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International Tax Watch

Did Anyone Notice the TCJA Made Code Sec. 367(b) Obsolete?

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1. Introduction

Before the 2017 Tax Cuts and Jobs Act ("TCJA"), the United States followed a worldwide tax system. Under this approach, all income a taxpayer earned worldwide was subject to U.S. federal income tax. Conversely, income a wholly owned subsidiary generated was not subject to U.S. federal income tax until the income was repatriated, provided that the income was not subject to anti-deferral measures, such as the subpart F provisions. Under the subpart F provisions, "U.S. Shareholders"[1] were and are subject to immediate tax and treated as if they had received a dividend of their *pro rata* share of certain income that controlled foreign corporations ("CFC")[2] they own generate.

Given that the Internal Revenue Code ("Code") provides exceptions to U.S. federal income tax on certain corporate restructurings, such as reorganizations, it was historically essential to impose some limits and conditions on those provisions so that the United States could preserve its ability to tax. For years, the United States generally relied on Code Sec. 367 to preserve its ability to tax income when taxpayers engaged in cross-border restructurings that would otherwise be tax-free. Code Sec. 367 preserved the United States' ability to tax outbound transfers of both tangible and intangible property, including transfers of shares, under Code Sec. 367(a) and (d). Code Sec. 367(b), which is the focus of this column, preserved the United States' ability to tax the earnings and profits ("E&P") of CFCs in connection with inbound and foreign-to-foreign transactions.

As readers know well, in the TCJA, the United States shifted away from the worldwide taxation system to a hybrid territorial system by introducing, among other provisions, Code Secs. 245A and 951A. Code Sec. 245A allows a domestic taxpayer to take a 100 percent dividends received deduction ("DRD") for the foreign source portion of a dividend received from a specified 10 percent-owned foreign corporation. While Code Sec. 245A is not a true participation exemption regime, it has the same effect as a true participation exemption regime in most cases. Simplifying, Code Sec. 951A imposes immediate U.S. federal income tax on a U.S. Shareholder's *pro rata* share of all income its CFCs generate above and beyond a 10 percent return on the U.S. Shareholder's *pro rata* share of its CFCs' basis in tangible assets.[3] After the Code Sec. 250 deduction and the haircut on foreign tax credits,[4] the GILTI rate correlates with the rate for Foreign Derived Intangible Income ("FDII"). By making these changes to the Code, Congress hoped to remove the incentive to migrate income and activities offshore and instead motivate U.S. multinationals to move in the other direction.[5]

As we demonstrate below, the United States has moved to a system in which all income is either subject to immediate U.S. federal income tax or it is never subject to U.S. federal income tax. Importantly, given these reforms, Code Sec. 367(b) almost never gives rise to an income inclusion. In light of these tax reforms, we believe that Code Sec. 367(b) and regulations implementing the policy behind Code Sec. 367(b) have generally outlived their usefulness. Interestingly, Treasury knows that the TCJA has changed the landscape. In November of last year, Treasury issued proposed regulations addressing a variety of foreign tax credit issues arising as a result of the TCJA. In the preamble, Treasury acknowledged that it is studying the impact of the TCJA to determine if certain changes to the Code Sec. 367(b) regulations would be appropriate. Unfortunately, Treasury's focus seems to be on whether additional regulations are needed to combat possible abuses, and not on whether any of the regulations could be withdrawn.[6]

2. Overview of Code Sec. 367

Congress introduced the predecessor to Code Sec. 367 in the Revenue Act of 1932 as part of section 112(k). The provision provided that a foreign corporation would not be considered a corporation in specific subchapter C nonrecognition transactions unless the taxpayer demonstrated beforehand to the IRS that the principal purpose of the plan was not to avoid taxes. The Tax Reform Act of 1976 eliminated the "principal purpose" requirement and established the form of Code Sec. 367 that we see today. In its current form, Code Sec. 367 provides coordination rules on how to apply Code Secs. 332, 351, 355 and 368 in the context of a cross-border transaction that would otherwise be tax-free. The section's purpose is to prevent taxpayers from using these transactions to avoid U.S. federal income taxes and to preserve the United States' ability to tax.[7]

