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Foreign Taxation: The Section 367(e) Regulations — No Place to Hide

*Walter D. Schwidetzky**

I. INTRODUCTION

Foreign taxpayers have long been a thorn in the side of Congress. Not only is the proper incidence of tax a far greater issue than in the domestic context, so is whether that tax will ever be collected. The average foreign taxpayer, with little the IRS can readily attach, is not overly concerned with whether the United States tax bill has been paid. Consequently, the Internal Revenue Code of 1986 (the Code) has a number of provisions designed to overcome the reluctance of foreign taxpayers to pay United States tax.¹

The Code permits taxpayers to engage in numerous transactions on a tax free basis, allowing them to defer to a more appropriate time the tax that would otherwise be due. Subchapter C of the Code contains most of the nonrecognition provisions that apply to corporate taxpayers. Part of the justification for the existence of this treatment is that in the covered transactions the taxpayer is changing the form but not the nature of the investment. For example, when a taxpayer contributes business property to a corporation in exchange for all of its stock, the form of the holding has clearly changed. The taxpayer instead of owning the assets directly, now owns them via a corporation. But the nature of the investment has not changed. The taxpayer still controls the business assets, it is just that the vehicle for doing so is now a corporation instead of a sole proprietor-

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¹ The withholding tax is perhaps the most potent weapon in this regard. See, e.g., I.R.C. §§ 1441-1446 (1986).

ship. Consequently, section 351 permits the taxpayer to avoid recognition of gain or loss on the contribution of property to a corporation in exchange for stock, provided the taxpayer "controls" the corporation after the contribution.² While the fisc forgoes its share of the gain inherent in the contributed property (and was not required to reduce the taxpayer's income by any inherent loss), it will be able to reap its share of any gain when the corporation sells the property. The tax on any gain is deferred but not ultimately avoided. Indeed, there may be a net benefit to the fisc given the double taxation of deferred gain once property is transferred to the corporation.³

In the international context, it is, however, possible for the tax deferral to become permanent. If the property is contributed to a foreign corporation, and that corporation is engaged exclusively in foreign undertakings, the U.S. probably will not have the jurisdiction to levy a tax on any gain incurred by the corporation upon sale of the property.⁴ Even if the United States were entitled to impose a tax on the sale of the property, it is often rather difficult to convince a corporation with no United States contacts to pay the United States tax.

Since 1932 the Code has limited the availability of subchapter C's tax free exchange rules to foreign corporations.⁵ Many of these limitations are now contained in section 367.⁶ Prior to the Tax Reform Act of 1984, section 367 generally denied tax free exchange treatment unless the taxpayer obtained a ruling from the Internal Revenue Service that the transfer did not have tax avoidance as a principal purpose.⁷ The Service attempted to use its ruling authority to prevent tax avoidance whether it was the principal purpose for the exchange or was merely incidental to a legitimately motivated transaction. As a result, the Service's ruling denials were often successfully challenged under a declaratory judgment pro-

² I.R.C. § 351(a) (1986). Control is defined in I.R.C. § 368(c) as "ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation". I.R.C. § 368 (1986).

³ The contributing shareholder takes a substituted basis in the stock under I.R.C. § 358(a) (1986) and the corporation takes a carryover basis in the contributed property under I.R.C. § 362 (1986). If the contributed property has a fair market value greater than its basis, both the stock and the property will have taxable gain inherent in it. The fisc has gone from being able to tax the property gain once in the hands of the original sole proprietor to being able to tax the gain twice, once via the gain inherent in the stock, and once via the gain inherent in the property.

⁴ See I.R.C. §§ 871(b), 882 (1986); see also M. McINTYRE, *THE INTERNATIONAL INCOME TAX RULES OF THE UNITED STATES* 1-3 - 1-4, 2-2 - 2-5 (1989).

⁵ M. McINTYRE, *supra* note 4, at 7-4.

⁶ I.R.C. § 367 (1986).

⁷ I.R.C. § 367 (West Supp. 1982) (amended 1984).

cedure.⁸ What the Service could not achieve in the court room it could achieve in Congress, and section 367 was significantly revised as part of the 1984 Act in a manner consistent with the Service's objectives. The general rule now is that gain must be recognized upon the transfer of appreciated property to a foreign corporation, notwithstanding the fact that subchapter C would otherwise apply a nonrecognition provision.⁹ Losses, however, generally may not be recognized.¹⁰

Temporary regulations were recently promulgated under sections 367(e)(1) and (2).¹¹ Section 367(e)(1) covers the application of section 355, which permits corporations to distribute stock or securities of a subsidiary to their shareholders on a tax free basis.¹² While the principal focus of section 367 is on transfers to corporations, in this instance it can apply to transfers to non-corporate persons as well. Section 367(e)(2) covers the application of section 337, which provides that a corporation may make a liquidating distribution of property to an eighty per cent or greater shareholder without recognizing gain or loss.¹³ This article will discuss these new regulations, critique them, and provide recommendations for reform.

II. SECTIONS 367(1) AND 355

A. Background

Section 355 permits certain corporate divisions to take place tax free.¹⁴ There can be a variety of legitimate business reasons for corporate divisions. Shareholders of a single corporation, in order to meet the demands of lenders for example, may want to put one of the corporate businesses into another corporation, but hold the stock directly.¹⁵ This can be achieved by transferring the relevant business to a subsidiary

⁸ See I.R.C. § 7477 (West Supp. 1982) (repealed 1984), *Hershey Foods Corp. v. Comm'r*, 76 T.C. 312, 317 (1981).

⁹ I.R.C. § 367(a) provides that a foreign corporate transferee will not be treated as a corporation for the purpose of gain recognition with regard to any exchange described in I.R.C. §§ 332, 351, 354, 356 or 361. All those code sections require the transferee to be treated as a corporation for the non-recognition rules to apply. I.R.C. § 367(a) (1986).

¹⁰ I.R.C. § 367(a) (1986).

¹¹ Temp. Treas. Reg. § 1.367(e)-1T, *et seq.* (1990).

¹² I.R.C. § 367(e)(1) (1986).

¹³ I.R.C. § 332(a) (1986); I.R.C. § 367(e)(2) (1986).

¹⁴ I.R.C. § 355(1986).

¹⁵ B. BITTKER & J. EUSTICE, *FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS* ¶ 13.01 (1987 & Supp. 1990). To fall within section 355, corporate divisions must have a bona fide corporate level business purpose. Treas. Reg. § 1.355-2(b)(2) (1989); *Bonsall v. Comm'r*, 317 F.2d 61, 64 (2d Cir. 1963); *Comm'r v. Wilson* 353 F.2d 184, 186-7 (9th Cir. 1965).

(nontaxable under section 351),¹⁶ and then distributing the subsidiary's stock to the shareholders pro rata. Alternatively, the corporation may be prevented from making important decisions due to a deadlock among the shareholders. The only solution may be to break up the corporation into separate corporate entities. Assets of one or more businesses are transferred to a subsidiary, and the stock of the subsidiary is distributed to the dissident shareholders in exchange for their stock in the original corporation.¹⁷

Distributions of the stock (and potentially the securities)¹⁸ are not taxable to the parent or its shareholders, if the following requirements are met:

1. Immediately before the distribution, the parent corporation must control the subsidiary whose stock and/or securities is being distributed. Control is defined as ownership of stock representing eighty per cent or more of the voting power of the subsidiary and eighty per cent of all other classes of stock.¹⁹
2. Immediately after the distribution both the subsidiary and the parent corporation must be engaged in the active conduct of a trade or business. Alternatively, the parent corporation need not be engaged in the active conduct of a trade or business, if immediately before the distribution the parent corporation holds no assets other than stock and securities in the controlled subsidiaries (in other words it is a holding company), and each subsidiary is engaged in the active conduct of a trade or business immediately after the distribution.²⁰
3. The active trade or business requirement is met if the trade or business is "actively conducted throughout the five year period ending on the date of the distribution," not acquired within that time "in a transaction in which any gain or loss [is] recognized in whole or in part", and not conducted by another corporation, control of which was acquired during the five year period in a taxable transaction.²¹
4. The parent must distribute all of its stock and securities of the subsidiaries, or, alternatively, distribute an amount constituting control and establish to the satisfaction of the Service that the retention of stock did not have a tax avoidance motive.²²
5. The distribution can not be principally "a device for the distribution of . . . earnings and profits."²³ This requirement may be violated, for example, if a prearranged plan to sell the stock received in the distribution existed.

¹⁶ I.R.C. § 351 (1986).

¹⁷ See BITTKER & EUSTICE, *supra* note 15, at ¶ 13.01.

¹⁸ Distributions of securities will only be tax free if a shareholder exchanges securities which have a principal amount due at least equal to the principal amount of the securities received. I.R.C. § 355(a)(3) (1986).

¹⁹ I.R.C. §§ 355(a)(1)(A), 368(c) (1986).

²⁰ I.R.C. § 355(a)(1)(C)(b) (1986).

²¹ I.R.C. § 355(b) (1986); See BITTKER & EUSTICE, *supra* note 15, at ¶ 13.04.

²² I.R.C. § 355(a)(1)(D) (1986).

²³ I.R.C. § 355(a)(1)(B) (1986).

In that event, the substance of the transaction may not be a bona fide corporate division, but an effort to convert an ordinary income dividend, (which results from a sale of the stock of the subsidiary and a cash distribution of the proceeds), into capital gain (which results from the company distributing the stock directly to shareholders who then, in turn, sell the stock).²⁴

6. The transaction must have a corporate level business purpose.²⁵

The parent is also shielded from gain on its distribution of stock (and prevented from taking any loss) under section 311(a).²⁶ Section 358 dictates the basis the shareholders take in the distributed stock and securities.²⁷ Assuming there is no boot, the aggregate basis of the original stock and securities is divided among the distributed and retained stock and securities in proportion to their market values (a "substituted basis").²⁸

Section 355 permits the parent's corporate level tax (that, but for section 355, would be assessed if the distributed stock were appreciated)²⁹ to be permanently avoided. The distributed stock is removed from corporate solution of the parent without the application of a tax and without the receipt of substitute property, the disposition of which would be taxable.³⁰ In a purely domestic context, any shareholder tax is only deferred.³¹ The shareholders avoid dividend income on receipt of the stock, but will recognize the gain on the taxable disposition of the distributed stock or securities, since they take a substituted basis in the distributed stock (instead of the fair market value basis they would have been given if the distribution had been a dividend).³² Additionally, the ordinary income dividend the shareholders otherwise would have re-

²⁴ Treas. Reg. § 1.355-2(d) (1989); *see*, BITTKER & EUSTICE, *supra* note 15, at ¶13.07. The mere fact that subsequent to the distribution the stock and securities are sold is not construed to mean that the distribution was used as a device to bail out earnings and profits, unless the sale was negotiated prior to the distribution. I.R.C. § 355(a)(1)(B) (1986).

²⁵ Such as the noted lender needs or a shareholder deadlock. *See* notes 16-17 and accompanying text. *See also* Treas. Reg. § 1.355-2(b)(2) (1989); *Bonsall v. Comm'r*, 317 F.2d 61, 64 (2nd Cir. 1963); *Comm'r v. Wilson*, 353 F.2d 184, 186-87 (9th Cir. 1965).

²⁶ I.R.C. §§ 311(a), 355(c) (1986). There is no requirement that the distribution be pro rata. Indeed, if there is acrimony among the shareholders, the distribution will typically not be pro rata. I.R.C. § 355(a)(2) (1986). *See*, BITTKER & EUSTICE, *supra* note 15, at ¶13.10.

²⁷ I.R.C. § 358 (1986).

²⁸ I.R.C. § 358(b)(1) (1986); Treas. Reg. § 1.358-2(a)(2) (as amended in 1979).

²⁹ I.R.C. § 355 (1986); *see* I.R.C. §§ 311(b), 336(a) (1986).

³⁰ I.R.C. § 355 (1986); *see* I.R.C. § 311(b)(1) (1986). Either the parent receives nothing in return for the distributed stock or receives its own stock back. *See also* I.R.C. § 1502 regulations. A corporation recognizes no gain or loss on the issuance of its own stock, I.R.C. § 1032 (1986).

³¹ I.R.C. §§ 316(a), 301(c), 301(d) (1986). *See* I.R.C. §§ 1221, 1222 (1986). Of course, if the stock had a substituted basis that was less than its fair market value at the time of distribution, or if the stock depreciated in value, a loss on a sale would be possible.

