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INTRODUCTION

A domestic corporation[1] operating in a foreign country through a branch office includes income from that operation in its worldwide income and deducts losses from its worldwide income. Net losses from foreign branch operations reduce the amount of income subject to the federal income tax. If at a future date the domestic corporation incorporates its foreign branch and transfers the branch assets to the foreign corporation[2] in exchange for its stock or securities, any future unearned income of the foreign corporation is removed from United States tax jurisdiction, provided that the foreign corporation does not engage in the conduct of a trade or business within the United States.[3]

When there have been foreign branch assets-for-shares transac-

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1 A domestic corporation is a corporation created or organized in the United States or under the law of the United States or of any state. I.R.C. § 7701(a)(4) (West Supp. 1982).

2 A foreign corporation is any corporation other than a domestic corporation. I.R.C. § 7701(a)(5) (1976).

3 A foreign corporation is only taxed on its taxable income if it is effectively connected with the conduct of a trade or business within the United States. I.R.C. § 882(a) (Supp. V 1981).

tions, the Internal Revenue Service[4] has been preoccupied with the mismatching of unearned income and losses, because mismatching could potentially involve a loss of United States tax receipts. To address situations of potential mismatching, the IRS issued Revenue Ruling 78-201[5] pursuant to section 367 of the Internal Revenue Code.[6] As a condition for obtaining a favorable ruling under section 367, Revenue Ruling 78-201 requires that the domestic parent corporation recognize as ordinary foreign source income an amount equal to the sum of the previously incurred foreign branch losses.[7]

However, Code section 904(f)(3), enacted as part of the Tax Reform Act of 1976,[8] provides for the recapture of overall foreign loss in the event that an American corporation elects to dispose of assets used primarily outside the United States.[9] Section 904(f)(3) and Revenue Ruling 78-201 overlap and indeed conflict with respect to the treatment of the recaptured income.

This article examines the development of Revenue Ruling 78-201 and section 904(f)(3). It concludes that neither section 367 nor Congressional intent supports Revenue Ruling 78-201. Indeed, this article argues that the IRS should revoke Revenue Ruling 78-201 to uphold Congress' intent that the IRS determine on a case-by-case basis whether branch assets-for-shares exchanges have the avoidance of federal income taxes as one of their principal purposes.

Determining Whether One of the Principal Purposes of a Transfer is Tax Avoidance

Section 351(a)[10] of the Internal Revenue Code[11] provides that if it meets certain requirements, a domestic corporation which operates an overseas branch may acquire or organize a foreign corporation under host country laws, and then exchange the assets of the overseas branch for the stock or securities of that foreign corporation without recognition of gain or loss on the transfer. However, the incorporation of a foreign branch operation which sustained losses prior to incorporation

4 Hereinafter referred to as "IRS."

5 Rev. Rul. 78-201, 1978-1 C.B. 91.

6 I.R.C. § 367 (1976) requires IRS approval of such transactions.

7 Rev. Rul. 78-201, 1978-1 C.B. 91, at 92. A favorable ruling would be that a transfer of branch assets to a foreign corporation did not have a tax avoidance purpose.

8 Pub. L. No. 94-455, § 1032(a), 90 Stat. 1525, 1624-25 (codified at 26 U.S.C. § 904(f)(3) (1976)).

9 *See infra* text accompanying notes 38-41.

10 I.R.C. § 351(a) (Supp. V 1981).

11 Hereinafter referred to as "Code."

is a case where the United States may lose income tax revenue. In such a case, the foreign branch losses have reduced the domestic corporation's worldwide taxable income, causing a corresponding loss in revenue receipts. As long as the branch is not incorporated, its later gains offset the loss. However, since foreign corporations are not subject to federal income tax jurisdiction,[12] once branch assets are exchanged for foreign corporation shares, there is no longer taxable earned income to offset prior branch operating losses which the domestic corporation has deducted from its worldwide income.

Without some provision for preserving United States tax on the branch's assets, which became liquid through the assets-for-shares transaction, a domestic corporation which has deducted branch losses from its worldwide income and then exchanged branch assets for foreign corporation shares will have unearned income in the amount of the deducted branch losses. This unearned income will not be subject to United States income tax. Hence, absent a scheme for preservation, there is potential for a branch assets-for-shares transaction to take place for the principal purpose of avoiding United States income tax.

The interlocking provisions of Code sections 351[13] and 367[14] pro-

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[12] This assumes that the foreign corporation does not generate any United States source income and does not engage in conduct of a trade or business within the United States. *See* I.R.C. §§ 881, 882 (1976 & Supp. V 1981).

