REFORM OF SECTION 367(A) AND SECTION 367(B) FOR A POST-TCJA ERA

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* Bret Wells is a Professor of Law at the University of Houston Law Center. The author wishes to thank Joseph Calianno, Derek Green, Phyllis A. Guillory, Mark L. Lubin, and John Woodruff for helpful comments on earlier drafts of this article. The author also wishes to thank Christopher Dykes, reference and research librarian at the O'Quinn Law Library of the University of Houston Law Center, for his help in procuring titles. All views and potential errors in this article are solely the responsibility of the author.

Abstract

Section 367 grants regulatory authority for the Treasury Department to divine whether and to what extent the normal Subchapter C rules should be modified in order to prevent tax avoidance when nonrecognition transactions involve a foreign corporation. But even though these policy goals are left for the Treasury Department to divine, it is still incumbent upon the Treasury Department to divine these goals in light of the design parameters that Congress has set forth in existing law. The Treasury Department has been diligent in its usage of Section 367(a) and Section 367(b) to protect the U.S. tax base from inappropriate tax avoidance transactions. Throughout that effort, the Treasury Department has rightly recognized that the normal Subchapter C rules might not adequately address tax avoidance concerns when nonrecognition transactions involve foreign corporations. So, when those nonrecognition provisions of Subchapter C intersect with a foreign corporation, section 367 provides broad authority to the Treasury to turn off the nonrecognition provisions when appropriate. The voluminous regulations under section 367, in provisions of numbing complexity, severely limit nonrecognition of gain in international corporate transactions to protect the U.S. tax base according to an elusive goal of ferreting out possible tax avoidance restructurings involving a foreign corporation. The regulations work by imposing conditions—known colloquially as "toll charges"—on international reorganizations whenever those reorganizations pose the risk of tax avoidance. Sometimes, the condition is partial or complete immediate recognition of gain; in other cases, it is the preservation of certain tax attributes.

However, a design challenge posed by all of this is that the contours of the United States tax system have been reformulated over several decades, culminating in 2017 in the so-called Tax Cuts and Jobs Act (TCJA), and yet the regulations promulgated under Section 367 have not been modified to harmonize with this landscape and instead remain focused on yesterday's policy concerns. The article sets forth recommendations for how the Treasury Department should fundamentally repurpose its regulatory guidance under Section 367(a) and Section 367(b) so that its regulations achieve results consistent with today's policy goals.

I. INTRODUCTION

Section 367 itself contains relatively little detail. It primarily consists of a mandate to the Treasury Department to issue regulations on different types of corporate nonrecognition transactions with some broadly sketched guidelines. The voluminous regulations under section 367, in provisions of numbing complexity, severely limit nonrecognition of gain in international corporate transactions according to an elusive goal of ferreting out possible tax avoidance restructurings involving a foreign corporation.[1] The regulations work by imposing conditions—known colloquially as "toll charges"—on international reorganizations whenever those reorganizations pose the risk of tax avoidance.[2] Sometimes, the condition is partial or complete immediate recognition of gain; in other cases, it is the preservation of certain tax attributes.

Despite the overwhelming complexity of the regulations under section 367, the basic idea of section 367 is nearly fathomable. It aims to preserve the U.S. jurisdiction's ability to tax a U.S. person on built-in gains in property that originally arose within the scope of the U.S. taxation regime and then is transferred in a nonrecognition transaction to a foreign corporation that could then sell it without incurring U.S. taxation. Section 367(a) addresses the transfer of appreciated property from a United States person to a foreign corporation. Section 367(b) addresses the shifting of foreign corporate earnings (to the extent not currently taxed to U.S. shareholders) through a restructuring

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1. Section 367's predecessor was first enacted in 1932 and at that time the provision had an explicit reference to address transactions unless a principal purpose was not tax avoidance. *See* PUB. L. NO. 72-154, 47 STAT. 169, 198 (June 6, 1932) (adding §112(k) which was the predecessor to section 367). Due to the subjective nature of this principal purpose test, the IRS had set forth standards for issuing rulings on whether the principal purpose standard was implicated in various nonrecognition transactions involving a foreign corporation. *See* Rev. Proc. 68-23, 1968-1 C.B. 821. The government refused to issue rulings in several cases where ultimately the courts determined that the outbound transfer of property in nonrecognition transactions did not have a principal purpose of tax avoidance notwithstanding that those transactions created significant avoidance potential. *See* Dittler v. Commissioner, 72 T.C. 896, 919–20 (1979) (holding it was unreasonable for the IRS to not issue a favorable ruling on the purported outbound transfer of lottery tickets); Hershey Foods v. Commissioner, 76 T.C. 312, 324–25 (1981) (holding that the IRS was unreasonable in not issuing a favorable ruling on the incorporation of a foreign branch that had previous losses). As a result of these cases, Congress decided to remove the subjective principal purpose standard from the statute in 1984. *See* H.R. REP. NO. 98-432, at 1313–14 (1984), *as reprinted in* 1984 U.S.C.C.A.N. 697, 969. Since 1984, section 367(a) applies objectively unless treasury regulations provided otherwise. *See* Tax Reform Act of 1984, PUB. L. NO. 98-369, § 131, 98 STAT 94, 662. Nevertheless, the Treasury Department has recognized that its section 367 regulations seek to ensure that the use of nonrecognition provisions of Subchapter C do not create an inappropriate avoidance of U.S. tax. *See, e.g.*, Notice of Proposed Rulemaking, REG-139483-13, 80 FED. REG. 55,568, 55,570–71 (proposed Sept. 16, 2015) (to be codified at 26 C.F.R. pt. 1) (discussing proposed changes to former section 367(a)(3)(C) that had provided an active foreign trade or business exception to section 367(a)(1) as motivated by the government's concern that inappropriate tax avoidance or abuse could arise in the nonrecognition treatment afforded to transfers to a foreign corporation as the rationale for a proposed change in the regulations).

2. *See* discussion *infra* Part III.A.

transaction to preserve the ultimate U.S. taxation over those earnings. The regulations under section 367(a) and (b) can be understood only in light of these objectives. Thus, section 367 implies a multi-step analysis. One must understand the basic application of the nonrecognition provisions of Subchapter C.[3] Then, one must determine when those Subchapter C rules need to be modified because of a concern that the nonrecognition transaction creates a tax avoidance possibility owing to a foreign corporation's involvement in the transaction.

One design challenge posed by all of this is that the contours of the United States international tax system have been reformulated over several decades, culminating in 2017 in the so-called Tax Cuts and Jobs Act (TCJA).[4] First, in 2002, Congress enacted a specific provision to address the corporation inversion phenomenon in Section 7874. Then, in 2004, qualified dividends were afforded capital gains rates. In 2017, Congress repealed an important exception to the immediate recognition of gain on an outbound transfer of a foreign trade or business. In addition, in 2017, the TCJA substantially reformed the United States tax system so that it now incorporates notions of a modified territorial regime. On the one hand, instances of immediate current taxation of foreign corporate earnings to the U.S. shareholder were expanded through the enactment of section 951A.[5] But on the other hand, foreign corporate earnings derived from active foreign business activities that were not subject to immediate income recognition under one of the anti-deferral regimes, as a general rule, are no longer subject to U.S. taxation to domestic corporate U.S. shareholders because of section 245A.[6] The legislative history of the 2017 Tax Act indicates that a critical policy goal behind the enactment of section 245A was to eliminate the "lock-out effect" by eliminating any U.S. residual taxation on foreign corporate earnings arising from active foreign businesses when repatriated to the United States.[7]

Notwithstanding these critical design changes, the regulations promulgated under section 367 have not been modified to harmonize with the new design parameters but instead remain locked-in on policy concerns of a prior era. As a result, the section 367 regulations still create toll charges to many nonrecognition transactions that represented a possible tax avoidance concern under prior law but no longer pose such a concern under current law. The lack of harmonization of the section 367 regulations with the current reality

3. Subchapter C of Title 26 of the US Code is comprised of section 301 through section 385.

4. PUB. L. NO. 115-97, 131 STAT. 2054 (Dec. 22, 2017).

5. *See* PUB. L. NO. 115-97, § 14201, 131 STAT. 2054, 2208 (Dec. 22, 2017) (enacting section 951A that affords taxation over global intangible low-taxed income).

6. *See* § 14101, 131 STAT. at 2208 (enacting section 245A that affords a foreign dividends received deduction).

7. *See* S. Rep. No. 115-20, at 358 (2017).

creates needless complexity and obscures and confuses the policy goals that should be relevant for triggering section 367. In Part II, this article will address how the Treasury regulations that implement section 367(a) should be reformed. In Part III, this article addresses how the regulations that implement section 367(b) should be reformed. In Part IV, the article provides concluding comments about the normative goals that should be effectuated in section 367(a) and (b) in this era.[8]

II. HISTORIC MISSION OF SECTION 367(A)

A. Statutory Framework for Section 367(a)

Section 367(a)(1) is characteristically difficult to unpack due to its antiquated wording, which is reproduced below:

> If, in connection with any exchange described in sections 332, 351, 354, 356, or 361, 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.

The use of a negative embedded in the provision, along with its cross-references to other Code sections, causes the provision to work in a decidedly roundabout fashion. Its mechanism is that in certain transfers to a foreign corporation, the latter is not "considered to be a corporation." Since nonrecognition treatment in the relevant class of transfers described in Subchapter C depends on the status of the receiving entity as a "corporation," as a general rule, section 367(a)(1) turns off the nonrecognition treatment afforded to transfers of property when made by a *United States person* to a *foreign* corporation. These are known broadly as "outbound" transfers. In effect, section 367(a)(1) requires recognition of gain in outbound transfers of property to a foreign corporation. The closest thing in section 367(a) to a general rule is that several provisions of Subchapter C that generally allow for nonrecognition of gain do *not* apply to transfers of property from a United States person to a foreign corporation.[9]

Four notable exceptions remain to section 367(a)(1)'s general rule as follows: (i) when the transferred property is stock in a foreign

8. This article does not exhaustively cover all of the potential contours of section 367(a) or section 367(b). Instead, this article is limited to those areas in the existing regulations under section 367(a) and section 367(b) that now seem outdated for the current era.

9. *See* Treas. Reg. § 1.367(a)-1(d)(3). Note, that the second sentence of this regulation carves out from the definition of a "transfer," one's entry into a "cost sharing arrangement" under section 1.482-7 or acquisition of rights to intangible property under such an arrangement. *See id*.

corporation and a gain recognition agreement is entered into by 5% shareholders,[10] but even so the transfer is still subjected to sections 367(b);[11] (ii) when the underlying property is an intangible asset owned by a U.S. person, in which case section 367(a) is made inapplicable and section 367(d) applies instead; (iii) when the distribution of property is stock distributed by a U.S. domestic corporation to a foreign transferee corporation in a transaction to which section 355 would otherwise apply, in which event section 367(e)(1) applies instead of section 367(a) and section 367(b); and (iv) when the distribution of property is pursuant to a complete liquidation of a foreign corporation and the transferee corporation is a domestic corporation, in which event section 367(e)(2) applies instead of section 367(a). Section 367(a) closes with section 367(a)(4), which recites that section 367(a)(1) "shall not apply to the transfer of any property which the Secretary, in order to carry out the purposes of this subsection, designates by regulation."[12] The need to make further adjustments is present when assets are transferred out of U.S. corporate solution to a foreign corporation in a triangular reorganization that affords nonrecognition treatment to the asset transfer. The policy goal underlying a further basis adjustment in that context is to ensure that the potential stock gain preserved in the stock basis of the transferor shareholders is not less than the corporate-level inside gain embedded in the corporate-level assets transferred because otherwise the outbound transfer could inappropriately circumvent the repeal of the General Utilities doctrine.[13] In these situations, the outside

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10. *See* Treas. Reg. § 1.367(a)-3(b)(1)(ii); Treas. Reg. § 1.367(a)-8(a). No gain recognition agreement is needed for less than five percent shareholders. *See* Treas. Reg. § 1.367(a)-3(b)(1)(i).

11. *See* I.R.C. § 367(a)(2). However, as will be discussed further in this article, the transfer may be subject to a toll charge under section 367(b) if the foreign earnings of the foreign corporation escape a CFC environment vis-à-vis the U.S. shareholder as a result of the nonrecognition transaction. *See* discussion *infra* Part III.B.

12. The current language now in section 367(a)(4) was added in 1988 as former section 367(a)(5). *See* Technical and Miscellaneous Revenue Act of 1988, PUB. L. NO. 100-647, § 1006(e)(13)(A), 102 STAT. 3342, 3402. The provision was renumbered to section 367(a)(4) in 2017. *See* PUB. L. NO. 115-97, § 14102(e)(1), 131 STAT. 2054, 2194 (Dec. 22, 2017).

13. *See* H.R. REP. NO. 100-795, at 60 (1988). The legislative history foreshadowed that basis adjustments would be appropriate when the inside gain on assets transferred in a nonrecognition transaction under section 361 was larger than the shareholder's outside stock gain in an outbound triangular reorganization, as indicated in the following statement in the report issued by the Senate Finance Committee:

> It is expected that regulations will provide this relief only if the U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is party to the reorganization equal to the lesser of (a) the U.S. corporate shareholder's basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation. . . . . In addition, it is expected that regulations will require the U.S. corporate transferor to recognize immediately any built-in gain that does not remain subject to U.S. taxation by virtue of a substituted stock basis.

basis in the stock received in the triangular reorganization would be reduced if the inside corporate gain were larger so that the adjusted stock basis preserved the full amount of corporate-level gain after adjustment. However, having said all of this, an untidy aspect of section 367(a)(4) is that its wording can be seen as an open invitation to the Treasury to determine the purposes of section 367(a).

The regulations that implement section 367(a)(1) generally require 5% or greater U.S. shareholders to enter into a five-year gain recognition agreement as a precondition for avoiding gain recognition with respect to an outbound foreign stock transfer when the U.S. shareholder transfers stock of a foreign corporation (including indirect stock transfers).[14] A triggering event that would require gain recognition under a gain recognition agreement includes, for example, a situation where the transferred corporation disposed of substantially all of its assets within the gain recognition period,[15] or if the stock of the transferee foreign corporation were disposed of during the gain recognition period,[16] among other reasons,[17] but subject to certain excepted dispositions.[18] At least to this author, the historic purposes for applying the GRA regime do not seem to have been altered by the reforms that have occurred since that regime was put into place.[19] Thus, no change in how that GRA regime would operate is considered in this article.[20] In the remainder of this Part II, this article addresses instances where the regulations promulgated under section 367(a) are now in need of reformulation.

B. Section 367(a) regulations need reform for the repealed active foreign trade or business exception.

An important historic exception to section 367(a)(1) existed with respect to the outbound transfer of a foreign active trade or business,

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See S. REP. NO. 100-445, at 62 (1988).

14. Treas. Reg. § 1.367(a)-3(b)(1). Shareholders that receive less than five percent of the stock of the transferee corporation are not required to enter into a gain recognition agreement under the existing regulations. *See* Treas. Reg. § 1.367(a)-3(b)(1)(i).

15. *See* Treas. Reg. § 1.367(a)-8(j)(2).

16. *See* Treas. Reg. § 1.367(a)-8(j)(1).

17. *See generally* Treas. Reg. § 1.367(a)-8(j) (listing triggering events that would implicate the requirement to recognize the deferred gain under the gain recognition event).

18. *See generally* Treas. Reg. § 1.367(a)-8(k) (listing triggering event exceptions).

19. For an excellent summary of the evolution of the requirement to enter into a gain recognition agreement with respect to outbound transfers, see Mark L. Lubin, *Working with the New Section 367 Indirect Transfer and GRA Rules*, 25 INT'L TAX J. 1 (1999).

20. The outbound transfer of stock or securities is concurrently subject to the requirements of section 367(b). *See* Treas. Reg. § 1.367(a)-3(b)(2) (as amended in 2020). Whether and to what extent section 367(b) should be reformed, however, is within the scope of this article. *See* discussion *infra* Part III.

but that exception was repealed in the 2017 Tax Act.[21] Yet, even though that historic exception has been repealed, the Treasury regulations that implemented guidance with respect to this historic exception remain in the existing Treasury regulations.

Consequently, here is the first place that the Treasury Department should look in terms of revising its regulations under section 367(a). Prior to the repeal of the active foreign trade or business exception contained in former section 367(a)(3)(C), the Treasury Department had issued regulations to address basis recovery with respect to boot received in asset transfers where gain was not recognized by reason of former section 367(a)(3)(C).[22] As previously mentioned, the legislative history to section 367(a)(4) provided that basis adjustments are appropriate in situations where the inside gain in corporate assets is not recognized in an outbound transfer and the inside gain is larger than the outside stock gain.[23] But, regulations were not issued that implemented section 367(a)(4) until 2008,[24] a full twenty years after the provision's enactment. When regulations were eventually issued, the government took the position that the stock basis adjustments must be made to the stock basis of the stock received and not the entire outside stock basis held in the transferee foreign corporation.[25] The implications of this nuanced handling of outside stock basis are further unpacked in Part III.D., *infra*. But what is important to note is that Treasury regulations impose immediate gain recognition, or allow nonrecognition treatment (if the taxpayer elects) but only if elective adjustments[26] can be made to

21. *See* PUB. L. NO. 115-97, § 14102(e), 131 STAT. 2054, 2193–95 (Dec. 22, 2017).

22. *See* Treas. Reg. § 1.367(a)-7(g), Ex. (1) (as amended in 2020); Treas. Reg. § 1.367(a)–7(g), Ex. (2) (as amended in 2020).

23. The Senate Finance Committee report indicated the following:

> It is expected that regulations will provide this relief only if the U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is party to the reorganization equal to the lesser of (a) the U.S. corporate shareholder's basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation. . . . . In addition, it is expected that regulations will require the U.S. corporate transferor to recognize immediately any built-in gain that does not remain subject to U.S. taxation by virtue of a substituted stock basis.

See S. REP. NO. 100-445, at 62 (1988).

24. *See* I.R.S. Notice 2008-10, 2008-1 C.B. 277. The IRS then issued proposed regulations that sought to incorporate this guidance. *See* Notice of Proposed Rulemaking, REG-2009006-89, 73 Fed. Reg. 49,278 (proposed Aug. 20, 2008) (to be codified at 26 C.F.R. pt. 1).

25. *See* I.R.S. Notice 2008-10, 2008-1 C.B. 277 (signaling this bifurcation of outside stock basis between shares issued in the reorganization that excludes old and cold basis).

