).

II. *Anti-Tax Haven Rules*
   A. *General Background*

A U.S. shareholder of a foreign corporation generally may defer U.S. tax on the corporation's income until the shareholder receives a distribution from the foreign corporation. Exceptions to this general rule are provided for certain tax-haven type activities conducted by corporations controlled by U.S. shareholders. Under these exceptions the income is deemed to be distributed to the U.S. shareholders so that they are taxed currently on the income.

Congress enacted the FPHC rules in 1937 to prevent U.S. taxpayers from accumulating investment income tax-free in foreign corporations. If five or fewer U.S. citizens or residents own, directly or indirectly, more than half of the outstanding stock (in value) of a foreign corporation that has primarily FPHC income (generally passive income such as dividends, interest, royalties, and rents (if rental income does not amount to 50% of gross income)), that corporation will be a FPHC. § 552. In that case, the foreign corporation's U.S. shareholders are subject to U.S. tax on their pro rata share of the corporation's undistributed FPHC income. § 551. In 1962 Congress imposed tax on the U.S. shareholders of foreign corporations engaging in certain tax-haven type activities by adding the subpart F rules to the Code. IRC § 951-964. These provisions apply to CFCs — a foreign corporation where more than 50% of the voting power is owned by "U.S. shareholders," which are U.S. persons owning at least 10% of the equity of the corporation. §§ 951(b), 957. Under subpart F, the foreign corporation's U.S. shareholders are subject to U.S. tax on their pro rata share of specified income of the CFC. § 951.

This income includes so-called subpart F income:

income from related party sales and services transactions through tax haven base companies, from insurance of U.S. risks, from shipping operations (unless the income is reinvested), from foreign oil related activities, and from passive investments. §§ 952, 954. Some of this income may also be taxable under the 1937 FPHC rules. Subpart F imposes a tax in other circumstances, such as investment by a CFC of its earnings in U.S. property, and a CFC's withdrawal of its previously excluded income from shipping operations. § 951(a)(1).

B. *Modification of Related Person Factoring Income*

1. *Background.* The factoring of trade accounts receivable by foreign subsidiaries has become an increasingly popular technique, and the application of the subpart F provisions to these transactions has been in doubt. *See, e.g.*, Roin & Rosenbloom, *Bringing foreign profits back to the U.S. by factoring: using the technique*, 58 J. Tax. 164 (1983); PLR 8338043 (June 17, 1983).

   The following examples illustrate typical international factoring transactions.

   Example (1): P sells to its CFC accounts receivable arising from sales by P to unrelated customers in the ordinary course of its trade or business. The receivables have a face value of $1000 and are sold for $900 cash. The CFC later collects $1000. P reports $900 of income with respect to the receivables, and the CFC claims income of $100, the difference between the face amount and the amount collected. This factoring transaction results in the shifting of $100 income from P to the CFC.

   Example (2): P has a CFC1 with low-taxed foreign earnings that P wishes to repatriate. P forms CFC2 that borrows money from CFC1 which CFC2 uses to factor P's receivables. CFC2 pays CFC1 an arm's-length interest rate. CFC2 is engaged in the conduct of a U.S. trade or business and files a U.S. income tax return on which it reports its factoring income. CFC2 distributes its income to P as a dividend. P is allowed an 85% dividend-received deduction under section 245 on such dividends. Most of CFC2's income is eliminated by the interest payment to CFC1. The purpose of this structure is to make the distribution of CFC1's earnings to P at a maximum rate of 6.9%. *Cf.* Rev. Rul. 76-192, 1976-1 C.B. 205. [This example is taken from H.R. Rep. 432, pt. 2, at 1304-05].

   When the factor is a CFC, several tax issues are raised, including some under subpart F:

   a. Is the transfer of the receivables a sale rather than a pledge of collateral for a loan?
   b. Is the factoring income subject to subpart F, either as interest income (which, in turn, is FPHC income) or as income from the performance of services for a related party (which is foreign base company service income)?
   c. Is the purchase of the receivable of a U.S. person from the related U.S. corporation an investment in "U.S. property" under section 956 and, therefore, subject to subpart F?
   d. Is the CFC factoring U.S. receivables engaged in a business within the U.S. so that its factoring income is subject to U.S. tax?

2. *Legislation.* DRA of 1984, Section 123

   a. For a general explanation, see H.R. Rep. 432, pt. 2, at 1304-06; Conf. Comm. Statement at H6623-24.
   b. The DRA of 1984 adds subsection (d) to section 864, which

provides that if any person acquires (directly or indirectly) a trade or service receivable from a related person, any income of such person from the trade or service receivable so acquired shall be treated as if it were interest on a loan to the obligor under the receivable. Thus, in Example (1), *supra*, the $100 factoring income of the CFC is treated as if it were interest on a loan of the CFC to the obligor under the receivables (*i.e.*, the unrelated customers of P), and the source rules (sections 861-63) will be applied according to this characterization of the factoring income.

c. Section 864(d) applies for purposes of the FPHC provisions, section 904, and subpart F. § 864(d)(2). Thus, in Example (1), if the obligors under the receivables are U.S. persons, when the CFC collects the income, that income is FPHC income and, therefore, subpart F income taxable currently to U.S. shareholders. It is also U.S. source income (unless the obligor pays foreign source income under section 861(a)(1)(B)), and it is subject to the separate credit limitation for interest under section 940(d). Under the operation of these provisions, the income from a domestic transaction (*i.e.*, the U.S. parent with its unrelated customers) remains domestic source income, taxed to the U.S. parent when collected by the CFC, and does not enter into the numerator of the separate section 904 credit limitation since it is U.S. source income. Congress subjected the factoring income to the separate credit limitation so that foreign tax on non-interest, non-factoring income cannot offset U.S. tax on the related person factoring income.

d. Section 864(d)(5) provides that the following special rules do not apply to any amount treated as interest under section 864(d)(1).
   (i) Section 904(d)(2)(A), (B), (C), and (D) which excludes certain types of interest from the separate credit limitation.
   (ii) Section 954(b)(3)(A) so that the U.S. owner of a CFC earning factoring income will be subject to tax whether or not the factoring income plus other tax-haven income are less than 10% of the CFC's foreign base company income.
   (iii) Section 954(c)(3) (which excludes certain trade or business income from subpart F).
   (iv) Section 954(c)(4) (relating to the exception from subpart F income for certain income received from a related person).

e. Section 864(d)(6) treats a loan by a CFC to the purchaser of goods or services of a related party like the acquisition by the CFC of the purchaser's receivable, so that any income from such a loan is treated as interest on a loan to the obligor of the receivable under section 864(d).

f. The income from factoring receivables of related parties in a U.S. possession is subject to tax (unless from sources within the possession when applying the new rule that treats factoring income as income from a loan to the obligor of the receivable); and such income is not eligible for the possessions tax credit under section 936 nor for reduction of Virgin Islands tax under section 934. § 864(d)(5)(B).

g. Section 956(b)(3) is added so that an investment in "U.S. property" includes any trade or service receivable of a related person who is a U.S. person if the obligor under that receivable is a U.S. person. Thus, U.S. shareholders of a CFC are currently taxed on the amount that the CFC pays for such a receivable (up to the amount of the CFC's e&p).