[13] I.R.C. § 351 (1976 & Supp. V 1981). Section 351 states, in pertinent part:

(a) General rule.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation.

(b) Receipt of Property.—If subsection (a) would apply to an exchange but for the fact that there is received, in addition to the stock of securities permitted to be received under subsection (a), other property or money, then—

(1) gain (if any) to such recipient shall be recognized, but not in excess of—

(A) the amount of money received, plus

(B) the fair market value of such other property received; and

(2) no loss to such recipient shall be recognized.

[14] I.R.C. § 367 (1976). Section 367 provides:

(a) Transfers of property from the United States.

(1) General rule.—If, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, there is a transfer 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 United States person to a foreign corporation, for purposes of determining the extent to which gain shall be recognized on such transfer, a foreign corporation shall not be considered to be a corporation unless, pursuant to a request filed not later than the close of the 183d day after the beginning of such transfer (and filed in such form and manner as may be prescribed by regulations by the Secretary), it is established to the satisfaction of the Secretary that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

(2) Exception for transactions designated by the Secretary.—Paragraph (1) shall not apply to any exchange (otherwise within paragraph (1)), or to any type of property, which the Secretary by regulations designates as not requiring the filing of a request.

(b) Other transfers.—

vide such a tax-preserving scheme. For its foreign corporation to be considered a "corporation" within the terms of Code section 351(a), and thus, to qualify for the benefits of Code section 367, the domestic corporation must obtain a ruling from the Secretary of the Treasury, pursuant to a request filed within 183 days after the beginning of an assets-for-shares exchange, that the exchange is not in pursuance of a plan having the avoidance of federal income taxes as one of its principal purposes.[15] The IRS will consider the transfer favorably if the domestic corporation devotes the transferred property to the active conduct of a trade or business in any foreign country, if the foreign corporation has need for a substantial investment in fixed assets, or if the foreign corporation will engage in the purchase and sale of manufactured goods abroad.[16] However, if the IRS determines that the transfer has tax avoidance as one of its principal purposes, section 367 does not apply, since the foreign corporation will not qualify as a "corporation" for the purposes of section 351. In that case, the domestic corporation will recognize gain or loss on any stock for asset exchange.[17]

Revenue Procedure 68-23[18] sets forth guidelines for making a determination of tax avoidance. First, it provides that the IRS will make

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(1) Effect of section to be determined under regulations.—In the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in subsection (a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.

(2) Regulations relating to sale or exchange of stock in foreign corporations.—The regulations prescribed pursuant to paragraph (1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing—

(A) the circumstances under which—

(i) gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both, or

(ii) gain or other amounts may be deferred for inclusion in the gross income of a shareholder (or his successor in interest) at a later date, and

(B) the extent to which adjustments shall be made to earnings and profits, basis of stock or securities, and basis of assets.

(c) Transactions to be treated as exchanges.—

(1) Section 355 distribution.—For purposes of this section, any distribution described in section 355 (or so much of section 356 as is related to section 355) shall be treated as an exchange whether or not it is an exchange.

(2) Contribution of capital to controlled corporations.—For purposes of this chapter, any transfer of property to a foreign corporation as a contribution to the capital of such corporation by one or more persons who, immediately after the transfer, own (within the meaning of section 318) stock possessing at least 80 percent of the total combined voting power of all classes of stock of such corporation entitled to vote shall be treated as an exchange of such property for stock of the foreign corporation equal in value to the fair market value of the property transferred.

15 *Id.* § 367(a)(1).

16 Rev. Proc. 68-23, § 3.01(1), 1968-1 C.B. 821, 823.

17 *Cf.* I.R.C. § 367(a) (1976).

18 Rev. Proc. 68-23, 1968-1 C.B. 821.

tax avoidance determinations on a case-by-case basis considering all the facts and circumstances.[19] Next, it describes those transactions which ordinarily receive favorable consideration under Code section 367.[20]

However, Congress has not provided any statutory guidance in the Code on what constitutes a plan having the avoidance of federal income taxes as one of its principal purposes, and the IRS and the courts have provided disparate guidelines. The United States Tax Court has held that a "principal purpose" is a purpose of first importance.[21] In contrast, Code section 367(a) refers to *one* of the principal purposes rather than *the* principal purpose.[22] Thus, under section 367(a), the taxpayer may be seen to have a valid business purpose for the transaction, but at the same time, be denied a favorable ruling for having tax avoidance as a principal purpose. A different standard appears in Code section 269, which refers to *the* principal purpose.[23] Therefore, following section 269, a valid business purpose supplants a tax avoidance purpose as the principal purpose for the transaction.[24]