26. In order to implement the goal of section 367(a)(5), the exceptions to gain recognition in section 367(a)(2) and old section 367(a)(3) do not apply in the case of a section 361 exchange in which a domestic corporation (U.S. transferor) transfers assets to a foreign corporation, unless

the U.S. person's stock basis of the actual stock received in the reorganization.[27] The old and cold basis in stock in the transferee corporation already owned by the transferor's shareholder is ignored in this basis adjustment analysis. Importantly, if the inside gain could not be adequately preserved because the basis in the newly received stock is insufficient on a stand-alone basis to accommodate a further basis adjustment for the inside gain, then immediate gain recognition is required.[28] The Treasury Department has identified this aspect of its regulations as potentially overly complex and unduly burdensome on taxpayers.[29]

However, given that an outbound transfer of foreign trade or business assets is fully taxable, this aspect of the Treasury regulations has become obsolete. Now that all of the built-in gain is recognized upon the transfer of an active foreign trade or business assets is fully taxable, there is no need to coordinate the stock basis adjustment. Thus, the complicated adjustments envisioned by section 367(a)(4) that apply to the normal basis rules under Subchapter C are now obsolete due to the repeal of Former section 367(a)(3)(C). To the extent these provisions might not be supplanted, they would appear to create applications that are not appropriate. Consequently, their continuing presence in the existing Treasury regulations adds needless complexity and a possible unwarranted trap for the unwary. It is true that these Treasury regulations could still be relevant for the outbound transfer of foreign stock that remains entitled to nonrecognition treatment under section 367(a)(2), but for the reasons discussed independently in Part II.C., *infra*, the complicated basis adjustments required by Treas. Reg. section 1.367(a)-7(c) no longer makes sense in that context either.

As previously addressed, section 367(a)(2) maintains nonrecognition treatment for the outbound transfer of stock in a foreign corporation except as otherwise provided in regulations. When stock in a foreign corporation is transferred, the implementing Treasury regulations generally allow for nonrecognition treatment as long as 5% shareholders enter into a gain recognition agreement and as long as the requirements of section 367(b) are separately satisfied.[30]

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the U.S. transferor is controlled (within the meaning of section 368(c)) by five or fewer (but at least one) domestic corporations (each a control group member, and together the control group) and basis adjustments and other conditions as provided in regulations are satisfied. *See* Treas. Reg. § 1.367(a)-7(c) (as amended in 2020).

27. Treas. Reg. § 1.367(a)-7(c)(3) (as amended in 2020); Treas. Reg. § 1.367(a)-3(e)(3)(i).

28. *See* Treas. Reg. § 1.367(a)-7(g), Ex. (1); Treas. Reg. § 1.367(a)-7(g), Ex. (2).

29. I.R.S. Notice 2017-38, 2017-30 I.R.B. 147.

30. *See* Treas. Reg. § 1.367(a)-3(b)(1). However, if the U.S. transferor in this outbound stock transfer is a five percent shareholder, then the nonrecognition treatment is conditioned upon the five percent shareholder entering into and complying with a five-year gain recognition agreement. *See* Treas. Reg. § 1.367(a)-3(b)(1)(ii); Treas. Reg. § 1.367(a)-8.

Section 367(a)(2), however, provides authority for the Treasury Department to issue regulations to turn off, in whole or in part, the nonrecognition treatment with respect to any outbound property transfer. Under this broader grant of regulatory authority under section 367(a)(2), the Treasury Department has provided that the transfer of stock of a *domestic* corporation to a foreign corporation is eligible for nonrecognition treatment but only if the legacy U.S. shareholders do not own more than 50% of the stock of the transferee foreign corporation.[31] Thus, the regulations permit nonrecognition treatment to be maintained in outbound transfers of stock of a domestic corporation to a foreign corporation (such as in a stock-for-stock "B" reorganization) but only if the U.S. transferors of the domestic corporate stock as a group hold no more than 50% of the stock of a transferee foreign corporation after the reorganization.[32] There must, in other words, be sufficient dilution of the continuing interest of the legacy shareholders so that the former domestic parent entity and its legacy shareholders own 50% or less of the new foreign parent entity. This ownership dilution threshold is not explained by the historic policy goals of section 367(a) because appropriate basis adjustments could be maintained in the stock of the transferee foreign corporation to adequately protect the U.S. tax base. What explains this usage of section 367(a) is a desire to address the corporate inversion phenomenon under the auspices of section 367(a).

Even so, the continuing justification for the Treasury Department's efforts to utilize its regulatory authority under section 367(a) to attack corporate inversion transactions requires closer inspection. In general, under the anti-inversion provisions of Treas. Reg. section 1.367(a)-3(c) enacted under section 367(a), U.S. shareholders that transfer stock in a U.S. corporation to a foreign transferee corporation and receive 50% or more of the transferee foreign corporation stock are immediately taxable on their stock gain.[33] Through its adoption of these anti-inversion regulations, the Treasury Department signaled that the anti-inversion policy goals and not just the historic goals of sections 367(a) and (b) would also serve to guide its regulatory design under section 367(a).

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31. *See* Treas. Reg. § 1.367(a)-3(c)(1). However, if the U.S. transferor in this outbound stock transfer is a five percent shareholder, then the nonrecognition treatment is further conditioned upon the five percent shareholder entering into a five-year gain recognition agreement. *See* Treas. Reg. § 1.367(a)-3(c)(1)(iii)(B); Treas. Reg. § 1.367(a)-8.

32. Treas. Reg. § 1.367(a)-3(c)(1). There are further wrinkles. If U.S. ownership of the stock of the transferee foreign corporation is widely dispersed in small holdings after the transfer, there are no other requirements. U.S. persons who own five percent or more of the stock of the foreign corporation, however, must enter into specific gain recognition agreements (a "GRA") with the IRS, whereby upon certain subsequent events within five years (such as a disposition by the foreign corporation of the transferred domestic stock) gain initially deferred is recognized in full.

33. *See* Treas. Reg. § 1.367(a)-3(c). An important exception to this general taxable result is provided for certain triangular reorganizations.

The curtailment of nonrecognition treatment in the context of the outbound transfer of the stock in a domestic corporation that is now expressed in Treas. Reg. section 1.367(a)-3(c) is perhaps best understood by reviewing the historical context that led to this regulatory action. In 1981, McDermott Inc. engaged in an inversion transaction by having one of its subsidiaries, a controlled foreign corporation (or "CFC") of the U.S. parent company, exchange newly issued stock to the public shareholders of McDermott in exchange for all the of McDermott stock owned by the public shareholders. After the exchange of stock with the public shareholders was completed, the corporate entities were in a flipped position. From the perspective of the former McDermott parent entity, the parent was inverted underneath its former subsidiary, as depicted in the below diagram.[34]

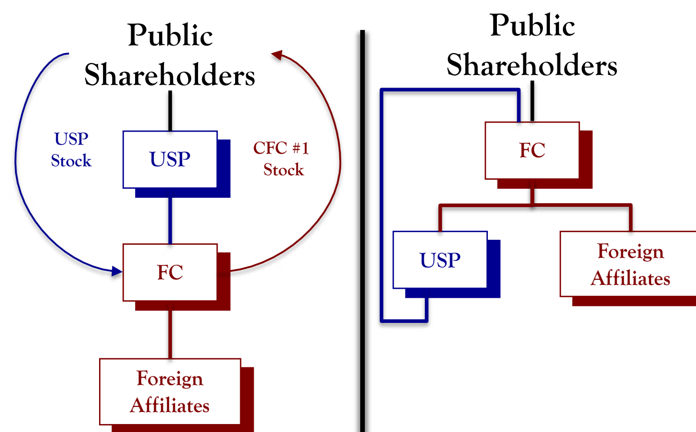

Figure 1. McDermott.

After the above corporate inversion transaction, the former "subsidiary" of McDermott was flipped to become the new publicly traded parent entity after the corporate inversion transaction. As a result, all future foreign investments could be made by FC or its foreign affiliates at a time when FC and its foreign affiliates were no longer controlled foreign corporations subject to the U.S. subpart F regime. Moreover, because FC is no longer a CFC, none of the foreign affiliates would be either, so their operations would largely escape the U.S. subpart F rules.

34. Kevin Dolan et al., U.S. TAXATION OF INTERNATIONAL MERGERS, ACQUISITIONS AND JOINT VENTURES ¶ 14.06[1] fig.14-5 (Thomson Reuters Tax & Accounting, 2022).

In response to this transaction, Congress enacted section 1248(i) with McDermott in mind.[35] Its effect was to require the former U.S. parent that participated in the inversion transaction to include in its income a dividend equal to the full amount of the earnings and profits of all of the foreign subsidiaries that had been CFCs but were no longer CFCs. The Treasury later followed up with Notice 94-93, 1994-2 C.B. 563, which required the former U.S. parent to recognize gain on its foreign subsidiary stock as if it had distributed that stock to its public shareholders in exchange for its own stock.

The public markets found a means to accomplish an alternative form of an inversion transaction that side-stepped section 1248(i) in later years. For example, in 1994, public shareholders of Helen of Troy Ltd. exchanged their stock in Helen of Troy for stock of a new foreign parent company.[36] Because the new foreign parent had no earnings and profits as it was newly created, the exchange of the Foreign Newco stock for the stock of the former U.S. Parent sidestepped section 1248(i).[37] The transaction technically did not represent a "flip" or reversal of the ownership of a former foreign subsidiary to become the ultimate foreign parent, but the effect was similar in the sense that this variation laid the foundation for a later migration of foreign businesses out from underneath ultimate U.S. ownership.[38] Thus, the inversion label "stuck," such that these transactions were referred to as corporate inversions as well.

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35. Deficit Reduction Act of 1984, PUB. L. NO. 98-369, § 133(a), 98 STAT. 494, 667; *see also* H.R. REP. NO. 98-432, pt. 2, at 1327 (1984) ("In the view of the committee, the ability to avoid ordinary income tax by causing a foreign corporation to engage in a transaction with the shareholders of its U.S. parent corporation would make a mockery of the principle of taxing accumulated earnings and profits of foreign corporations upon repatriation.").

36. The nuances of how this form of expatriating transaction was accomplished under the old section 367 regulations has been adequately addressed by other commentators. *See* David R. Tillinghast, *Recent Developments in International Mergers, Acquisitions, and Restructurings,* 72 TAXES 1061, 1063–68 (1994); *see also* Benjamin G. Wells, *Section 367(a) Revisited,* 96 TAX NOTES TODAY 113-106 (June 10, 1996).

37. The nuances of how this form of expatriation transaction was accomplished under the old Section 367 regulations have been adequately addressed by other commentators. *See* Tillinghast, *supra* note 36, at 1063–68; *see also* Wells, *supra* note 36, at 1511.

38. In the McDermott form of corporation inversion, the foreign corporations were immediately no longer CFCs as a result of the actual transaction. In this later variation, an ultimate foreign parent was inserted in the structure but the migration of businesses to ownership outside the U.S. ownership chain would occur later.

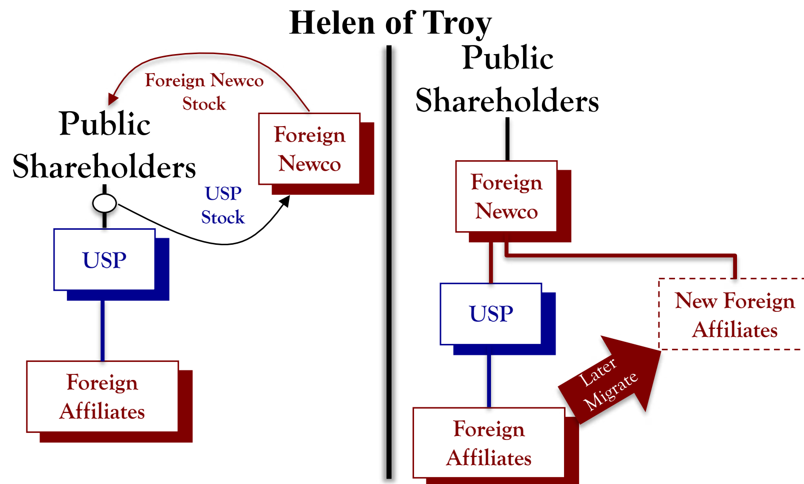

Figure 2. Helen of Troy.

Once the Newco Foreign Parent became the ultimate parent, new foreign investments could be made outside the U.S. ownership structure and thus outside the reach of the U.S. jurisdictional tax rules. Moreover, out-from-under planning could then be done to transfer or migrate the businesses of foreign affiliates owned by USP to new foreign affiliates owned outside of the USP ownership structure.

In response to this later iteration of an inversion transaction, the Treasury issued Notice 94-46, 1994-1 C.B. 356, and eventually promulgated Treas. Reg. section 1.367(a)-3(c), causing the U.S. shareholders to be taxable on their built-in gain if the legacy shareholders of the U.S. parent owned more than 50% of the foreign parent company.[39] The fullest explanation for the policy rationale for Notice 94-46 and the ultimate adoption of Treas. Reg. section 1.367(a)-3(c) was set forth in the following sentence found in the preamble to the predecessor temporary regulations:

> The purpose of Notice 94-46 was to forestall outbound transfers that are structured to avoid or that lay a foundation for future avoidance of the Internal Revenue Code anti-deferral regimes by imposing a shareholder-level tax on such transfers.[40]

The tax avoidance concern identified here is the out-from-under planning that could be done once the inversion was completed. That

39. *See* T.D. 8702, 61 FED. REG. 68633, 68634 (Dec. 30, 1996) (to be codified at 26 C.F.R. pts. 1, 602).

40. T.D. 8638, 60 FED. REG. 66739, 66741 (Dec. 26, 1995).

out-from-under planning was identified as inappropriate potential tax avoidance, according to the Treasury Department.

In the above diagram, the legacy shareholders of USP as a group hold all of the Foreign Newco stock after the transaction, so their stock-for-stock exchange would be fully taxable, given that the legacy shareholders of the former U.S. parent entity hold more than 50% of the new foreign parent stock. The promulgation of Treas. Reg. section 1.367(a)-3(c) was a stop-gap response to the corporate inversion phenomenon. The regulations required immediate shareholder-level gain recognition, even though the transferor U.S. shareholder's basis in the stock received in the nonrecognition exchange could have preserved all built-in gain. Thus, section 367(a) was enlisted for purposes other than the historic mission of section 367(a) because corporation inversion transactions were deemed problematic and in need of a policy response.

Even so, after another wave of corporate inversions in 2002 in which shareholder-level taxation was not a significant friction cost,[41] Congress finally enacted section 7874 as a Congressional response to the corporate inversion phenomenon.[42] Under section 7874, the new foreign parent would be treated as a U.S. corporation for U.S. tax purposes if the legacy shareholders of the U.S. corporation owned 80% or more of the new foreign parent entity except where the new foreign parent had a substantial business presence in the new foreign parent's jurisdiction of incorporation.[43] The Treasury issued regulations in June 2006 that defined the substantial business activities standard.[44] Although the Treasury Department's regulations initially afforded a safe harbor for the substantial presence test, the final regulations effectively removed any safe harbor definition and relied solely on a facts and circumstances test.[45] If the continuing former shareholder ownership is

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41. For a thorough review of expatriations from 1996 through 2000, see Willard B. Taylor, *Corporate Expatriations — Why Not?* 78 TAXES 146 (2000); Bret Wells, *Corporate Inversions and Whack-a-Mole Tax Policy*, 143 TAX NOTES FED. (TA) 1429, 1430 (June 23, 2014). Congress would later respond by adopting section 7874 to further attack the corporate inversion phenomenon, but section 7874 has also not stopped inversions. *See* Bret Wells, *Cant and the Inconvenient Truth About Corporate Inversions,* 136 TAX NOTES FED. (TA) 429, 429 (July 23, 2012). Nevertheless, Treas. Reg. § 1.367(a)-3(c) has remained a permanent fixture of the section 367(a) regulations and, as such, has fundamentally modified the application of section 367(a).

42. American Jobs Creation Act of 2004, PUB. L. NO. 108-357, § 801(a), 118 STAT. 1418, 1562.

43. I.R.C. § 7874(a)(2)(b)-(b).

44. T.D. 9265, 71 Fed. Reg. 32437, 32439–40 (June 6, 2006) (to be codified at 26 C.F.R. pt. 1).

45. *See* T.D. 9453, 74 Fed. Reg. 27,920, 27922 (June 12, 2009) (to be codified at 26 C.F.R. pt. 1). In the preamble to T.D. 9453, the Service and Treasury said they had concluded that the safe harbor provided by the 2006 temporary regulations may apply to some transactions that are inconsistent with the purposes of Section 7874 and that the 2009 temporary regulations therefore did not retain the safe harbor provided by the 2006 temporary regulations. *Id.* The 2009 temporary

at least 60% but less than 80% (by vote or value), the foreign acquiring corporation is respected as foreign, but full U.S. tax must generally be paid with respect to certain income or gain recognized by the expatriated U.S. entity and its affiliates in connection with the inversion or within the ten-year period ending after the completion of the inversion (the "60-percent test").[46] This latter stricture sought to ensure that full U.S. taxation would apply if out-from-under planning occurred that moved assets out of the U.S. domestic corporation after the inversion transaction if the 60% threshold was crossed. In other words, this 60-percent test and the triggering of non-allowance of corporate level attributes sought to ensure that out-from-under-planning would bear full corporate level taxation. What is important to understand is that this Congressional response to the out-from-under planning concerns utilized a policy solution that was different and inconsistent with the manner that the Treasury Department had sought to address this same policy concern. The out-from-under planning is forestalled entirely for inversions where the legacy shareholders own 80% or more given that the surrogate foreign parent is treated as a U.S. corporation. The out-from-under planning is subject to significant corporate level taxation given the restriction on usage of corporate attributes over ten years for inversions where the legacy shareholders own between 60% and 80% of the surrogate foreign corporation. Thus, in the end, Congress responded to the corporate inversion phenomenon, and its response is contained in an earlier enactment of section 1248(i) and then in the latter enactment of section 7874.

In the Treasury Department's 2022 Greenbook, the Biden administration proposed to broaden the definition of an inversion transaction under section 7874 by replacing the 80% test with a greater than 50% test and eliminating the 60-percent test.[47] Thus, the new FP would be treated as a U.S. corporation any time the 50% threshold is crossed. The proposal would also provide that, regardless of the level of shareholder continuity, an inversion transaction would occur if (1) immediately prior to the acquisition, the fair market value of the domestic entity is greater than the fair market value of the foreign acquiring corporation, (2) after the acquisition the expanded affiliated group is primarily managed and controlled in the United States, and (3) the expanded affiliated group does not conduct substantial business

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regulations also do not retain the examples illustrating the general rule in the 2006 temporary regulations. *Id.* Thus, after the issuance of the 2009 temporary regulations, taxpayers could no longer rely on the safe harbor or on the examples illustrating the general rule provided by the 2006 temporary regulations. *Id.*

46. I.R.C. § 7874(a)(2)(B), (d)(2).

47. 2022 U.S. DEP'T. OF TREASURY GEN. EXPLANATIONS OF THE ADMIN.'S FY REVENUE PROPOSALS 8 (2021) [hereinafter FY 2022 REV. PROP. EXPLS.].

activities in the country in which the foreign acquiring corporation is created or organized.[48]

Given Congress' eventual policy response to the corporate inversion phenomenon now expressed in section 7874, the Treasury Department's earlier independent response in Treas. Reg. section 1.367(a)-3(c) differs from how Congress has now statutorily addressed the corporation inversion phenomenon. Before the enactment of section 7874, Congress had not holistically addressed the corporate inversion phenomenon. As a result, in an era prior to the Congressional enactment of section 7874, the Treasury Department utilized its regulatory authority under section 367(a) to independently address the corporate inversion phenomenon. During the period of non-action by Congress, Treasury had authority to formulate a response, and it was appropriate for the Treasury Department to act under its existing authority. However, now that Congress ***has*** set forth a statutory response to the out-from-under tax avoidance concerns posed by corporate inversion through its enactment of section 7874, the Treasury Department should align its anti-inversion prescription within the rubric and under the scope set forth in section 7874, as that is the provision that now directly sets forth the parameters of the Congressional response. Now that Congress has addressed the out-from-under corporate inversion policy concern via section 7874, there is no continuing rationale for causing the section 367(a) regulations to create a divergent response under Treas. Reg. section 1.367(a)-3(c) when those concerns were directly addressed statutorily in section 7874 in another, more direct, manner.