   It is the intent of this provision to cover the indirect transaction in Example (2), *supra*. This amendment to section 956 treats the loan by CFC1 to CFC2, which then factors the receivables of P, as an investment by CFC1 in U.S. property for purposes of section 956 (thus, applying the principles of Rev. Rul. 76-192, *supra*). Accordingly, the amount deemed to be invested in U.S. property would be taxed to P under subpart F. *See* H. Rep. 432, pt. 2, at 1036; Conf. Comm. Statement at H6624.

h. "Trade or service receivable" is defined to mean any account receivable or evidence of indebtedness arising out of (1) the disposition by a related person of property described in section 1221(1), or (2) the performance of services by a related person. § 864(d)(3).

i. A "related person" is defined as (1) any person who is a related person within the meaning of section 267(b), and (2) any U.S. shareholder (as defined in section 951(b)) and any person who is a related person, within the meaning of section 267(b) to such shareholder. § 864(d)(4). The second part of the definition prevents tax-free, related-person factoring by foreign corporations owned by several U.S. persons.

j. *Effective date.* These provisions apply to accounts receivable and evidences of indebtedness transferred after March 1, 1984, in taxable years ending after that date.

C. Coordination of Subpart F with FPHC Provisions

1. *Background.* As described at I.A., *supra*, the FPHC rules and the subpart F rules may overlap. Where they do, the Code provided that the FPHC rules take priority. § 951(d). Because of this provision, taxpayers argued that when they were subject to tax under the FPHC provisions in a given taxable year, they were not subject to the subpart F provisions that same year.

   Example (3): FS is both a FPHC and a CFC. In 1983, FS has FPHC subject to the FPHC rules. Also, in 1983, FS takes accumulated e&p and makes an investment in "U.S. property" within the meaning of section 956. Under Treas. Reg. section 1.951-3, the government takes the position that section 951(d) applies in this case to exclude only the current FPHC income from the subpart F provisions. Otherwise, subpart F applies to the investment of prior year's earnings in U.S. property. FS argues, however, that under section 951(d), FS is subject in 1983 only to the FPHC rules and is exempt from taxation in that year under the subpart F rules on the investment in U.S. property.

   Because historical earnings invested in U.S. property, for example, might be substantially greater than current income taxed under the FPHC rules, such a position, if sustained, could undercut much of subpart F. Courts have split on this issue. *Compare* Whitlock v. Commissioner, 494 F.2d 1297 (10th Cir.), *cert. denied*, 419 U.S. 839 (1974) (holding the regulation valid and the taxpayer liable for tax under subpart F), *with* Lovett v. United States, 621 F.2d 1130 (Ct. Cl. 1980) (holding the regulation invalid and no subpart F tax was due).

Note also that FPHC income includes dividends and interest from a related corporation that operates a trade or business in the recipient's country, but the CFC rules of subpart F do not taint this kind of income. § 954(c)(4)(A).

2. *Legislation.* DRA of 1984, Section 132(c)
   a. For general explanation, see H.R. Rep. 432, pt. 2, at 1541-42; Conf. Comm. Statement at H6631.
   b. The DRA of 1984 settles this overlap issue in favor of the government's position under current law. It amends section 951(d) to provide that if income is taxable to a U.S. shareholder both under the FPHC provisions and the subpart F provisions, then that income is taxed only under subpart F. Thus, under this new rule, the existence of income subject to tax under the FPHC rules does not preclude taxation of income under subpart F. In Example 3, both the FPHC income and the amount invested in U.S. property would be taxed to FS's shareholders under subpart F.
   c. The DRA of 1984 also removes dividends and interest from a related corporation that operates a trade or business in the recipient's country from the FPHC calculation, except where the dividends or interest are from a corporation that is itself a FPHC. § 552(c).
   d. *Effective date.* This provision amending section 951(d) applies to taxable years of U.S. shareholders beginning after the date of enactment. The legislative history states that "no inference as to the proper result under present law is intended." H. Rep. 432, pt. 2, at 1342. The provision amending section 552 applies to taxable years of foreign corporations beginning after March 15, 1984.

D. *Modification of FPHC Provisions*
   1. *Background*
      a. *Family attribution.* The FPHC provisions contain constructive ownership rules that determine whether a foreign corporation is more than 50% owned by five or fewer U.S. citizens or residents. § 554. These rules treated an individual as owning stock owned, directly or indirectly, by or for his or her partners, brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants. § 554(a)(2). One case, however, cast doubt on the operation of these constructive ownership rules when nonresident aliens were the only family members who owned stock in a foreign corporation.

         Example (4): X is a Canadian corporation. Two Canadian sisters own over half of the X stock. A is a U.S. citizen and resident, is the brother of the two sisters, and owns none of the X stock. Is the X stock owned by the two sisters attributed to their brother, A, so that X is a FPHC for U.S. tax purposes? A dividend Tax Court answered this question in the negative in *Estate of Nettie S. Miller*, 43 T.C. 760 (1965), *non acq.*, 1966-1 C.B. 4, notwithstanding the language of the Code. Thus, the U.S. shareholders of X, who are unrelated to the Canadian sisters, are not subject to tax under the FPHC provisions.

b. *Partner Attribution.* Section 554(a)(2) also provided that an individual will be treated as owning stock owned, directly or indirectly, by or for his partner.

c. *Income inclusion through foreign entity.* Shareholders in a FPHC who are U.S. citizens or residents, U.S. corporations, U.S. partnerships, or estates and trusts (other than estates and trusts whose gross income includes only income from sources within the United States) must include their share of undistributed FPHC income in their gross income. These shareholders are called "United States shareholders." § 551(a). If a FPHC is a shareholder in another FPHC, the first company includes in its gross income, as a dividend, its share of the undistributed FPHC income of the second FPHC. § 555(b). Interposition of a foreign partnership, a foreign corporation other than a FPHC, or an estate or a trust whose gross income includes only income from sources within the U.S. between a taxpayer and a FPHC, however, arguably may allow avoidance of the FPHC rules. Although stock owned, directly or indirectly, by or for a corporation, partnership, estate, or trust is considered as being owned proportionately by its shareholders, partners, or beneficiaries for the purpose of determining whether a corporation is FPHC, some taxpayers have taken the position that these tracing rules do not necessarily apply to impose a tax on the ultimate owners of a FPHC.