2.1 Code Sec. 367(a)

Code Sec. 367(a) applies to outbound transfers of assets (including stock in CFCs) other than intangible property to foreign corporations, and ensures that the United States has an opportunity to impose tax on the appreciation in those assets. The original version of Code Sec. 367(a) that Congress enacted in 1932 provided that outbound transfers would be taxable unless the taxpayer "established to the satisfaction of the Secretary" that avoiding U.S. federal income tax was not one of the principal purposes of the exchange.[8] Under this approach, taxpayers had to obtain a private letter ruling from the IRS to secure tax-free treatment.[9] Congress updated Code Sec. 367(a) to provide more rigid rules in 1976. Although the rules changed, the purpose remained the same: to stop abusive transactions that might prevent Treasury from imposing tax on the appreciation in the assets.[10] Those rules generally remained until the TCJA.[11] Under the previous rules, Code Sec. 367(a) required taxpayers to recognize gain on outbound transfers unless (i) the transfer qualified for the active foreign trade or business exception, or (ii) the assets consisted of stock or securities of a foreign corporation and the U.S. transferor entered into a gain recognition agreement ("GRA") to preserve the gain.[12] In the TCJA, Congress eliminated the active trade or business exception. Accordingly, it is no longer possible to incorporate a foreign branch in a tax-free transaction. The only exception that now remains is with respect to a transfer of stock in a subsidiary by virtue of a GRA.

2.2 Code Sec. 367(d)

Code Sec. 367(d) applies to outbound transfers of intangible property, including goodwill and going concern value. Historically, Code Sec. 367(d) incorporated the definition of intangibles from Code Sec. 936(h)(3)(B), which previously had not listed goodwill and going concern value as intangible property.[13] Treasury finalized proposed Code Sec. 367 regulations on December 16, 2016 to include goodwill and going concern value in the definition of intangible property.[14] Congress adopted Treasury's view in 2018. In the Consolidated Appropriations Act, Congress amended Code Sec. 367(d) to add "goodwill, going concern value, or workforce in place" to the definition of intangible property under Code Sec. 367(d)(4)(F).[15] Code Sec. 367(d) treats the U.S. transferor as if it had sold the intangible property in exchange for payments that are contingent on the productivity, use or disposition of the intangibles.[16] The U.S. transferor must, over the useful life of the intangible property, annually include in gross income an appropriate arm's-length charge determined in accordance with Code Sec. 482 and the regulations.[17] Code Sec. 367(d) provides that the contingent payments the U.S. transferor recognizes must be commensurate with the income attributable to the intangibles.[18]

Both Code Sec. 367(a) and (d) therefore prevent U.S. Shareholders from moving appreciated assets offshore, ensuring that the United States does not lose the opportunity to tax the built-in gain in those assets. The TCJA did not change the ongoing need for these subsections.[19]

2.3 Code Sec. 367(b)

Code Sec. 367(b) generally provides that certain inbound and foreign-to-foreign tax-free exchanges will be treated as taxable except to the extent provided in Treasury regulations. Specifically, Code Sec. 367(b)(1) provides:

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

Code Secs. 332, 351, 354, 355, 356, and 361 all provide tax-free treatment to transactions in which tax attributes are preserved. Transactions under Code Secs. 332 and 361 (to the extent relating to certain reorganizations under Code Sec. 368(a)(1)) are subject to Code Sec. 381, which provides for the carryover of tax attributes such as E&P.

(a) Code Sec. 367(b)'s Purpose

(i) The Code and Legislative History. At least at a very high level, the Code itself indicates the purpose of Code Sec. 367(b) when it states that the Secretary shall prescribe regulations "which are necessary or appropriate to prevent the avoidance of federal income taxes." The legislative history to Code Sec. 367(b) confirms that the purpose of this section is to prevent the avoidance of federal income tax. In the Senate Committee Report accompanying the Tax Reform Act of 1976, the committee states that "a foreign corporation will not be treated as a corporation to the extent that the Secretary of the Treasury provides in regulations that are necessary or appropriate to prevent the avoidance of Federal income taxes."[20] The committee report further states that for transfers "constituting a repatriation of foreign earnings" involving solely foreign corporations and shareholders, "the regulations will not provide for any immediate U.S. tax liability due but will maintain the potential tax liability of the U.S. shareholder."[21]

Read together, both the Code and the Senate Committee Report tell us that, from Congress' perspective, the most important possible "avoidance of U.S. federal income tax" was the possible avoidance of U.S. federal income tax on current or accumulated, but untaxed, E&P on an inbound or a foreign-to-foreign reorganization. Absent Code Sec. 367(b), a taxpayer could permanently avoid U.S. federal income tax on such foreign E&P in a tax-free inbound reorganization because the United States acquiring corporation would succeed to the E&P, tax-free, pursuant to Code Sec. 381. In the absence of such a transaction, the E&P ultimately would be subject to U.S. ordinary income tax upon repatriation as a dividend under Code Sec. 301. Similar opportunities might arise in connection with, or following, a foreign-to-foreign tax-free reorganization if the target corporation ceased to be a CFC or the U.S. Shareholder ceased to be a U.S. Shareholder.