³² I.R.C. § 301(d) (1986). *See supra* notes 27-28 and accompanying text.

ceived typically is converted into capital gains on the sale of the stock.³³

B. Section 355 in the Foreign Context

A difficulty arises when the stock is distributed to a shareholder who is a nonresident foreigner, assuming the stock is a capital asset. The United States does not generally impose a tax on capital gains incurred by a nonresident, foreign individual or a foreign corporation, provided the capital gains are not effectively connected with a U.S. trade or business.³⁴ Assuming there is no tax, the fisc may have lost the opportunity to levy a tax both at the corporate level and the shareholder level. To prevent this, section 367(e)(1) provides that, except to the extent otherwise provided in regulations, the rules of 355 will not apply and gain will be recognized upon the distribution by a domestic parent of stock or securities in a domestic or foreign subsidiary to a non-United States person.

There is some question of whether it is appropriate for section 367 to apply to section 355 at all when the distributed stock is that of a *domestic* subsidiary. When a corporation sells the stock of a subsidiary, it normally makes a section 338(h)(10) election. While the intricacies of section 338(h)(10) are happily beyond the scope of this article, it generally provides that no gain or loss is recognized by a corporation on the sale of an eighty percent cent owned subsidiary's stock.³⁵ Instead the subsidiary is considered to have sold its assets.³⁶ In a purely domestic context, therefore, there typically is no corporate level tax to the parent, whether the parent sells the domestic subsidiary's stock (due to section 338(h)(10)) or distributes it (due to section 355). Because normally no corporate level tax exists on the disposition of a domestic subsidiary's stock (by sale or distribution) in the domestic context, it seems odd that Congress found it necessary to apply one in the foreign context.

The Code's general objective is to tax income once when in corporate solution and once when it is taken out of corporate solution. Double taxation is both one of the cornerstones as well as one of the most contested topics in corporate taxation.³⁷ Usually only one level of corporate

³³ See I.R.C. §§ 316, 301(c)(1), 1221, 1222 (1986).

³⁴ I.R.C. §§ 871(a)(2), 881(a) (1986).

³⁵ I.R.C. § 338(d)(h)(10) (1986); see BITTKER & EUSTICE, *supra* note 15 at ¶¶ 11.47-11.49; see also Bush & Mullaney, *Section 338(h)(10) Under the New Temporary Regulations*, 65 J. TAX'N. 130 (1986); Ginsberg, *Taxing Corporate Acquisitions*, 38 TAX L. REV. 171 (1983).

³⁶ *Id.*

³⁷ See Warren, *The Relation and Integration of Individual and Corporate Income Taxes*, 94 HARV. L. REV. 719 (1981); TREAS. DEPT. REP. TO THE PRESIDENT, *TAX REFORM FOR FAIRNESS, SIMPLICITY, AND ECONOMIC GROWTH*, 117-19 (Nov. 27, 1984); See generally Steuerle, *A Simplified Integrated Tax*, 44 TAX NOTES 335 (July 17, 1989) and McNulty, *Reform of the Individual Income*

tax is imposed on a dollar of income, regardless of how many tiers of corporations are involved.³⁸ If a wholly owned subsidiary earns income which it uses to pay a dividend to its parent, the subsidiary pays a tax on the income it earned, but the parent is exempted from tax on receipt of the dividend.³⁹ As noted above, there is typically also no tax to the parent on a sale or distribution of the subsidiary's stock, the inherent gain in which usually is represented by the subsidiary's undistributed income.⁴⁰ A second level of tax will apply if the parent makes a dividend distribution of the income to an individual shareholder, resulting in the requisite double taxation.⁴¹ Thus the income is taxed once when in corporate solution, and once when it is taken out of the corporate solution.

Section 367(e)(1), however, breaks with this historic policy position and taxes income twice while still in corporate solution. The income is taxed once when earned by the domestic subsidiary, and a second time when the corporate parent distributes the appreciated stock of the subsidiary to a foreign person (at least if the appreciation is attributable to undistributed income of the subsidiary). It is unclear why the double taxation premise around which the corporate tax system is designed is not followed in this instance. The fact that the distribution is made to a foreign instead of a United States taxpayer does not seem germane. In both cases the government has already collected one level of corporate tax.

The issues are different when a domestic parent holds stock in a *foreign* subsidiary. Except for income effectively connected with a U.S. trade or business, the fisc will not have the jurisdiction to apply a corporate level tax to the foreign subsidiary's income.⁴² If no tax is applied on the distribution of the foreign subsidiary's stock by the domestic parent to foreign persons, the fisc may have lost the ability to apply *any* corporate level tax, since the government also would have no jurisdiction to

Tax by Integration of the Corporate Income Tax, 46 TAX NOTES 1445 (Mar. 19, 1990) (for proposals concerning an integration of corporate and individual income taxes).

³⁸ See BITTKER & EUSTICE, *supra* note 15, at ¶¶ 1.02, 5.05.

³⁹ I.R.C. §§ 243(a)(3), (b) (1986). The "dividend received deduction" is only 100 per cent if the payor and payee is connected by eighty percent ownership, otherwise the dividend received can be as low as 70 percent. I.R.C. § 243(a)(1) (1986). Upon a distribution of income subject to a lower I.R.C. § 243 rate to a shareholder, more than two levels of taxation can be assessed on the income (i.e. once on the upper tier corporation, once on the lower tier corporation and once on the lower tier corporation's shareholder). See also I.R.C. § 11 (1986) (taxation of corporations in general).

⁴⁰ I.R.C. §§ 355, 338(h)(10) (1986). See *supra*, notes 35-36 and accompanying text.

⁴¹ I.R.C. §§ 316, 301(c)(1) (1986).

⁴² See I.R.C. §§ 871(b), 882 (1986); See also M. MCINTYRE, *supra* note 4, at 1-3 -1-4, 2-2 - 2-5 (for general idea that there must be a nexus between the United States and the person earning income if the United States is to collect a tax).

tax gain on the later disposition of foreign stock by a foreign person.⁴³ Yet the gain arose while the stock was held by a *domestic* corporation, to wit the parent, an entity subject to United States taxation. Hence it is appropriate for section 367(e)(1) to require gain recognition when a domestic corporation distributes the stock of a *foreign* subsidiary. This is consistent with the tax treatment of a sale of the stock by the parent. Section 338(h)(10) does not apply to the sale of stock in a foreign subsidiary, and consequently gain is recognized.⁴⁴

C. The General Rule

The general rule of the regulations is that if a *domestic* parent distributes stock or securities in a domestic or foreign subsidiary to a non-United States person in a transaction that otherwise qualifies under section 355, gain will be recognized in the amount by which the fair market value of the distributed stock or securities exceeds the adjusted basis.⁴⁵ No loss may be recognized.⁴⁶ While the parent recognizes gain, the distributee treats the distribution as if section 355 fully applied. Thus the distributee does not have dividend treatment, no withholding tax applies, and basis in the distributed stock and securities is computed using the regular rules.⁴⁷ The distributee is not permitted to adjust the basis in the distributed stock or securities for the gain recognized to the parent.

Example

FC, a Country X corporation, owns all of the outstanding stock of DC1, a domestic corporation, that owns all of the outstanding stock of DC2, also a domestic corporation. FC has a basis in the DC1 stock of \$100. The stock has a fair market value of \$300. DC1 has a basis in the DC2 stock of \$40, and the stock has a fair market value of \$180. Neither U.S. corporation is a United States Real Property Holding Corporation, and Country X does not maintain any treaties with the U.S. With these

⁴³ See I.R.C. §§ 871(b), 882 (1986).

⁴⁴ I.R.C. § 338(h)(10) provides that it will only apply if the 'target' here the subsidiary, files a consolidated return with other members of the selling consolidated group. I.R.C. § 338(h)(10) (1986). A consolidated return cannot be filed with a foreign corporation. I.R.C. §§ 1501, 1504(a)(b) (1986).

⁴⁵ Temp. Treas. Reg. § 1.367(e)-1T(b) (1990). A United States person is a citizen or resident of the United States, a domestic partnership, a domestic corporation, or an estate or trust other than a foreign estate or trust. I.R.C. § 7701(a)(30) (1986), *See also* I.R.C. 7701(b) (1986). Note the possible application of I.R.C. § 1248. Distributions of a subsidiary's stock by *foreign* corporations are outside the scope of section 367(e)(1). While a distribution of stock might fall within the gain recognition provisions of I.R.C. § 1001, it is of no consequence since capital gains incurred by a foreign corporation are not subject to U.S. taxation, I.R.C. § 881 (1986).

⁴⁶ Temp. Treas. Reg. § 1.367(e)-1T(b) (1990).

⁴⁷ Temp. Treas. Reg. § 1.367(e)-1T(b), (e)(1) (example 1) (1990). *See supra* notes 27-28 and accompanying text.

facts, none of the exceptions to the general rule, which are discussed below, will apply.

If, in a transaction that otherwise qualifies under section 355, DC1 distributes all of the stock of DC2 to FC, the tax result under section 367(e)(1) will be as follows: DC1 will recognize a gain of \$140 (\$180-\$40); FC does not treat the transaction as a dividend; the DC2 stock has a fair market value of \$180, and therefore, after the distribution, the DC1 stock will have a fair market value of \$120 (\$300-\$180); of its \$100 basis in the DC1 stock, FC allocates \$60 to DC2 stock ($\$180/\$300 \times \100) and \$40 to the DC1 stock ($\$120/\$300 \times \100).⁴⁸

This rule is consistent with the operation of subchapter C generally with regard to distributions to shareholders. Normally, distributee shareholders compute their basis in distributed property independent of the corporate level treatment. This approach is necessary to insure that double taxation takes place. If shareholders were simply permitted to increase their basis in the distributed stock and securities by the gain recognized to the parent, they typically would take a fair market value basis. Yet since there is no dividend treatment, there normally would be no shareholder level income.⁴⁹ To preserve the shareholder level gain the shareholders take a substituted basis in the distributed stock and securities, notwithstanding the gain recognized at the corporate level.

D. Exceptions

1. *United States Real Property Holding Corporations*

The general rule of Section 367(e)(1) does not apply if, immediately *after* the distribution, both the parent and the subsidiary are United States real property holding corporations (USRPHC's).⁵⁰ A USRPHC is a domestic corporation half or more of the property of which consists of United States real property interests.⁵¹ Under section 897, if a non-United States person disposes of a U.S. real property interest, the gain or loss generally is considered to be effectively connected with a United States trade or business.⁵² As such, it is taxed at the ordinary income,

⁴⁸ Temp. Treas. Reg. § 1.367(e)-1T(e)(1) (example 1) (1990).

⁴⁹ Gain would be recognized if the fair market value of the distributed stock or securities exceeds the distributee shareholders stock basis. I.R.C. § 301(c)(3) (1986). See Temp. Treas. Reg. § 7.367(b)-10,-11.

⁵⁰ Temp. Treas. Reg. § 1.367(e)-1T(c)(1) (1990).

⁵¹ I.R.C. § 897(c)(2) (1986). A United States real property interest is an interest in real property located in the United States or the Virgin Islands and any non-creditor interest in any domestic corporation unless the taxpayer establishes that during the five year period ending on the date of the disposition of the interest that the corporation at no time was a USRPHC. I.R.C. § 897(c)(1) (1986). A ten percent withholding applies to insure collection, I.R.C. § 1445 (1986).

⁵² I.R.C. § 897(a)(1) (1986).

graduated tax rates applicable to United States persons.⁵³ A United States real property interest includes a noncreditor interest in a USRPHC.⁵⁴

Section 367 was enacted to prevent the avoidance of United States taxes by transferring appreciated property outside the United States⁵⁵ This principle cannot apply to real property because of its immobility. Nor will it apply to a stock which represents a U.S. real property interest. A foreign distributee's sale of this type of stock will not escape U.S. taxation because of section 897.⁵⁶ Hence, there is no need to tax the initial section 355 distribution.

While it is easy to see why the subsidiary should be a USRPHC, it is more difficult to justify requiring that status for the parent corporation. Section 355 provides nonrecognition treatment for the stock of the subsidiary which is being distributed. The stock of the parent is not considered since there is no disposition of it. There seems to be no legitimate reason for the section 367(e) regulations to focus on the classification of the parent, either. The subsidiary needs to be a USRPHC to justify the nonapplication of section 367(e)(1). The stock of the parent, with regard to which there has been no distribution or disposition, is not relevant to the process, and should remain above the fray. This is one of several examples where the regulations try to expand the requirements of code sections to which section 367 applies in a manner which goes beyond the needs of section 367 itself. Given the general complexity of tax law, the Service would be well advised to stick to the job at hand and modify its regulations to remove these extracurricular efforts.

The USRPHC exception granted by the section 367(e) regulations may be taken away by section 897(e)(1). Section 897(e)(1) provides that "any *nonrecognition provision* shall apply for purposes of this section to a transaction only in the case of an *exchange* of a United States real property interest for an interest the sale of which would be subject to taxation under this chapter."⁵⁷ The section 897 regulations provide that section

⁵³ I.R.C. §§ 871(b) and 882(a)(1) (1986).