The legislative history of Code section 367(a) indicates, however, that prior to the enactment of the Tax Reform Act of 1976,[25] the IRS deemed that there were two situations where it would find that an assets-for-shares transaction would not have the avoidance of federal income taxes as one of its principal purposes.[26] At the time, the IRS accorded tax-free treatment if the United States tax was paid, or was preserved for future payment, first "on accumulated earnings and profits (in the case of transfers into the United States by a foreign corporation)," or second, on "the potential earnings from liquid or passive investment assets (in the case of transfers of property outside the United States)."[27] Code section 351(a) involves the second situation.[28]

Taking both section 351(a) and pre-1976 IRS practice into ac-

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19 *Id.* § 2.02.

20 *Id.* § 3.

21 Dittler Bros., Inc. v. Commissioner, 72 T.C. 896, 915 (1979), *aff'd in unpublished opinion*, 642 F.2d 1211 (5th Cir. 1981).

22 I.R.C. § 367(a) (1976).

23 I.R.C. § 369 (1976).

24 Dittler Bros., Inc. v. Commissioner, 72 T.C. 896, 914-15, *aff'd in unpublished opinion*, 642 F.2d 1211 (5th Cir. 1981).

25 Pub. L. No. 94-55, 90 Stat. 1525 (1976).

26 JOINT COMM. ON TAXATION, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, 257 (Comm. Print 1976) [hereinafter cited as 1976 ACT LEGISLATIVE HISTORY].

27 *Id.*

28 I.R.C. § 351(a) (Supp. V 1981); *see also supra* text accompanying notes 15-16.

count, it is clear that prior to the enactment of the Tax Reform Act of 1976, the IRS was not concerned with mismatches of past losses and future earned income, but instead concentrated on preserving the United States tax on liquid or passive investment assets. With the 1976 Act, Congress generally approved the existing administrative standard of according tax-free treatment when United States tax was paid or preserved for future payments on earnings from liquid passive investment assets. Yet, Congress also decided that the standard needed some changes.[29] Specifically, Congress maintained that the IRS should determine the tax effects of a transaction involving a foreign corporation on the basis of a statute and regulations, rather than through individual rulings.[30]

Accordingly, Congress amended section 367 in 1976 to cover two types of transactions.[31] The section now contains a rule for outbound transfer transactions, which involve the removal of appreciated assets or inventory from United States tax jurisdiction before their sale.[32] It also provides for the taxation of accumulated profits of controlled foreign corporations.[33] The amended section 367 rule dealing with outbound transfers applies in the case of exchange of foreign branch assets for foreign corporation stock. Since the 1976 amendment to Code section 367 primarily addresses the timing of the determination of tax avoidance, it must be concluded that when applying the outbound transfers rule, Congress intended that the IRS use the pre-1976 administrative standards.[34]

Two years after Congress expressed its intent by amending section 367, however, the IRS responded to the problem of preserving United States tax after a foreign branch assets-for-shares transaction by issuing Revenue Ruling 78-201.[35] This ruling is still in effect.

Significantly, the IRS claimed that it issued Revenue Ruling 78-201 pursuant to Code section 367.[36] According to the Ruling, a domestic corporation will receive a determination, necessary under Code sec-

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29 1976 ACT LEGISLATIVE HISTORY, *supra* note 26, at 258.

30 *Id.* at 259.

31 The amendments came in section 1042 of the Tax Reform Act of 1976, Pub. L. No. 94-455, § 1042, 90 Stat. 1525, 1530.

32 I.R.C. § 367(a) (1976); *see also* 1976 ACT LEGISLATIVE HISTORY, *supra* note 26, at 260.

33 I.R.C. § 367(b) (1976); *see also* 1976 ACT LEGISLATIVE HISTORY, *supra* note 26 at 260.

34 Prior to the 1976 amendment, section 367(a) required that the taxpayer establish that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of federal income taxes before the exchange. A taxpayer now has 183 days after the beginning of the transfer to file a request for a ruling. I.R.C. § 367(a) (1976).