Moreover, the Treasury Department, in its 2022 Greenbook proposal, has advocated further reforms under section 7874 that would completely nullify the applicability of Treas. Reg. section 1.367(a)-3(c) because (under that reform proposal) the transferee foreign corporation would be deemed to be a U.S. corporation and thus would be recast out of the scope of section 367(a) in all situations where Treas. Reg. section 1.367(a)-3(c) might have applied.[49] The overlapping nature of the section 7874 reform proposal further illustrates the larger point

48. FY 2022 REV. PROP. EXPLS., *supra* note 47, at 5. In addition, the Treasury Department also indicated that its proposed reform:

The proposal would also expand the scope of an acquisition for purposes of section 7874 to include a direct or indirect acquisition of substantially all of the assets constituting a trade or business of a domestic corporation, substantially all of the assets of a domestic partnership, or substantially all of the U.S. trade or business assets of a foreign partnership. Furthermore, a distribution of stock of a foreign corporation by a domestic corporation or a partnership that represents either substantially all of the assets or substantially all of the assets constituting a trade or business of the distributing corporation or partnership would be treated as a direct or indirect acquisition of substantially all of the assets or trade or business assets, respectively, of the distributing corporation or partnership.

Id.

49. *See id.*, at 5, 7–8.

that Treasury's effort to address corporate inversions under its authority under section 367(a) is unmoored to what Congress has statutorily prescribed in section 7874 and unmoored to the further reforms that Congress has contemplated in that context. Now that section 7874 sets forth a comprehensive Congressional response to the corporate inversion concerns, Treasury should withdraw Treas. Reg. section 1.367(a)-3(c) because it now represents an ultra vires response to corporate inversions that is outside the design parameters set forth in section 7874.[50] If the Treasury Department believes that Congress has not adequately addressed the tax avoidance concerns posed by corporate inversions in section 7874 such that a further response under section 367(a) is still warranted, then the Treasury Department should articulate with more specificity why it believes that a lingering policy justification remains so that the tax community better understands the additional tax avoidance concerns that are sought to be addressed.

C. Section 367(a) regulation's anti-repatriation provisions are now arguably obsolete and should be withdrawn.

Starting in earnest in 2006,[51] the Treasury Department utilized its regulatory authority to alter the normal Subchapter C basis recovery rules when those rules would provide tax-free cash repatriations from foreign corporations without a corresponding dividend inclusion of the underlying foreign corporate earnings that generated the foreign cash. As part of that effort, the Treasury Department identified reorganizations described in section 368(a)(1)(D) that involved cash boot paid to a shareholder that had a high stock basis as an inappropriate means to repatriate foreign cash in a tax-free manner. Two variations of the "all-cash D reorganizations" or "Deadly D reorganizations" that concerned the government are set forth in the below diagrams.

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50. A similar recommendation was made by the Tax Section of the New York State Bar Association in 2009, but that observation was not acted upon at that time. *See* TAX SECTION, N.Y. STATE BAR ASS'N, REPORT ON PROPOSED REGULATIONS ISSUED UNDER CODE SECTION 367, 1248 AND 6038B, at 48 (Jan. 28, 2009) [hereinafter N.Y. S.B.A. REP. ON PROP. REGS. UNDER SECTION 367]. The passage of time has not taken away from the accuracy of this assertion.

51. The commencement of this effort began in the context of the regulations under section 367(b) with I.R.S. Notice 2006-85, 2006-2 C.B. 677. Because Notice 2006-85 involves an analysis of the section 367(b) regulations, further discussion of it is deferred for a discussion in the context of those regulations in Part III.D. *See* discussion *infra* Part III.D.

In these reorganizations, cash boot is paid to the transferor corporation for substantially all of the transferor's assets at a time when

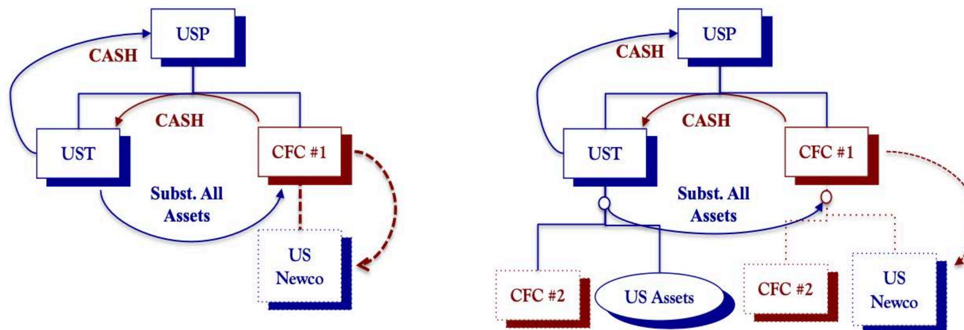

Figure 3. "Deadly D" Reorganizations/All Cash D Reorganization."

both are under common control, and the transferor corporation is then immediately liquidated as part of the reorganization. Under the Subchapter C provisions of the Code, the cash boot paid by CFC #1 in both of the above diagrams is not taxable to the transferor corporation (i.e., the company designated as "UST" in the above two diagrams) if the transferor corporation (UST) distributes that cash boot to its shareholder.[52] In this scenario, the transferor shareholder (USP) is taxable on the receipt of the cash boot only to the extent that the cash boot exceeds the shareholder's (i.e., USP's) basis in its UST stock.[53] Furthermore, taxpayers had concluded that UST's and USP's receipt of cash should not create an independent tax recognition event under section 367(a) as long as appropriate basis adjustments contemplated by section 367(a)(4) were made in USP's basis in the CFC #1 shares to preserve the historic built-in gain in those CFC #1 shares, or at least so thought by taxpayers. As a result of this analysis, "all-cash D reorganization" strategies came to be employed to repatriate cash from foreign subsidiaries without triggering an income inclusion of CFC #1's unrepatriated section 1248 earnings and profits in instances where a high stock basis existed in the target corporation stock.

The potential to repatriate cash from a foreign corporation in a manner that afforded basis recovery was viewed as a tax avoidance transaction when adjudged against the alternative path of simply declaring a cash dividend from the foreign corporation under the pre-2017 law. As a result of this concern, in Notice 2008-10,[54] the IRS

52. *See* I.R.C. § 361(b)(1)(A).

53. *See* I.R.C. § 356(a)(1)-(2).

54. Notice 2008-10, 2008-3 C.B. 277.

surprised many in the tax community by stating that these transactions resulted in immediate gain recognition without the ability to utilize any of the old and cold stock basis in the target stock as would be normally allowed under the Subchapter C provisions.[55] The Treasury Department's means of accomplishing this outcome was ingenious, and it involved a nuanced handling of the Treasury Department's authority under section 367(a)(4). According to Notice 2008-10, the Treasury Department indicated that it had authority to require immediate gain recognition equal to the cash boot if appropriate basis adjustments could not be made as required by section 367(a)(4). The Treasury Department then went on to state that the necessary basis adjustments required by section 367(a)(4) could only be made with respect to the ***newly-issued*** CFC #1 shares, and that any basis in the old and cold CFC #1 shares must be excluded in this analysis. In effect, the Treasury Department bifurcated the basis in the CFC #1 stock into "old basis" and "new basis." Thus, in the above diagrams, since no new CFC #1 shares were issued in the all-cash D reorganization, the U.S. parent did not receive any new shares in CFC #1. Thus, it did not have any "new basis" in an amount equal to the inside gain inherent in the assets transferred in the reorganization. Consequently, the Treasury Department said that the built-in gain that exists in the U.S. target's assets could not be appropriately preserved in the new shares received. Because appropriate basis adjustments required by section 367(a)(4) could not be made in the new shares received to preserve the inside gain inherent in the UST assets, the government stated that the built-in gain in the assets that were transferred as part of the valid section 368(a)(1)(D) reorganization was taxable. Proposed regulations[56] were issued later that same year consistent with this notice, and final regulations were issued in 2013.[57] Under the final regulations, as long as newly-issued shares in CFC #1 were issued in the reorganization and those newly-issued shares had a fair market value equal to or in excess of the inside gain in the assets that UST was transferring to CFC #1, then, and only then, would an appropriate basis adjustment be possible within the meaning of section 367(a)(4) such that the outbound transfer would not be taxable to any extent under section 367(a)(1).[58] The effect of this redefinition of basis preservation was motivated by a desire to prevent

55. *See* N.Y. S.B.A. REP. ON PROP. REGS. UNDER SECTION 367, *supra* note 50, at 8–9, 15–22.

56. *See* Prop. Treas. Reg. § 1.367(a)-7, 73 Fed. Reg. 49278, 49287 (proposed Aug. 20, 2008). In general, these proposed regulations retained Notice 2008-10's pronouncement that basis adjustments required by § 367(a)(4) can only be made to the newly-issued CFC #1 stock received as part of the reorganization exchange and could not be made to the basis in the "old and cold" CFC #1 stock. *See id.*

57. *See* T.D. 9814, 78 Fed. Reg. 23487 (Apr. 19, 2013) (to be codified at 26 C.F.R. pt. 1).

58. *See* Treas. Reg. § 1.367(a)-7(c)(3) (as amended in 2020). For an illustration of this nuance, see Treas. Reg. § 1.367(a)-7(g), Ex. (1) (as ameneded in 2020).

U.S. corporations from effectively availing themselves of the boot-within-gain rule of section 356(a) with respect to old and cold high basis shares in UST.

The regulations also seek to address appropriate gain recognition in foreign-to-foreign reorganizations where the U.S. shareholder exchanged stock in a corporation for foreign stock and boot as a means to address tax-free cash repatriations through foreign-to-foreign reorganizations under section 368(a)(1)(D).[59] Again, these difficult basis adjustment gyrations were premised on the policy goals of not allowing tax-free repatriation of cash when the underlying foreign earnings had not been subject to U.S. taxation.

The interplay of Section 304 as applied to foreign corporations is another area evidencing the Treasury Department's and the IRS's evolving concern with respect to the ability to repatriate cash in a tax-free manner. Before 2006, the IRS apparently believed that both section 367(a) and section 367(b) applied to any cross-border section 304 transaction.[60] In 2005, the Treasury Department proposed to entirely exempt the deemed section 351 transfer that occurs as part of a section 304(a)(1) exchange from a Section 367 analysis.[61] This section 351

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59. *See* Treas. Reg. § 1.367(a)-3(e)(8), Ex. (3) (1996).

60. *See e.g.*, Rev. Rul. 92-86, 1992-2 C.B. 199; Rev. Rul. 91-5, 1991-1 C.B. 114.

61. *See* Notice of Proposed Rulemaking, REG-127740-04, 70 Fed. Reg. 30,036 (proposed May 25, 2005) (to be codified 26 C.F.R. pt. 1). In this notice of proposed rulemaking, the government stated as follows:

> In a section 304(a)(1) transaction in which a U.S. person transfers the stock of an issuing corporation to a foreign acquiring corporation, without the application of section 367(a), the U.S. person will nevertheless recognize an amount of income that is at least equal to the inherent gain in the stock of the issuing corporation that is being transferred to the foreign acquiring corporation. This income recognition results from the construct of the transaction as a distribution in redemption of the acquiring corporation shares. The income recognized may be in the form of dividend income, gain on the disposition of stock, or both. Section 301(c)(1),(3).

Id.

exchange is graphically depicted in the below diagram by the transfer of the CFC #1 shares from USP to CFC #2.

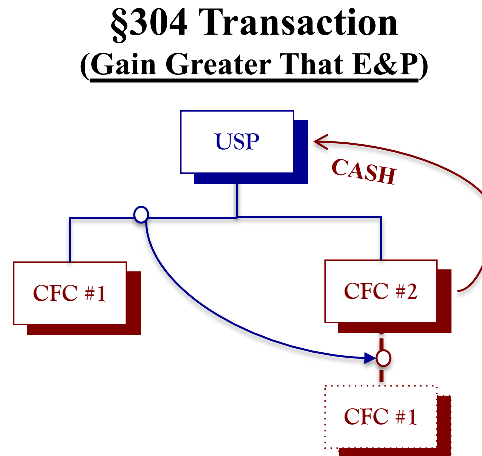

Figure 4. §304 Transaction.

The government finalized these regulations in 2006, and the final regulations continued the government's belief that the policies of section 367(a) and section 367(b) would be preserved if section 304 solely applied because the treatment of the cash as a section 301(c) distribution in a section 304 transaction generally would result in an income inclusion that would exceed the transferor's built-in gain in the assets transferred in the section 351 leg of that transaction.[62] Thus,

62. *See* T.D. 9520, 71 Fed. Reg. 8,802 (Feb. 21, 2006), which states as follows:

> The IRS and Treasury believe that, in most or all cases, the income recognized in a section 304 transaction will equal or exceed the transferor's inherent gain in the stock of the issuing corporation transferred to the foreign acquiring corporation. Elimination of the application of section 367(a) and (b) in this context will also serve the interests of sound tax administration by creating greater certainty and simplicity in these transactions, and by avoiding the over-inclusion of income that could result when section 367 and section 304 both apply to such transactions. As a result, this Treasury decision finalizes the proposed regulations and makes section 367(a) and (b) inapplicable to deemed section 351 exchanges pursuant to section 304(a)(1) transactions.

T.D. 9520, 71 Fed. Reg. at 8,803.. However, the preamble to the final regulations did caution that instances where the income inclusion under section 304 was less than what would otherwise be required under section 367(a) and (b) may be problematic in the following statement:

> [C]ommentators posit that P in the above example may not recognize income or gain because the adjusted basis of both the F2 stock that is treated as being issued in the deemed section 351 exchange, and the adjusted basis of the F2 stock already held by P prior to the transaction, is available for reduction under section 301(c)(2). On these particular facts (i.e., no earnings and profits in either the acquiring corporation or the issuing corporation), this basis position would mean that income or gain is not

allowing the transaction to be controlled entirely by section 304 meant that the distribution would first be treated as a dividend to the extent of earnings and profits of CFC #1 and CFC #2, and then secondarily as a return of capital, and then thirdly as gain. Consequently, in situations where CFC #1 and CFC #2 did not have significant earnings and profits, the distribution would be treated as a tax-free return of capital because of section 301(c)(2). The downward basis adjustment in the case of a tax-free repatriation would ensure that the built-in gain in the property transferred in the section 304 transaction would be preserved, which again was the historical concern of section 367(a). The IRS repeated this belief that the framework of section 304 appropriately handled any possible section 367(a) concerns such that section 367 was not generally applicable to such transactions, at least according to proposed regulations issued in 2009.[63]

However, later in 2009 before the ink was dry on the proposed regulations, the Treasury Department reversed course. The government explained its course reversal by stating that although section 367(a) and (b) generally would not apply to an outbound transaction subject to section 304, section 367(a) would nevertheless continue to apply where a taxpayer recovered basis in the old and cold shares and not solely from the stock issued and redeemed under section 304.[64] This bifurcation of basis recovery in terms of "new stock" and "old and cold stock" echoes the government's approach in the Deadly D guidance.

As a final part of this course correction, in Notice 2012-15,[65] the Treasury Department stated that going forward, all outbound section 304(a)(1) transactions would be subject to both section 367(a) and (b). Thus, again, the effect of this notice is to prevent the taxpayer from claiming that they are not taxable on the receipt of cash from their controlled foreign corporations in a transaction that represents a return of basis under section 301(c)(2) with respect to the high old and cold share basis.

> recognized as a result of the transaction. The IRS and the Treasury believe, however, that current law does not provide for the recovery of the basis of any shares other than the basis of the F2 stock deemed to be received by P in the section 351(a) exchange (which would take a basis equal to P's basis in the F1 stock). Thus, in the case described, P would recognize $100x of gain under section 301(c)(3) (the built-in gain on the F1 stock), and P would continue to have a $100x basis in its F2 stock that it holds after the transaction. This issue will be addressed as part of a larger project regarding the recovery of basis in all redemptions treated as section 301 distributions. This larger project will be the subject of future guidance.

T.D. 9520, 71 Fed. Reg. at 8,803.

63. *See* Prop. Treas. Reg. § 1.304-2(a)(4), 74 Fed. Reg. 3395, 3515 (Jan. 21, 2009).

64. *See* Temp. Treas. Reg. § 1.367(a)-9T, (b)-4T (2009); Temp. Treas. Reg. § 1.1248-1T(b) (2009).

65. I.R.S. Notice 2012-15, 2012-9 I.R.B. 424.

The above analysis makes clear that a key design feature for the section 367(a) regulations in the last twenty years has been to utilize them to forestall tax-free cash repatriations in the form of boot in foreign-to-foreign reorganizations that afford basis recovery under the Subchapter C rules. However, under current law, the repatriation of cash as boot in a reorganization entitled to basis recovery no longer represents a potential tax avoidance transaction. In the context of domestic corporate U.S. shareholders, now that the 2017 Tax Act generally affords tax-free status to repatriation of actual cash dividends of foreign earnings from specified foreign corporations, the section 367(a) regulations should no longer be triggered for anti-repatriation policy reasons for domestic corporate shareholders that can otherwise utilize section 245A on the repatriation of an actual dividend, and section 961(d) provides appropriate downward basis adjustments to prevent a recognition of a loss for the exempt amount and section 1059 requires a reduction of basis for any extraordinary dividend amount. So, recovery of tax basis is not a tax avoidance technique compared with an actual cash dividend any longer. In the context of individual U.S. shareholders, dividends from a qualified foreign corporation are eligible for capital gains rates, so there is rate parity now in that context. As a result, the policy justification for altering the basis recovery rules seems mooted even in the individual U.S. shareholder context.

Consequently, the Treasury Department finds itself at an inflection point. The existing regulations require gyrations under the auspices of section 367(a) to the normal basis recovery rules of Subchapter C to prevent the utilization of a nonrecognition transaction as the occasion for repatriating foreign cash with basis recovery, and so section 367(a)(4) was enlisted to alter the normal Subchapter C outcomes when these nonrecognition transactions would have allowed for basis recovery in lieu of the alternative path of simply remitting a cash dividend.