⁵⁴ I.R.C. § 897(c)(1) (1986).

⁵⁵ See S. REP. NO. 169, 98th Cong., 2d Sess. 360 (1984). Non-U.S. persons are generally exempt from a tax on capital gains, as would arise on the typical sale of stock and securities, *see supra* notes 33-34 and accompanying text.

⁵⁶ A U.S. real property interest includes not only an interest in an existing USRPHC, but also an interest in a corporation which constituted a USRPHC within the five year period ending on the date of the distribution of the interest. I.R.C. § 897(c)(1)(A)(ii)(II) (1986). An interest in an erstwhile USRPHC will not qualify under the regulations for exemption from taxation. Only an interest in an existing USRPHC qualifies for the exception. Since both types of interest receive the same tax treatment under I.R.C. § 897, both should receive the same treatment under the regulations.

⁵⁷ I.R.C. § 897(e)(1) (1986)(emphasis supplied).

355 constitutes a nonrecognition provision.⁵⁸ The section 897 regulations also provide one circumstance, not relevant in this context, in which a distribution otherwise qualifying under section 355 will be taxable.⁵⁹ No more guidance is given in section 897 or its regulations. Under a literal reading of section 897(e), the USRPHC exception in the section 367(e) regulations is moot. The nonrecognition provisions (such as section 355) can only apply in the 897 context if there is an *exchange* of a United States real property interest for an interest the sale of which would be subject to United States taxation. In a section 355 transaction, the parent may not receive anything in return for the distribution, which extinguishes the "exchange" precondition to nonrecognition treatment under 897(e).⁶⁰ Moreover, when there is an exchange, what is received by the parent is its own stock (in return for the distributed stock).⁶¹ The later issuance of that stock by the parent would not be subject to United States taxation, once again preventing nonrecognition treatment under section 897(e).⁶² Hence, a literal interpretation of section 897(e) would appear to require gain recognition in any case in which a USRPHC stock is distributed in a section 355 transaction.

An example of what appears to be the focus of section 897(e) is an exchange under section 1031 which provides for nonrecognition on the exchange of real property.⁶³ If a United States real property interest were exchanged by a foreign person for a foreign real property⁶⁴ interest and section 1031 were permitted to apply, the foreign person might avoid United States taxation altogether on any gain that might be inherent in the United States real property interest. This avoidance is possible because the exchange is tax free, and the fisc typically does not have jurisdiction to tax the sale of the foreign real property.⁶⁵ If United States real

⁵⁸ Temp. Treas. Reg. § 1.897-6T(a)(2) (1990).

⁵⁹ See Temp. Treas. Reg. 1.897-6T(a)(4) (1990). The regulation provides:

If a domestic corporation, stock in which is treated as a U.S. real property interest, distributes stock in a foreign corporation or stock in a domestic corporation that is not a U.S. real property holding corporation to a foreign person under section 355(a), then the foreign person shall be considered as having exchanged a proportionate part of the stock in the domestic corporation that is treated as a U.S. real property interest for stock that is not treated as a U.S. real property interest.

This typically will result in a taxable transaction to the foreign person. I.R.C. § 897(e)(1) (1986). See *supra* notes 50-54 and accompanying text.

⁶⁰ I.R.C. § 897(e)(1) (1986). I.R.C. § 358(c) (1986) provides for a deemed exchange to permit the computation of basis, but I.R.C. § 358(c) only applies "[f]or purposes of this section," i.e., I.R.C. § 358, not I.R.C. § 897.

⁶¹ *Id.*

⁶² I.R.C. § 1032 (1986).

⁶³ I.R.C. § 1031 (1986).

⁶⁴ See M. MCINTYRE, *supra* note 4, at 1-3 - 1-4, 1-9 - 1-12.

⁶⁵ See *supra* notes 3-5 and accompanying text.

property is exchanged for United States real property this will not be the case, since the property received is still subject to United States taxation. Accordingly 897(e) prohibits section 1031 from applying in the former case, and permits it to apply in the latter case. The avoidance of United States taxation will not occur if a United States real property interest is transferred in a section 355 transaction by a domestic corporation to a foreign person, since the foreign person will still be subject to tax on the disposition of the United States real property interest. The section 897 regulations should be clarified to provide that section 897(e) will not prevent nonrecognition treatment under these circumstances.

2. *Closely Held Domestic Corporations*

Section 355 will apply unimpeded by section 367(e)(1) if the requirements of the closely held corporation exception are met. In the event that both this exception and the USRPHC exception apply, the USRPHC exception controls.⁶⁶ For the closely held corporation exception to apply, both the parent and subsidiary corporations must be domestic corporations⁶⁷ and the following additional requirements must be met:

1. Immediately before the distribution, five or fewer persons, each of whom is an individual or a corporation (for United States tax purposes), must own 100 percent of the outstanding stock of the parent.⁶⁸
2. The persons owning the stock in the parent must have held at least ninety per cent (by value) of that corporation's stock for at least two years at the time of the distribution.⁶⁹
3. If the foreign distributee is a corporation, the stock held by it in the parent must have a fair market value of less than fifty per cent of the total fair market value of all the outstanding stock of the *distributee* corporation immediately before the distribution. For purposes of computing the fair market value, cash, cash items such as bank deposits and receivables, and marketable securities held by the distributee corporation are not considered (thereby making it harder to meet the test).⁷⁰
4. After the distribution, a foreign individual distributee must continue to be a resident of, and a foreign distributee corporation must continue to be incorporated in, a foreign country that maintains an income tax treaty with the United States, and the treaty must contain an information exchange provision.⁷¹
5. The fair market value of the distributed stock and securities must be no more than half of the total fair market value of the parent's stock and secur-

⁶⁶ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(iv) (1990).

⁶⁷ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(i) (1990).

⁶⁸ Director qualifying shares are excluded. Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(i)(A) (1990).

⁶⁹ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(i)(B) (1990).

⁷⁰ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(i)(C) (1990).

⁷¹ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(i)(E) (1990).

ities immediately before the distribution.⁷²

6. The separate corporate existence of the parent must be maintained for five full taxable years beginning with the taxable year following the year of the distribution ("the five year period"). A domestic successor corporation under section 368(a)(1)(F) is treated as the parent.⁷³

7. Each foreign distributee must retain its stock ownership in the distributing and controlled corporation throughout the five year period.⁷⁴ It must also certify this by a certificate provided to the parent no later than the end of each of the five years, and the parent must attach the certificate to its tax returns for each of those years.⁷⁵ The Service generously provides that this standard will not be violated if death caused an individual to fail to meet the ownership standard.⁷⁶ That is the only exception, however. Thus, for example, a foreign *corporate* distributee must remain in existence throughout the five year period. There is no section 368(a)(1)(F) type exception in this regard, as there was for the comparable requirement for the parent.⁷⁷ The reasons for this are not immediately apparent. A successor corporation that is in substance the same as its predecessor, a standard that has to be met for section 368(a)(1)(F) to apply would not seem troublesome. Substance should control and the Service should provide that if the foreign distributee reorganizes in a manner permissible for domestic corporations under the type F reorganization rules, any successor corporation continues to qualify.

8. The parent and subsidiary corporations must attach a disclosure statement to their U.S. income tax returns for the taxable year of the distribution. The disclosure statement requires information that demonstrates that the exception's requirements have been met.⁷⁸

9. If the post-distribution standards are not met, the parent must file an amended return for the year of the distribution, recognizing the gain realized on the original distribution. Interest is also assessed on the tax for the period from the date of the distribution to the date of payment.⁷⁹ If the standard is not met because the parent did not properly maintain its existence for the five year period, the amended return must be filed no later than sixty days after the adoption of a resolution or agreement providing for the dissolution, liquidation or other termination of the parent.⁸⁰ An amended return must also be filed no later than sixty days after either a failure of a foreign distributee to file the certificate (due at the end of each of the five years), or sixty days after the parent knows, *or has reason to know*, the five

⁷² Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(i)(F) (1990).

⁷³ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(i)(G) (1990). I.R.C. § 367(a)(1)(F) permits a tax free reorganization which involves "a mere change in identity, form, or place of organization of one corporation, however effected." I.R.C. § 367(a)(1)(F) (1986).

⁷⁴ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(ii)(F) (1990).

⁷⁵ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(ii)(F), (G) (1990).

⁷⁶ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(iii)(A) (1990).

⁷⁷ See *supra* note 73 and accompanying text.

⁷⁸ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(i)(I), (c)(2)(ii) (1990).

⁷⁹ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(iii) (1990).

⁸⁰ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(iii)(B).

year ownership standard has not been met.⁸¹ Thus, if the parent has reason to know that the foreign distributee has failed to meet the standard, the fact that the foreign distributee has filed a fraudulent certificate will not prevent gain recognition. Admittedly, it will be difficult to prevent a foreign distributee no longer related to the parent or its shareholders from liquidating. However, in most countries it should be possible to prevent a foreign distributee from disposing of distributed stock and securities by causing it to letter its distributed stock and securities with a provision that any transfer within the five year period is void.

10. The statute of limitations for collection of a tax is normally three years, and would, accordingly, expire before the end of the five year holding period.⁸² Consequently the regulations require the distributing company to waive the applicable statute of limitations until three years after the filing of its tax return for the fifth year.⁸³

The 100 percent and 90 percent holding requirements were presumably imposed to limit the availability of the exception to longstanding shareholders and to facilitate the monitoring of future stock sales.⁸⁴ The 100 percent requirement seems excessive. An across the board 90 percent requirement would be sufficient to avoid abuse. The requirement that the shareholders only be individuals or corporations was presumably added to prevent indirect dispositions of stock via dispositions of an interest in pass-through entities that hold the stock directly. If this is true, stock holdings by pass-through entities, the interests in which generally may not be transferred, such as ESOPS and many trusts, should be excepted.⁸⁵ The two year holding requirement also seems unduly restrictive. Any contribution to a controlled subsidiary in exchange for stock would apparently start a new holding period.⁸⁶ It would seem fairer to permit holding periods for the stock to tack to that of the contributed property as generally permitted under section 1223(2).⁸⁷ Potential abuse, however, could arise if section 1223(2) were given unabridged application and nothing else were done. For example, the five shareholder limitation could be avoided by having ten shareholders contribute their stock to a single holding corporation, with the holding company being the shareholder of the parent.⁸⁸ But if the shareholding limitation is determined under section 318-type attribution rules this problem

⁸¹ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(iii)(A) (1990).

⁸² I.R.C. § 6501(a) (1986).

⁸³ Temp. Treas. Reg. § 1.367(e)-1T(c)(2)(ii)(H) (1990).

⁸⁴ See *NYSBA Tax Section Submits Clarifications to Section 367(e) Regulations* [hereinafter *NYSBA*], 90 TNT 145-28 19, (July 9, 1990).

⁸⁵ *Id.*

⁸⁶ The contribution would be tax free under I.R.C. § 351 (1986).

⁸⁷ I.R.C. § 1223 (1986).

⁸⁸ See *NYSBA*, *supra* note 84, at 20.

would be avoided, and section 1223(2) could fully apply.⁸⁹

It seems odd that the closely held corporation exception is limited to distributions of stock in domestic corporations. The Service was authorized to promulgate regulations consistent with section 367(a).⁹⁰ Section 367(a)(2) permits nontaxable transfers of stock of foreign but not domestic corporations, which indicates more congressional favor for the former than the latter.⁹¹ Perhaps the reason the Service reversed this bias is that it felt it could more readily observe domestic corporations. Related considerations will be discussed in more detail below.⁹²

The fair market value standards contained in the third and fifth requirements, means that both the parent and subsidiary corporations must have other significant business involvements besides the subject matter of the distribution. Informally, the Service has indicated that one reason for the fair market value standards for distributees is to prevent the closely held corporation exception from being available to a distributee holding company, in other words, a distributee whose only function is to hold stock in the parent (prior to the distribution).⁹³ The mere fact that the distributee is a holding company does not seem particularly offensive in this context. The closely held corporation exception is not limited to small taxpayers. The five or fewer shareholders of the parent could all be members of the Fortune 500. Finally, the distributee can still be a holding company as long as it holds stock in more than just the parent, and otherwise still meets the exception. The fair market value standards as they apply to the distributee corporation seem hard to justify.