35 Rev. Rul. 78-201, *supra* note 5, at 91.

36 *Id.*

tion 351,[37] that the transfer of branch assets to the foreign corporation is not in pursuance of a plan having the avoidance of federal income taxes as one of its principal purposes, only if the domestic corporation recognizes as gain on the transfer, an amount of ordinary foreign source income equal to the sum of the losses which its branch previously incurred. The IRS has followed Revenue Ruling 78-201 consistently in its determinations involving incorporation of a foreign branch which had sustained losses prior to incorporation.[38]

Contrary to Congressional intent, Revenue Ruling 78-201 does not address the potential avoidance of the United States tax on liquid or passive investment assets. Rather, it involves branch operating losses which the domestic corporation could deduct from its worldwide income. While the ruling requires recapture of a previous foreign operating loss, Congress specifically has addressed recapture of foreign losses in section 904(f) of the Code, and not under section 367, which the IRS claims supports Revenue Ruling 78-201. Section 904(f)(1) provides that when a taxpayer has an overall foreign loss in any taxable year, that loss will be recaptured when the taxpayer subsequently generates taxable income from its foreign activities.[39] The foreign loss is recap-

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[37] *See supra* notes 15-16 and accompanying text.

[38] *See, e.g.*, P.L.R. 8001024, *as amended by* P.L.R. 8018037, Feb. 5, 1980; P.L.R. 8117119, Jan. 29, 1981; P.L.R. 8143108, July 31, 1981; P.L.R. 8205079, Nov. 9, 1981.

[39] I.R.C. § 904(f) (Supp. IV 1980). Section 904(f) states:

(f) Recapture of Overall Foreign Loss.—

(1) General rule.—For purposes of this subpart and section 936, in the case of any taxpayer who sustains an overall foreign loss for any taxable year, that portion of the taxpayer's taxable income from sources without the United States for each succeeding taxable year which is equal to the lesser of—

(A) the amount of such loss (to the extent not used under this paragraph in prior taxable years), or

(B) 50 percent (or such larger percent as the taxpayer may choose) of the taxpayer's taxable income from sources without the United States for such successive taxable year, shall be treated as income from sources within the United States (and not as income from sources without the United States).

(2) Overall foreign loss defined.—For purposes of this subsection, the term "overall foreign loss" means the amount by which the gross income for the taxable year from sources without the United States (whether or not the taxpayer chooses the benefits of this subpart for such taxable year) for such year is exceeded by the sum of the deductions properly apportioned or allocated thereto, except that there shall not be taken into account—

(A) any net operating loss deduction allowable for such year under section 172(a), and

(B) any—

(i) foreign expropriation loss for such year, as defined in section 172(h), or

(ii) loss for such year which arises from fire, storm, shipwreck, or other casualty, or from theft,

to the extent such loss is not compensated for by insurance or otherwise.

(3) Dispositions.—

(A) In general.—For purposes of this chapter, if property which has been used predominantly without the United States in a trade or business is disposed of during any taxable year—

tured by treating a portion of the taxpayer's subsequent foreign source taxable income as United States source income.

If during the taxable year the taxpayer disposes of property which he used predominantly outside the United States, and before he recaptures the overall foreign loss, section 904(f)(3)(A)(i) deems the taxpayer to have received and recognized foreign source income in the year of disposition.[40] The amount of foreign source income recognized is the lesser of the unrecaptured losses or the gain realized on the disposition.[41] Therefore, Code section 904(f)(1) applies to the foreign source income recognized under section 904(f)(3), which treats foreign source income as United States source income.[42] Since section 904(f)(3) applies to the disposition whether or not gain or loss is recognized on the transfer, section 904(f)(3) is applicable to section 351(a) transactions, which, in turn, makes it applicable to section 367(a).[43]

Section 904(f)(3) and Revenue Ruling 78-201 obviously conflict. If the IRS were to give section 904(f)(3) and Revenue Ruling 78-201

(i) the taxpayer, notwithstanding any other provision of this chapter (other than paragraph (1)), shall be deemed to have received and recognized taxable income from sources without the United States in the taxable year of the disposition, by reason of such disposition, in an amount equal to the lesser of the excess of the fair market value of such property over the taxpayer's adjusted basis in such property or the remaining amount of the overall foreign losses which were not used under paragraph (1) for such taxable year or any prior taxable year, and

(ii) paragraph (1) shall be applied with respect to such income by substituting "100 percent" for "50 percent."

In determining for purposes of this subparagraph whether the predominant use of any property has been without the United States, there shall be taken into account use during the 3-year period ending on the date of the disposition (or, if shorter, the period during which the property has been used in the trade or business).

(B) Disposition defined and special rules.—

(i) For purposes of this subsection, the term "disposition" includes a sale, exchange, distribution, or gift of property whether or not gain or loss is recognized on the transfer.