2. *Legislation.* DRA of 1984, Section 132(a)

   a. For an explanation, see H.R. Rep. 432, pt. 2, at 1534-37; Conf. Comm. Statement at H6631.

   b. *Family Attribution.* The DRA of 1984 adds subsection (c) to section 554 which provides that stock owned by a nonresident alien (other than a foreign trust or foreign estate) shall not be considered by reason of section 554(a)(2), as it relates to attribution through family membership, as owned by a citizen or a resident alien individual who is not the spouse of the nonresident individual and who does not otherwise own stock in such corporation. § 554(c)(1). Thus, in Example (4), since A is neither the spouse of the Canadian sisters nor owns X stock, the X stock owned by the Canadian sisters is not attributed to A. If A had owned some of the X stock, however, then the X stock owned by the Canadian sisters would have been attributed to A.

   c. *Partner Attribution.* The DRA of 1984 also provides in the new subsection (c) to section 554 that stock of a corporation owned by any foreign person shall not be considered by reason of section 554(a)(2), as it relates to attribution through partners, as owned by a citizen or resident of the United States who does not otherwise own stock in such corporation. § 554(c)(2). For example, if the nonresident alien partner of a U.S. citizen owns 60% of a foreign corporation, while a second U.S. citizen (who is wholly unrelated to the first U.S. citizen and to the nonresident alien) owns the remaining 40%, the foreign corporation will not be a FPHC.

d. *Income inclusion through foreign entity.* The DRA of 1984 adds a tracing rule to section 551 that makes it clear that taxpayers cannot interpose foreign corporations (other than FPHCs), foreign partnerships, estates or trusts whose gross income includes only income from sources within the U.S., or other entities between themselves and the foreign corporation to avoid the FPHC rules. It provides that stock of a FPHC that is owned by a partnership, estate, or trust that is not a U.S. shareholder, or by a foreign corporation that is not a FPHC, shall be considered (for income inclusion purposes) as being owned proportionately by its partners, beneficiaries, or shareholders. § 551(g). This rule applies to trace ownership and attribute income through tiers of such entities. The legislation grants regulatory authority to the Secretary of the Treasury to provide for such adjustments in the FPHC rules as may be necessary to carry out the purposes of this rule. Such an adjustment could be necessary, for example, to prevent double taxation of FPHC income.

This situation could arise in a case where a U.S. person owns shares in a foreign corporation which is not a FPHC which in turn owns stock in a foreign corporation that is a FPHC. Under the legislation, the U.S. person would be subject to tax on his pro rata share of the income of the FPHC and, unless an adjustment were made, could be subject to tax again upon a dividend distribution from the same earnings from the FPHC which, in turn, is redistributed as a dividend by the foreign corporation to the U.S. shareholder. Rules similar to those contained in section 959 should apply.

e. *Effective date.* These provisions generally apply to taxable years of foreign corporations beginning after Dec. 31, 1983. The rules relating to interposed foreign entities apply, however, to taxable years of foreign corporations beginning after December 31, 1984, with respect to certain stock owned by certain trusts.

III. *Modifications of Section 1248*

A. *General Background*

Section 1248 is designed to prevent U.S. shareholders of foreign corporations from accumulating earnings free of U.S. tax and then, rather than repatriating the earnings in the form of dividends taxable as ordinary income, disposing of the stock at capital gain rates for a price that reflects the accumulated earnings. Accordingly, when a U.S. person who is a 10% or greater shareholder in a CFC disposes of that corporation's stock, the gain recognized by that shareholder is treated as a dividend distribution to the extent of that corporation's post-1962 e&p attributable to the period that stock sold was held by the shareholder while the corporation was a CFC.

The Tax Reform Act of 1976 extended the rule for disposition of stock in a foreign corporation to a U.S. corporate shareholder that disposes of such stock in a transaction governed by sections 311, 336, or 337. The amount of the dividend income required to be included in the U.S. corporation's income is equal to the difference between the fair market value of the stock and its basis, subject to the post-1962 e&p limitation. § 1248(f).

B. *McDermott Transaction*

1. *Background.* Although section 1248 has generally carried out its purpose, a U.S. corporation recently carried out a transaction with respect to the stock of a CFC to which the U.S. corporation claimed section 1248 did not apply. In this transaction, a Panamanian company, which was a CFC of McDermott Incorporated, a U.S. corporation whose stock was widely held, exchanged its newly issued shares plus a small amount of cash for shares representing a majority interest in McDermott. If the form of the transaction is followed, the shareholders of McDermott pay a capital gains tax on the difference between the value of the foreign corporation's stock plus the cash and their basis in the McDermott stock. Further, McDermott claims that because the transaction results in the Panamanian company ceasing to be a CFC, e&p accumulated prior to the exchange is permanently exempt from U.S. corporate tax. The transaction was specifically structured to avoid having McDermott itself exchange its stock in its Panamanian subsidiary, so that dividend treatment under section 1248(f) of the Panamanian corporation's e&p was avoided. The prospectus covering the transaction indicated that a principal reason for the transaction was to avoid paying U.S. tax on almost $600 million of subpart F income expected to be generated over the next five years; and the transaction also enabled McDermott to claim the avoidance of treatment of the deferred earnings of the Panamanian company as a dividend under section 1248.
2. *Legislation.* DRA of 1984, Section 133(a), (b)
   a. For an explanation, see H.R. Rep. 432, pt. 2, at 1326-28; Conf. Comm. Statement at H6631-32.
   b. Under the legislation, if shareholders of a U.S. corporation exchange stock in the U.S. corporation for newly issued stock (or treasury stock) of a foreign corporation 10% or more of the voting stock of which is owned by the U.S. corporation, the transaction is recast for purposes of section 1248. The foreign corporation is viewed as having issued the stock to the U.S. corporation, and the U.S. corporation is then treated as having distributed that stock in redemption of its shareholders' stock. § 1248(i). Under section 1248(f), the distribution of the stock in the foreign corporation under section 311 causes the distributing corporation to recognize dividend income. The amount of that income is equal to the difference between the fair market value of the stock received by the shareholders of the U.S. corporation and the U.S. corporation's basis for its stock in the foreign corporation, subject to the post-1962 e&p limitation. Under an amendment to section 959 (relating to the exclusion of gross income of a CFC's previously taxed e&p), the e&p of the foreign corporation are treated as previously taxed income under section 959 by the amount of dividend income recognized by the U.S. corporation under section 1248. § 959(e). *See* III.C.1, *infra.*

   The following example is provided by the legislative history.