But, the rate parity for qualified dividends with capital gains rates for individual shareholders and the 2017 Tax Act changes afforded to the treatment of foreign dividends to domestic corporate U.S. shareholders fundamentally changes the relevant design parameters. As to individual U.S. shareholders, there is no reason that cash boot in a foreign reorganization should be treated differently than cash boot in a domestic corporate reorganization now that foreign dividends have rate parity with capital gains rates. Moreover, for domestic corporate U.S. shareholders, as a result of the 2017 Tax Act, the section 1248 amount can now be repatriated by a domestic corporate U.S. shareholder as a tax-free dividend by reason of the foreign dividends received deduction under section 245A. Thus, because an actual cash dividend is not subject to U.S. taxation in that context, the alternative path of repatriating cash as boot no longer presents a tax avoidance pathway compared to the

alternative path of simply remitting a cash distribution eligible for a 100% foreign dividends received deduction under section 245A. There is a great irony here. A significant evolution in the regulatory guidance under section 367(a) over the last twenty years has been premised on the idea that the utilization of basis recovery was inappropriate when there was unrepatriated foreign earnings that had not been included in income at ordinary income rates. But now, those foreign earnings can be repatriated tax-free for domestic corporate U.S. shareholders and can be repatriated with rate parity with capital gains rates for individual U.S. shareholders. So why does section 367(a) create difficult alterations to the basis recovery rules in this era? The regulations under section 367(a) are targeted for yesterday's problem and thus fail to recognize the current reality.

The existing regulations that target basis recovery transactions and designate them as "tax avoidance transactions" requiring adjustments under section 367(a)(4) are premised on design parameters that no longer are relevant. As a result, the anti-repatriation nuances of the existing section 367(a) regulations should be repealed because those regulations create needless complexity with no continuing policy rationale for doing so. Specifically, Treas. Reg. section 1.367(a)-7(c) and Treas. Reg. section 1.367(a)-3(e)(3)(i) should now be repealed with the consequence that the normal basis recovery rules afforded under Subchapter C for boot received in a reorganization should simply be allowed to work unhindered.[66] Section 304 transactions should be governed solely by section 304 without the need to apply section 367(a) or section 367(b) as was the case in the 2006 final regulations. The need to refine the basis recovery rule through adjustments under section 367(a)(4) is no longer appropriate, given that cash repatriations of unremitted foreign earnings no longer represent a tax avoidance transaction.[67] If the Treasury Department,

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66. A disclosure is perhaps in order here. The author has argued that the Subchapter C rules for basis recovery should be reformed more generally. *See* Bret Wells, *Reform of Corporate Distributions in Subchapter C*, 37 VA. TAX REV. 365, 367–68, 418–19 (2018). The policy reasons for the reforms that this author proposed for Subchapter C are premised on policy goals relevant for Subchapter C. *See id.* In fact, the international tax changes made by the 2017 Tax Act make the need for the basis recovery reforms proposed in that earlier article less relevant for the international context that is the topic of this article and of more import in the context of nonrecognition transactions involving the domestic-only context. *See id.* Thus, whatever reforms are needed to the basis recovery rules of Subchapter C, those reforms should be made in Subchapter C. *See id.* There is no longer a unique policy goal for utilizing section 367 for altering the basis recovery rules of Subchapter C, and in fact given the tax changes made by the 2017 Tax Act the reform proposals that should be made in the domestic reorganization context would not likely have a meaningful impact in the outbound context. *See id.*

67. If the Treasury Department believed that some targeted rule should exist with respect to the acceleration of foreign earnings to the extent that those earnings are ineligible for a section 245A dividends received deduction, then such a change could be made. However, targeting the

upon reflection, believes otherwise, then it would be a significant benefit to the tax community if the Treasury Department would articulate the contours of its lingering tax avoidance concerns that justify why it believes that an additional prescription for altering the normal basis recovery rules of Subchapter C remains necessary in an era where the section 1248 amount is generally afforded capital gain rate parity to individual U.S. shareholders and is generally exempt from taxation for domestic corporate U.S. shareholders.

III. HISTORIC MISSION OF SECTION 367(B)

A. Section 367(b) and Superseding Design Changes in US Law

Section 367(b)'s application is even more circuitous than section 367(a)(1) because it defines its scope in a three-step manner: (i) through cross-references to nonrecognition provisions in Subchapter C, (ii) through the determination that the transaction is not addressed in section 367(a), but then (iii) only if regulations are enacted under section 367(b) to address the specific transaction. In this regard, section 367(b) applies to the same scope of nonrecognition provisions of Subchapter C as section 367(a) but only in instances when the transaction is not addressed by section 367(a) and where Treasury regulations have been promulgated. Thus, in order to understand when Section 367(b) applies, one needs to identify a nonrecognition transaction described in Subchapter C, determine whether it is described in section 367(a), and then determine whether regulations under section 367(b) address the transaction. If the answer to the first part is "yes," if the answer to the second part is "no," and the answer to the third part is "yes," then section 367(b) applies. The transactions covered by section 367(b) include incorporations, reorganizations, divisions, and liquidations, to the extent assets move among foreign corporations or from foreign corporations to U.S. persons. Specifically, section 367(b)(1) provides as follows:

> In the case of any exchange described in Section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in [Section 367(a)(1)] a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of federal income taxes.

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regulations to that very narrow fact pattern is not likely to be relevant to the vast number of US taxpayers that need to apply these regulations, given the expansive breadth of the section 245A foreign dividends received deduction.

As indicated above, section 367(b)(1) leaves the extent of recognition of gain in this family of transfers to be determined by Treasury regulations. Treasury regulations under section 367(b) need only be "necessary or appropriate" to prevent "the avoidance of . . . tax." This phraseology leaves the Treasury Department significant latitude in shaping the contours of its regulatory regime, but even so the regulations should address instances of potential tax avoidance. Section 367(b)(2) establishes slightly more explicit guidelines for the Treasury Department's exercise of discretion in framing regulations by providing that regulations should specify:

> (A)the circumstances under which—
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> (i)gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both, or
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> (ii)gain or other amounts may be deferred for inclusion in the gross income of a shareholder (or his successor in interest) at a later date, and
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> (B)the extent to which adjustments shall be made to the earnings and profits, basis of stock or securities, and basis of assets.

In the language that has grown up around section 367(b), what this provision does is establish the framework for various income recognition events imposed on transfers that the regulations designate as being subject to section 367(b) and also sets forth authority for making further correlated adjustments to the tax attributes of the assets and/or the stock basis of the corporations involved. In terms of understanding the policy drivers for the regulatory regime under section 367(b), the Treasury Department provided the following summary of its policy goals under section 367(b) in the preamble to regulations issued in 2000:

> The principal purpose of Section 367(b) is to prevent the avoidance of U.S. tax that can arise when the Subchapter C provisions apply to transactions involving foreign corporations. The potential for tax avoidance arises because of differences between the manner in which the United States taxes foreign corporations and their shareholders and the manner in which the United States taxes domestic corporations and their U.S. shareholders.
>
> The Subchapter C provisions generally have been drafted to apply to domestic corporations and U.S. shareholders, and thus do not

> fully take into account the cross-border aspects of U.S. taxation (such as deferral, foreign tax credits, and Section 1248). Section 367(b) was enacted to help ensure that international tax considerations in the Code are adequately addressed when the Subchapter C provisions apply to an exchange involving a foreign corporation. Because determining the proper interaction of the Code's international and Subchapter C provisions is "necessarily highly technical," Congress granted the Secretary broad regulatory authority to provide the "necessary or appropriate" rules, rather than enacting a complex statutory regime. H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975).
>
> Accordingly, . . . the Section 367(b) regulations require adjustments or inclusions in order to prevent the material distortion of income that can occur when the Subchapter C provisions apply to an exchange involving a foreign corporation. . . . The modifications are based on further considerations of fairness, simplicity, and administrability.[68]

Since their inception, the Treasury regulations under section 367(b) have attempted to preserve the U.S. tax jurisdiction over foreign earnings held in a CFC environment. They hem in every possible escape of untaxed foreign earnings from the U.S. tax environment and trigger immediate income inclusions if there is a de facto cash repatriation in a reorganization. Thus, careful attention to foreign earnings and profits and cash repatriation is required to unpack these regulations. Those levers were important in an era when foreign dividends from foreign subsidiaries were subject to U.S. taxation at ordinary income rates upon an actual or deemed repatriation of these foreign earnings. It was in that context that the regulations under sections 367(b) set forth a series of toll charges as a means to adequately preserve U.S. tax jurisdiction over untaxed foreign earnings that may migrate out of a foreign subsidiary in a nonrecognition transaction and where carryover asset basis may allow assets to migrate into the hands of a U.S. person with a high basis.

An additional "anti-repatriation" policy concern surfaced in 2006 when the Service believed that taxpayers could use a reorganization to repatriate cash in the form of boot in the reorganization and utilize a return of basis in instances where the U.S. shareholder held a high basis in the foreign stock. The Service believed this allowance of a return of basis in foreign stock raised policy concerns under sections 367(b) even though the earnings remained classified as sections 1248 earnings and profits because the repatriation of cash was not treated as an immediate

68. *See* Stock Transfer Rules, Preamble, T.D. 8862, 65 Fed. Reg. 3589, 3589–90 (Jan. 24, 2000).

income inclusion.[69] Thus at least since 2006, the Treasury Department has extended the scope of its toll charges to instances where foreign cash is repatriated in a reorganization transaction where the cash boot is generally afforded basis recovery under Subchapter C. However, one needs to juxtapose these historical concerns with the design parameters that now exist under current law. At least three critical design changes have been made to U.S. law that call into question the architecture set forth at the core of the Section 367(b) regulations as follows.

1. Design Change #1: Qualified Dividends Eligible for Capital Gain Rates.

If the foreign corporation is incorporated in a treaty jurisdiction, then the foreign dividend would represent a qualified dividend[70] that is eligible for the preferential capital gains rate specified in Section 1(h) when received by an individual U.S. shareholder. This preferential capital gain rate parity for qualified dividends has existed since the 2003 Tax Act.[71] A qualified dividend includes an actual dividend from a qualified foreign corporation,[72] and the Service has agreed that a qualified dividend includes a deemed dividend by reason of section 1248.[73] A qualified foreign corporation that is eligible to remit a qualified dividend includes any foreign corporation (other than a passive foreign investment company) that is either: (i) incorporated in a possession of the United States, or (ii) eligible for benefits of a comprehensive income tax treaty (the "treaty test").[74]

In the formative period of the section 367(b) regulations, the Treasury Department was rightly concerned with nonrecognition transactions that would allow individual U.S. shareholders to bail-out untaxed foreign subsidiary earnings at capital gains rates, so toll charges were put into place to ensure dividend treatment to U.S. individual shareholders. Preservation of the section 1248 amount as an ordinary dividend made sense in that era.

However, in a world where the same capital gains rate preference exists for the sale of foreign subsidiary stock as exists for the receipt of

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69. I.R.S. Notice 2006-85, 2006-2 C.B. 677. This policy concern resulted in Reg. § 1.367(b)-10. *See* T.D. 9526, 76 Fed. Reg. 28,890 (May 19, 2011).

70. *See* I.R.C. § 1(h)(11)(C).

71. *See* Jobs and Growth Tax Relief Reconciliation Act of 2003, PUB. L. NO. 108-27, § 302(a), 118 STAT. 752, 760. Section 1(h)(11) was made permanent in 2012. *See* Am. Taxpayer Relief Act of 2012, PUB. L. NO. 112-240, § 102, 126 STAT. 2313, 2318–19 (2013).

72. A qualified foreign corporation is a corporation that is incorporated in a possession of the United States or is eligible for benefits under a comprehensive income tax treaty with the United States or is publicly-traded on a U.S. exchange. I.R.C. § 1(h)(11)(C)(i), (ii).

73. I.R.S. Notice 2004-70, 2004-2 C.B. 724, 726.

74. *See* I.R.C. § 1(h)(11)(C)(i), (iii). The Secretary of the United States determines if the treaty is satisfactory for the purpose of these provisions, including an exchange of information program.

a qualified foreign dividend,[75] the historical need to preserve ordinary dividend characterization of the section 1248 amount for individual U.S. shareholders is no longer necessary as the rate parity between capital gains and foreign qualified dividends makes this prior era bail-out concern no longer relevant. Taxpayers under current law have multiple self-help paths to avail themselves of qualified dividend rates. For example, the taxpayer could interpose a foreign corporation that is a resident of a treaty jurisdiction so that any dividends from lower-tier CFCs can be re-remitted to the individual U.S. shareholder from a qualified foreign corporation that is eligible for relief.[76] Alternatively, a taxpayer could migrate its non-treaty based foreign corporation to an eligible treaty jurisdiction so that dividends from them would be eligible for qualified dividend treatment.[77] Or, an individual U.S. shareholder could transfer its ownership in any nonqualified foreign corporations to a U.S. domestic holding corporation so that the foreign dividends from the nonqualified foreign corporation to the U.S. domestic holding corporation would be eligible for exemption by reason of section 245A. Then, thereafter, the re-remittance of the divided from the domestic corporation to the ultimate individual U.S. shareholder would be treated as a qualified dividend.[78] Thus, multiple paths exist for taxpayers to avail themselves of the benefits of the reduced rate of taxation for qualified dividends. Perhaps, in a particular case, a taxpayer would not be able to avail itself of one of these alternatives. However, the sheer diversity of alternative paths to achieve capital gains rate parity for foreign dividends leads one to believe that, in today's context, the imposition of a toll charge to individual U.S. shareholders under the section 367(b) regulations for the section 1248 amount creates an accelerated income inclusion when there is no underlying rate differential concern that justifies this outcome particularly when the ultimate shareholder level gain can be adequately preserved in the stock basis of individual U.S. shareholders under the normal Subchapter C rules. Thus, the continued toll charge under the section 367(b) regulations now represents a trap for the unwary and fails to promote a discernible normative policy goal. Consequently, because the ultimate amount of capital gain can be adequately preserved under the normal basis rules of Subchapter C without the need for a section 367(b) toll charge, the continued

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75. *See* I.R.C. § 1(h)(11).

76. *See* I.R.C. § 1(h)(11)(C)(i)(II). The Service has set forth a listing of jurisdictions where the entities that are residents in those jurisdictions are recognized by the Service to be qualified foreign corporations. *See* I.R.S. Notice 2011-64, 2011-2 C.B. 231.

77. This was the intended planning addressed in Smith v. Commissioner, 151 T.C. 41, 42, 73 (2018) (holding the taxpayer's loss rested upon the taxpayer's inability to demonstrate that the foreign corporation had obtained tax residency status in Cyprus at the time of the dividend remittance).

78. *See* I.R.C. § 1(h)(11)(B)(i)(I).

imposition of a toll charge is no longer based on a goal of preventing an inappropriate bail-out of foreign earnings at capital gains rates now that foreign dividends are generally afforded rate parity with capital gains rates.

If the Treasury Department were to conclude otherwise, then the Treasury Department should articulate why its section 367(b) regulations should continue to create such toll charges because the policy rationale for doing so is no longer clear.

2. Design Change #2: Elimination of U.S. Taxation on repatriation or remittance of foreign dividends from specified foreign corporations to a domestic corporate U.S. shareholder alters the policy parameters for how Section 367(b) should now apply in that context.

Historically, as will be discussed in Part III.C., *infra*, toll charges were put into place in instances where section 1248 earnings and profits migrated out of CFC solutions. When those earnings were repatriated or were the subject of a deemed repatriation event from CFCs, those earnings were subject to U.S. taxation upon the actual[79] or deemed repatriation event.[80]

However, subject to the analysis in the next succeeding paragraph, section 245A(a) now largely eliminates U.S. taxation on the actual repatriation of section 1248 earnings and profits to domestic corporate U.S. shareholders through the enactment of a 100% foreign dividends received deduction. Only to the extent that foreign earnings represent **Section 245A Ineligible Earnings** (discussed further below) is there a potential need to protect the scope of the U.S. tax base. Absent the existence of Section 245A Ineligible Earnings, when a capital gain arising from the sale of a controlled foreign corporation is recharacterized now as a deemed foreign dividend, section 1248(j), added in the 2017 Tax Act, provides that "any amount received by the domestic corporation which is treated as a dividend by reason of this section shall be treated as a dividend for purposes of applying section 245A."[81] Thus, a deemed repatriation event under current law provides the same nontaxable outcome. The Treasury Department, through regulations, has eliminated any income inclusion under section 956 for earnings that would have been eligible for section 245A treatment.[82]

79. *See* I.R.C. § 61(a)(7).

80. *See* I.R.C. § 951(a)(1)(B); I.R.C. § 956(a).

81. I.R.C. § 1248(j).

82. Treas. Reg. § 1.956-1(a)(2) (as amended in 2022). A further analysis of the Treasury Department's aggressive use of its regulatory authority is beyond the scope of this article, but is addressed by the author elsewhere. *See* JOSEPH ISENBERGH & BRET WELLS, INTERNATIONAL TAXATION: U.S. TAXATION OF FOREIGN PERSONS AND FOREIGN INCOME ¶ 75.5.1 (6th ed. 2022).

Thus, the section 1248 amount (or gain to the extent of those earnings), whether actually distributed, deemed repatriated through a disposition of the stock, or deemed repatriated through loans from the a CFC, are now effectively exempt from U.S. taxation to a domestic corporate U.S. shareholder.

So, it is now entirely appropriate to question whether section 367(b) should be reformed, given that its scope for applying toll charges far exceeds the scope needed to protect the U.S. tax jurisdiction's reach regarding section 1248 earnings when those earnings are effectively exempt from U.S. taxation to domestic corporate U.S. shareholders. Yet, even though section 1248 earnings are in large part no longer taxable, the section 367(b) toll charges require accelerated exempt income inclusions even though the design parameters of current law obviate any tax avoidance rationale for their doing so.

Instead of how section 367(b) sets forth its triggering events for toll charges, a more narrowly tailored set of toll charges should be in place with respect to the earnings of a foreign corporation that would not be eligible for the section 245A foreign dividends received deduction. In this regard, earnings attributable to a hybrid dividend are ineligible for the Section 245A foreign dividends received deduction,[83] but this prohibition is substantially reduced in practical impact with respect to hybrid dividends received by CFCs because hybrid dividends are immediately taxable under Subpart F if received by a CFC.[84] Section 245A does not apply to any earnings attributable to a dividend from a qualified electing fund,[85] but the CFC regime applies in lieu of a passive foreign investment company ("PFIC") regime in the overlap situation[86] so that this provision has limited implications for a U.S. person that owns CFCs. Section 245A does not apply to any earnings attributable to U.S. source income or that are attributable to foreign earnings that have already been subject to taxation in the U.S.,[87] but, through self-planning, much U.S. source income is typically not earned by CFCs. Section 245A does not apply to a dividend from a foreign corporation that is not a 10% specified foreign corporation.[88] Section 245A also does not apply to a distribution from a corporation that does not satisfy certain holding period requirements.[89] Furthermore, section 245A does not apply to dividends received from tax-exempt organizations[90] or to any dividends received by a domestic corporation from a foreign corporation that is

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83. *See* I.R.C. § 245A(a), (e).
84. I.R.C. § 245A(e)(2)(A).
85. I.R.C. § 245A(f).
86. I.R.C. § 1297(d).
87. I.R.C. § 245(c).
88. I.R.C. § 245A(a).
89. I.R.C. § 246(c)(1); I.R.C. § 246(c)(5).
90. I.R.C. § 246(a)(1).

itself a hybrid dividend.[91] Finally, through regulations, the Treasury Department has designated foreign earnings that represent an extraordinary reduction amount and fifty percent of any extraordinary disposition amount are ineligible for section 245A treatment.[92] As a collective, earnings that fall into one or more of the above categories are ineligible for section 245A treatment and are collectively referred to in this article as "**Section 245A Ineligible Earnings**." To the extent that foreign earnings constitute Section 245A Ineligible Earnings, the transfer of those Section 1245A Ineligible Earnings in a manner that purges their taint arguably should trigger a section 367(b) toll charge, but only when that is in fact what happens. Said differently, if no Section 245A Ineligible Earnings exist, or if the transaction does not create a purge of the Section 245A Ineligible Earnings taint, then the movement of unrepatriated foreign earnings presents no tax avoidance concern and thus, the regulations under section 367(b) should not create a triggering event beyond that scope.