(ii) Any taxable income recognized solely by reason of subparagraph (A) shall have the same characterization it would have had if the taxpayer had sold or exchanged the property.

(iii) The Secretary shall prescribe such regulations as he may deem necessary to provide for adjustments to the basis of property to reflect taxable income recognized solely by reason of subparagraph (A).

(C) Exceptions.—Notwithstanding subparagraph (B), the term "disposition" does not include—

(i) a disposition of property which is not a material factor in the realization of income by the taxpayer, or

(ii) a disposition of property to a domestic corporation in a distribution or transfer described in section 381(a).

40 *Id.*, § 904(f)(3)(A)(i). Overall foreign loss is computed on a worldwide basis, not a per-country basis. *Id.* § 904(f)(2).

41 I.R.C. § 861 (1976 & Supp. V 1981).

42 *Id.* § 904(f)(3).

43 *Id.*

independent effect, a domestic corporation would have to recognize its prior unrecaptured foreign branch operating losses as United States source income under section 904(f), and, additionally, include the same amount of losses as ordinary foreign source income under the terms of Revenue Ruling 78-201. This would result in a double inclusion of the amount of previous foreign branch losses in gross income.

In 1980, the IRS attempted to resolve the conflict between section 904(f)(3) and Revenue Ruling 78-201 through Revenue Ruling 80-246,[44] which clarified Revenue Ruling 78-201. The IRS' position in Revenue Ruling 80-246 was that section 904(f)(3) and Revenue Ruling 78-201 operate independently of one another.[45] To the extent of any overlap their effect is to be integrated to prevent double recapture.[46] Thus, the amount of gain recognized as foreign source income is reduced by the United States source income recognized under section 904(f)(3), giving priority to section 904(f). Yet, contrary to IRS objectives, Revenue Ruling 78-201 as modified by Revenue Ruling 80-246 went beyond the scope of section 904(f). Now, the treatment of the recaptured foreign source income under Revenue Ruling 78-201 differs greatly from that of section 904(f).[47] Indeed, by modifying Revenue Ruling 78-201, the IRS set the stage for the inevitable confrontation between the IRS and taxpayers who incorporate a foreign branch which had previously sustained operating losses.

HERSHEY FOODS CORP. V. COMMISSIONER[48]

The most significant change in section 367 under the Tax Reform Act of 1976 was to allow the taxpayer to file a request for a determination within 183 days after the beginning of the transfer, rather than establish non-tax avoidance purpose prior to the transfer.[49] That change, plus the addition of section 7477 to the Code in 1976,[50] for the first time allowed a taxpayer to litigate the determination of the Secretary with respect to tax avoidance under section 367. The Tax Court now has the power to judge the reasonableness of the Secretary's determination, and, if it is not reasonable, the Tax Court may make an in-

44 Rev. Rul. 80-246, 1980-2 C.B. 125.

45 *Id.* at 126.

46 *Id.*

47 *See infra* notes 84-91 and accompanying text.

48 Hershey Foods Corp. v. Commissioner, 76 T.C. 312 (1981), *appeal settled* (3d Cir. Sept. 16, 1981).

49 I.R.C. § 367(a)(1) (1976).

50 *Id.* § 7477(a)(1) (Supp. IV 1980).

dependent determination.[51]

Hershey Foods Corporation, a domestic corporation, operated a Canadian branch which had been unprofitable from 1970 through 1978 with the single exception of 1976. Hershey included the branch's losses and 1976 profit in its consolidated tax returns which, in effect, reduced Hershey's world-wide income in years other than 1976.

In 1977, Hershey acquired all the stock of Y & S Candies, Inc., which operated a profitable Canadian branch office. After Hershey acquired Y & S, Hershey included the Y & S branch profit for 1978 in its 1978 consolidated return. That year, Hershey requested a determination pursuant to Code section 367 on a proposed transaction involving the transfer of both Hershey and Y & S Canadian branch assets to a Canadian corporation in exchange for all of the Canadian corporation's stock. Under the proposal, Hershey Canada, Ltd. would retain and use the transferred assets in an active trade or business for the foreseeable future.[52] This, and the fact that Hershey Canada would have a need for a substantial investment in fixed assets in its business,[53] brought Hershey within the requirements of section 3.02, Revenue Procedure 68-23.[54]