Another informal justification for the parent fair market value standard is to improve the likelihood that the parent will have sufficient assets with which to pay any tax that might become due should the five year ownership standard not be met.⁹⁴ In this context the Service's concerns have greater validity. A five year holding term is pointless if a corporation or shareholders hold insufficient assets to pay the tax during that time. The parent, of course, could also dissipate its assets during the five year term. The Service could do little about this latter problem without impermissibly interfering in the business operations of the parent. If assurance of the payment of any future tax is the objective, the Service could have provided alternatives to the fair market value requirement for

⁸⁹ *Id.*

⁹⁰ See NYSBA, *supra* note 84, at 18. See also I.R.C. § 367(a)(2) (1986) and *infra* notes 99-119 and accompanying text.

⁹¹ I.R.C. § 367(a)(2) (1986).

⁹² See *infra* notes 99-119 and accompanying text.

⁹³ Telephone interview with the Internal Revenue Service in August, 1990.

⁹⁴ Telephone interview with the Internal Revenue Service in August, 1990.

the parent. The shareholders and/or the controlled corporation, for example, could give guarantees.⁹⁵

The five year post-distribution holding requirement appears to be an effort by the Service to address concerns with section 355 via the section 367(e) regulations. For section 355 to apply to any distribution, whether or not the distributee is a foreign person, the transaction cannot be "used principally as a device for the distribution of earnings and profits."⁹⁶ Section 355 goes on to provide that the "mere fact that subsequent to the distribution stock or securities in one or more of the distributing or controlled corporations are sold or exchanged by all or some of the distributees. . . shall not be construed to mean that the transaction was used principally as such a device."⁹⁷ Thus, not only does the statute not place a holding requirement on domestic distributees, it specifically provides that even a sale immediately subsequent to the distribution does not mean that the device test automatically has been violated. It is not difficult to see why the Service prefers a holding requirement. The longer the holding period, the less chance there is that a tax avoidance scheme is at work. However, the problem is one that is inherent in section 355 as currently drafted. Section 367, on the other hand, was enacted to prevent foreign taxpayers from end-running their United States tax bill via nonrecognition provisions. The five year holding requirement, as such, does not contribute to this objective. Since they are normally excepted from a tax on capital gains, the foreign taxpayers will not be taxed by the fisc whether they sell the stock one day or five years after the distribution. To the extent the section 367 regulations add to the substantive requirement of section 355, as occurs with the post-distribution requirements of the closely held corporation exception, rather than furthering the objective of section 367 itself, they may amount to an improper usurpation of legislative authority.

The certification rules are more justifiable. While post-distribution sales are themselves not evidence of a device for the distribution of earnings and profits, a post-distribution sale even by a domestic distributee can provide useful information in this regard. For example, a *prearranged* sale would taint the transaction and the Service could choose to investigate transactions based on when sales take place.⁹⁸ Accordingly, it is entirely appropriate for the Service to want to track dispositions of the distributed stock and similar matters. It is also fair to impose the

⁹⁵ See NYSBA, *supra* note 84, at 20.

⁹⁶ I.R.C. § 355(a)(1)(B) (1986).

⁹⁷ *Id.*

⁹⁸ See BITTKER & EUSTICE, *supra* note 15, at ¶ 13.07.

certification burdens on foreign taxpayers, even though they are not imposed on domestic taxpayers, since the Service does not have the ready audit access to foreign taxpayers that it has with domestic taxpayers.

The Service may argue that the legislative history of the 1984 Act supports the post-distribution holding requirements. The 1984 Act placed section 367's coverage of section 355 in section 367(a). As will be discussed in more detail below, that coverage was not moved to section 367(e) until 1986.⁹⁹ Accordingly, the 1984 Act's legislative history underlying section 367(a) is relevant to this discussion. Section 367(a)(1) generally provides that corporate nonrecognition provisions will not apply on transfers to foreign corporations.¹⁰⁰ An exception is provided in section 367(a)(3) for property transferred to a foreign corporation for use in the active conduct of its trade or business outside the United States.¹⁰¹

The legislative history to section 367(a) contains the following language under a heading of "Treatment of Stock or Securities."

Certain transfers of stock and securities by a U.S. person to a foreign corporation will fall within the active trade or business exception [of section 367(a)(3), as opposed to section 367(a)(2)] and will therefore be free of U.S. tax. The Committee believes that transfers of stock such as that in the *Kaiser* case (where the stock was akin to a direct interest in producing assets), should fall within the exception under the bill.

The regulations *implementing the active trade or business exception* are also to specify additional circumstances under which outbound transfers of stock may fall within the active trade or business exception. . . . Generally, additional circumstances which might place a transfer of stock within the exception include substantial ownership by the transferee in the corporation whose stock is transferred, and integration of the business activities of that corporation with the business activities of the transferee. The committee believes that the IRS should set forth regulations whereby, where appropriate, the IRS would not impose a 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.*¹⁰²

It is clear from the context that when Congress provided for the possibility of a mandatory holding period, it was thinking of transfers of stock which fell within the scope of the active trade or business exception to section 367(a). For example, in the *Kaiser* case the stock transferred was in a corporation that had been formed for the exclusive purpose of

⁹⁹ See *infra* notes 111-114 and accompanying text.

¹⁰⁰ I.R.C. § 367(a)(1) (1986).

¹⁰¹ I.R.C. § 367(a)(3) (1986).

¹⁰² See S. REP. 169 *supra* note 55, at 365. (emphasis added).

processing bauxite into alumina for its shareholders.¹⁰³ The Tax Court held that the transferred stock was akin to a direct interest in producing assets and qualified for a favorable ruling under the pre-1984 tax avoidance standard of section 367.¹⁰⁴ The type of stock discussed in the legislative history is distinguishable from stock in the typical section 355 situation. There, the transferred stock is not itself a trade or business asset, but represents a holding in a corporation which (as section 355 requires) is conducting an active trade or business, and is not simply formed to perform a processing or similar function in aid of its parents' business. The subsidiary is usually a free standing business entity.

It is clear that the active trade or business exception of section 367(a)(3) was not intended to apply where the business of the parent and subsidiary were not integrated, which is the normal section 355 transaction. Accordingly, section 367(a)(3) has no significant role to play with regard to section 355, and therefore the legislative history underlying section 367(a)(3) cannot be the basis for section 367(e) regulations that apply in the section 355 context.

A somewhat better argument can be made for the Service's position if the pre-1984 standard for section 367 is applied. This standard focused on whether the transaction had the avoidance of Federal income taxes as one of its principal purposes.¹⁰⁵ Requiring that the stock or securities be held for five years makes it less likely that tax avoidance is a *principal* purpose, and more likely that legitimate business motivations are involved in the distribution. Tax avoidance schemes tend to focus on the present, and five years will often be beyond the time horizon of transactions with a heavy tax focus.

The problem with using the tax avoidance standard is that Congress repealed it in 1984,¹⁰⁶ and it is clear from the legislative history that Congress did not intend it to have continued application. The legislative history states that while the tax avoidance standard had worked well over the years, a series of Tax Court cases had threatened to weaken it.¹⁰⁷ The legislative history provides:

The bill *replaces* the principal purpose [of tax avoidance] test of the present law with an "active trade or business" exception.¹⁰⁸

¹⁰³ Kaiser Aluminum & Chemical Corp. and Kaiser Alumina Australia Corp. v. Comm'r., 76 T.C. 325 (1981).

¹⁰⁴ See *supra* notes 6-10 and accompanying text.

¹⁰⁵ See *supra* notes 6-10 and accompanying text.

¹⁰⁶ I.R.C. § 367 (West Supp. 1982) (amended 1984).

¹⁰⁷ See S. REP. 169, *supra* note 55, at 360.

¹⁰⁸ See S. REP. 169, *supra* note 55, at 360. (emphasis added).

The word “replaces” indicates that the old standard is removed, and the new standard carries on alone.

The repeal of the tax avoidance test raises questions about the closely held corporation’s exception in its entirety, because it is difficult to justify the exception on grounds other than tax avoidance. A review of the history of section 367(e) is helpful in this regard. As indicated above, prior to 1984 the Tax Court, in Congress’s view, took a fairly narrow interpretation of the tax avoidance test, requiring that a tax avoidance purpose be greater than any other business purpose before gain need be recognized on the transfer of property to a foreign taxpayer.¹⁰⁹

Congress legislatively overruled the Tax Court. In 1984 section 367(a) was amended to provide:

If in connection with any exchange described in section 332, 351, 354, 355, 356 or 361, [all nonrecognition provisions] a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.¹¹⁰

Two principal exceptions were provided. They are for transfers of stock and securities of a foreign corporation which is a party to the exchange or reorganization, and transfers for use by a foreign corporation in the active conduct of a trade or business outside the United States.¹¹¹

All of the enumerated provisions, *except section 355*, require the transferee to be a corporation for the nonrecognition rules to apply. Providing that a foreign corporation will not be treated as a corporation for purposes of those rules meant that the nonrecognition rules were not, by definition, available. Section 355, unlike the other code provisions, does not require a transferee to be a corporation for there to be nonrecognition of gain or loss. Section 355 can apply to a transfer to any shareholder, including an individual and consequently, it was fully available on out-bound transfers, notwithstanding the 1984 Act’s version of section 367.

Congress had not intended this result. Consequently, as part of the 1986 Act Congress enacted 367 (e)(1), which provides that in the event of a section 355 distribution, gain shall be recognized on any transfer by a domestic corporation to a non-United States person, except “to the extent provided in regulations.”¹¹² Congress in the legislative history to

¹⁰⁹ See S. REP. 169, *supra* note 55, at 360; and *Dittler Brothers, Inc. v. Comm’r.*, 72 T.C. 896 (1979).

¹¹⁰ I.R.C. § 367(a) (West Supp. 1984) (amended 1986).

¹¹¹ Except as provided in regulations, I.R.C. § 367(a)(2) and (3) (1986).

¹¹² I.R.C. § 367(e)(1) (1986).

section 367(e) did not provide any significant enlightenment as to what the exceptions should be. All Congress said on the matter was:

The committee expects that the Secretary will carefully consider the extent to which it is appropriate, in view of the purposes of section 367(e), to require the recognition of gain upon the transfer of the stock of a . . . corporation to foreign persons under section 355.¹¹³

Since section 367(e)(1) was only enacted because section 367(a) could not achieve its objectives with regard to noncorporate distributees in section 355 distributions, the "purposes" of section 367(e)(1) generally should be the same as the purposes of section 367(a). Accordingly, section 367(e) should require gain recognition whenever section 367(a) would have, adjusting for the fact that the transferee need not be a foreign corporation.

Section 367(a)(1) generally requires gain recognition for outbound transfers.¹¹⁴ Section 367(a)(2) provides an exception when stock and securities of a foreign corporation which is a party to the exchange or reorganization are transferred.¹¹⁵ It is difficult to harmonize this exception with the closely held corporation exception since the former applies to transfers of stock and securities of *foreign* corporations, and the latter is limited to stock and securities of *domestic* corporations. Nor is the controlled corporation truly a "party" to the exchange. The parties are the parent and distributee shareholder. The subsidiary is something of an innocent bystander. There need not be an "exchange."¹¹⁶ Finally, by definition, a section 355 transaction is not a "reorganization."¹¹⁷ Accordingly, section 367(a)(2) does not find meaningful application in the section 355 context.

As discussed above, with the exception of a *Kaiser* type situation, rare in the section 355 context, the trade or business exception of section 367(a)(3) would not apply either.¹¹⁸ The controlled corporation, the stock of which is being distributed, will itself have to conduct an active trade or business in order for section 355 to apply. Normally, however, the distributed stock or securities themselves are not a trade or business asset, as such.

Based on the current statute and its legislative history, the closely held corporation exception to section 367(e) does not appear justifiable. While it benefits certain taxpayers, it appears to be inconsistent with the

¹¹³ See H.R. REP. NO. 3838, 99th Cong., 1st Sess. 931 (1985).

¹¹⁴ I.R.C. § 367(a)(1) (1986).

¹¹⁵ I.R.C. § 367(a)(2) (1986).

¹¹⁶ See *supra* notes 60-62 and accompanying text.

¹¹⁷ Reorganizations are defined in I.R.C. § 368(a) (1986).