3. Design Change #3: Section 1059 and Section 961(d) Basis Adjustments Outside Section 367(b).

If earnings are actually repatriated and eligible for the 100% dividends received deduction, section 1059 generally requires a corporation's stock basis to be reduced by the amount of any extraordinary dividends. To the extent that section 1059 does not apply, then section 961(d) requires the basis in the stock of a specified foreign corporation to be reduced by the amount of that exempt repatriation for purposes of computing loss upon the subsequent disposition of the stock for the tax-free repatriation of cash followed by a deductible loss on the sale of the foreign subsidiary thereafter when its value is reduced by the exempt distribution.[93] Now that these provisions provide their own basis adjustment rule, section 367(b) no longer needs to make basis adjustments because section 1059 and section 961(d), in combination, provide for basis adjustments that already adequately protect against transactions that bail out CFC earnings through exempt dividends and then later dispose of the stock at a loss. Thus, the historic concern of a bail-out of foreign earnings at capital gains rates is no longer a relevant concern under current law, and the ultimate individual shareholder gain or loss is adequately addressed outside of section 367(b). In the next and succeeding sections, this article will further

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91. I.R.C. § 245A(e)(1).

92. Treas. Reg. § 1.245A-5(b)(2) (as amended in 2020). A discussion of the Treasury Department's authority to construct these further exclusions from Section 245A is beyond the scope of this article and is addressed elsewhere. *See* ISENBERGH & WELLS, *supra* note 82, ¶ 55.7.2.

93. *See* I.R.C. § 961(d). Section 961(d) requires coordination if stock basis in the foreign corporation is reduced by reason of section 1059 so that a double reduction does not occur. *Id.*

unpack how the above design changes made under current law call into question the existing scope of and rationale for the accelerated toll charges imposed under the section 367(b) regulations.

B. Section 367(b) Inbound Issues.

Treas. Reg. section 1.367(b)-3(a) applies to a U.S. domestic corporation that acquires assets from a foreign corporation in a transaction described in section 332 or section 368(a)(1). These transactions involve the inbound transfer of assets where the assets are afforded a carryover basis to the U.S. domestic corporation and the U.S. domestic corporation succeeds to the earnings and profits of the foreign corporation. However, the foreign corporation may never have been subject to U.S. taxation on those earnings, so the section 367(b) regulations require the U.S. domestic corporation to include, as a deemed dividend, the "all earnings and profits amount" that it inherits by reason of section 381(a).[94] The Treasury Department explained the rationale for this deemed income inclusion of the all earnings and profits amount in inbound nonrecognition transactions in the following manner:

> The principal policy consideration of Section 367(b) with respect to inbound nonrecognition transactions is the appropriate carryover of attributes from foreign to domestic corporations. This consideration has interrelated shareholder-level and corporate-level components. At the shareholder level, the Section 367(b) regulations are concerned with the proper taxation of previously deferred earnings and profits. At the corporate level, the Section 367(b) regulations are concerned with both the extent and manner in which tax attributes carryover in light of the

94. Treas. Reg. § 1.367(b)-3(b)(3). "The term all earnings and profits amount with respect to stock in a foreign corporation means the net positive earnings and profits . . . attributable to such stock . . . ." Reg. § 1.367(b)-2(d)(1). The "all earnings and profits amount" includes only the earnings of the corporation itself whose shares are exchanged, and not the earnings of any lower-tier corporations. Reg. § 1.367(b)-2(d)(3)(ii). Earnings and profits are determined in the same manner as for domestic corporations, except that various amounts specified in section 1248(d), which include earnings previously taxed under Subpart F and income effectively connected with a U.S. business, are left out. Reg. § 1.367(b)-2(d)(2)(ii). The "all earnings and profits amount" with respect to stock of a foreign corporation is determined according to the attribution principles of section 1248. Reg. § 1.367(b)-2(d)(3)(i)(A)(1); Reg. § 1.1248-8. However, the "all earnings and profits amount" is "determined without regard to the amount of gain that would be realized on a sale or exchange of the stock of the foreign corporation." Reg. § 1.367(b)-2(d)(1). Thus, while the attribution principles of section 1248 apply, the amount ultimately established under these principles is not the amount that would actually be taxed under section 1248. In addition, unlike the methodology for determining the section 1248 amount, "the all earnings and profits amount is determined without regard to whether the foreign corporation was a [CFC] at any time during the five years preceding the Section 367(b) exchange . . . without regard to whether the shareholder owned a ten percent or greater interest in the stock, and without regard to whether the earnings and profits of the foreign corporation were accumulated in post-1962 taxable years or while the corporation was a [CFC]." Reg. § 1.367(b)-2(d)(3)(i)(A)(1).

> variations between the Code's taxation of foreign and domestic corporations.
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> The Section 367(b) regulations have historically focused on the carryover of earnings and profits and bases of assets, simultaneously addressing the shareholder and corporate level concerns by accounting for any necessary adjustments through an income inclusion by the U.S. shareholders of the foreign acquired corporation (and without limiting the extent to which the domestic acquiring corporation succeeds to the attributes). . . . The requirement to include in income the all earnings and profits amount results in the taxation of previously unrepatriated earnings accumulated during a U.S. shareholder's (direct or indirect) holding period. This income inclusion prevents the conversion of a deferral of tax into a forgiveness of tax and generally ensures that the Section 381 carryover basis reflects an after-tax amount. . . . .
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> In finalizing these regulations, the IRS and Treasury considered whether future Section 367(b) regulations should limit the extent to which tax attributes carryover from foreign to domestic corporations. Such a limitation would more directly implement the Section 367(b) policy related to the carryover of attributes and, as a result, reduce the class of U.S. persons required to have an income inclusion in connection with an inbound nonrecognition transaction. Such a limitation would also enable the Section 367(b) regulations to address the carryover of attributes attributable to a non-U.S. person's holding period. The IRS and Treasury request comments as to the merits of an attribute carryover limitation, as well as other approaches that could address the carryover of tax attributes related to a non-U.S. person's holding period under Section 367(b).[95]

The above Treasury regulatory pronouncement, issued in 2000, contemplates the need for adjustments to the carryover basis regime in certain situations.

Subsequently, as part of the 2004 Tax Act,[96] Congress amended section 362(e) to prevent the import of a net built-in loss carryover basis transaction or Section 351 transfer. Thus, the migration of a built-in loss asset basis in a carryover basis transaction is now addressed elsewhere so that a further overlay from section 367(b) is no longer needed. In addition, as part of the 2017 Tax Act, section 961(d) was enacted to provide that the stock basis of a specified foreign corporation is reduced by the amount of any exempt repatriation for purposes of

95. *See* T.D. 8862, 65 Fed. Reg. 3589, 3590 (Jan. 24, 2000).

96. American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 836(a), 118 STAT. 1418, 1594.

computing loss upon the subsequent disposition of that stock,[97] thus obviating a further need to utilize section 367(b) in that endeavor. These provisions, in tandem, provide adjustments that adequately address attempts to create artificial stock losses in the CFC stock or create built-in loss assets in a carryover basis transaction.

With this background in mind, the fundamental question that is now presented is whether and to what extent an inbound reorganization or tax-free liquidation should require the U.S. domestic corporation to include, as a deemed dividend, the all earnings and profits amount. When assets move from a CFC to a domestic corporation (most often by a liquidation that would normally be tax-free under Section 332), a "toll charge" is imposed on foreign earnings (in the form of a constructive dividend).[98] The constructive dividend is not treated as an "extraordinary reduction" of the interest of the U.S. shareholder.[99] So, the deemed dividend should be entitled to a 100% dividends received deduction under section 245A, assuming that the transferee foreign corporation was a specified foreign corporation that had been held for the requisite length of time to satisfy the holding period requirements of section 246(c).[100] Said differently, in the post-2017 Tax Act era, the "toll charge" has been reduced to zero in the context of an inbound distribution of earnings and profits. However, the section 367(b) regulations still operate to trigger a "toll charge" of an exempt inclusion, at least if the all earnings and profits amount is not tainted with section 245A Ineligible Earnings. Thus, the section 367(b) regulations go through a lot of work in the inbound section 332 liquidation or inbound reorganization context for apparently no continuing policy reason now that section 245A is in the Code. As a result, section 367(b) should no longer require a toll charge that includes the all earnings and profits amount as part of an inbound reorganization except to the extent that the all earnings and profits

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97. Section 961(d) requires coordination if stock basis in the foreign corporation is reduced by reason of section 1059 so that a double reduction does not occur. *See* Amendment to 1986 Code, Pub. L. No. 115–97, § 14102(b)(1), 131 Stat. 2192 (2017).

98. To avoid a double counting or double exclusion problem, the "all earnings and profits" amount that is included as a deemed dividend is not again carried over to the transferee corporation. Treas. Reg. § 1.367(b)-3(f). However, because earnings and profits or deficits in earnings and profits that are effectively connected with the conduct of a trade or business within the U.S. or attributable to a permanent establishment are excluded from the "all earnings and profits" amount, those earnings attributes are carried over to the transferee domestic acquiring corporation. *Id.*

99. *See* Treas. Reg. § 1.245A-5T(e)(2)(i)(A).

100. The holding period requirement requires the stock to be held for at least 365 days during the 731 day period that begins 365 days before the deemed dividend date. *See* I.R.C. § 246(c)(1), (c)(5). Because in an inbound reorganization or inbound liquidation the basis in the stock of the transferee foreign corporation disappears, this holding period requirement effectively requires the transferee foreign corporation to have held the stock for one year prior to the inbound transaction because no post-transfer holding period exists given the stock disappears. *See id.*

amount represents a Section 245A Ineligible Amount. This same policy argument was recently made by the New York State Bar Association in a report it issued on section 367(b).[101] This report provides further evidence that there is broad recognition that the existing section 367(b) regulations do not appear right-sized for today's policy paradigms in the context of inbound reorganizations and liquidations.[102]

If the reason that the all earnings and profits amount is ineligible for section 245A treatment is simply that the holding period requirement of section 246(c) has not been satisfied, then arguably, this defect should not trigger a toll charge under section 367(b) either. In this regard, the holding period requirement rationally matters in situations where the foreign corporate stock might be disposed of in a taxable transaction after the nonrecognition event, but that later stock disposition is not possible in a situation where the transferee foreign corporation disappears as part of the inbound nonrecognition transaction. Thus, the policy concerns that should matter in terms of a holding period requirement are obviated when the foreign stock to which the holding period requirement would otherwise relate ***disappears*** in the inbound nonrecognition transaction. The disappearance of the foreign corporate stock basis obviates the concerns that the holding period rules were designed to protect.

If the Treasury Department were concerned that some holding period requirement should be met, then this holding period requirement could be formulated so that it looks to a combined holding period. For example, a holding period requirement could be designed to be satisfied if the U.S. domestic corporation's holding period for the transferee foreign corporation stock and its holding period for the transferee foreign corporation's assets received in the inbound nonrecognition transaction, in combination, satisfy the holding period time frame of section 246(c). If this continuity exists, the inbound nonrecognition transaction has not created a tax avoidance potential that should require a toll charge for earnings that are ineligible for section 245A solely because the holding period requirement was not met.[103] Regardless, if the Treasury Department, upon reflection, believes otherwise, then it would be a significant benefit to the tax community if the Treasury Department would articulate the contours of its policy rationale for why it believes that the section 367(b) regulations should create a toll charge when the underlying earnings (except where Section 245A Ineligible Earnings exist) are eligible for exemption under section

101. For a further discussion of these issues, see TAX SECTION, N.Y. STATE BAR ASS'N, REPORT NO. 1463, AN ANALYSIS OF POTENTIAL DESIGN CHANGES TO REGULATIONS 1.367(B)-3 IN LIGHT OF THE TAX CUTS AND JOBS ACT (2022) [hereinafter N.Y. S.B.A. 2022 REP.].

102. *Id.* at 22–24.

103. *Id.* at 26–27.

245A for domestic corporate U.S. shareholders and section 362(e) already prevents the importation of a net built-in loss under Subchapter C rules.

As a final comment on inbound issues, the changes in the design parameters of current law have now afforded taxpayers an inappropriate stock basis step-up under the section 367(b) regulations in the context of inbound triangular reorganizations that is no longer justifiable under current law. The below diagram sets forth an illustrative transaction that implicates the interplay of the section 367(b) regulations with the normal Subchapter C results in the context of an inbound triangular reorganization.

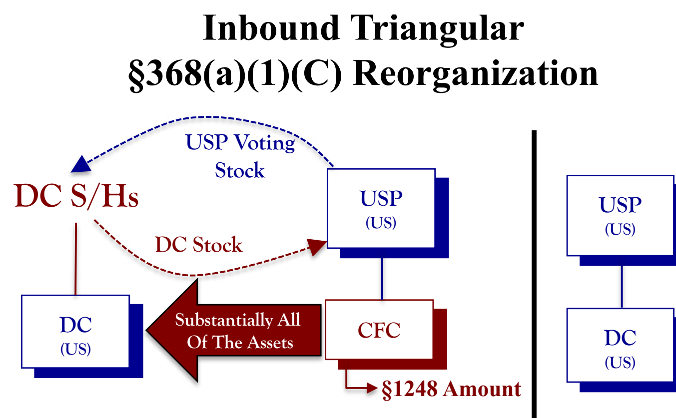

Figure 5. Inbound Triangular §368(a)(1)(C) Reorganization.

Under normal Subchapter C rules, USP would normally be entitled to nonrecognition treatment and a substitute stock basis on the exchange of its USP voting stock for the DC stock by reason of section 354 and section 358 in a reorganization described in section 368(a)(1). However, the section 367(b) regulations alter this normal Subchapter C result in at least two relevant ways. First, under the existing section 367(b) regulations, the normal Subchapter C rules are altered such that a section 1248 shareholder of a controlled foreign corporation (USP in the above diagram) must include as a deemed dividend its pro rata share of its CFC's section 1248 amount because its CFC no longer maintains its status as a CFC after the inbound reorganization.[104] In addition, as a further modification to normal Subchapter C rules, the U.S. shareholder (USP in the above diagram) is entitled to increase its basis in the stock received in the reorganization above the amount normally afforded under section 358 because of its deemed dividend inclusion of

104. Treas. Reg. § 1.367(b)-3(a), (b)(3) (as amended in 2022).

the section 1248 amount with respect to its CFC stock.[105] This added stock basis bump made sense in the pre-2017 era because the added taxable deemed dividend inclusion to USP altered the normal Subchapter C nonrecognition rules and so absent any corresponding stock basis step-up there would be a potential double taxation result to USP when it ultimately disposed of its DC stock.

However, the 2017 Tax Act has changed the relevant design parameters such that this added stock basis adjustment is now no longer appropriate. In this regard, the domestic corporate U.S. shareholder (USP in the above diagram) is entitled to claim a 100% foreign dividends received deduction because of section 245A as part of the deemed dividend inclusion of the section 1248 amount from its CFC, so the effect of current law is that USP has no U.S. taxable income inclusion and yet USP is still afforded a stock basis step-up under the section 367(b) regulations in addition to what the normal Subchapter C rules would have allowed for a triangular reorganization. This stock basis adjustment, which had been premised on a desire to prevent a double taxation result, is only justifiable when the deemed dividend inclusion of the all earnings and profits amount is subject to U.S. taxation, but that is no longer true when the domestic corporate U.S. shareholder is able to avail itself of section 245A. Thus, the current reality is that the continued allowance of a stock basis adjustment creates an inappropriate windfall for taxpayers. As a result, given the design parameters of current law, the section 367(b) regulations should not require a deemed dividend inclusion of the all earnings and profits amount to the extent it is eligible for a section 245A deduction, and more importantly, the section 367(b) regulations should not provide any positive stock basis adjustments as a result of an exempt foreign deemed dividend income inclusion that did not create any net U.S. income tax exposure. The net effect of these gyrations required by the existing section 367(b) regulations is to afford an artificial stock basis adjustment to taxpayers beyond the Subchapter C rules even though there is no double taxation concern in the post-2017 era. Consequently, under current law, the Treasury Department should simply allow the normal Subchapter C results to apply in the inbound reorganization context without any modification to those rules by reason of section 367(b) when the impact would be that the foreign deemed dividend income inclusion would simply be offset by a foreign dividends received deduction under section 245A, and in that context, the Treasury

105. *See* Treas. Reg. § 1.367(b)-3(b)(3)(i) (as amended in 2022); Treas. Reg. § 1.367(b)-2(e)(3)(ii) (as amended in 2022). For a further discussion of these basis adjustment alterations by reason of a section 1248 amount inclusion, see Joseph M. Calianno & Brent J. Gregoire, *CFC Restructuring and Disposition: How International Provisions Alter the General Rule*s, 12 J. INT'L TAX'N 34 (2001).

Department should no longer provide any corresponding positive stock basis adjustment beyond what section 358 affords.

C. Section 367(b) Foreign-to-Foreign Issues.

Prior to the 2017 Tax Act, earnings and profits generated directly or indirectly by the foreign corporation while it constituted a controlled foreign corporation (the so-called "section 1248 amount")[106] was subject to a toll charge if a section 1248 shareholder[107] lost its status as such with respect to the section 1248 amount as part of a reorganization or section 351 transfer.[108] The section 1248 amount is a core concept of the section 367(b) regulations. In simplest terms, it is the previously untaxed earnings in a controlled foreign corporate solution that are attributable to a U.S. shareholder's ownership in that controlled foreign corporation and its chain of subsidiaries.[109] The section 1248 amount normally includes the earnings of *all* the lower-tier corporations in a chain of corporations. It is this basic amount—all previously untaxed post-1962 earnings—that would be included in income as a dividend under section 1248 absent some nonrecognition transaction shielding the amount from immediate U.S. taxation to a U.S. shareholder.