In its proposal, Hershey advanced four business rationales for the transfer to show that United States tax avoidance was not one of the transfer's principal purposes. First, Hershey declared its wish to minimize the risks of foreign exchange through facilitation of borrowing in Canada. It also wanted to pay fewer Canadian taxes. Hershey stated that the transfer would allow for more efficient administration of its Canadian operations, and finally, would help it to comply with Canadian Foreign Investment Review Agency conditions.[55]

The IRS issued a final determination letter in March, 1980. The letter stated that the IRS would view the proposed transaction as having the avoidance of federal income taxes as one of its principal purposes, unless Hershey agreed to include in its income in the taxable year of transfer an amount equal to the Canadian branch's net cumulative loss from 1970 through 1978 as ordinary foreign source income, reduced by the Y & S branch's net cumulative profit for 1978.[56] The amount in question was approximately five million dollars.[57] Hershey

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51 *Id.*

52 Hershey Foods Corp. v. Commissioner, 76 T.C. at 316.

53 *Id.*

54 Rev. Proc. 68-23 § 3.02; *see supra* text accompanying notes 18-20.

55 Hershey Foods Corp. v. Commissioner, 76 T.C. at 316-17.

56 P.L.R. 8001024, *as amended by* P.L.R. 8018037, Feb. 5, 1980.

57 Hershey Foods Corp. v. Commissioner, 76 T.C. at 317.

refused to make the inclusion, and, after exhausting administrative remedies,[58] filed suit in the Tax Court to contest the reasonableness of the IRS determination.[59]

The IRS argued before the court that transferring an historically unprofitable branch to a foreign corporation gives rise to a presumption of tax avoidance.[60] This presumption is based on a perceived mismatching of loss and income, since the transferee corporation's future income, if any, will not be subject to federal income taxes.[61]

In deciding on the reasonableness of the determination, the Tax Court examined the proposed transaction to determine whether any potential for tax avoidance existed.[62] If no such potential existed, tax avoidance could not be one of the principal purposes for the proposed transfer. The court was unable to find any tax avoidance purpose.[63] In response to the IRS' presumption of tax avoidance, the court held that the perceived mismatching of loss and income assumed a transactional taxation scheme rather than an annual system.[64] The United States Supreme Court has rejected transactional taxation.[65]

In the Tax Court's view, the IRS had essentially based its position on a tax benefit theory. The court noted that, while Congress and the courts have generally adhered to an annual accounting system, prior events may determine the tax consequences of subsequent receipts and payments.[66] The Tax Court in *William L. Mitchell*[67] said that *Arrowsmith v. Commissioner*[68] required a nexus between the transaction in one year and the transaction in a subsequent year.[69] There is, however, no relationship between foreign branch losses incurred in different tax years, though they all reduce a domestic corporation's worldwide in-

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58 *See* I.R.C. § 7477(b)(2) (Supp. IV 1980).

59 This procedure is available under I.R.C. § 7477(a) (Supp. IV 1980).

60 Hershey Foods Corp. v. Commissioner, 76 T.C. at 319.

61 This assumes that the foreign corporation does not generate any United States source income and does not engage in the conduct of a trade or business within the United States. *See* I.R.C. §§ 881, 882 (1976 & Supp. V 1981).

62 Hershey Foods Corp. v. Commissioner, 76 T.C. at 321.

63 *Id.* at 321.

64 *Id.* at 319-20.

65 Arrowsmith v. Commissioner, 344 U.S. 6, *reh'g denied*, 344 U.S. 900 (1952).

66 *Id.*; Dorsey v. Commissioner, 49 T.C. 606 (1968). In *Arrowsmith*, shareholders who had received distributions in liquidation of their corporation which received long-term capital gain treatment were required to treat repayments in satisfaction of a judgment against the corporation as long-term capital loss instead of ordinary business loss. For a discussion, see Rabinowitz, *Effect of Prior Year's Transactions on Federal Income Tax Consequences of Current Receipts as Payments*, 28 TAX. L. REV. 85 (1972-73).

67 Mitchell v. Commissioner, 52 T.C. 170 (1969).

68 344 U.S. 6, *reh'g denied*, 344 U.S. 900 (1952).

69 Mitchell v. Commissioner, 52 T.C. 170, 173-75 (1969).

come. Similarly, the corporation's federal tax liability before a branch assets-for-shares transaction and the receipt of income in taxable years following incorporation are not related, since the foreign corporation is not subject to federal income tax. The incorporation breaks the required nexus between the transactions.