Example (5): P, a U.S. corporation, is and always has been the sole shareholder of F, a foreign corporation. F, which was organized in 1959, has previously untaxed post-1962 e&p of $40 million. P, whose shares are widely held, has assets worth $100 million (including F shares representing $40 million of value). In recent years, while profits from P's operations have declined, F's foreign operations have generated substantial income. P has a zero basis in the F stock. In addition, many of P's shareholders have losses in their P stock. P's shareholders transfer all of their stock in P to F in exchange for newly issued F stock representing 90% of the total number of outstanding F stock plus a de minimis amount of cash. After the exchange, F owns all of the outstanding stock of P, and the former P shareholders own stock of F with a value approximating $100 million. The principal purpose of this transaction was to enable the corporate group to retain and reinvest F's accumulated and future foreign earnings free of U.S. tax. The bill taxes the transaction in accordance with its economic substance. The effect of the bill is to treat the excess of the value held by the former P shareholders after the exchange ($100 million) over the amount by which F's value was augmented ($60 million) as if P had distributed F shares equal to that difference ($40 million in the example) to its shareholders. Under section 1248(f), P would recognize ordinary income of $40 million if the F stock were distributed as a dividend-in-kind or in liquidation. Similarly, under the bill, $40 million is includible in P's income as a dividend. H.R. Rep. 432, pt. 2, at 1327-28.

c. *Effective date.* This provision applies to exchanges after the date of enactment in taxable years ending after such date.

C. *Double Counting*

1. *Background.* The IRS has taken the position that an income inclusion under section 1248 due to the sale of stock of a CFC does not reduce the e&p of the CFC by the amount of that income inclusion. *See* Rev. Rul. 71-388, 1971-2 C.B. 314. In Rev. Rul. 83-182, 1983-51 I.R.B. 12, the IRS announced that it was reconsidering this position, however, and that pending such consideration, Rev. Rul. 71-388 was suspended. Under the IRS position in Rev. Rul. 71-388, the taint of the previously untaxed e&p would remain even though the e&p has borne tax at the shareholder level. Under this position, a subsequent distribution by the CFC could, therefore, cause dividend treatment again on account of e&p that had already caused a dividend inclusion. In addition to this double income inclusion, the new owner could take the position that it is entitled to foreign tax credits for taxes imposed on the CFC that the first owner has already credited. This double credit, if the law were interpreted to allow it, could reduce U.S. tax on other foreign income twice.

Similarly, when a U.S. corporation in sections 311, 336, 337 transaction disposes of an interest in a CFC, it recognizes dividend income in an amount equivalent to the difference between the fair market value and its cost basis in the shares distributed, to the extent of the accumulated e&p of the CFC. It was not entirely clear whether the e&p of the CFC was reduced in the hands of the distributee. If the distributee received a distribution from the CFC, it might be subject to tax at ordinary income rates on account of the e&p accumulated while the distributor owned the stock if the e&p were not reduced, again causing a double income inclusion. Taxpayers could attempt to credit the same taxes twice in this situation also.

2. *Legislation.* DRA of 1984, Section 133(b)
   a. For an explanation, see H. Rep. 432, pt. 2, at 1538-40; Conf. Comm. Statement at H6631.
   b. The legislation provides that to the extent that accumulated e&p has previously characterized income as ordinary income, that same e&p will not do so again. It technically achieves this result by treating the e&p taxed under section 1248 as previously-taxed income under section 959(e) of the subpart F rules; therefore, actual distributions from such previously taxed income would not be taxed again. Thus, if a U.S. corporation owns stock in a CFC and that U.S. corporation liquidates, the dividend income generated under section 1248(f) on account of the accumulated e&p of the CFC will be treated as previously taxed income under section 959 by the amount of that income inclusion. Also, if a U.S. person sells its interest in a CFC and recognizes dividend income under section 1248(a) on account of accumulated e&p, that income inclusion will be treated as previously taxed income under section 959.
   c. The legislation clarifies present law to provide that the new owner will not be entitled to foreign tax credits for taxes imposed on the CFC that the first owner had already credited. This is technically achieved in the legislation by treating the previously taxed dividend income under section 1248 as an amount included in income under the subpart F rules for purposes of section 960(b), which prevents the double claim to a foreign tax credit.

D. *Indirect Ownership*

1. *Background.* Some taxpayers have taken the position that they may avoid ordinary income treatment on e&p of a CFC by a series of transactions between related parties. The following example illustrates their argument.

   Example (5): P owns all of the stock of CFC1 and CFC2. P contributes the stock of CFC1 to the capital of CFC2. P then sells the stock of CFC2. P claims that the e&p that CFC1 accumulated before the contribution of its stock to CFC2 is not subject to ordinary income treatment, on the basis that a cross-reference in the Code (section 1248(c)(2)(D)(ii)) indicates that e&p accumulated during direct ownership does not count when a U.S. person disposes of an interest held indirectly (such as a second-tier subsidiary).

2. *Legislation.* DRA of 1984, Section 133(c).
   a. For an explanation, see H. Rep. 432, pt. 2, at 1539-40; Conf. Comm. Statement at H6631-32.
   b. The legislation clarifies current law to provide that e&p that a CFC accumulated while controlled by U.S. owners is subject to ordinary income treatment whether its U.S. owners controlled it directly or indirectly. This result is technically achieved by

amending section 1248(c)(2)(D) to strike out "section 958(a)(2)" and insert instead "section 958(a)."

E. *Effective Dates of Provisions in C. and D.*
  1. In general, these changes apply with respect to transactions under sections 1248(a) and (f) occurring after the date of enactment.
  2. Under appropriate elections, the amendments with respect to "double counting" apply to transactions under section 1248(a) and (f) occurring after October 9, 1975 (the effective date of certain changes to section 1248).
     a. In the case of sales or exchanges of foreign corporate shares, the foreign corporation (or its successor in interest) is eligible to make an election. If a foreign corporation that is eligible to make an election has been liquidated by the date of enactment or within the election period, its successors in interest would be determined under rules similar to rules provided under section 964. H. Rep. 432, pt. 2, at 1540.
     b. In the case of a section 311, 336 or 337 transaction by a U.S. corporation that owns stock of a CFC, the distributing U.S. corporation or its successor is eligible to make the election.
     c. All elections with respect to post-October 9, 1975 transactions are required to be made within 180 days after enactment.