¹¹⁸ See *supra* notes 101-105 and accompanying text.

legislative mandate of 367(e).¹¹⁹

3. *Publicly Traded Corporations*

The regulations also provide an exception if a domestic parent makes a distribution of the stock and securities of a domestic subsidiary and the stock of the parent is publicly traded.¹²⁰ For this exception to apply (1) at least 80 per cent of the total value of all classes of outstanding stock of the parent must be regularly traded on an established securities market located in the United States; (2) eighty per cent or more of the value of the domestic subsidiary must be distributed with respect to publicly traded shares of the parent; and (3) the parent cannot know or have reason to know that a foreign distributee owns, directly or indirectly, more than five per cent by value of the shares in the class of publicly traded stock with respect to which the stock of the subsidiary is distributed.¹²¹ Again the USRPHC rules override the publicly traded rules if both apply.¹²²

This exception also does not appear to find any support in the statute or the legislative history. For the reasons discussed with regard to closely held corporations, neither the reorganization nor the active trade or business statutory exceptions typically would apply. If tax avoidance were the focus, this exception would be easier to justify. It is unlikely that a distribution to smaller than five per cent shareholders of a publicly held corporation will have a tax avoidance purpose. Any distribution to public shareholders will tend to have a legitimate, business purpose for no other reason than no corporation knows the tax picture of all of its public shareholders. The Service gets no help here, however, since it seems clear that the tax avoidance standard no longer applies. (It should be added that distributions by a public corporation of a subsidiary's stock to the public shareholders is not a widespread phenomenon).

¹¹⁹ As part of the Technical and Miscellaneous Revenue Act of 1988 (1988 Act), Congress enacted I.R.C. § 367(a)(5). I.R.C. § 367(a)(5) provides that the exceptions to 367(a) are not available in the case of an I.R.C. § 361 exchange. I.R.C. § 361 generally provides that a corporation does not recognize gain or loss on certain transfers when it is a party to, and the transfers are pursuant to, a reorganization. The reason for I.R.C. § 367(a)(5) is that Congress intends for I.R.C. § 367(e)(2), discussed below, to be the exclusive forum in this area. There is an exception to I.R.C. § 367(a)(5), if five or fewer domestic corporations own eighty percent or more of the transferor. While this demonstrates some Congressional sympathy for closely held, distributing corporations, it is hardly a basis for the Service to bootstrap the closely held corporation exception to I.R.C. § 367(e)(1). A different code section is involved, the control requirements differ (80% versus 100%), and the types of shareholders differ (domestic corporations versus any type).

¹²⁰ Temp. Treas. Reg. § 1.367(e)-1T(c)(3)(i) (1990).

¹²¹ *Id.*

¹²² Temp. Treas. Reg. § 1.367(e)-1T(c)(3)(ii) (1990).

If the exception for publicly traded corporations is to be retained, the regulations should clarify *when* the two 80 percent tests and "reason to know" standard should be met (presumably immediately before the distribution).¹²³ The meaning of direct or indirect ownership should also be clarified.¹²⁴ Under a literal reading of the current regulations, no gain recognition would be required on a distribution of the domestic subsidiary's stock to ten foreign corporations each of whom owns five percent of the stock of the publicly held domestic corporation, even if each foreign corporation is wholly owned by the same foreign parent. While this does not violate the letter of the current regulations, it does violate their spirit. The application of section 318-type attribution rules would remedy this potential abuse.¹²⁵

III. SECTION 367(e)(2)

When a corporation makes a liquidating distribution to a shareholder, it recognizes any gain or loss inherent in the distributed property, assuming no nonrecognition rules apply.¹²⁶ The recipient shareholder also recognizes a gain or loss based on the difference between the fair market value of the property received and the basis in the stock surrendered, again assuming no nonrecognition rules apply.¹²⁷ This treatment insures that corporate income will be taxed twice, once at the corporate level and once at the shareholder level.

Prior to the 1986 Act, corporations were not usually required to recognize gain on liquidating distributions, due to the pre-1986 codification of what had become known, somewhat inappropriately, as the General Utilities Doctrine.¹²⁸ Congress repealed the General Utilities Doctrine as part of the 1986 Act.¹²⁹ However, if more than one tier of

¹²³ NYSBA, *supra* note 84, at 22.

¹²⁴ *Id.* The NYSBA, *supra* note 84, at 22, points out that "the 'reason to know' standard with respect to foreign shareholders is likely to be difficult to administer, particularly since most of the stock of a publicly-traded corporation typically is held through a clearing system or by other nominees. [The NYSBA] suggest[s] that the Regulations delete the 'reason to know' standard. . . ." The Regulations, by way of example, state that a corporation that has received a notice pursuant to the rules and regulations of the Security and Exchange Commission [hereinafter SEC] that a foreign shareholder owns six percent of the class of its stock with respect to which there is a distribution, knows that the foreign distributee owns more than five percent of such class of stock. Temp. Treas. Reg. § 1.367-1T(c)(3)(i)(C) (1990). The NYSBA suggests that the "SEC" standard be retained.

¹²⁵ NYSBA, *supra* note 84, at 22.

¹²⁶ I.R.C. § 336(a) (1986).

¹²⁷ I.R.C. § 331(a) (1986).

¹²⁸ In *General Utilities v. Helvering*, 296 U.S. 200 (1935), the Supreme Court did not find it necessary to rule on whether a corporation recognized gain on the distribution of appreciated property; *See BITTKER & EUSTICE, supra* note 15, at ¶ 7.20.

¹²⁹ I.R.C. § 311(a)(2),(b) (1986); I.R.C. § 336 (West Supp. 1984) (repealed 1986).

corporations is involved, the possibility of more than two levels of taxation arises. For example, assume A, an individual, owns all the stock of Y, which owns all the stock of Z. Assume Z liquidates into Y, and Y then liquidates and distributes all of its properties to A. If the gain recognition rules were given full reign the result would be three levels of taxation: (1) Z would recognize any gain inherent in its properties; (2) Y would recognize gain to the extent that the fair market value of the liquidating distribution exceeded the basis in its Z stock. Y's gain on its distribution of property could be taxable, but since Y would have taken a fair market value basis in the property received from Z,¹³⁰ if Z had been required to recognize gain, there would be no gain for Y to recognize on its distribution of the property received from Z); (3) A would also recognize gain to the extent that the fair market value of the liquidating distributor exceeded the basis of A's stock. The result is three levels of taxation. If more levels of corporations were involved, more levels of taxation would be possible. Virtually all profits could be paid to the taxman. Consequently, section 337 provides that a subsidiary will not recognize any gain or loss if it makes a liquidating distribution to an eighty per cent or greater corporate parent.¹³¹ The Code provides that an eighty per cent or greater parent will also not recognize any gain or loss on its receipt of property in a liquidation of its subsidiary.¹³² The parent takes a carryover basis in the property received.¹³³

That system works well as long as A, Y and Z are subject to United States taxation. If, for example, only Z is a domestic corporation, Y is a foreign corporation, A is a nonresident alien, and both Z and Y escape U.S. taxation on their liquidating distributions, the United States may never again have the chance to tax the appreciation inherent in the distributed property, particularly if it is disposed of by foreign persons in a foreign jurisdiction.¹³⁴ Congress addressed this situation by providing in section 367(e)(2) that when the eighty per cent distributee is a foreign corporation, section 337 will not apply except to the extent provided in regulations. The regulations have two sets of provisions, one for liquidat-

¹³⁰ I.R.C. § 331, 334 (1986).

¹³¹ I.R.C. § 337(a) (1986). Technically, the distribution must be made to an "80-percent distributee," (*i.e.* a corporation who owns "at least 80 percent of the total voting power" of the distributing corporation and whose total stock ownership has "a value equal to at least 80 percent of the total value of the stock of the [distributing] corporation"). I.R.C. §§ 1504(a)(2), 332(b)(1) and 337(c) (1986).

¹³² I.R.C. §§ 332, 1504(a)(2) (1986).

¹³³ I.R.C. § 334(b)(1) (1986) (amended 1988).

¹³⁴ *See supra* notes 3-5 and accompanying text. *See also* I.R.C. § 864(c)(7) (1986).

ing distributions made by domestic subsidiaries and one for liquidating distributions made by foreign subsidiaries.

A. Liquidating Distributions by Domestic Subsidiaries

1. Generally

If section 337 does not apply, a corporation generally will recognize both the gain and loss inherent in the property distributed in liquidation.¹³⁵ If section 367 restricts the application of section 337 because a liquidating distribution is made by a domestic subsidiary to a foreign parent, the regulations under section 367(e)(2) provide that that gain will be recognized by the domestic subsidiary, but limitations are placed on the extent to which losses may be recognized.¹³⁶

Losses are broken into two categories, capital losses and ordinary losses. Capital losses may only be recognized to the extent of capital gains recognized on the liquidating distribution, and ordinary losses may only be recognized to the extent of ordinary income recognized on the distribution.¹³⁷ If only a portion of the losses is recognized, then the capital and ordinary losses are treated as being recognized on a "pro rata basis."¹³⁸ The regulations do not specifically provide how this is to be done, but presumably recognized losses will be allocated among the distributed properties based on the gross loss associated with each property.¹³⁹ The foreign parent's basis in the distributed property is the domestic subsidiary's basis, increased by any gain and decreased by any loss recognized by the domestic subsidiary.¹⁴⁰ To the extent that the subsidiary is not permitted to recognize a loss, the foreign parent will take the distributed property with a higher basis, and may itself, therefore, recognize the loss on a later taxable disposition of the property.¹⁴¹ While

¹³⁵ I.R.C. § 336(a) (1986).

¹³⁶ Temp. Treas. Reg. § 1.367-2T(b)(1)(i) (1990).

¹³⁷ Temp. Treas. Reg. § 1.367-2T(b)(1)(ii) (1990).

¹³⁸ *Id.*

¹³⁹ For example, assume the subsidiary only holds property A with a fair market value of \$1,000 and a basis of \$1,300, property B with a fair market value of \$500 and a basis of \$1,100, and property C with a fair market value of \$600 and a basis of \$300. Total capital losses equal \$900 and total capital gains equal \$300. The subsidiary will recognize \$300 of capital gains with regard to property C. This means that the subsidiary may only recognize \$300 of the total of \$900 of capital losses it has with respect to properties A and B. The allocation of the recognized losses to properties A and B would presumably take place as follows:

$\$300/\$900 \times \$300$ or \$100 of the recognized loss would be allocated to property A and $\$600/\$900 \times \$300$ or \$200 of the recognized loss would be allocated to property B.

¹⁴⁰ Temp. Treas. Reg. § 1.367(e)-2T(b)(3)(i) (1990).

¹⁴¹ In the example discussed in note 139, *supra*, the parent's basis in property A would be \$1,300 - \$100 or \$1,200 (giving it an inherent loss in the property of \$200), and its basis in property B would be \$1,100 - \$200 or \$900 (giving the parent an inherent loss of \$400).

section 337 does not apply to the domestic subsidiary, section 332 continues to apply to the foreign parent which therefore recognizes no gain or loss on its receipt of the liquidating distribution.

The treatment of capital losses is consistent with their treatment under section 1211(a).¹⁴² However, the limitation on the use of ordinary losses is curious. Ordinary losses normally may be deducted from any type of income, including capital gains, and there is no obvious reason why this should not be true in the section 367 context.¹⁴³

If the domestic subsidiary has a significant amount of gain to recognize, the foreign parent may be tempted to contribute loss property to the domestic subsidiary, which normally can be done tax free under section 351.¹⁴⁴ Section 367(a) would not prevent section 351 from applying, because the contribution would be to a domestic corporation, whereas section 367(a) only applies to transfers to foreign corporations. The domestic subsidiary would take a carryover basis in the property and could then use the losses to offset the gains recognized in the subsequent liquidating distribution.¹⁴⁵ As noted above, the foreign parent's basis in the loss property distributed back in liquidation would be the domestic subsidiary's basis reduced by the losses recognized by the domestic subsidiary.¹⁴⁶ On the distribution of the loss property back to the foreign parent, therefore, the foreign parent would take a lesser basis than it had on the property prior to the contribution to the domestic subsidiary. However, the foreign parent might prefer this route which would save the domestic subsidiary tax dollars on the recognized gains, leaving more for the foreign parent to receive in the distribution.

It is difficult to justify the recognition of losses by the domestic subsidiary solely for purposes of the liquidation, especially when the property was not used by the domestic subsidiary in its business in any significant way. Consequently, the regulations provide an "anti-stuffing" rule. The domestic subsidiary may not recognize losses on properties acquired within five years of the liquidation through a capital contribution, a liquidation under section 332, or an exchange under section 351 or 361.¹⁴⁷ (Like section 351, the other provisions permit the transferor to transfer the property to the domestic subsidiary tax free, and the domestic subsidiary to receive the property tax free, with a carryover basis.)¹⁴⁸

¹⁴² I.R.C. § 1211(a) (1986).

¹⁴³ I.R.C. § 165(a) (1986).

¹⁴⁴ I.R.C. § 351 (1986).

¹⁴⁵ I.R.C. § 362(a) (1986).

¹⁴⁶ I.R.C. § 358(a)(1) (1986).

¹⁴⁷ Temp. Treas. Reg. § 1.367(e)-2T(b)(1)(ii) (1990).

¹⁴⁸ See I.R.C. §§ 332, 351, 361 (1986).