If the assets of a CFC remain in a CFC environment in the course of a corporate readjustment, current U.S. taxation is generally not imposed under section 367(b) as long as a U.S. person's status as a U.S. shareholder remains intact vis-à-vis the successor CFC and the section 1248 amount.[110] However, when assets move from a CFC to a foreign corporation that is not a CFC, current U.S. taxation is generally imposed on the U.S. shareholder on the section 1248 amount. For transactions

106. Treas. Reg. § 1.367(b)-2(c) (as amended in 2022).

107. Treas. Reg. § 1.367(b)-2(b) (as amended in 2022).

108. Treas. Reg. § 1.367(b)-4(b)(1) (2000).

109. The "term section 1248 amount with respect to stock in a foreign corporation means the net positive earnings and profits (if any) that would have been attributable to such stock and includible in income as a dividend under section 1248 and the regulations thereunder if the stock were sold by the shareholder." Treas. Reg. § 1.367(b)-2(c)(1) (as amended in 2022). The limitation of the section 1248 amount to net positive earnings and profits prevents specific foreign subsidiaries' deficits in earnings and profits from being taken into account in section 367(b) exchanges. In determining the section 1248 amount when a shareholder is a foreign corporation, the foreign corporation is deemed to be a U.S. person. Treas. Reg. § 1.367(b)-2(c)(1)(i) (as amended in 2022). A section 1248 amount is, thus, separately defined with respect to stock of lower-tier foreign subsidiaries that have no direct U.S. shareholders. A foreign corporation is not treated as a U.S. person, however, for the purpose of determining whether foreign corporations further down a chain of subsidiaries are themselves CFCs. *See id.* Therefore, a non-CFC in a chain does not create the status of CFC for its own subsidiaries by virtue of being deemed a U.S. person. *See* Treas. Reg. § 1.367(b)-2(c)(2), Ex. (2) (as amended in 2022). The holding period of such a foreign shareholder is determined by reference to the period that the foreign corporation's own section 1248 shareholders held an interest in it. Treas. Reg. § 1.367(b)-2(c)(1)(ii) (as amended in 2022); Treas. Reg. § 1.1248-8 (as amended in 2016); *see* Treas. Reg. § 1.367(b)-2(c)(2), Ex. (3).

110. *See* Treas. Reg. § 1.367(b)-4(b) (2000).

involving lower-tier CFCs, however, earnings can be preserved for U.S. taxation by being imputed to a higher-tier subsidiary that remains a CFC. A host of ancillary adjustments are necessary to make these imputations accurate. Taken together, these patterns ensure that all earnings arising in the CFC environment will eventually be subject to U.S. tax under the presupposition that those earnings would be taxed as ordinary income when received. If the transfer of the CFC stock did not cause a U.S. shareholder to lose its status as a section 1248 shareholder vis-à-vis the transferee foreign corporation, then no income inclusion of the section 1248 amount is needed as those earnings are adequately preserved as a section 1248 amount attributable to the U.S. shareholder. To this end, one must recognize when toll charges are imposed, and those typically occur when earnings slip out of controlled foreign corporate solution or are repatriated. Toll charges are not typically imposed when the section 1248 amount remains within the controlled foreign corporate environment when the section 1248 amount is preserved. When imposed, the result is to create previously taxed income that must be tracked and to which foreign currency exchange gain or loss must then be determined upon actual repatriation. The springing to life of these tax concepts creates divergences and complexity in how the transaction would normally be characterized under foreign law or Subchapter C. This adds needless complexity and contravenes the stated policy goals of the section 367 regulations.[111] The Treasury Department explained the policy rationale for these toll charges in the following manner:

> The historic policy objective of section 367(b) in both of these contexts has been to preserve the potential application of section 1248. Thus, the amount that would have been recharacterized as a dividend under section 1248 upon a disposition of the stock (section 1248 amount) generally must be included in income as a dividend at the time of the section 367(b) exchange to the extent such section 1248 amount would not be preserved immediately following the section 367(b) exchange.[112]

The concern over the transfer of untaxed foreign earnings through a nonrecognition transaction that allows the section 1248 amount to lose its status as such vis-à-vis the U.S. shareholder made sense in an era when foreign dividends were taxed at a different rate than capital gains rates for individual U.S. shareholders and where foreign dividends were subject to taxation to domestic corporate U.S. shareholders upon

111. *See* T.D. 8862, 65 Fed. Reg. 3589, 3589–90 (Jan. 24, 2000) (stating that the modifications to the section 367(b) regulations "are based on further considerations of fairness, simplicity, and administrability").

112. *Id.*

repatriation. However, with the enactment of section 1(h)(11) (eliminating the bail-out of foreign earnings at capital gain rate concern for individual U.S. shareholders) in 2004, the enactment of section 245A (eliminating the deferral of foreign earnings concern for domestic corporate U.S. shareholders) in 2017, and the Treasury Department's elimination of section 956 inclusions to domestic corporate U.S. shareholders through regulations, the need to preserve the section 1248 amount no longer represents a tax avoidance policy concern that should trigger a section 367(b) toll charge.[113] However, the section 367(b) regulations still remain locked into a goal of preserving the section 1248 amount and triggering a toll charge if and when it is not preserved.

Yet, the need to trigger a toll charge needs to be evaluated in terms of design changes that have been made since these regulations were issued. For domestic corporate U.S. shareholders, an actual distribution of the section 1248 amount to a domestic corporate U.S. shareholder[114] is tax exempt given section 245A, and a distribution of the section 1248 amount to an individual shareholder[115] creates no rate difference if the section 1248 amount represents a qualified dividend. Thus, nonrecognition transactions that shift the status of a shareholder with respect to the section 1248 amount no longer creates a tax avoidance potential as the design parameters under current law are fundamentally different than the design parameters that existed when the section 367(b) toll charges were fashioned around the section 1248 amount.

Instead of triggering toll charges based on the paradigm of a bygone era, section 367(b) should be recalibrated so that it only creates toll charges in one of two ways, the first being if foreign earnings would not be eligible for section 1(h)(11) treatment vis-à-vis individual U.S. shareholders if the Treasury Department believed that there were some compelling reason to create an income recognition event at that time. The alternative triggering scenario should arise if the earnings represent Section 245A Ineligible Earnings vis-à-vis domestic corporate U.S. shareholders and the nonrecognition transaction causes those earnings to somehow lose that taint vis-à-vis the U.S. domestic corporate shareholder. Stated in the negative, if the unrepatriated foreign earnings would be eligible for section 1(h)(11) treatment vis-à-vis individual U.S. shareholders or the taxpayer could, through self-

113. Others have recognized this as well. *See* Stewart Lipeles et al., *Did Anyone Notice the TCJA Made Code Sec. 367(b) Obsolete?*, 99 TAXES MAG., July 7, 2021, at 7–8.

114. For domestic corporate shareholders, the ability to rely on section 245A effectively means that the earnings are exempt from taxation entirely.

115. For individual shareholders, the ability to claim a capital gains preference for qualified dividends under section 1(h)(11) creates the need to preserve earnings or create repatriation of earnings when there is no rate differential between qualified dividends and capital gains. This makes the historic need to preserve foreign earnings for ordinary income treatment an overly complex exercise based on an antiquated concern.

planning, create a structure that affords that result, then the nonrecognition transaction has not implicated a U.S. tax avoidance concern in the individual U.S. shareholder context. In the domestic corporate U.S. shareholder context, if the foreign earnings would be eligible for section 245A treatment vis-à-vis a domestic corporate U.S. shareholder or even if those earnings are tainted as section 245A Ineligible Earnings but would not lose that tainted status after the nonrecognition transaction, then the nonrecognition transaction has not implicated a U.S. tax avoidance concern in the domestic corporate U.S. shareholder context. At present, the current section 367(b) regulations impose a toll charge beyond what is needed to adequately protect against a tax avoidance concern and thus create a potential trap for the unwary and create outcomes that are unmoored to the fundamental policy goals that section 367(b) should seek to promote.

D. Section 367(b) regulations and their antiquated anti-repatriation toll charges.

As previously mentioned in Part II.D, *supra*, the Treasury Department decided to utilize its regulatory authority under section 367(a) to prevent the nontaxable repatriations of cash from foreign subsidiaries even though the built-in gain in foreign subsidiary stock was preserved and the U.S. parent company had not altered its position with respect to the unrepatriated section 1248 earnings and profits of its controlled foreign corporations. This anti-repatriation policy goal has also taken root in the section 367(b) regulations. In this regard, in 2006, the Treasury Department stated that it had become concerned about transactions where a controlled foreign corporation purchased the stock of its U.S. parent and then used the U.S. parent stock to acquire a foreign target corporation in a transaction that was intended to qualify as a tax-free reorganization under section 368(a)(1)(B).[116] Under normal Subchapter C rules, the U.S. parent corporation's receipt of cash in exchange for its own shares would be nontaxable because of section 1032,[117] and the controlled foreign corporation obtained a cost basis in the parent shares by reason of section 1012. The transaction, under this construct, did not require the U.S. parent to incur an income inclusion with respect to the foreign subsidiary's unrepatriated section 1248 amount.[118] These repatriation techniques came to be known as "Killer B

116. INTERNAL REVENUE SERV., CORP. INVERSIONS – OVERVIEW OF MAJOR ISSUES 3 (2016), https://www.irs.gov/pub/int_practice_units/isocup_1_10_01.pdf.

117. *See* Treas. Reg. § 1.1032-1(a).

118. *See* Treas. Reg. § 1.367(b)-4(b)(1)(ii) (as amended in 2000). The U.S. parent stock was disposed of before the close of a quarter-end in order to avoid an income inclusion by reason of having an investment in U.S. property. *See* I.R.C. § 956(a).

Transactions." Two common variations of these Killer B Transactions are graphically depicted in the below diagrams.

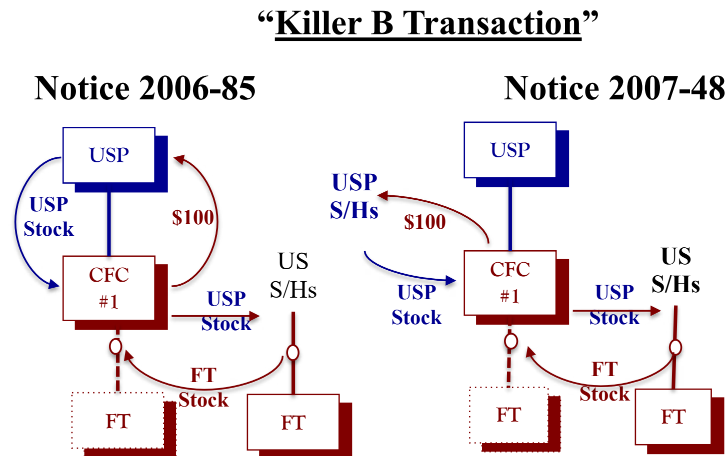

Figure 6. "Killer B Transaction."

In two notices, the Treasury Department announced that these Killer B Transactions raise significant policy concerns because they allow the U.S. parent corporation to repatriate and/or access foreign subsidiary cash ($100 in the above diagrams) while avoiding any income inclusion with respect to the unrepatriated section 1248 earnings and profits of the controlled foreign corporation. In Notice 2006-85,[119] the Treasury Department stated that it intended to issue regulations under section 367(b) that would treat the $100 payment from CFC #1 to USP in the above-left diagram as a separate transaction that, for tax purposes, is bifurcated from the overall exchange, thus, in effect, treating CFC #1's payment of the $100 of cash in the Notice 2006-85 diagram as a stand-alone taxable section 301 dividend in much the same manner as section 304 would have done if it had been applicable.[120] In Notice 2007-48,[121] the Treasury Department expanded the deemed section 301 dividend treatment of Notice 2006-85 to include transactions where a subsidiary acquires stock of its U.S. parent

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119. I.R.S. Notice 2006-85, 2006-2 C.B. 677, *obsoleted by* T.D. 9400, 73 Fed. Reg. 30,301 (May 27, 2008), *adopted with modification by* T.D. 9626, 76 Fed. Reg. 28,890 (May 19, 2011).

120. The IRS agrees that "[s]ection 304, by its terms, does not apply to the transfer by a shareholder of its own stock to a controlled corporation in exchange for property, even though the economic effect of that transaction is essentially identical." *Id.* at 679. However, the IRS then went on to state that "a triangular reorganization involving a foreign corporation is described in section 367(b) and, therefore, may be subject to regulations issued under the broad regulatory authority granted therein" and that it was "on this basis that regulations will be issued to address the triangular reorganizations covered by this notice." *Id.* at 680.

121. I.R.S. Notice 2007-48, 2007-1 C.B. 1428, *obsoleted by* T.D. 9400, 73 Fed. Reg. 30,301 (May 27, 2008), *adopted with modification by* T.D. 9626, 76 Fed. Reg. 28,890 (May 19, 2011).

from the open market in order to use such stock as part of a larger acquisitive reorganization.[122]

Subsequently, the Treasury Department issued temporary[123] and eventually final regulations[124] to implement reforms designed to prevent the tax-free repatriation of cash through triangular reorganizations. The resulting regulations included rules that would apply either the regulations promulgated under section 367(a) or the regulations promulgated under section 367(b)—but not both— to these triangular reorganizations through a series of priority rules. Under the priority rules, section 367(a) would apply if the gain recognized by the shareholders of the target corporation under section 367(a) would be equal to or greater than the amount of the deemed distribution from the acquiring corporation to its parent compared to the amount that would be treated as a dividend under the section 367(b) regulations if section 367(b) toll charges caused income inclusions as a result of treating the boot as deemed dividends under section 301(c)(1) or gain under section 301(c)(3). If the section 367(a) gain amount were less than the section 367(b) toll charges that could have applied, then the priority rules would allow the section 367(b) regulations to apply such that the cash utilized by the subsidiary to acquire parent stock in exchange for property would be treated as a deemed distribution in the triangular reorganization in the amount of the property transferred by the subsidiary to its parent for the parent stock.

No built-in gain property was transferred in these Killer B Transactions, and the section 1248 earnings of CFC #1 remained within a controlled foreign corporation environment.[125] Yet, the section 367(b) regulations were amended to create an immediate income inclusion to the U.S. parent in the context of Killer B Transactions. Why? The reason is that the use of CFC #1's cash to purchase U.S. parent stock was seen as a de facto repatriation event and thus represented an appropriate occasion to subject to U.S. taxation a corresponding amount of the unrepatriated section 1248 earnings and profits of CFC #1. Thus, seen in its larger context, the Treasury Department utilized its authority under section 367(b) to create tax results that were analogous to the results afforded under section 304 without the benefit of section 304's

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122. This result reversed longstanding case law and the Service's administrative guidance that had concluded in the non-section 367 context that a subsidiary's acquisition of its parent stock in the open market for cash was not a deemed dividend to the U.S. parent. *See* Broadview Lumber Co. v. U.S., 561 F.2d 698, 702–05 (7th Cir. 1977); Virginia Materials Corp. v. Comm'r, 67 T.C. 372, 378–79 (1976), aff'd 577 F.2d 739 (4th Cir. 1978); Webb v. Comm'r, 67 T.C. 293, 301, 304–07 (1976), *aff'd* 572 F.2d 135 (5th Cir. 1978); Rev. Rul. 80-189, 1980-2 C.B. 106.

123. *See* Temp. Treas. Reg. § 1.367(b)-14T (2008).

124. Treas. Reg. § 1.367(b)-10 (2011).

125. *See* Joseph Calianno & Kagney Petersen, *IRS Issues Notice on 'Killer B' Transactions: Curbing Repatriation or Overreaching?,* 18 J. INT'L TAX'N 52, 54–55 (2007) (making this observation).

direct applicability.[126] Respected practitioners questioned whether the Treasury Department had exceeded its authority for several reasons,[127] including because the failure to treat a foreign corporation as a corporation (the sanction prescribe by the statutory language of section 367(b) when it does apply) would not result in the recast deemed dividend treatment prescribed by the Treasury Department's guidance. Thus, even though the Treasury regulations prescribe a result beyond the literal stricture of simply not treating a party to a reorganization as a corporation, which again is the statutory sanction of section 367(b), the government rejected these concerns[128] and finalized its regulations,[129] thus utilizing its section 367(b) regulatory authority to attack repatriation strategies even when the section 1248 amount was preserved in the transaction.

Specifically, Treas. Reg. section 1.367(b)-10(a)(2)(iii) provides that the section 367(b) final regulations do not apply to a triangular reorganization if, in an exchange under section 354 or 356, one or more U.S. persons exchange stock or securities of the target corporation and the amount of gain in the target stock by such U.S. persons under section 367(a)(1) is equal to or greater than the sum of the amount of the deemed distribution that the parent corporation would treat as a dividend under section 301(c)(1) or as gain under section 301(c)(3) (together, section 367(b) income). This aspect of the coordination is referred to as the section 367(a) priority rule: if sufficient gain were

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126. Section 304 on its face is inapplicable to this transaction because section 304(a)(2) applies to a subsidiary's purchase of its parent's stock from an entity other than the parent corporation. *See* Treas. Reg. § 1.1032-1(a) (2001) (disposal of parent stock for cash is not taxable to parent); Rev. Rul. 80-189, 1980-2 C.B. 106 (subsidiary purchases parent stock from sole parent shareholder not a section 304 transaction); Rev. Rul. 69-261, 1961-1 C.B. 94 (subsidiary's purchase of parent stock from open market is not a section 304 transaction); Joseph Caliano & Kagney Petersen, *Have the IRS and Treasury Overextended Their Reach?,* J. CORP. TAX'N, Sept./Oct. 2007, at 11, 12, 15.

127. *See* Robert Willens, *Service Rejects 'Killer Bees' Technique for Repatriating Earnings of Foreign Subsidiary but Courts May Reject Move for Lack of Authority,* DAILY TAX REP. (BNA), Oct. 5, 2006, at J-1; Calianno & Petersen, *supra* note 125, at 55; Calianno & Petersen, *supra* note 126, at 15–16; Joseph Calianno & Kagney Peterson, *Notice 2007-48, a Further Attack on 'Killer B' and Similar Transactions,* J. INT'L TAX'N, Aug. 2007, at 18, 18 ; Joseph Calianno & Kagney Petersen, *"Killer B" The Saga Continues: IRS Issues New Regulations,* J. INT'L TAX'N, Sept. 2008, at 34, 64; Jeffrey L. Rubinger, *Final 'Killer B' Regulations Further Expand Likelihood of Gain Recognition by Taxpayers,* J. TAX'N, at 365, 370; William R. Pauls & H. Karl Zeswitz, Jr., *A Gambit Vanquished: The Rise and Fall of the 'Killer B',* 52 TAX MGMT MEM. (BNA) 419 (2011).

128. *See* T.D. 9400, 73 Fed. Reg. 30301, 30302 (May 27, 2008) (justifying its regulatory attack on the 'Killer B Transactions' by stating in the preamble that Congress granted the Secretary authority to provide regulations "necessary or appropriate to prevent the avoidance of Federal income taxes" and identified "transfers constituting a repatriation of foreign earnings" as a type of transfer to be covered in regulations to be promulgated by the Secretary); *see also* T.D. 9526, 76 Fed. Reg. 28890, 28891 (May 19, 2011) (stating that the government was not adopting comments that section 304 concepts should not apply to a subsidiary's use of cash to purchase parent stock in the open market).