The Tax Court in *Hershey* stated that, within the framework of annual taxation, the taxpayer had clearly reflected its income each year, and the IRS did not contend that Hershey failed to reflect its income clearly in any year in which a foreign branch loss occurred.[70] The court also noted that while the potential for tax avoidance in future years was an element to consider,[71] in *Hershey* the IRS could only show that the potential tax avoidance would occur because Hershey's branch would cease to be an asset of a United States citizen once Hershey exchanged branch assets for Hershey Canada stock. After the transfer, income from the assets themselves would not be subject to United States tax.[72]

The flaw in the IRS' argument was that, despite the exchange, income which Hershey gained from its Canadian operation would still be clearly reflected in future years even though Hershey Canada itself was not subject to United States tax. The IRS' contention with respect to future income assumed that the foreign corporation would be profitable. Such a presumption could have been unwarranted, and its impact could be severe, since the IRS offered no offsetting provision to lessen the impact of recognition of gain through the recapture of previous losses. Furthermore, the IRS contended only that there was an unclear reflection of income and resulting tax avoidance when an unprofitable branch was incorporated. Yet its argument did not address the *profitable* foreign branch whose future income is removed from federal tax jurisdiction through incorporation, or the continuously unprofitable branch whose losses reduce worldwide corporate group income. The Tax Court held that it was irrelevant whether the foreign branch was profitable or unprofitable prior to incorporation since future earned income would be removed from United States tax jurisdiction in either event.[73] Overall, the *Hershey* court found that the IRS' determination of a tax avoidance purpose was unreasonable, and that Revenue Ruling 78-201 was an unsupportable[74] and unreasonable use of power con-

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70 Hershey Foods Corp. v. Commissioner, 76 T.C. at 320.

71 *See* Dittler Bros., Inc. v. Commissioner, 72 T.C. 896, 917, *aff'd in unpublished opinion*, 642 F.2d 1211 (5th Cir. 1981).

72 Hershey Foods Corp. v. Commissioner, 76 T.C. at 320.

73 *Id.* at 321.

74 *Id.* at 319.

ferred by section 367.[75]

The legislative history of section 367[76] and the comprehensive approach Congress took in 1976 in dealing with foreign losses[77] support the *Hershey* court's conclusion. Congress' three major steps at the time were: (1) repeal of the per-country method of calculating available foreign tax credits;[78] (2) recharacterization of certain foreign source income as United States source income to compensate for excess foreign losses;[79] and (3) the enactment of section 904(f)(3).[80] The overall effect of these changes was to allow foreign source losses to offset *only* foreign source income and to recapture reductions in United States source income attributable to foreign losses. In view of the fact that Congress amended section 367 at the same time that it enacted section 904(f), Congress arguably did not intend for taxpayers to use section 367 to recapture prior foreign branch losses on incorporation of that branch.[81]

The IRS has not acquiesced in the *Hershey* decision, however. It continues to apply Revenue Ruling 78-201, and to require that domestic corporations recognize as ordinary income those losses not recaptured pursuant to section 904(f)(3) upon incorporation of a foreign branch.[82]

INTERACTION BETWEEN SECTION 367 RECAPTURE UNDER REVENUE RULINGS 78-201 AND 80-246 AND SECTION 904(f)(3)

Under Code section 367 and Revenue Ruling 78-201, the foreign branch loss is recaptured without regard to other foreign source income. A domestic corporation does not use other worldwide income to reduce the foreign branch loss.[83] For example, a domestic corporation could operate an unprofitable foreign branch in Country A and a profitable foreign branch in Country B. Incorporation of the foreign

75 *Id.* at 324-25.

76 *See supra* note 26.

77 *See* Tax Reform Act of 1976, § 1032(a), Pub. L. No. 94-455, 90 Stat. 1525, 1624-25.

78 *Id.*, § 1031(a), 90 Stat. at 1620-24.

79 *Id.*, § 1032(a), 90 Stat. at 1624-25.

80 *Id.*

81 Hershey Foods Corp. v. Commissioner, 76 T.C. at 324.

82 *See, e.g.*, P.L.R. 8143108, July 31, 1981; P.L.R. 8205079, Nov. 9, 1981.