While the Service's concern is legitimate, section 336(d) already has an otherwise applicable anti-stuffing rule.¹⁴⁹ Section 336(d) reflects Congress's view of when a corporation should be prohibited from recognizing losses in liquidation, and it is questionable for the Service to provide a separate (and somewhat expanded) rule in the section 367 context.¹⁵⁰

The regulations do not provide an exception for contributions made on formation (which is consistent with section 336(d)). Consequently, if a domestic subsidiary has been in existence for less than five years at the time of the liquidation, all losses it recognizes on liquidation will be disallowed, even if the properties were owned by the domestic subsidiary at the outset and used in its business. Property contributed on formation, particularly if used in the domestic subsidiary's business, is not likely to be at the center of a tax avoidance scheme. If the Service is going to have a separate rule from section 336(d), it should consider allowing the recognition of losses on the distribution of such property in liquidation even if the liquidation occurs within five years of contribution.

The Service's position is also inequitable when a domestic subsidiary liquidates into a domestic parent which in turn immediately liquidates into its foreign parent in a liquidation otherwise qualifying under sections 337 and 332. The domestic parent will take a carryover basis in the assets of its domestic subsidiary.¹⁵¹ The domestic parent will not be permitted to recognize any losses inherent in the property received from its domestic subsidiary, because it did not hold the property for the requisite five years. No policy basis for this position exists. There is no tax abuse in permitting the domestic parent to recognize losses inherent in the assets of its own domestic subsidiary, at least if the domestic subsidiary held those assets longer than five years. The domestic subsidiary should be considered an extension of its domestic parent for these purposes.¹⁵² This is particularly true, since the regulation's anti-stuffing rule can be easily avoided by liquidating the domestic parent first.

The regulations do not address the possibility of gain property being contributed in contemplation of liquidation. A domestic subsidiary could have losses inherent in its properties which it could not use under the regulations due to the fact that it has inadequate gains. The foreign parent could be tempted to increase the capital gain or ordinary income property that the liquidating corporation has in order to take full advan-

¹⁴⁹ I.R.C. § 336(d) (1986) (amended 1988). See NYSBA, *supra* note 84, at 13.

¹⁵⁰ I.R.C. § 336(d) applies to property acquired in a section 351 transaction or as a contribution to capital. The regulation's anti-stuffing rule applies in those circumstances, but also applies to property received under sections 332 or 361. See *supra* notes 147-149 and accompanying text.

¹⁵¹ I.R.C. § 334(b)(1) (1986) (amended 1988).

¹⁵² NYSBA, *supra* note 84, at 13.

tage of the losses. For example, if the foreign parent is holding appreciated property and the domestic subsidiary has excess losses, the foreign parent could make a contribution of gain property to the domestic subsidiary shortly before the liquidation. The contribution would be tax free and the domestic subsidiary would take a carryover basis in the property.¹⁵³ The domestic subsidiary would recognize the gain inherent in the contributed property on liquidation. The gain would be offset by the preexisting losses.

Whether or not the foreign parent will want to do this will be a function of how and where it wants to use the relevant properties. Assuming the domestic subsidiary otherwise had no gain property, and no gain properties are contributed, the foreign parent will take a full carryover basis in the loss properties it received in the liquidating distribution.¹⁵⁴ This permits it to recognize the loss at a later date and/or generate higher depreciation deductions in the interim.¹⁵⁵ If, on the other hand, gain property is contributed to the domestic subsidiary, the domestic subsidiary will be able to recognize some of its losses. To the extent it does so, the foreign parent is required to reduce its carryover basis in the distributed loss property by the loss recognized. The converse applies with regard to the contributed property on which gain was recognized. The foreign parent will receive these properties back with a stepped up basis, which can be used to generate higher depreciation deductions.

Example

Assume the domestic subsidiary holds only one piece of property, equipment with a basis of \$200, and a fair market value of \$100. If the foreign parent does nothing, it will receive the equipment with the \$200 basis, and the loss will go unrecognized. Conversely, assume prior to the liquidation the foreign parent contributes machinery with a basis of \$100 and a fair market value of \$200 in exchange for stock, which is tax free under section 351.¹⁵⁶ The domestic subsidiary will take a carryover basis in the machinery.¹⁵⁷ On the liquidating distribution the domestic subsidiary will recognize the \$100 loss on the equipment and the \$100 gain on the machinery, for a net gain of zero. The foreign parent takes a basis of \$100 in the equipment (\$200 basis — \$100 loss) and a basis of \$200 in the machinery (\$100 basis + \$100 gain).

Absence of a rule in this area gives the foreign parent a planning opportunity. It can leave well enough alone, if it prefers a higher basis in

¹⁵³ I.R.C. §§ 351(a), 362(a) (1986).

¹⁵⁴ Temp. Treas. Reg. § 1.367(e)-2T(b)(3)(i) (1990).

¹⁵⁵ See I.R.C. §§ 167, 168 (1986).

¹⁵⁶ I.R.C. § 351 (1986).

¹⁵⁷ I.R.C. § 358(a)(1) (1986).

the domestic subsidiary's loss property. Alternatively, if the foreign parent prefers a higher basis in gain property it holds, it can contribute those properties to the domestic subsidiary shortly before the liquidation. This manipulation of the bases of property is hard to justify and the Service should promulgate a rule for gain property converse to that for losses.

2. Partnership Interests

If the property distributed is a partnership interest, the determination of what is distributed is somewhat more complex. A partnership interest is typically a capital asset, but represents a right to partnership property, which may consist of ordinary income property, capital assets, or both. Consequently, the regulations provide that if the domestic subsidiary distributes a partnership interest in liquidation, it is treated as having distributed its proportionate share of the partnership assets.¹⁵⁸ The foreign corporation's basis in the distributed partnership interest is the same as that of the domestic subsidiary's increased by the gain and reduced by the loss recognized.¹⁵⁹

An exception to the partnership rule is provided for limited partnership interests which are regularly traded on an established securities market.¹⁶⁰ This type of partnership interest is treated as stock, meaning gain or loss is recognized based on the character of the limited partnership interest to the domestic subsidiary, and not the character of the underlying partnership assets.¹⁶¹ This exception was probably motivated by the significant practical problem that exists in determining what a limited partner's share of partnership assets is in a large, publicly traded partnership. The exception will have limited application, however, since only publicly traded partnerships, the income of which consists principally of certain types of passive income, will be treated as partnerships for tax purposes. Other publicly traded partnerships, although they may be considered partnerships for state law purposes, are taxed as corporations

¹⁵⁸ Temp. Treas. Reg. § 1.367(e)-2T(b)(1)(iii)(A) (1990). Where the property of the partnership includes an interest in a lower-tier partnership the applicability of any exception with respect to the interest in the lower-tier partnership is determined with reference to the property of the lower-tier partnership. "A domestic corporation's proportionate share of partnership property [is] determined under the rules and principles of [I.R.C.] §§ 701 to 706 and the regulations thereunder". *Id.*

¹⁵⁹ Temp. Treas. Reg. § 1.367(e)-2T(b)(1)(iii)(B) (1990). For purposes of I.R.C. §§ 743 and 754, "the foreign corporation [is] treated as having purchased the partnership interest for an amount equal to [this basis]". *Id.* This permits the parent to take an "inside basis" in the partnership assets equal to its "outside basis," assuming an I.R.C. § 754 election is in effect.

¹⁶⁰ Temp. Treas. Reg. § 1.367(e)-2T(b)(1)(iii)(C) (1990). "Whether [a limited partnership] interest is regularly traded on an established securities market [is] determined under [Temp. Treas. Reg.] § 1.367(a)-1T(c)(3)(ii)(D)".

¹⁶¹ Temp. Treas. Reg. § 1.367(e)-2T(b)(1)(iii)(C) (1990).

under section 7704.¹⁶²

3. *Exception for Continued Use In United States Trade or Business*

Section 337 will be permitted to apply when the distributed property has been used by the domestic subsidiary and continues to be used by the foreign parent in a United States trade or business provided a number of other requirements are met.¹⁶³ To qualify for this exception, gain on the sale of the distributed property would have to be considered effectively connected with a United States trade or business (as would typically be the case).¹⁶⁴ Income effectively connected with a United States trade or business is subject to United States taxation at the ordinary income, graduated rates.¹⁶⁵ Since the property is not being removed from the United States taxing jurisdiction, one of the principal reasons for the enactment of section 367 does not apply, and the exception generally makes sense.

Another requirement is that the foreign parent cannot be a controlled foreign corporation (CFC).¹⁶⁶ The reason for this requirement is not clear. A CFC is a foreign corporation in which more than half of the voting stock or more than half of the outstanding stock by value is owned by "U.S. shareholders."¹⁶⁷ United States shareholders are United States persons who own ten percent or more of the voting stock of the CFC.¹⁶⁸

¹⁶² I.R.C. § 7704 (1986). The NYSBA, *supra* note 84, at 14 notes the following: In general, the Committee approves of Reg. Sec. 1.367(e)-2T(b)(1)(iii), which adopts a complete look-through approach to liquidating distributions of partnership interests. The Committee seeks clarification, however, of the coordination of the FIRPTA nonrecognition rule, the general nonrecognition rule of Reg. Sec. 1.367(e)-2T(b)(2)(i), and the statute and regulations under Section 897(g), which do not incorporate a complete look-through approach to the treatment of partnership interests. Under Reg. Sec. 1.897-7T, a partnership interest itself may be treated in full, in part, or not at all, as a U.S. real property interest. (*But see* Notice 88-72, 1988-2 C.B. 383.) The Committee assumes that the look-through rules of Reg. Sec. 1.367(e)-2T(b) take precedence, but this should be clarified.

The Committee also seeks clarification of the effect of the rule which treats the distribution of a publicly-traded limited partnership interest 'in the same manner as a distribution of stock'. Reg. Sec. 1.367(e)-2T(b)(1)(iii)(C). Presumably, this rule was adapted from the partnership rules of Reg. Sec. 1.367(a)-1T(c)(3), where the effect of treatment as 'stock' is clear. Treatment as stock under Section 1.367(e) of the Regulations, however, does not answer whether the limited partnership interest is a U.S. trade or business asset . . . and leaves other open questions, such as how gain or loss recognized in respect of such a distribution interacts with the 'netting rules' for recognition of ordinary and capital losses.

¹⁶³ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i) (1990).

¹⁶⁴ *Id.* Generally, all U.S. source gross income of a foreign person is considered to be "effectively connected" if that person is engaged in a trade or business in the U.S. I.R.C. § 864(c)(1),(3) (1986). *See* M. McINTYRE, *supra* note 4, at 2-17.

¹⁶⁵ I.R.C. § 882(a)(1) (1986).

¹⁶⁶ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i)(A)(1) (1990).

¹⁶⁷ I.R.C. § 957(a) (1986).

¹⁶⁸ I.R.C. § 951(b) (1986).

Certain classes of, in the main, passive income of a CFC are taxed to the U.S. shareholders when earned by the CFC, regardless of whether or not the income is distributed to the shareholders ("section 951 income").¹⁶⁹ But for the CFC rules, and certain other rules such as the foreign personal holding company rules,¹⁷⁰ United States taxpayers could earn foreign passive income through a foreign corporation and defer United States taxation until repatriation, since foreign corporations are not normally subject to United States taxation on foreign income.¹⁷¹ General business income of a CFC does not flow through to the United States shareholders, but if that income is earned in the United States through a United States trade or business, it is, of course, subject to United States taxation.¹⁷² Accordingly, if the other requirements of the regulatory exception are met, income from the disposition of the property by the foreign parent would still be effectively connected with a United States trade or business, and still subject to a United States tax on disposition, regardless of whether or not the foreign parent is a CFC. Why the Service requires the foreign parent not to be a CFC is therefore uncertain.

A further requirement of the United States trade or business exception is that the foreign parent use the distributed property in the conduct of a United States trade or business for ten years from the date of the distribution.¹⁷³ If the property fails to be used in a United States trade or business for the specified time, the foreign parent is required to cause the domestic subsidiary to amend its return for the year of the distribution, and pay tax on the unrecognized gain plus interest from the date of the distribution.¹⁷⁴ The domestic subsidiary is not required to file an amended return if the foreign parent disposes of the property in a transaction in which gain or loss is recognized in full and the entire amount of any gain is reported on a timely filed United States tax return.¹⁷⁵ Apparently under any other circumstances, including a partial recognition or reporting of gain by the foreign parent for United States tax purposes, the domestic subsidiary is required to amend its return and report the gain in *full*.¹⁷⁶ To the extent that the domestic subsidiary recognizes a gain, the basis of the property in the hands of the foreign parent is in-

¹⁶⁹ I.R.C. § 951(a) (1986). The foreign corporation must qualify as a CFC for an uninterrupted period of 30 days during the tax year. *Id.*

¹⁷⁰ See I.R.C. §§ 551-558 (1986).