129. *See* Treas. Reg. § 1.367(b)-10 (as amended in 2022).

subject to taxation under section 367(a), then section 367(b) is supplanted. However, the final regulations give priority to the section 367(b) regulations if the amount of the section 367(a)(1) gain (without regard to any exceptions thereto) is less than the section 367(b) income determined under the section 367(b) final regulations. In that situation, Treas. Reg. section 1.367(a)-3(a)(2)(iv) provides that section 367(b) takes priority rule with the consequence that the section 367(b) priority rule turns off the application of section 367(a)(1) (the so-called section 367(b) priority rule).

Although the government's goal in its promulgation of the priority rules of Treas. Reg. section 1.367(b)-10(a)(2)(iii) and Treas. Reg. section 1.367(a)-3(a)(2)(iv) was to stop Killer B Transactions or at least require gain or dividend inclusion in the amount of the cash repatriated in the transaction, the amendments made to the section 367 regulations that effectuated this anti-repatriation goal unexpectedly provided taxpayers with the means to implement an inversion that avoided the anti-inversion regulations contained in Treas. Reg. section 1.367(a)-3(c). The relevant planning opportunity is set forth in the below two diagrams that are based on two publicly announced inversion transactions:[130]

130. The diagrams are based on two high profile deals where respected tax counsel advised shareholders that the legacy U.S. shareholders potentially would receive tax-free treatment on their exchange of U.S. target stock for the foreign acquirer stock even though the legacy U.S. target shareholders owned more than fifty percent of the vote and value of the combined entity. *See* Endo Health Sols. Inc., Proxy Statement (Schedule 14A), at 108–09 (Jan. 24, 2014); Liberty Global, Inc., Proxy Statement (Schedule 14A), at 170–72 (May 1, 2013).

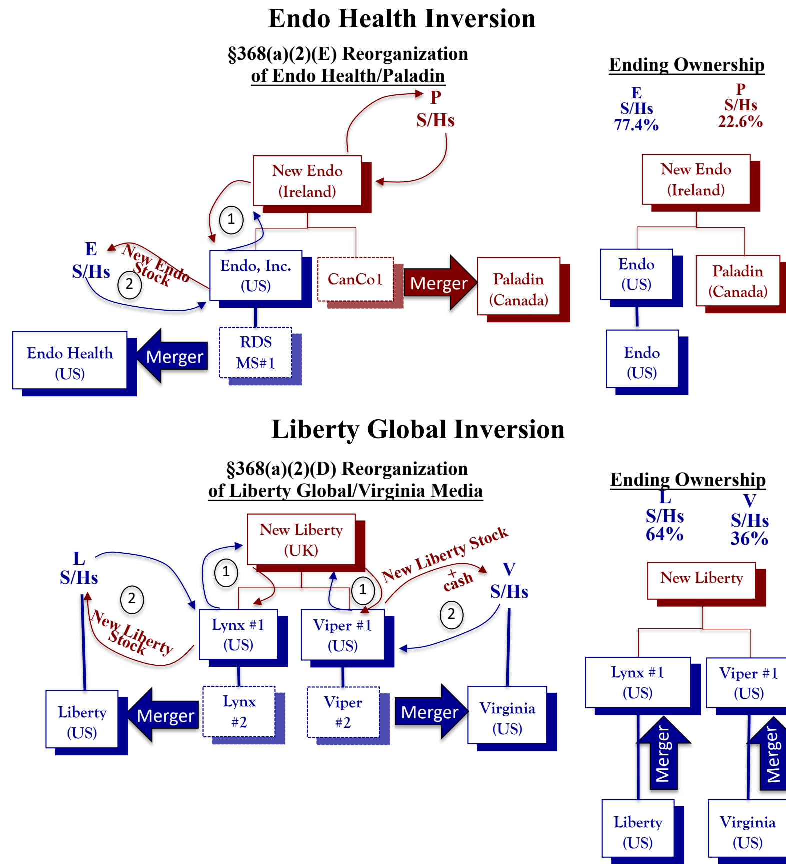

Figure 7. Endo Health and Liberty Global.

In both the Endo Health diagram (the above top diagram) and the Liberty Global diagram (the above bottom diagram), a U.S. subsidiary (Endo, Inc. (US) in the top diagram and Lynx #1 and Viper #1 in the bottom diagram) purchased stock of a newly created inverted parent entity by issuing its own promissory note and stock to the inverted parent entity (New Endo in the top diagram and New Liberty in the bottom diagram). Under general corporate tax principles, this transaction would have been treated as a purchase transaction, but the changes to the section 367(b) regulations designed to attack the "Killer B Transactions" supplant this result and treat the transfer of the subsidiary's promissory note as a section 301 distribution in an amount equal to the full value of the note.[131] The transfer of the parent stock is treated as a separate transaction that occurs after the distribution of the subsidiary's promissory note and is treated as a contribution in an

131. *See* Treas. Reg. § 1.367(b)-10(b)(1) (as amended in 2022).

amount equal to the fair market value of the contributed parent stock.[132] Because the subsidiary that issued its promissory note was also newly created, the amount of its earnings and profits and the basis in its stock (apart from the later-in-time basis increase occasioned by the subsequent contribution of the parent stock) was insignificant, so the distribution of the subsidiary's promissory note created a substantial amount of section 301(c)(3) gain in the hands of the inverted parent company.[133] However, this section 301(c)(3) gain escapes any actual U.S. taxation by reason of the applicable U.S. tax treaty.[134] In addition, even though this section 301(c)(3) gain was not subject to any actual U.S. taxation, its existence causes section 367(a) to become inapplicable. In this regard, under a coordination rule contained in Treasury Regulation section 1.367(a)-3(a)(2)(iv), the Treasury regulations provide that section 367(a) is inapplicable to any triangular reorganization where the total amount of the income recognized by the inverted parent under section 301(c)(1) or (c)(3) is greater than the aggregate built-in gain of the target U.S. shareholders in their U.S. target stock.[135] In these transactions, the aggregate gain was recognized by the inverted foreign parent,[136] so all aspects of the section 367(a) regulations (including Treas. Reg. section 1.367(a)-3(c)) were turned off even though the inverted foreign parent was not actually subject to U.S. taxation on its section 301(c)(3) gain. The irony of this result is striking: the U.S. subsidiary issues a promissory note, and this promissory note along with the acquisitive reorganization accomplishes a leveraged corporate inversion that affords significant earnings stripping advantages (a flashpoint for Congress and the Treasury

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132. This result was explicitly clear in the temporary regulations that contained an example. *See* T.D. 9400, 73 Fed. Reg. 30301, 30302 (May 27, 2008). The final regulations modified this example but state that the distribution and contribution are separate transactions and the distribution is listed first, so presumably it occurs first-in-time consistent with the temporary regulations. *See* Treas. Reg. § 1.367(b)-10(b)(1)-(3) (as amended in 2022).

133. *See* I.R.C. §§ 301(c)(1)-(3), 316(a)(1)-(2); Prop. Treas. Reg. § 1.301-2, 74 Fed. Reg. 3509 (Jan. 21, 2009). The later-in-time contribution then provided the inverted parent with a basis increase in its subsidiary stock in an amount equal to the fair market value of the parent stock that was transferred to the subsidiary. *See* Treas. Reg. § 1.367(b)-10(b)(2) (as amended in 2022).

134. Taxpayers claimed that the minor dividend amount would be entitled to reduced withholding taxes under U.S. tax treaties and that the section 301(c)(3) gain would be exempt from all U.S. taxation pursuant to treaty. *See* Endo Health Sols. Inc., *supra* note 130, at 110).

135. In this regard, Treas. Reg. § 1.367(a)-3(a)(2)(iv) provides that neither section 367(a) generally, nor the anti-inversion provisions of Treas. Reg. § 1.367(a)-3(a) apply to triangular reorganization if the requirements of Treas. Reg. § 1.367(b)-10(a)(2)(iv) are met. Treas. Reg. § 1.367(b)-10(a)(2)(iv) provides that this provision is met if the amount of gain in the U.S. target corporation's stock or securities that would otherwise be recognized under section 367(a)(1) is less than the sum of the amount of the deemed distribution under section 301(c)(1) and the amount of such deemed distribution treated as gain from the sale or exchange of property under section 301(c)(3).

136. This is due to treating the note as a distribution taxable under section 301(c)(1) and section 301(c)(3) with no meaningful basis in the note.

Department),[137] and yet, it is the addition of this promissory note into the triangular reorganization rubric that affords the opportunity to avoid the applicability of the anti-inversion regulations of Treas. Reg. section 1.367(a)-3(c). From a policy perspective, one would have thought that an inversion that is combined with earnings stripping attributes would be the poster child for when the anti-inversion regulations of section 367(a) should apply, yet it is this transaction that is excluded from their application as a result of the amendments to the sections 367(b) regulations that were made in order to stop the Killer B Transactions. Furthermore, the final regulations under section 367(b) provided a similar rule, stating that section 367(b) is inapplicable to any triangular reorganization if the total amount of the income recognized by the inverted parent under sections 301(c)(1) or (c)(3) is greater than the aggregate built-in gain of the target U.S. shareholders in their U.S. target stock.[138]

In what can be understood as an "uh-oh moment" for the government, the IRS issued Notice 2014-32.[139] In this notice, the IRS stated that forthcoming amendments to its existing regulations will provide that only dividend income and section 301(c)(3) gain ***that is actually subject to U.S. taxation*** should be considered for purposes of applying the coordination rule of Treas. Reg. section 1.367(a)-3(a)(2)(iv). This change effectively means that section 301(c)(3) gain that escapes any U.S. taxation will be excluded for purposes of determining whether the inverted parent receives a taxable section 301

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137. The earnings stripping opportunities afforded by inversion debt has been well documented. *See* S. REP. NO. 108-192, at 142 (2003); *see also* STAFF OF THE JOINT COMM. OF TAX'N, 109TH CONG., GEN. EXPLANATION OF TAX LEGIS. ENACTED IN THE 108TH CONGRESS 343 (Comm. Print 2005); OFF. OF TAX POL'Y, U.S. DEP'T TREASURY, REP. TO THE CONG. ON EARNINGS STRIPPING, TRANSFER PRICING, AND U.S. TAX TREATIES 8 (2007).

138. *See* Treas. Reg. §1.367(b)-10(a)(2)(iii) (as amended in 2022). What is more, inversion benefits arising from these transactions are not assailable under section 7874. *See* I.R.C. § 7874. The recent round of inversions has spurred further congressional calls for further tightening section 7874. *See* Stop Corporate Inversion Act of 2014, S. 2360 113th Cong. (2014); Andrew Velarde & Lindsey McPherson, *Inversion Rule Tightening to Wait for Tax Reform, Wyden Says*, 74 TAX NOTES INT'L (TA) 724 (May 21, 2014). The author has stated elsewhere that such efforts, although commendable, are unlikely to be effective because what is needed is to address the base erosion opportunities afforded to all foreign-owned multinational corporations; simply attacking inversion transactions without addressing the underlying financial incentives that make inversion transactions financially attractive, ensures that efforts to effectuate inversions will continue. *See* Wells, *supra* note 41, at 429-30, 437; *see also* Bret Wells, *What Corporate Inversions Teach Us About International Tax Reform,* 127 TAX NOTES FED. (TA) 1345, 1345 (June 21, 2010); In the Endo Health inversion, the foreign parent is not treated as a surrogate foreign parent under Section 7874 because the legacy U.S. shareholders of the U.S. target corporation own less than 80% of the foreign parent. *See* I.R.C. § 7874(b); *see also* Endo Health Solutions Inc., *supra* note 130, at 105. Likewise, in the Liberty Global inversion, the foreign parent is not a surrogate foreign parent under section 7874 because the foreign parent possesses a substantial foreign business presence conducted in the country of the inverted parent's incorporation. *See* I.R.C. § 7874(a)(2); Temp. Treas. Reg. § 1.7874-3T (2018); *see also* Liberty Glob., Inc., *supra* note 130 at 167–68.

139. *See* I.R.S. Notice 2014-32, 2014-20 I.R.B. 1006.

distribution in an amount that exceeds the aggregate built-in gain of the U.S. shareholders.[140] Once that section 301(c)(3) gain is excluded from the analysis, the inversion transactions depicted in the above diagram will not be able to fall within the section 367(b) priority rule contained in Treas. Reg. section 1.367(a)-3(a)(2)(iv) because the inverted parent's section 301(c)(3) gain that is actually subject to U.S. taxation under section 367(b) is likely to be less than the aggregate built-in gain of the U.S. shareholders of the U.S. target corporation that is subject to U.S. taxation under section 367(a). So, section 367(a) would continue to apply.[141] As an additional belt and suspenders approach, the Treasury Department indicated in Notice 2014-32 that both section 367(a) and (b) would both apply to triangular reorganizations even if the inverted parent's total income exceeds the aggregate built-in gain of the U.S. shareholders in the scenario where the inverted parent receives a dividend from a U.S. subsidiary that is not subject to any actual U.S. taxation or where no actual dividend exists in the transaction.[142] The above regulatory modifications, once effective, will cause the U.S. shareholders in the above diagrams to recognize their built-in gain in their U.S. target stock by reason of Treas. Reg. section 1.367(a)-3(c) because that aspect of the section 367(a) regulations would continue to apply regardless of whether or not the section 367(a) priority rule or the section 367(b) priority rule were controlling. With this said, these proposed amendments to the existing regulations would only apply from the date of the 2014 notice.[143] Thus, the transactions contemplated

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140. *See id.* at 1007–08.

141. *See id.*

142. *See id.* at 1008 (stating that "the regulations will clarify that the no-U.S.-tax exception [in Treas. Reg. § 1.367(b)-10(a)(2)(ii)] will apply if the deemed distribution that would result from application of § 1.367(b)-10 to the triangular reorganization would not be treated as a dividend under section 301(c)(1) that would be subject to U.S. tax (for example, by reason of an applicable treaty or by reason of an absence of earnings and profits)."). Furthermore, this notice states that Treas. Reg. § 1.367(b)-10(b)(4) will be modified to provide that the parent corporation ("New Endo" in the left diagram and "New Liberty" in the right diagram) must treat the transfer of the parent stock to its subsidiary as being part of the later-in-time triangular reorganization. *See id.* This has the consequence that the inverted parent company's basis in its subsidiary stock is increased in an amount equal to the exchanging U.S. shareholders' aggregate basis in their stock, which could well be less than the fair market value of the parent stock used in the exchange. *See* Treas. Reg. § 1.358-6 (2008). Finally, the anti-abuse rules in the regulations will be clarified to take into account the earnings and profits of other corporations (even if unrelated) for purposes of determining the application of these rules. *See* I.R.S. Notice 2014-32, 2014 I.R.B. 1006, 1007–08.

143. *See* I.R.S. Notice 2014-32, 2014-20 I.R.B. 1006, 1008. Below, the Service describes when the proposed changes to the regulations in the Notice take effect:

> Except as otherwise provided in this section 5, the regulations described in section 4 of this notice will apply to a triangular reorganization that is completed on or after April 25, 2014. The regulations described in this notice will not apply if (i) T was not related to P or S (within the meaning of section 267(b)) immediately before the triangular reorganization; (ii) the triangular reorganization was entered into either pursuant to a

for Liberty Global and Endo Health appear to be grandfathered in.[144] The Treasury Department has indicated in its 2022 Priority Guidance Plan that regulations under section 367(b) to implement guidance announced in Notice 2014-32 are a priority even though this notice has been outstanding for the past eight years and final regulations have not yet been issued to implement its guidance.[145] This episode has caused many to believe that the Treasury Department has experienced significant growing pains in its efforts to implement its anti-repatriation goals under section 367 alongside its existing anti-inversion goals.[146]

Following its issuance of Notice 2014-32, the Treasury Department issued Notice 2016-73.[147] In Notice 2016-73, the Treasury Department announced its need to further modify the priority and coordination rules to address additional instances where its anti-repatriation efforts were trampled on by other aspects of its regulations that were promulgated to address other policy concerns. In particular, Notice 2016-73 seeks to modify the overlapping priority rules in the following manner: (i) future regulations will provide that the priority rules will give priority to the section 367(b) regulations whenever the target corporation is a foreign corporation so that the outcome would be that a deemed dividend distribution from the foreign corporation to its parent is considered to have been made in the amount of the cash and property used to acquire the parent stock in the triangular reorganization; and (ii) if the target corporation is foreign, Notice 2016-73 would also require the foreign target corporation's shareholders to recognize all of the gain with respect to the target stock (either by reason of an inclusion of the section 1248 amount or simply as section 301(c)(3) gain) without the ability to enter into a gain recognition agreement. To accomplish these goals, Notice 2017-63 announced that the Treasury Department would modify the section 367(a) priority rule contained in Treas. Reg. section 1.367(b)-10(a)(2)(iii) so that the section 367(a) priority rule only applies when the target corporation in the triangular reorganization is a domestic corporation; when the target

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> written agreement that was (subject to customary conditions) binding before April 25, 2014 and all times afterward, or pursuant to a tender offer announced before April 25, 2014 or that is subject to comparable foreign laws; and (iii) to the extent the P acquisition that occurs pursuant to the plan of reorganization is not completed before April 25, 2014, the P acquisition was included as part of the plan before April 25, 2014.

Id.

144. *See id.* The Service did make a statement that it believed that the anti-abuse rules of Treas. Reg. § 1.367(b)-10(d) have been too narrowly construed by taxpayers. *See id.* So, it will be interesting to see if the Service proceeds to attack these transactions on that basis.

145. *See* U.S. DEP'T OF THE TREASURY, PRIORITY GUIDANCE PLAN FOR 2021-2022: THIRD QUARTER UPDATE 16 (June 1, 2022).

146. *See* Mindy Herzfeld, *News Analysis: The IRS Shuts Down the Serial 'Killer B'*, 74 TAX NOTES INT'L 394 (May 5, 2014).