IV. Foreign Collapsible Corporations

A. *Background*

Section 341 generally requires a shareholder's gain on the sale of liquidation of a collapsible corporation to be reported as ordinary income rather than capital gain. Section 341(f)(1) permits, however, a shareholder to obtain capital gain treatment on the disposition of stock if the corporation consents to recognize gain on disposition of its non-capital assets when realized. It may be possible to circumvent section 341 by causing a foreign corporation to give a section 341(f) consent under circumstances that render enforcement of the consent impractical (*e.g.*, if the foreign corporation ceases to be engaged in a U.S. trade or business and the stock is sold to a foreign person). Section 341(f)(3) also provides an exception from the collapsible corporation rules for certain tax-free corporate organizations, reorganizations, and liquidations, where the corporation makes a section 341(f) consent. This exception may also present opportunities for tax avoidance.

B. *Legislation.* DRA of 1984, Section 135
  1. For an explanation, see H.R. Rep., at 2, at 1345; Conf. Comm. Statement at H6632-33.
  2. The legislation amends section 341(f) to provide that the section 341(f)(1) election shall not apply to a foreign corporation except to the extent provided in regulations, and also that section 341(f)(3) shall not apply if the transferee is a foreign corporation except to the extent provided in regulations. § 341(f)(8).
  3. The Conference Committee made the following comments about the application of section 341(f) to foreign corporations (Conf. Comm. Statement at H6632-33):

     There is no policy reason to allow the use of the collapsible corporation device by U.S. taxpayers simply because the corporation is organized under the laws of a foreign country to engage in an activity abroad. This result may occur, however, where the stock of a foreign collapsible corporation is sold to a foreign person and the section 341(f) consent procedure is used. The conferees intend that a section 341(f) consent given by a foreign corporation will not be given effect if the consenting corporation is not engaged in a U.S. trade or business and stock in the corporation is sold to a foreign person. The conferees recognize that there may be cases in which a section 341(f) consent given by a foreign corporation should be given effect. Accordingly, the conference agreement authorizes the Secretary to prescribe regulations setting forth circumstances in which it would be appropriate to give effect to a section 341(f) consent given by a foreign corporation. The conferees are informed that taxpayers have taken the position that section 341 should not apply to a foreign corporation that derives no U.S. source income, and that section 341(f) properly provides a means to accomplish this result. This position is premised on the notion that the primary purpose of section 341 is to insure the collection of a federal corporate income tax. To the contrary, the legislative history makes clear that section 341 is designed to prevent the conversion of ordinary income to capital gain by use of a corporation; the avoidance of tax at the corporate level is incidental to the conversion technique. Thus, the fact that the income of a foreign collapsible corporation is not subject to U.S. tax does not present a reason to permit the corporation's shareholders to circumvent section 341 by use of a section 341(f) consent.[1]

4. *Effective date.* This provision is effective on the date of enactment.

V. *Treatment of Certain Transportation Income*

A. *Background*

The Code provides that generally rental income from property located in the U.S. is U.S.-source income and rental income from property located outside the U.S. is foreign-source income. §§ 861(a)(4), 862(a)(4). Further, income from transportation or other services rendered partly in and partly outside the U.S. is partly U.S.-source income and partly foreign-source income. § 863(b)(1). Treasury regulations (Treas. Reg. sections 1.861-5, 1.862-1(a)(4), and 1.863-4) and rulings provide more detailed sourcing rules for transportation income.

Under the regulations and rulings, the source of transportation income depends on whether the income is rental income (bareboat charter hire) or transportation service income (*e.g.*, time or voyage charter hire). If the income is rental income, it is foreign-source income to the extent allocable to periods when the vessel is outside the U.S. and its territorial waters (the three-mile limit), whether that voyage is between two U.S. ports or a U.S. port and a foreign port. Rev. Rul. 75-483, 1975-2 C.B. 286. If the income is a payment for transportation services between two U.S. ports or a U.S. port and a foreign port, the income is allocated between U.S. and foreign sources by comparing costs incurred within the U.S.'s territorial limits and costs incurred outside the U.S.'s territorial limits. PLR 8229005 (March 30, 1982).

Whether income attributable to transportation of cargo between two U.S.

1. The conferees acknowledge that it may be appropriate for Congress to review the relationship between the subpart F provisions, section 1248, and section 341.

ports (or a U.S. port and a foreign port) is rental income or services income, the income will be mostly foreign source income provided the route of transport lies primarily beyond the three-mile limit. Thus, for example, persons who transport crude oil from Alaska to West Coast points or, by way of the Panamanian pipeline, to East Coast points, may treat income earned from such transportation as deriving from foreign sources to the extent allocable to periods when the transporting vessel was outside the U.S. territorial limit. Treating transportation income attributable to transportation beginning and ending in the U.S. as foreign source income increases the foreign tax credit limitation of the carrier and affiliates. If the carrier or its affiliates have excess foreign tax credits as a result of unrelated foreign operations, this increase in the foreign tax credit limitation effectively enables the carrier to use the excess credits to offset all or part of any U.S. tax that should be imposed on the transportation income. Thus, the carrier and its affiliates may pay little or no U.S. tax on the transportation income.

B. *Legislation.* DRA of 1984, Section 124
   1. For an explanation, see H.R. Rep. 432, pt. 2, at 1337-41; Conf. Comm. Statement at H6624.
   2. The legislation provides that all transportation income attributable to transportation which begins and ends in the U.S. is to be treated as U.S.-source income. § 863(c). A special rule is provided for transportation between the United States and any possession. Transportation income attributable to transportation which begins in the United States and ends in a U.S. possession (or vice versa) is treated as 50% U.S.-source income and 50% foreign-source income. § 863(c)(2)(A). Those U.S. possessions whose tax laws "mirror" the Code (see the discussion at VI., *infra*) will, because of the way the "mirror" Codes operate, treat this transportation income as 50% domestic source and 50% foreign source. Thus, transportation income attributable to transportation that begins in the United States and ends in Guam, for example, will in effect be split between the United States and Guam for tax purposes. Transportation income earned from the leasing of aircraft eligible for the investment tax credit to U.S. persons (other than a member of the same controlled group of corporations) who are regularly scheduled air carriers is treated as wholly U.S.-source income. § 863(c)(2)(B). Transportation income from transportation between U.S. possessions or within a possession is excluded from the scope of the new sourcing rule and is not treated as either wholly U.S.-source income or as 50% U.S. source income by operation of the new provision.
   Transportation income is defined as any income derived from or in connection with the use, or hiring or leasing for use, of a vessel or aircraft or the performance of services directly related to the use of such vessel or aircraft. § 863(c)(3). Thus, the legislation applies to transportation income attributable to both rentals and the provision of transportation services. Transportation income includes income from transporting persons as well as income from shipping. The legislation states that the term "vessel or aircraft" includes any container used in connection with a vessel or aircraft. Under the

legislation, transportation of oil, for example, from U.S. points to other U.S. points, either directly or by way of the Panamanian pipeline, is transportation "which begins and ends in the United States" and thus, transportation income from such transportation is U.S. source income. H.R. Rep. 432, pt. 2, at 1340.