¹⁷¹ See M. MCINTYRE, *supra* note 4, at 6-3 - 6-7.

¹⁷² I.R.C. § 882(a)(1) (1986).

¹⁷³ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i)(A)(2) (1990). In the case of inventory, the parent must continue to hold property for sale to customers. *Id.*

¹⁷⁴ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i)(C)(3), (5) (1990).

¹⁷⁵ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i)(C)(3) (1990).

¹⁷⁶ *Id.*

creased.¹⁷⁷ Any gain recognized by the foreign parent on its disposition will not include the gain recognized by the subsidiary, and the latter gain will, therefore, only be taxed once. In most situations the foreign parent will recognize its gain in full, and since the property is used in a United States trade or business, the gain will be fully reportable in the United States. Consequently, the domestic subsidiary usually will not have to amend its return.

While the domestic subsidiary may be required to recognize gain under the ten year rule, it may not recognize any realized losses that went unrecognized in the year of liquidation.¹⁷⁸ Why the domestic subsidiary should be treated more harshly than it would have been had the United States trade or business exception not applied at the outset is not immediately apparent.¹⁷⁹ In the latter circumstance the domestic subsidiary would have been permitted to recognize certain losses to the extent of certain gains.¹⁸⁰ The loss recognition should continue to be permitted when an amended return is required because the United States trade or business exception is not met for the relevant term.

The ten year use rule will not be violated if United States trade or business property is exchanged under section 1031 for, or involuntarily converted under section 1033 into, other property used in a United States trade or business.¹⁸¹ Both sections contain nonrecognition provisions. There is no reason not to permit them to fully apply, as long as the investment continues in United States trade or business property. The requirements of the United States trade or business exception also will not be breached if property is distributed under section 337 in a manner that otherwise qualifies for nonrecognition under the regulations, or if the property is abandoned or disposed of as worthless or obsolete.¹⁸² Similar situations that are not excepted by the regulations, but should be, include expropriation by a foreign government, casualty losses, contributions to partnerships under section 721, and if the partnership continued to use the property in a United States trade or business.¹⁸³ Annual certification

¹⁷⁷ *Id.*

¹⁷⁸ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i)(C)(1) (1990). The regulations provide that "losses" (presumably meaning net operation loss carryovers) which were not available to the subsidiary in the year of the distribution may be used to offset the gains. *Id.*

¹⁷⁹ See *supra* notes 135-141 and accompanying text; See also NYSBA, *supra* note 84, at 13.

¹⁸⁰ See *supra* notes 135-141 and accompanying text.

¹⁸¹ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i)(C)(4) (1990). The foreign parent and the domestic subsidiary must file amended returns for the year of liquidation to substitute the property received in place of the property exchanged or converted. *Id.*

¹⁸² Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i)(C)(4) (1990). The rules of Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(i) (1990) will apply.

¹⁸³ NYSBA, *supra* note 84, at 15.

of the use in the United States trade or business is required, which should enable the Service to keep adequate tabs on the location of its source for the collection of taxes when and if they become due.¹⁸⁴

The requirement that a liquidated domestic subsidiary file an amended return for up to ten years after the liquidation is troublesome. The foreign parent is entitled to step up its basis in the distributed property by the amount of any recognized gain reported on the amended return.¹⁸⁵ That increased basis can generate increased depreciation deductions to the foreign parent.¹⁸⁶ Consequently, if the liquidated subsidiary must amend its original return, the foreign parent may also need to amend its returns for any open intervening years to permit it to take the extra depreciation.¹⁸⁷ Moreover, the gain may permit the domestic subsidiary to use its net operating loss carryovers that otherwise flowed through to the foreign parent under section 381.¹⁸⁸ This reduction in the availability of net operating losses to the foreign parent will require it to amend its returns for those years in which it used the losses to offset income. These amendments can become an accounting nightmare.

An alternative procedure recommended by the New York State Bar Association (NYSBA) requires the foreign parent to recognize the gain on removal of the property from a United States trade or business notwithstanding section 864(c)(7) (which only requires gain recognition if the removed property is *disposed of* within ten years of the time it ceases to be used in a United States trade or business).¹⁸⁹ This is a sensible alternative that solves the problems created by the present regulations. The foreign parent's trade or business assets represent the collateral for the payment of the tax, which is fair because the domestic subsidiary has disappeared and the foreign parent as shareholder would typically be liable to the extent of distributions for the debts including unpaid taxes of the subsidiary.¹⁹⁰ In addition, the NYSBA would not require the foreign parent to pay interest on the tax.¹⁹¹ This position is less defensible. Since the tax was not assessed at the outset on the condition that the property would be used in a United States trade or business for ten years, failure to meet the ten-year requirement justifies the payment of interest on the tax during the term the tax was not paid.

¹⁸⁴ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i)(B),(C) (1990).

¹⁸⁵ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i)(C)(3) (1990).

¹⁸⁶ See I.R.C. §§ 167, 168 (1986).

¹⁸⁷ See NYSBA, *supra* note 84, at 11.

¹⁸⁸ I.R.C. §§ 381 (1986). See I.R.C. § 382 (1986).

¹⁸⁹ See NYSBA, *supra* note 84, at 11; I.R.C. § 864(c)(7) (1986).

¹⁹⁰ See, e.g., MD. CORPS. & ASS'NS. § 3-419 (1985). See also I.R.C. §§ 6901-6905 (1986).

¹⁹¹ See NYSBA, *supra* note 84, at 11.

The requirement that the domestic subsidiary amend its return if the foreign parent does not use the property in a United States trade or business for ten years raises an interesting planning opportunity if the domestic subsidiary has net operating loss carryovers (NOL's). Section 382 places limits on the use of NOL's if a "change in ownership"¹⁹² of the corporation occurs. In any given year, the general limitation is the value of the corporation, before the change, multiplied by the long term tax exempt rate.¹⁹³ The liquidation of an eighty percent owned domestic subsidiary into its foreign parent is not a change in ownership.¹⁹⁴ The foreign parent will inherit the domestic subsidiary's NOL's¹⁹⁵ and will be able to fully utilize them without regard to section 382's limitations.¹⁹⁶ If the foreign parent, however, is involved in a change of ownership after the subsidiary's liquidation, the section 382 limitation could apply thereafter. Depending on the value at the time of the change in ownership, the section 382 limitation can virtually eliminate the availability of the pre-change NOL's to the post-change corporation. To avoid this effect, the foreign parent may wish to cease using the distributed property in a United States trade or business prior to the expiration of the ten year term. The domestic subsidiary would then be forced to recognize any gain inherent in the distributed property as of the date of the liquidation. The domestic subsidiary at this point can use its available NOL's that might otherwise be suspended for periods following the foreign parent's change of ownership.

The Service probably derived the ten year term of the United States trade or business exception from section 864(c)(7).¹⁹⁷ As indicated above, section 864(c)(7) provides that if property ceases to be used in connection with a United States trade or business by a foreign person and the property is disposed of within ten years of such cessation, the gain is considered to have been incurred immediately prior to the cessation.¹⁹⁸ Thus the gain is effectively treated as being connected with a United States trade or business, making it subject to United States taxation.¹⁹⁹ One of the objectives of this code section is to prevent foreign taxpayers from avoiding United States taxes by withdrawing property from a

¹⁹² See I.R.C. § 382(a), (b), (g) (1986). See also Parker, *The Innocent Civilians in the War Against NOL Trafficking: Section 382 and High Tech Start Up Companies*, 9 VA. TAX REV. 625 (1990).

¹⁹³ See I.R.C. § 382(g) (1986).

¹⁹⁴ See I.R.C. § 382(b)(1) (1986).

¹⁹⁵ See I.R.C. §§ 381 and 382(l)(3) (1986). See also Temp. Treas. Reg. §§ 7.367(b)-10, 11 (1977).

¹⁹⁶ See *supra* notes 193-94 and accompanying text.

¹⁹⁷ I.R.C. § 864(c)(7) (1986).

¹⁹⁸ *Id.*

¹⁹⁹ I.R.C. § 882(a)(1) (1986).

United States business and promptly selling it overseas.²⁰⁰

As a result of the regulation and section 864(c)(7), income from the disposition of United States trade or business property by a foreign person can be subject to United States taxation for a very lengthy period after distribution by the domestic subsidiary. The ten year use requirement of the regulation when added to the ten year cease-of-use-rule of section 864(c)(7), potentially makes such gain subject to United States taxation for twenty years after the liquidating distribution.²⁰¹ This seems excessive. Either section 864(c)(7) should not apply in this context, or the required period of use under the United States trade or business exception should be shortened. Three years seems sufficient to insure a good faith use in a United States business.²⁰²

The United States trade or business exception does not apply to the distribution of intangibles.²⁰³ This is presumably because of section 367(d), which contains a special rule for intangibles.²⁰⁴ Under section 367(d), no gain or loss is recognized on the outbound transfer of intangibles, such as patents, in an exchange described in sections 351 or 361.²⁰⁵ Instead, the United States transferor is treated as having sold the intangibles for annual payments which are contingent on the use of the intangibles.²⁰⁶ The deemed annual payments are a function of the income actually earned.²⁰⁷ Thus, a taxpayer cannot incur deductible research expenses in this country²⁰⁸ and then transfer the resulting patent or other intangible to a foreign corporation and lodge the income it earns outside the United States. Section 367(d), in effect, requires whatever an appropriate annual return would be on a transfer of the intangible (the determination of which may be no easy matter) to be deemed to be paid to the transferor, making it subject to United States taxation. How section 367(d) can apply in the section 367(e)(2) context is decidedly unclear, however, since the United States taxpayer, being liquidated, no longer exists to receive the imputed income.²⁰⁹ The fact that section 367(d) is designed to have prophylactic application in its area, and the

²⁰⁰ See M. McINTYRE, *supra* note 4, at 2-15.

²⁰¹ See Mogenson and Rogers, *New Temporary Regulations on Outbound Distributions and Liquidations: An Analysis*, 72 J. TAX'N 304, 309 (1990). Removal of the property from the U.S. also has potential branch profit tax implications. See I.R.C. § 884 (1986).

²⁰² See *infra* notes 225-227 and accompanying text.

²⁰³ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i) (1990).

²⁰⁴ I.R.C. § 367(d) (1986).

²⁰⁵ I.R.C. § 367(d)(1) (1986).

²⁰⁶ I.R.C. § 367(d)(2) (1986).

²⁰⁷ *Id.*

²⁰⁸ See I.R.C. § 174 (1986).

²⁰⁹ See Mogenson and Rogers, *supra* note 201, at 309.

fact that the intangibles could have a payout period well beyond the ten year use term, probably induced the Service to make intangibles an exception to the exception.

4. Distribution of U.S. Real Property Interests

The regulations provide that gain need not be recognized, assuming section 337 would otherwise apply, on the distribution of a United States real property interest.²¹⁰ If both the United States trade or business and the United States real property interest exceptions apply, the latter controls.²¹¹ Since a United States real property interest represents an asset readily accessible by the fisc, the concerns that give rise to section 367(e)(2) do not apply, hence the exception.²¹²

This general rule will not apply and gain will be recognized if the distributed stock is in a former USRPHC, which section 897 continues to treat as a United States real property interest for five years after the corporation ceases to be a USRPHC.²¹³ The fact that a United States tax could be avoided after a fairly short waiting period probably induced the promulgation of this latter provision. The regulations fail to expressly discuss losses but presumably losses will also be recognized in this circumstance. The regulations should be clarified in this regard.²¹⁴

B. Distributions By Foreign Subsidiaries

When a foreign corporation makes a liquidating distribution to another foreign corporation otherwise qualifying under sections 332 and 337, the policy issues differ. From the perspective of the United States government, typically it does not make a difference whether the foreign subsidiary or foreign parent holds the property. Either way, the property is held by a foreign corporation and the same types of policy considerations apply. The property is not taken out of the hands of a person sure to pay United States taxes and put in the hands of someone not sure to do so, as would be the case when a domestic corporation makes a distribution to a foreign distributee. Consequently, no overwhelming need to impose a tax on the foreign subsidiary's liquidating distribution exists. Accordingly, the regulations provide that, in general, section 337 will apply and no gain or loss will be recognized on an otherwise qualifying

²¹⁰ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(ii) (1990).

²¹¹ *Id.*

²¹² See *supra* notes 50-56 and accompanying text.

²¹³ Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(ii) (1990).