83 Under P.L.R. 8001024, *as amended by* P.L.R. 8018037, Feb. 5, 1980, Hershey was required to recognize as foreign source income the amount of losses incurred by its Canadian branch but no offsetting income from its affiliate or Canadian branch was allowed. In response to *Hershey*, the Internal Revenue Service issued Rev. Rul. 81-89, 1981-1 C.B. 129, in which the IRS held that the losses and profits incurred by foreign branches in the same country, of an affiliated group of corporations filing a consolidated return, will be combined to determine the amount to be included in income on incorporation pursuant to Rev. Rul. 78-201.

branch in Country A would result in the domestic corporation recognizing the foreign branch losses as foreign source income, a condition to a favorable ruling under section 367 and Revenue Ruling 78-201, notwithstanding income derived from the foreign branch in Country B.[84] Conversely, incorporation of the foreign branch located in Country B causes no recognition of foreign source losses in Country A.

Code section 904(f), however, is couched in terms of *overall* foreign loss from *all* foreign sources.[85] Pursuant to section 904(f), the overall foreign loss is computed so that there is recapture only to the extent that the foreign source losses exceed foreign source income.[86] Section 904(f) is, therefore, in tune with the Congressional mandate that foreign losses first offset foreign income.[87] While Code section 367 and Revenue Ruling 78-201 require recognition of foreign branch losses as *ordinary* foreign source income, section 904(f)(3)(B)(ii) provides that any taxable income recognized shall have the same character it would have had if the taxpayer had sold or exchanged the property.

The amount of foreign source ordinary income that the domestic corporation must recognize as a condition to a favorable determination under Revenue Ruling 78-201 pursuant to section 367 is not limited to the gain realized on the transfer of assets to the newly incorporated foreign branch.[88] Revenue Ruling 80-163[89] states that such a limitation does not take the full amount of the losses associated with the transferred assets into consideration, and hence does not prevent the mismatch of related income and losses which Revenue Ruling 78-201 was designed to prevent.[90] Yet section 904(f)(3)(A)(i) limits the recapture of overall foreign losses to the lesser of the gain that would have resulted from the transfer or the remaining uncaptured overall foreign losses. To avoid double counting under Revenue Ruling 78-201 and Code section 904(f)(3), Revenue Ruling 80-246[91] provides that the amount of taxable income recognized under section 904(f)(3)(A) will reduce the amount of foreign source ordinary income to be recognized pursuant to Revenue Ruling 78-201, apparently without regard to the character of the 904(f)(3)(A) income.

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84 Rev. Rul. 81-89. This ruling refers only to different branches operating in the same country.

85 For the text of IRC § 904(f) (1982), see *supra* note 39.

86 I.R.C. § 904(f) (Supp. IV 1980).

87 Hershey Foods Corp. v. Commissioner, 76 T.C. 312, 322 (1981), *appeal settled* (3d Cir. Sept. 16, 1981).

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

89 *Id.*

90 *Id.*

91 1980-2 C.B. at 127.

CONCLUSION

While the IRS may be rightly concerned with the mismatching of income and losses which may occur when United States corporations exchange foreign branch assets for foreign corporation stock, the IRS exceeded the mandate of Code section 367 when it issued Revenue Ruling 78-201. The legislative history of section 367 clearly indicates that Congress intended to limit the potential for tax avoidance in *outbound* transfers of liquid or passive investment assets, and did not intend for the IRS to apply section 367 to the mismatching of unearned income and past operating losses. Congress intended to address the situation through Code section 904(f)(3), which sets out a comprehensive approach to the recapture of overall foreign losses.

The Tax Court's conclusion in *Hershey* that Revenue Ruling 78-201 is unsupportable,[92] combined with the force of Congressional intent, presents the IRS with a challenge. As long as the IRS continues to ignore *Hershey*, to apply Revenue Ruling 78-201, and to maintain that, contrary to Congressional purpose, section 367 reaches the problem of the mismatching of unearned income and past operating losses, well-informed domestic corporations incorporating a foreign branch which has past operating losses will not request a determination of whether their transfers are for the purposes of tax avoidance.[93] Instead, these newly-formed foreign corporations will not be recognized as "corporations" for the purposes of Code section 351.[94] In such cases, the domestic corporation will reach the same result as under section 904(f)(3), having to recognize gain or loss on the transfer of assets. Yet, through this process, the corporation altogether circumvents the Congressional intent behind Code section 367, namely to deter branch assets-for-shares exchanges which have avoided United States income tax as one of their primary purposes. In view of this situation, the IRS should revoke Revenue Ruling 78-201 and issue new rulings which bring the treatment of foreign branch incorporations in line with Congressional intent.

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92 Hershey Foods v. Commissioner, 76 T.C. 312, 319 (1981), *appeal settled* (3d Cir. Sept. 16, 1981).

93 *See supra* notes 12-18.

94 *See supra* note 11 and accompanying text.