The new sourcing rule is to be applied in accordance with regulations prescribed by the Secretary of the Treasury. The legislative history gives numerous examples for purposes of describing when transportation of cargo or persons would be considered to "begin and end in the U.S.," and presumably these examples would be included in the Regulations.

3. *Effective date.* This new sourcing rule applies to transportation beginning after the date of enactment in taxable years ending after that date.

VI. *Treatment of Payments to Guam and Virgin Islands Corporations*

A. *Background*

Payments of U.S. source interest, dividends, and other passive income to foreign investors are generally subject to a 30% U.S. withholding tax. §§ 871(a), 881. The U.S. does not impose withholding tax, however, on payments of passive income to corporations organized in Guam or in the Commonwealth of the Northern Mariana Islands. §§ 881(b), 1442(c). The U.S. does not tax any U.S. income (either active or passive) of "inhabitants" of the U.S. Virgin Islands. Some taxpayers contend that passive U.S. source income can flow through Guam or Marianas corporations or corporate inhabitants of the Virgin Islands to foreign investors free of U.S. tax and free of significant tax in the possession.

These possessions generally use the Code as their territorial income tax law by substituting the name of the possession for the words "United States" in the Code where appropriate to give the law proper effect ("mirror Code"). The U.S. has an "80-20" source rule that treats interest and dividends paid by a U.S. corporation as foreign source income if less than 20% of the corporation's income has a U.S. source. § 861(a)(1)(B), (a)(2)(A). In these possessions, then, application of the "mirror Code" might indicate that interest and dividends paid by a corporation organized in the possession are not possession source income if less than 20% of the corporation's income is from sources in the possession.

Example (6): G is a Guamanian corporation whose sole activity is investing in or lending money to its U.S. affiliate and to unrelated U.S. persons. The U.S. would not apply its 30% withholding tax to the passive income of G. G also claims, that under the "mirror Code," it earns only non-Guamanian source income, and any payments of interest or dividends to its foreign investors are not subject to the 30% withholding tax of Guam. Temporary Treasury regulations and rulings provide, however, that income derived from one of these possessions that is not subject to tax to the recipient in the possession is U.S. source income for purposes of the "80-20" source rule. Under the "mirror Code," then, income derived from the U.S. (such as interest paid from a U.S. corporation to a Guamanian finance subsidiary) that is not subject to U.S. tax to the recipient (because of U.S. rules exempting such income from tax) is possession source income for purposes of applying the 80-20 source rule under the possession's mirror Code. Temp. Reg. § 4a.861-1; Rev. Rul. 83-9, 1983-1 C.B. 126. Under the Treasury Department's interpretation, then, if a Guamanian or Marianas corporation received interest and dividend income from a U.S. corporation, the "80-20" rule does not apply, and the

possession must impose a 30% withholding tax on payments from the local corporation to the foreign investor. Treasury has applied similar rules to Virgin Islands inhabitants. Rev. Rul. 83-10, 1983-1 C.B. 127.
The Committee on Ways and Means expressed concern with the proliferation of conduit entities that purport to shield foreign investors from U.S. tax. It agreed that rules that eliminate U.S. tax on payments of passive income to corporations organized in U.S. possession should not apply to foreign-owned corporations or to corporations that derive a large portion of their gross income from outside U.S. possessions. However, it did not wish to alter tax incentives that the possessions extend to U.S. investors.

B. *Proposed Legislation.* DRA of 1984, Section 130
   1. For an explanation, see H.R. Rep. 432, pt. 2, at 1342-44; Conf. Comm. Statement at H6628-29.
   2. The legislation provides that U.S. source interest, dividends, and other passive income paid from U.S. sources to a corporation organized in Guam or the Virgin Islands will *not* be subject to the U.S. withholding tax if the recipient corporation meets two requirements: (1) that at all times during the taxable year less than 25% of the value of the stock of the corporation is owned directly or indirectly by foreign persons; and (2) that at least 20% of its gross income is from local sources for the three year period ending with the close of the preceding taxable year of the corporation (or for such part of the 3-year period as the corporation has been in existence). § 881(b). Under this legislation, for example, payments of U.S. source interest and dividends to a Guamanian corporation that (1) is owned solely by residents of Guam and (2) derives at least 30% of its gross income from Guam will not be subject to U.S. tax. The legislation also applies to Marianas corporations, because references in the Code to Guam are deemed generally also to refer to the Marianas, absent expressed intent not to have them apply.
      For purposes of the ownership requirement, the term "foreign person" means any person other than either a U.S. person or a person who would be a U.S. person if the general Code definition of the United States included references to the U.S. possession. § 881(b)(3). Accordingly, residents of the possessions will not be foreign persons for this purpose. In determining whether stock of a corporation that belongs to another corporation is owned indirectly by foreign persons, only foreign persons who own at least 5% in value of the corporate shareholder are considered as owning stock in the underlying corporation. § 881(b)(3)(B). This rule will allow territorial subsidiaries of publicly traded U.S. corporations many of whose shareholders are nominees (but with less than 25% in value of their stock held by foreign persons owning 5% or more in value) to meet the ownership requirement for reduced withholding.
      The 20% of gross income requirement makes it clear that a corporation formed in a U.S. possession is not eligible for reduced U.S. withholding tax on any U.S. source income if it could make payments of interest or dividends that are free of withholding tax in the possession. The purpose of this requirement is to assure collection of one tax on foreigners who invest in the United States. If 20% or

more of the gross income of a corporation organized in Guam, the Marianas, or the Virgin Islands during the applicable period were local source income, payments from its U.S. parent would not be subject to U.S. tax, but its payments to foreign investors would be subject to territorial withholding tax. On the other hand, the U.S. withholding tax will apply to payments to a corporation chartered in the possessions, if its payments of interest and dividends to foreigners are not subject to territorial tax.