²¹⁴ See NYSBA, *supra* note 84, at 14.

liquidation of the foreign subsidiary.²¹⁵ Of course, if the property itself is held outside the United States, the fisc would normally also have no jurisdiction to impose a tax, since the transaction would be entirely foreign.²¹⁶

The foreign parent takes a carry-over basis in the distributed property, increased by any gain recognized by the foreign subsidiary on the distribution (as discussed below, gain can be recognized under certain circumstances).²¹⁷ If the distributed property consists of a partnership interest, the subsidiary is treated as having distributed a proportionate share of the partnership property, as was the case for domestic subsidiaries discussed above.²¹⁸ Presumably, the rules for distributions of limited partnership interests are the same for foreign subsidiaries as they were for domestic subsidiaries. The regulations are nebulous in this regard.²¹⁹

The premise upon which the continued application of section 337 is based will not apply if the foreign subsidiary uses the property in a United States trade or business and the foreign parent does not intend to. In that event, the government may lose its opportunity to collect a tax on any gain inherent in the property. While the property is used in a United States trade or business it is subject to United States taxation.²²⁰ Once it is removed, section 864(c)(7) can apply, but there are the practical problems of collection.²²¹ Accordingly, the regulations provide that the liquidating foreign subsidiary will recognize gain (but not loss) to the extent the distributed property (other than United States real property interests) is used in the conduct of a trade or business within the United States at the time of the liquidation, unless the foreign parent continues to use the property in the conduct of a United States trade or business for

²¹⁵ Temp. Treas. Reg. § 1.367(e)-2T(c)(1) (1990).

²¹⁶ See M. MCINTYRE, *supra* note 4, at 1-19 - 2-9.

²¹⁷ Temp. Treas. Reg. § 1.367(e)-2T(c)(3)(i) (1990). The basis cannot exceed the fair market value of the property if the foreign parent recognizes gain under I.R.C. § 897(e) (1986) or the regulations thereunder. *Id.* See also I.R.C. § 367(b) (1986) and its regulations.

²¹⁸ Temp. Treas. Reg. § 1.367(e)-2T(c)(1) (1990); see notes 158-162 and accompanying text.

²¹⁹ The relevant sentence in the regulations reads as follows: "If a distributing foreign corporation distributes an interest as a partner in a partnership (whether domestic or foreign), then such a corporation shall be treated as having distributed a proportionate share of the property of the partnership in accordance with the principles of [Temp. Treas. Reg. § 1.367(e)-2T(b)(1)(iii)]." Temp. Treas. Reg. § 1.367(e)-2T(c)(1) (1990). The referenced regulation includes a discussion of distributions of limited partnerships, but it is unclear whether this reference, which focusses on the "proportionate share," is sufficient to incorporate that discussion. Temp. Treas. Reg. § 1.367(e)-2T(b)(1)(iii) provides for distributions of limited partnership interests, which under that regulation do not receive proportionate share treatment. See *supra* notes 158-162 and accompanying text.

²²⁰ See I.R.C. § 882 (1986).

²²¹ I.R.C. § 864(c)(7) (1986); see *infra* notes 228-231 and accompanying text.

ten years.²²² The trade or business need not be the same and in addition, any treaty benefits that could reduce or eliminate the United States tax must be waived.²²³ Notification and certification rules apply.²²⁴

The provisions regarding United States trade or business property are at least partially defensible. If the property were not used at all by the parent in a United States trade or business, section 864(c)(7) would require gain recognition on the liquidating distribution.²²⁵ This gain recognition occurs because a liquidating distribution simultaneously meets the two preconditions to the application section 864(c)(7): (1) a disposition of the property and, (2) cessation of its use in a United States trade or business.²²⁶ In addition to the collection problems, it would not seem appropriate for a taxpayer to be able to defer this gain recognition simply by having the foreign parent use the property in a United States trade or business for a short amount of time, and then transfer it to a foreign branch (which meets the cease-of-use test, but presumably not the disposition test). Accordingly, some meaningful United States use is appropriate. For the reasons stated above, the ten year property-use period seems excessive, and three years would be more appropriate.²²⁷

The gain can not be avoided by ceasing to use the property in the United States trade or business within a short (or even fairly long) time before the liquidation. If the property (other than United States real property interests) ceases to be used in a United States trade or business by the liquidating corporation within ten years prior to the liquidation, the regulations also require gain recognition on the distribution.²²⁸ This overlaps entirely with section 864(c)(7). That section also applies to any "disposition" after a property has ceased to be used in a United States trade or business 864(c)(7).²²⁹ Liquidating distributions are a form of disposition. The regulations do provide that section 864(c)(7) will govern the treatment of any gain recognized, in other words, that the income will be treated as effectively connected with the conduct of a trade or business.²³⁰ But section 864(c)(7) would appear to apply in its en-

²²² Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(i)(A) (1990). A foreign corporation includes a foreign corporation that makes an I.R.C. § 897(i) (1986) election to be treated as a domestic corporation. *Id.*

²²³ Temp. Treas. Reg. §§ 1.367(e)-2T(c)(2)(i)(B) (1990).

²²⁴ Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(i)(B) (1990).

²²⁵ I.R.C. § 864(c)(7) (1986).

²²⁶ *Id.*

²²⁷ See *supra* notes 201-202 and accompanying text.

²²⁸ Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(ii) (1990).

²²⁹ I.R.C. § 864(c)(7) (1986).

²³⁰ Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(ii) (1990).

tirety, not just for gain characterization purposes. This part of the regulation thus appears unnecessary and should therefore be repealed.

Losses may not be recognized and offset against recognized gains, even if of the same character.²³¹ It seems curious that losses are entirely disallowed here, but allowed to the extent of gains when the subsidiary is a domestic corporation. There does not appear to be a policy justification for this discrimination, and the rule should be the same in both contexts.

An exception to the exception exists. Even if the foreign parent does not use the property in the conduct of a United States trade or business for ten years, it does not recognize gain on the liquidating distribution, if the following requirements are met:

1. Both the foreign subsidiary and its foreign parent are CFC's.²³²
2. The foreign parent uses the property in the conduct of a trade or business within the United States immediately after the distribution (but not necessarily for ten years). Section 864(c)(7) can therefore apply to subsequent dispositions, hence this requirement.²³³
3. There was no prior liquidating distribution subject to section 367(e)(2) of a domestic or foreign corporation into the foreign subsidiary (or predecessor corporation) involving property used in a United States trade or business (other than from a CFC into another CFC).²³⁴
4. The foreign parent is not entitled to benefits under a comprehensive income tax treaty, but if the foreign subsidiary (or predecessor corporation) was entitled to benefits under such a treaty, the foreign parent may, (but need not) be entitled to benefits under a comprehensive income tax treaty.²³⁵

The reason for this exception to the exception is not clear. If a CFC is involved, the fisc can be confident that the corporation's United States shareholders will eventually be taxed: when the income flows through to those shareholders under section 951; when the corporation repatriates or is deemed to repatriate the non-section 951 income as a dividend; or when the shareholders dispose of the stock (the fair market value of which will presumably reflect gain inherent in corporate property).²³⁶

For a corporation to constitute a CFC it need not have one hundred percent United States ownership. United States shareholders need only

²³¹ Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(i)(A) (1990).

²³² Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(i)(A)(1) (1990).

²³³ Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(i)(A)(2) (1990); I.R.C. § 864(c)(7) (1986).

²³⁴ Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(i)(A)(3) (1990). There is a technical error in the regulations. At Temp. Treas. Reg. 1.367(e)-2T(c)(2)(i)(A)(3) (1990) a reference is made to paragraphs "(b)(2)(i)" and "(c)(2)(i)." Temp. Treas. Reg. § 1.367(e)-2T(b)(2)(i) (1990) refers to circumstances when the corporation *cannot* be a CFC, whereas Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(i) (1990), the regulation under discussion, refers to the corporation *being* a CFC. In context the Service clearly intends to refer to situations where the corporation *is* a CFC.

²³⁵ Temp. Treas. Reg. § 1.367(e)-2T(c)(2)(i)(A)(4) (1990).

²³⁶ See *supra* notes 167-172 and accompanying text.

own the majority of the voting stock or the majority of the stock by value.²³⁷ The balance of the shareholders may be foreign. Under the CFC exception to the United States trade or business rule these foreign shareholders, whom section 367 is designed to target, would have ten fewer years to wait than their counterparts in non-CFC's to avoid a U.S. tax on any gain from a disposition of the distributed property. Since the property initially has to be used in a United States trade or business for some period of time (a nanosecond would apparently suffice), section 864(c)(7) would apply.²³⁸ Accordingly, if the property were withdrawn from the United States trade or business shortly after liquidation, it could not be disposed of for ten years without a United States tax applying to any gain that is recognized. Thereafter, however, the United States tax could be avoided. This is to be contrasted to the situation where the foreign corporations are not CFC's, when the property must be used in a United States trade or business for ten years, whereafter section 864(c)(7) can *still* apply!²³⁹ Why non-CFC's need ten years of United States use whereas CFC's need only a brief use is not obvious, when both can have foreign shareholders. In an informal conversation, the Service indicated that the reason for this exception to the exception is because the section 367(b) regulations were meant to be given primacy in this area.²⁴⁰ Yet there is nothing in those regulations which would have meaningful application in this context.²⁴¹ Even if there were some reason for the rule, it is not clear why *both* the foreign parent and the foreign subsidiary need be CFC's. To the extent that a CFC is entitled to special treatment, it would seem sufficient if the foreign parent had that status. The status of the foreign subsidiary, given that it disappears in liquidation in any event, does not seem crucial. Given the shaky ground on which this exception to the exception rests (if any such ground can indeed be found), the best solution would be to eliminate it.

Distributions by foreign corporations of United States real property interests are covered by section 897. That section generally requires gain recognition, unless an election has been made to be treated as a domestic corporation.²⁴²

²³⁷ I.R.C. § 957(a) (1986).

²³⁸ I.R.C. § 864(c)(7) (1986).

²³⁹ See *supra* notes 220-222 and accompanying text.

²⁴⁰ Telephone conversation with the Internal Revenue Service in September 1990. See Temp. Treas. Reg. § 7.367(b)-1 *et seq.* (as amended in 1990).

²⁴¹ See Temp. Treas. Reg. § 7.367(b)-5 (1977).

²⁴² I.R.C. § 897(d),(e),(i) (1986).

IV. CONCLUSION

Once income or property has been removed from the country, it is very difficult to assess or collect an otherwise appropriate tax. As a consequence, the Service has tended to be fairly heavy handed in the promulgation of foreign tax regulations. Unlike other areas of taxation, the typical player in the foreign arena tends to be fairly sophisticated. The Service has little motivation, therefore, to limit the complexity of its regulations out of a concern that the end-users may not be able to understand them. (The Service's motivation in this regard is never very strong.)

In this context, the section 367(e) regulations are a tolerable effort. By and large, the goals are both reasonable in nature and reasonably achieved. The basis for some of the rules is not obvious, and it would have been helpful if the Service had included an explanatory preamble. Generally, however, gain is recognized in appropriate circumstances.

The regulations are most objectionable when the Service expands them beyond what is needed to achieve the objectives of section 367. It is not surprising that the Service has a tendency to over step its bounds given the now unfortunately common mega-delegation of authority made by Congress. As the Code gets more and more complex, Congress is less able to comprehend it, and consequently shifts more of the responsibility for substantive rules to the Service. The Service in turn takes greater advantage of the delegated authority it receives, and promulgates broader rules, until they often bear little resemblance to what Congress contemplated when it enacted a particular piece of tax legislation. Thus, for example, the section 367(e) regulations which address section 355 transactions go well beyond what is needed to insure section 355 is not used as a means to permanently avoid United States taxation, the basic brief of section 367(e)(1).²⁴³ The section 367(e) regulations added rules that, in the foreign context, have the effect of amending substantive provisions of section 355, without having any bearing on whether the fisc would or would not be deprived of its tax due to the involvement of foreign persons in the transaction.²⁴⁴

Particularly in the international arena, the Service cannot hope to cover every contingency, and simultaneously develop a set of regulations that can both be understood by tax practitioners and enforced by the Service. The Service should consider a "minimalist" strategy, where instead of taking maximum advantage of its authority, often to the point of

²⁴³ See *supra* notes 34-44 and accompanying text.

²⁴⁴ See *supra* notes 92-97 and accompanying text.

overreaching, it drafts rules only to the extent necessary to insure that the basic policy provisions of a particular Code provision are met. While “strict constructionism” may be a debatable concept in the area of constitutional law, it is a quite valuable aid in achieving much needed simplicity in the area of tax law. If so-called loopholes result, other mechanisms, including the judicial system and revenue rulings, exist to address them. Many of the new regulations are too complex for the Service’s personnel to understand and therefore enforce in any event. To close a loophole with such complex regulations often is not to close it at all.