147. I.R.S. Notice 2016-73, 2016-52 I.R.B. 908.

corporation is instead a foreign corporation, the section 367(b) regulations will take priority unless an exception under Treas. Reg. section 1.367(b)-10(a)(2)(i) or (ii) applies.[148] The effect of this modification will be that property provided to an acquiring foreign corporation will be treated as a taxable distribution of property in full by reason of the section 367(b) regulations regardless of how much gain is otherwise recognized in the triangular reorganization under section 367(a). Furthermore, for any U.S. exchanging shareholders in the transaction subject to section 354 or section 356 under Subchapter C, the section 367(b) priority rule contained in Treas. Reg. section 1.367(a)-3(a)(2)(iv) will be revised to provide that those shareholders will be subject to section 367(b) and not section 367(a))(1) with the consequence that those U.S. shareholders will include their share of the section 1248 amount under the section 367(b) regulations and then will recognize stock gain on the exchange of the stock in the foreign corporation for the acquirer's stock.[149]

In addition to the modifications to triangular reorganizations, Notice 2016-73 also announced an intention to modify the regulations that apply to inbound nonrecognition transactions (including inbound section 332 liquidations or inbound reorganizations under section 368)[150] to increase the all earnings and profits amount that must be included as a toll charge to include "specified earnings." For this purpose, "specified earnings" is defined as the lesser of the following three amounts: (i) the sum of the earnings and profits (including deficits) of the lower-tier subsidiaries of the foreign acquired corporation, (ii) the "excess asset basis," and (iii) the built-in gain in the stock of the foreign acquired corporation (reduced by the all earnings and profits amount determined without regard to Notice 2016-73). Excess asset basis exists when the tax basis of the assets in the foreign acquired corporation exceeds the following: (i) the outside stock basis of the foreign acquired corporation, (ii) the earnings and profits of the foreign acquired corporation, and (iii) the liabilities of the foreign acquired corporation that the acquiring domestic corporation assumes. When this situation occurs, the inside asset basis exceeds the outside stock basis plus the earnings and profits inclusion so that the effect of the inbound transaction is to import a greater tax basis to the U.S. corporation through a nonrecognition transaction without a corresponding amount of an income inclusion. Said differently, the concept of "excess asset basis" attempts to identify carryover asset basis that was created in transactions that did not generate earnings and profits, is not from borrowed funds, and is not a result of a shareholder

148. *See id.* at 911.
149. *See id.*
150. These regulations are set forth in Treas. Reg. § 1.367(b)-3 (as amended in 2022).

contribution. The Treasury Department believes that the carryover of this excess tax basis in an inbound nonrecognition transaction affords tax basis in a manner that is inappropriate when the deemed income inclusion is of a lesser amount. This aspect of Notice 2016-73 thus applies beyond the triangular reorganization context and signals an effort to address all inbound tax-free transactions.

The Treasury Department provided two examples to illustrate how further regulations would alter the outcomes governed by existing Treas. Reg. section 1.367(a)-4. The facts for the two examples are set forth in the below diagram.

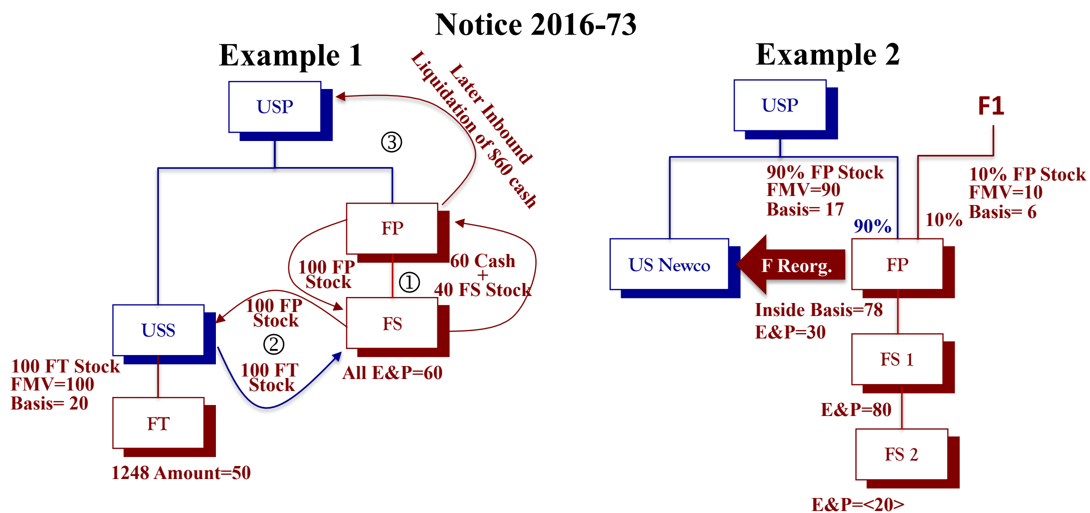

Figure 8. Notice 2016-73.

In the facts posited in Example 1 of Notice 2016-73,[151] FP has no earnings and profits but owns all the stock of FS which has $60 of earnings and profits. In Step 1, FP transfers 100 of its FP stock to FS in exchange for 60 of cash and 40 of additional FS stock. In Step 2, FS exchanges its newly-acquired FP stock for all of the stock in FT. On a later date, and purportedly unrelated to the reorganization depicted in Step 2, FP in Step 3 engages in an inbound transfer described in Treas. Reg. section 1.367(b)-3 such as an inbound liquidation under section 332 where all of FP's assets (namely, $60 of cash) are received by USP at a time when FP on a stand-alone basis had no earnings and profits but held $60 of cash. Prior to Notice 2016-73, the subsequent transfer of the $60 of cash to USP in Step 3 arguably would have repatriated $60 of cash without incurring any section 367 toll charges as arguably there were

151. The facts and analysis here are identical to those set forth in I.R.S. Notice 2016-73, 2016-52 I.R.B. 908, 912.

no associated earnings and profits attributable to the inbound liquidation. Prior to Notice 2016-73, a deemed distribution from FS to FP would not result in section 367(b) income, as described in the 2014 notice, because any dividend income to FP would not be subject to U.S. tax and would not give rise to an income inclusion under section 951(a)(1)(A) by reason of section 954(c)(6) and a subsequent inbound transaction with respect to FP results in no income inclusion to USP under Treas. Reg. section 1.367(b)-3 because FP's earnings and profits are not increased under the final regulations. Thus, FP's all earnings and profits amount remains zero.[152] Notice 2016-73 would alter this outcome by making adjustments that have the effect of treating the $60 of cash received by USP at the time of the FP liquidation as in effect representing a distribution of an allocable amount of the section 1248 earnings of FT and a partial recognition of gain on the FT stock.[153] In this regard, pursuant to section 4.01 of Notice 2016-73, Treas. Reg. section 1.367(b)-4 (as modified by section 4.02 of Notice 2016-73) applies to the $60 of FT stock exchanged for FP stock that FS acquired from FP for $60 of cash in lieu of section 367(a)(1). After stating that the section 367(b) rules would take priority in all events, the Treasury Department then asserted that the exchange of 60 of the FP stock for 60 of the FT stock creates a toll charge in the form of an income inclusion from USS of a $30 deemed dividend for the section 1248 amount of FT (i.e., 60% of the transaction represents a distribution of 60% of the $50 of the section 1248 amount). In addition, USS would then recognize an additional $18 of gain ($48 gain (i.e., ($80 total built-in stock gain x 60% of the transfer related to tainted stock) - $30x deemed dividend) with respect to the transfer of its FT stock.[154]

In Example 2,[155] USP has a higher built-in gain in the FP stock than earnings and profits that exist in FP while FP owns subsidiaries that

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152. *See* N.Y. STATE BAR ASS'N, REP. ON NOTICE 2016-73, REP. NO. 1377, at 7 (2017).

153. Notice 2016-73 accepts that the transaction in Example 1 represents a triangular reorganization described in Treas. Reg. § 1.367(b)-10(a). *See* I.R.S. Notice 2016-73, 2016-52 I.R.B. 908, 912. Pursuant to Treas. Reg. § 1.367(b)-10(b)(1), as modified by the rules announced in Notice 2014-32, adjustments must be made that have the effect of treating the $60 of cash from FS to FP as a distribution under section 301. *See id.*; I.R.S. Notice 2014-32, 2014-20 I.R.B. 1006. As a result, the effect of Notice 2014-32 is to cause the $60 of cash in step 1 to be considered as a dividend distribution that is separate from, and occurring immediately before, FS's acquisition of FP stock. *See* I.R.S. Notice 2016-73, 2016-52 I.R.B. 908, 912–13; I.R.S. Notice 2014-32, 2014-20 I.R.B. 1006. That dividend would have generally not been subject to taxation, however. *See* I.R.C. § 954(c)(6).

154. If USS properly files a gain recognition agreement pursuant to Treas. Reg. §§ 1.367(a)-3(b)(2) and 1.367(a)-8, USS does not recognize gain under section 367(a)(1) with respect to the $40x of FT stock exchanged for FP stock that FS acquired from FP in exchange for the $40x of FS common stock. The concurrent application of both a full section 367(b) toll charge and a gain recognition event under section 367(a) is controversial. Commentators have argued that the statute does not allow concurrent application of both means of creating an income inclusion at the same time. *See* N.Y. STATE BAR ASS'N, *supra* note 152, at 16–20.

155. The facts and analysis here are identical to those set forth in I.R.S. Notice 2016-73, 2016-52 I.R.B. 908, 913.

have additional earnings and profits at lower tiers levels. USP must include in income as a deemed dividend the all earnings and profits amount with respect to its FP stock by reason of Treas. Reg. section 1.367(b)-3(b)(3) which, under the final regulations, would be $27 (90% of the FP earnings and profits). This is where Notice 2016-73 attempts to alter the results. Pursuant to section 4.03 of Notice 2016-73, the all earnings and profits inclusion from the allocable share of the all earnings and profits amount of $27 is further increased by the specified earnings of FP.[156] Under the existing final regulations, the inbound reorganization had the effect of importing the higher inside asset basis without creating an income inclusion on the higher outside stock basis, so the effect of the inbound reorganization is to import "excess basis." Under Notice 2016-73, to address this disparity, USP must increase the all earnings and profits amount by the lesser of the earnings and profits that exist at lower-tier levels or the amount of the excess basis, whichever is less. To accomplish this outcome, Notice 2016-73 proposes to modify the definition of all earnings and profits set forth in Treas. Reg. section 1.367(b)-2(d)(3)(ii) so that it includes "specified earnings" of

156. *See id.* at 911–12. In this regard, based on the facts posited in Example 2, USP must increase the FP all earnings and profits amount by $25x of specified earnings because excess asset basis of $25x exists with respect to FP because that is "the amount that the inside asset basis of FP ($78x) exceeds the sum of (i) the earnings and profits of FP ($30x), (ii) the aggregate basis in all of the FP stock ($23x), and (iii) the liabilities of FP assumed by US Newco ($0x)." *Id.* at 913. On the facts posited in Example 2:

> The specified earnings with respect to the stock of FP exchanged by USP equals $23x, the lesser of the following amounts (but not below zero) (i) $60x, the sum of the earnings and profits (including deficits) with respect to FS1 and FS2 attributable under section 1248(c)(2) to the stock of FP exchanged by USP; (ii) $23x, the product of the excess asset basis with respect to FP ($25x), multiplied by USP's specified percentage (92%), determined based on a fraction, the numerator of which is USP's specified stock gain ($46x), and the denominator of which is the sum of the aggregate of the specified stock gain and gain realized with respect to FP stock ($50x), and (iii) $46x, USP's specified stock gain, which is the amount of gain that would be realized by USP if immediately before the inbound transaction USP had sold the stock of FP for fair market value ($73x), reduced by USP's all earnings and profits amount (determined without regard to the modifications described in this notice) ($27x).

Id. Thus, at the end of the day, the all earnings and profits amount is included "as a deemed dividend of $50x ($27x + $23)." *Id.* Under Treas. Reg. § 1.367(b)-2(e)(2) (as amended in 2022), "$23x of the deemed dividend is determined by reference to the earnings and profits of FS1 and is considered as having been paid by FS1 to USP through FP." *Id.* Additionally,:

> Under § 1.367(b)-2(e)(3)(ii), immediately before the exchange, USP's basis in the stock of FP is increased by the amount of the $50x deemed dividend for purposes of determining USP's basis in its stock of US Newco. However, the basis increase under § 1.367(b)-2(e)(3)(ii) is not taken into account for purposes of calculating USP's all earnings and profits amount, as modified by Section 4.03 of this notice.

Id.

lower-tier subsidiaries if there is "excess asset basis" that is imported to a U.S. transferee corporation. Notice 2016-73 then sets forth rules for determining specified earnings and excess asset basis.[157]

These contortions create a complex series of adjustments to the basis rules under Subchapter C in order to prevent the repatriation of cash (or tax basis in assets) to a U.S. corporation without an income inclusion with respect to the underlying foreign earnings and profits that generated that cash or tax basis in assets. But, in the post-2017 era, should any of this really matter anymore? The anti-repatriation amendments to Treasury regulations commencing with Notice 2006-85 through Notice 2016-73 are intended to discourage taxpayers from using triangular reorganizations and inbound nonrecognition transactions to facilitate repatriation of untaxed foreign earnings while utilizing a recovery of tax basis without recognizing an associated income inclusion for unrepatriated foreign earnings.[158] But now, the all earnings and profits amount generally can be repatriated as an exempt dividend under section 245A, and to the extent some earnings are ineligible for section 245A treatment then to that extent a toll charge could be targeted for such limited amounts. But even in that context, the section 367(b) regulations should arguably not alter the Subchapter C results as long as the Section 245A Ineligible Amounts are preserved and retain their status as ineligible for a later income inclusion event. If the Treasury Department, upon reflection, believes otherwise, then it would be a significant benefit to the tax community if the Treasury Department would articulate the contours of its policy rationale for why it believes that the section 367(b) regulations should create an accelerated toll charge when the underlying earnings (except where Section 245A Ineligible Earnings exist) are eligible for exemption under section 245A for domestic corporate U.S. shareholders and where the individual U.S. shareholders have rate parity with capital gains rates in a wide array of fact patterns with respect to unremitted foreign earnings.

IV. CONCLUSION

One of the hallmarks of the 2017 Tax Act and its enactment of section 245A was to eliminate the "lock-out effect," and the legislative history explained that the purpose of this provision was to eliminate residual U.S. taxation on unrepatriated foreign earnings upon their repatriation back to the United States. Except for the repeal of the active foreign trade or business exception in former section 367(a)(3)(C), the

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157. *See id.* at 911–12.

158. This is widely understood in the tax community. *See e.g.*, N.Y. STATE BAR ASS'N, *supra* note 152, at 2–5.

2017 Tax Act was largely silent as to the ramifications of its fundamental changes on the section 367 policy goals. Perhaps this is appropriate because section 367 grants regulatory authority for the Treasury Department to divine whether and to what extent the normal Subchapter C rules should be modified in order to prevent tax avoidance when nonrecognition transactions involve a foreign corporation. But even though these policy goals are left for the Treasury Department to divine, it is still incumbent upon the Treasury Department to divine these goals in light of the design parameters that Congress has set forth in existing law. The Treasury Department has been diligent in its usage of section 367(a) and section 367(b) to protect the U.S. tax base from inappropriate tax avoidance transactions. Throughout that effort, the Treasury Department has rightly recognized that normal Subchapter C rules might not adequately address tax avoidance concerns when nonrecognition transactions involve foreign corporations, and so when those provisions of Subchapter C intersect with a foreign corporation, section 367 provides broad authority to turn off the nonrecognition provisions when appropriate. The outworking of these efforts has caused the Treasury Department to create considerable complexity within its existing regulatory framework. These provisions can only be tackled by persons who have a detailed training of both Subchapter C and the general international tax provisions including the scope of the U.S. anti-deferral provisions.

This complexity problem is made all the more objectionable because the section 367(a) and the section 367(b) regulations have not been updated to reflect the design changes made in the law that have occurred in recent years and thus the regulations inappropriately remain locked into policy goals that were relevant in a bygone era but are no longer relevant in today's era. Thus, in order to divine the intended application of these regulations, one must look to the policy goals that were relevant to prior law, not current law. The section 367(a) regulations were significantly altered in their formulation in order to address corporate inversions prior to the Congressional enactment of section 7874. This aspect of those regulations remains a key design parameter of the existing regulations even though Congress has chosen since 2002 to address those transactions holistically through the rubric set forth section 7874 with the consequence that the anti-inversion aspects of the section 367(a) regulations are now unmoored and divergent from the manner of addressing corporation inversions that Congress has statutorily enacted. Moreover, since 2006, much of the complexity in both the section 367(a) regulations and the section 367(b) regulations is explained by an attempt to prevent the use of nonrecognition transactions as a means to allow tax-free cash repatriation with basis recovery while deferring taxation over unremitted foreign earnings. But under current law, unremitted foreign

earnings as a general rule are now eligible for exempt repatriation, so those historic policy concerns are no longer a critical policy design feature of current law with respect to the domestic corporation U.S. shareholder entitled to rely on section 245A. And, since 2004, rate parity for qualified foreign dividends with capital gains rates means that there is no need to supplant the normal basis rules for individual U.S. shareholders since the normal basis rules of Subchapter C can adequately preserve the shareholder level gain. Now that rate parity effectively eliminates any bail-out concern due to the fact that foreign dividends are generally afforded rate parity with capital gains rates, there is no longer a policy justification to accelerate an income inclusion with respect to the section 1248 amount for individual U.S. shareholders.

As a result, it is now time for the Treasury Department to walk back much of its guidance under section 367(a) and section 367(b) because of subsequent events have made the original design parameters that the Treasury Department relied upon to formulate key components of its existing regulations unmoored to the design parameters of current law. Corporate inversions are now addressed in section 7874, and so the Treasury Department's pre-section 7874 policy response has been supplanted and should be withdrawn. The Treasury Department utilized its authority under section 367 to thwart tax-free repatriations with basis recovery as those techniques as inappropriate tax avoidance techniques under prior law. However, now that Congress has enacted section 245A, those techniques no longer represent a tax avoidance technique in comparison to the alternative path of simply remitting a cash distribution as a dividend to a corporate U.S. shareholder under current law. Moreover, since 2004, individual U.S. shareholders have rate parity for qualified foreign dividends and capital gains rates and multiple paths exist for individual U.S. shareholders to structure into such parity.[159] These realities lead one to conclude that there is no longer a tax avoidance reason to alter the basic Subchapter C results that apply to a series of cross-border transactions given the design parameters of current law, so the Treasury Department should not seek to alter the basic Subchapter C results through toll charges when those transactions provide no policy reason to do so.

Section 367(a) and section 367(b) provide broad authority to the Treasury Department, but the Treasury Department's usage of that authority should be tailored in their application so that they only apply in instances where the usage of the nonrecognition provisions of Subchapter C create inappropriate tax avoidance outcomes because of the involvement of a foreign corporation in the nonrecognition transaction. The design parameters for determining tax avoidance are

159. *See* Section 1(h)(11).

different under current law than prior law, so the design challenge for the Treasury Department is that it must repurpose its regulatory guidance under section 367(a) and section 367(b) so that its regulations apply only when there is tax avoidance concern under current law. If such an endeavor were undertaken, a significant pruning of the section 367 regulations could be done to promote considerations of fairness, simplicity, and administrability, which the Treasury Department has stated are important guiding principles for its section 367 regulations. The Treasury Department is to be commended for being up to the challenge to issue nuanced, detailed, and ingenious provisions to address the anti-inversion and anti-repatriation policy goals of the earlier era. But now that the goal posts have changed both through the enactment of section 7874 and through the enactment of section 1(h)(11) and section 245A, the Treasury Department should redouble its efforts to reformulate its section 367 regulations for this new era because the existing regulations remain focused on yesterday's policy goals. If the Treasury Department, upon reflection, believes that there is a continuing need for some aspect of its section 367 regulations that this article has identified for removal, then it would be greatly beneficial to the tax community if the Treasury Department would articulate why those provisions remain important under the design parameters of current law. Now is the time for the Treasury Department to take up that challenge to withdraw its obsolete regulations along the lines proposed in this article, or if not then to provide a reasoned justification for their continuance based on the design parameters of current law so that the policy goals that are sought to be promoted are understood by the tax community who are charged with complying with these regulations.