The legislation also provides that for purposes of applying section 881(b) with respect to income tax liability incurred to Guam, the term "foreign corporation" does not include a Guamanian corporation. This provision makes it clear that the imposition of tax on certain Guamanian corporate recipients of U.S.-source income does not have any effect on the Guamanian tax liability of U.S. recipients of Guamanian source income. Thus, the rule of this legislation is not "mirrored" under the "mirror" Code. § 881(b)(2).

3. *Effective date.* These provisions apply to payments made after March 1, 1984.

VII. *Foreign Investment Companies*

A. *Background*

Taxpayers are using foreign corporations to avoid certain anti-tax avoidance rules.

1. *Tax Straddle Rules*

Taxpayers attempted to avoid the application of the loss deferral rules applicable to straddles under section 1092. The Code defines a straddle as offsetting positions with respect to personal property. § 1092(c). Personal property is defined to include only property (other than corporate stock) of a type which is actively traded. § 1092(d)(1). A taxpayer is treated as holding offsetting positions with respect to personal property if there is a substantial reduction in the taxpayer's risk of loss from holding any position in personal property because the taxpayer holds one or more other positions with respect to personal property. § 1092(c)(2).

The deduction of losses on positions that are part of a straddle is limited to the amount by which those losses exceed unrecognized gains on offsetting positions. § 1092(a). Some taxpayers attempted to avoid the application of the loss deferral rule by using a straddle consisting of a directly held position and stock in a foreign corporation which holds a position that offsets the directly held position. The taxpayer then sought to deduct losses despite unrecognized gains in the hands of the corporation that offset the shareholder's losses. The taxpayer argued that the reciprocal gain in the foreign corporation did not result in the application of the loss deferral rule because "stock" is not treated as "personal property." As a result, for purposes of the rule, there is neither an "offsetting position" nor a "straddle."

2. *Offshore Commodity Funds*

Offshore investment funds owned by U.S. persons have been created to engage in commodities trading, with the goal of avoiding current taxation of the trading income and of obtaining full capital gains treatment on a subsequent sale of the investment. These funds are often established in foreign tax havens.

Example (7): An investment adviser sets up a foreign corporation, X, which in turn sets up a foreign corporation, Y. Both are incorporated in tax havens. X issues its shares to a large number of U.S. persons. Y engages in commodities trading through an independent U.S. broker. The intended tax results are as follows: (1) Y will not be subject to current U.S. taxation on its trading income because it is not engaged in the conduct of a U.S. trade or business (see section 864(b)(2)(B)); (2) X will not be subject to current tax, either corporate or accumulated earnings tax (AET), because it derives no U.S. source income (dividends from Y are not U.S.-source income since Y is not engaged in a U.S. trade or business (section 861(a)(2)(B)); (3) X's shareholders are not subject to current U.S. tax under the anti-avoidance provisions with respect to foreign corporations because of the widely held ownership of X stock (see II *supra*); (4) X's shareholders will obtain capital gains treatment on a sale of their X stock, since X is neither a CFC under section 1248 nor treated as a foreign investment company under section 1246 (X is not registered under the Investment Company Act of 1940, and certain case law holds that commodities do not constitute securities for purposes of the Act); and (5) since Y is not engaged in a U.S. trade or business, it is not subject to the mark to market rule for taxation of certain commodity future contracts under section 1256(a), which treats each regulated futures contract as if it were sold or otherwise liquidated for fair market value on the last business day of the year and taxed at a maximum rate of 32%.

B. *Legislation.* DRA of 1984, Sections 101(b), 134, and 125
   1. For an explanation, see H.R. Rep. 432, pt. 2, at 1713-19; Conf. Comm. Statement at H6614-16, H6632 and H6624.
   2. *Straddles*, Section 101(b)
      a. The legislation makes the following changes:
         (i) It amends section 1092(d)(1), which defines "personal property," to strike out "(other than stock)."
         (ii) Section 1092(d)(2) is added to provide that "personal property" includes stock only when
            (a) the stock is part of a straddle at least one of the offsetting positions of which is
               (i) an option with respect to such stock or substantially identical stock or securities, or
               (ii) a position with respect to substantially similar or related property (other than stock), and
            (b) any stock of a corporation formed or availed of to take positions in personal property which offset positions taken by any shareholder.

      Thus, a transaction in which a taxpayer directly holds an interest in stock and holds an offsetting position in substantially similar or related property (other than stock) would be a straddle for tax purposes and subject to the loss deferral rule that losses are deferred if offsetting position stock contained unrealized gains. An example of such a straddle is offsetting positions in stock and a convertible debenture of the same corporation where the price movements of the two positions are related. Conf. Comm. Statement at H6616.

b. *Effective date.* This provision applies to positions established on or after May 23, 1983, in tax years ending on or after such date.

3. *Offshore Commodity Funds,* Sections 134 and 125

a. The legislation expands the definition of "foreign investment company" under section 1246 for purposes of determining when gain on the sale of shares of that stock will be ordinary income rather than capital gain. A foreign investment company includes any foreign corporation that is engaged (or holding itself out as being engaged) primarily in the business of investment, reinvesting, or trading in securities, commodities, or any interest (including a futures or forward contract or option) in commodities or securities, at a time when 50% or more of the total combined voting power of all classes of stock entitled to vote, or the total value of all classes of stock, is held directly or indirectly by U.S. persons as defined in section 7701(a)(3). § 1246(b)(2). For this purpose, "securities" are defined in section 2(a)(36) of the Investment Company Act of 1940, as amended. If that definition in the Investment Company Act is amended in the future, then the definition for Code purposes would also change. A primary effect of this provision is to bring commodity trading companies within the definition of a foreign investment company. The legislation would generally not affect the treatment of foreign corporations registered under the 1940 Act.

b. The legislation makes it clear that U.S. persons cannot use two or more tiers of foreign corporations to avoid the AET on certain U.S. earnings. For purposes of the AET rules, if at least 10% of the e&p of any foreign corporation for any taxable year are derived from sources within the U.S. or are effectively connected with the conduct of a trade or business within the U.S., then any distribution received (directly or indirectly) by a U.S. owned foreign corporation out of those e&p will be treated as derived by the receiving corporation from sources within the U.S. § 535(d). That is, the earnings become U.S.-source earnings in the hands of the receiving (upper-tier) corporation, so that they will be subject to the AET. The AET can apply to any U.S.-source earnings of foreign corporations, whether or not the earnings are, or are viewed as, effectively connected. A similar rule applies to interest paid by a foreign corporation. If the paying corporation meets the 10% e&p threshold, all interest it pays to a U.S.-owned foreign corporation is U.S.-source income for the purpose of the AET. The legislation defines the term "United States-owned foreign corporation" to have the meaning given to that term in section 904(g)(6).

c. *Effective dates.* The change in the definition of "foreign investment company" generally applies to sales and exchanges (and distributions) on or after Sept. 29, 1983. In the case of shares held on Sept. 29, 1983, and held continuously thereafter by one taxpayer, however, the legislation applies to sales and exchanges (and distributions) made after one year after date of enactment. The modification in the AET rules applies to distributions received by a U.S.-owned foreign corporation on or after May 23, 1983. In the case of a foreign corporation that was a U.S.-owned foreign corporation on May 23, 1983, however, the provision first applies to taxable years of the foreign corporation that begin after Dec. 31, 1984.

VIII. *Stapled Stock; Stapled Entities*

A. *Background*

Taxpayers have devised plans for tax avoidance wherein the stock of two (or more) entities is "stapled" or "paired" so that a shareholder cannot trade the stock separately. Widely held U.S. corporations have attempted to avoid the anti-tax-haven rules and the anti-international boycott rules by splitting off their foreign operations and conducting them through separate corporations. Then the stock of the foreign corporation is "stapled to" or "paired with" the stock of the original U.S. corporation so that a shareholder cannot buy or sell the stock of one corporation without buying or selling the stock of the other. Assuming the U.S. corporation, and thus the new foreign corporation, are sufficiently widely held, this device arguably reaches the result that the new foreign corporation is not subject to these rules. Such stapling of a U.S. corporation with a foreign corporation could also raise problems of transfer pricing where the foreign corporation operates in a low-tax jurisdiction.

B. *Legislation.* DRA of 1984, Section 136

1. For an explanation, see H.R. Rep. 432, pt. 2, at 1543-47; Conf. Comm. Statement at H6633.
2. The legislation adds new section 269B to the Code. This provision provides that where a foreign and a domestic corporation are stapled entities, the foreign corporation will be treated as a domestic corporation. § 269B(a)(1). The stapled foreign corporation would thus be subject to U.S. tax on its worldwide income.

   The legislation defines the term "stapled entities" to mean any group of two or more entities if more than 50% in value of the beneficial ownership in each of such entities consists of stapled interests. Two or more interests are stapled interests if, by reason of form of ownership, restrictions or transfer, or other terms or conditions, the connection with the transfer of one of such interests, the other such interests are also transferred or required to be transferred.

   Example (8): Two U.S. citizens each own 50% of a U.S. corporation and a foreign corporation. Under two separate standard death redemption agreements, the corporation agrees to buy, and each shareholder obligates his estate to sell, all of the shares owned by the first shareholder to die. These shares are not stapled for purposes of the legislation, so long as each shareholder may trade shares of the two corporations freely before death. H.R. Rep. 432, pt. 2, at 1546.

   Example (9): Assume that two U.S. citizens each own 50% of a U.S. corporation and a foreign corporation. Under two separate standard right of first refusal agreements, neither shareholder may sell or exchange any of the shares of either corporation without allowing the other shareholder (or, alternatively, the corporation) the right to match the price offered for his or her shares. These shares are not stapled for purposes of the legislation, so long as either shareholder may dispose of his interest in one corporation without disposing of his interest in the other. H.R. Rep. 432, pt. 2, at 1547.

3. The provision also provides that stock in one corporation which constitutes a stapled interest with respect to stock of a second corporation will generally be treated as owned by the second corporation for purposes of section 1563; the effects of this section 1563 treatment include denial of multiple surtax exemptions and denial of multiple accumulated earnings tax credits.]] 269B(a)(2).
   Under the standard rules governing consolidated returns, stapled U.S. corporations generally would not be eligible to file consolidated returns. Under the same rules, a foreign corporation that is stapled to a U.S. corporation would not be eligible to file a consolidated return with its U.S. sister (whether or not an election to treat the foreign sister as owned by the U.S. company to the extent of the stapling is in effect (see 4(a), *infra*). A contiguous country stapled corporation described in section 1504(d) might be eligible to consolidate under the regular rules, however.
4. The following exceptions are included in the provision:
   a. If a foreign corporation and a U.S. corporation were stapled entities on June 30, 1983, the U.S. corporation may elect to be treated as owning all interests in the foreign corporation that constitute stapled interests with respect to stock of the U.S. corporation. To the extent that the stock of both companies is stapled, the U.S. corporation would, upon this election, be subject to tax on certain income of the foreign corporation, including its subpart F income, if any. Also, if some of the stock of the foreign corporation (1) is not stapled to stock of the U.S. corporation and (2) belongs to non-U.S. shareholders, then (after an election to treat the foreign corporation as a foreign subsidiary of the U.S. corporation) earnings attributable to that stock or dividends to a foreign shareholder would not generally be subject to current U.S. tax. An election to treat a foreign corporation as a foreign subsidiary of a U.S. corporation is required to be made not later than 180 days after the date of enactment. This election is revocable only with the consent of the Secretary.
   b. The stapled stock provision generally overrides treaties. § 269B(d). However, the legislation does not restrict treaty benefits in the case of entities stapled on June 30, 1983, to which those entities were entitled on that date, so long as those entities remain entitled to those benefits under the applicable treaty. For example, the legislation provides that a foreign corporation stapled to a U.S. corporation is taxable as a U.S. corporation. A treaty may provide, for example, that a corporation incorporated under the laws of the treaty partner is not taxable in the U.S. on industrial or commercial profits unless it has a U.S. permanent establishment. In such a case, a foreign corporation stapled on June 30, 1983 to a U.S. corporation would be entitled to applicable treaty benefits. Stapled companies would lose such current treaty benefits if treaties were subsequently renegotiated to eliminate such benefits.
   c. The legislation does not apply to U.S. corporations stapled to Puerto Rican corporations as of June 30, 1983 if the Puerto Rican corporation is described in section 957(c) of the Code (or would be described in that subsection if dividends from section 957(c) corporations were income described in section 957(c)), and if it does not own stock in any corporation that is not de-

scribed in section 957(c). To qualify for this treatment, the stapled Puerto Rican corporation must also meet the activity test of section 957(c)(2).

5. *Effective date.* In general, the provision takes effect on the date of enactment. However, for interests stapled on or before June 30, 1983, the legislation does not apply until Jan. 1, 1985. In addition, the legislation does not apply to foreign corporations stapled to U.S. corporations on June 30, 1983, until Jan. 1, 1987. These effective dates allow stapled entities the opportunity to remove the requirement that shares trade in tandem.