Simply put, the legislative history of Code Sec. 367(b) shows that the statute's primary purpose is to preserve the United States' ability to tax a CFC's E&P. Another possible purpose is to preserve the tax attributes in a manner that will not distort income. As discussed below, in particular, the regulations under Code Sec. 367(b) prevent taxpayers from converting E&P that ordinarily would be recognized as ordinary income in connection with a dividend into capital gain.

(ii) Treasury's View of Code Sec. 367(b)'s Purpose. Treasury has confirmed that Code Sec. 367(b)'s purpose is to ensure that E&P is not repatriated tax-free or otherwise siphoned off to another entity, which may or may not be owned by a U.S. person so that it is not subject to U.S. federal income tax. Treasury has also staked out the position that Code Sec. 367(b) serves to ensure tax attributes properly carry over. According to the Preamble to the 2000 Final Regulations dealing with certain inbound and foreign-to-foreign corporate transactions under Code Sec. 367(b), the purpose of Code Sec. 367(b) is as follows:

> 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 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 carry over in light of the variations between the Code's taxation of foreign and domestic corporations .... The historic policy objective of section 367(b) in [foreign-to-foreign nonrecognition transactions] 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.[22]

Parsing this language, there are two principal policy considerations that arise in connection with an inbound nonrecognition transaction.[23] At the shareholder level, the Code Sec. 367(b) regulations "are concerned with the proper taxation of previously deferred earnings and profits." In other words, the regulations ensure that income that otherwise would have been taxed as an inbound dividend under Code Sec. 301 cannot be repatriated tax-free. The preamble goes on to say that the regulations are concerned with "both the extent and manner in which tax attributes carry over" at the corporate level.[24] The regulations historically addressed these two issues through an income inclusion of the all earnings and profits amount ("all earnings and profits amount").

The preamble sets forth a similar purpose for Code Sec. 367(b) in the context of foreign-to-foreign transactions. Specifically, as noted above, the preamble states that the principal policy consideration with respect to foreign-to-foreign nonrecognition transactions is to "preserve the potential application of section 1248." As explained below, Code Sec. 1248 ensures that taxpayers cannot convert offshore earnings that otherwise would be taxed as ordinary dividend income under Code Sec. 301 into capital gains, which may be (and historically were) taxed at a much lower rate. In other words, once again, the purpose of Code Sec. 1248 comes down to preventing the avoidance of U.S. federal income tax by preserving the ability to tax the E&P. Simply put, Code Sec. 367(b) serves as a backstop to Code Sec. 1248 and ensures that E&P is taxed as ordinary income. Accordingly, the Code Sec. 367(b) regulations may require a corporation engaging in a foreign-to-foreign transaction to include in income as a deemed dividend the "section 1248 amount" that "would not be preserved immediately following the section 367(b) exchange."[25]

The Preamble of the 2006 Final Regulations reiterates and elaborates on the policy underlying Code Sec. 367(b).[26] The preamble states:

> Congress enacted section 367(b) to ensure that international tax considerations in the Code are adequately addressed when the Subchapter C provisions apply to an exchange involving a foreign corporation. A primary consideration in this regard is to prevent the avoidance of U.S. taxation .... These final regulations address the carryover of foreign earnings and profits and foreign income taxes in tax-free corporate asset acquisitions by generally applying the principles of Subchapter C provisions such as section 381, which governs the carryover of earnings and profits (and other tax attributes) in certain tax-free corporate reorganizations described in section 368 and in corporate liquidations described in section 332. However, these regulations (like the 2000 proposed regulations) modify certain of the mechanics of the Subchapter C rules as necessary or appropriate to ensure that those rules are as consistent as possible with key international tax policies of the Code and to prevent material distortions of income .... As a general policy matter, the importation of various tax attributes in inbound transactions is carefully scrutinized. In fact, inbound importation issues have been the subject of recent legislative reforms (*see* section 362(e)). The policy relating to importation of tax attributes also has been reflected in prior section 367 regulations. For example, the preamble to the January 2000 final regulations generally describes international policy issues that can arise in inbound nonrecognition transactions. The preamble states that 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."

Again, the language in the preamble confirms that Treasury believes that the purpose of Code Sec. 367(b) is to prevent the avoidance of U.S. taxation by preserving the United States' ability to tax a CFC's E&P. The principal policy consideration for inbound nonrecognition transactions under Code Sec. 367(b) has "interrelated shareholder-level and corporate-level components." As stated above, Treasury wanted to preserve the United States' ability to tax a CFC's E&P to ensure that income will not be repatriated tax-free at the shareholder level and that tax attributes would carry over at the corporate level.

The preamble to the regulations also states that the regulations' purpose is to "ensure that [Subchapter C rules] are as consistent as possible with key international tax policies of the Code and to prevent material distortions of income."[27] Treasury was typically concerned about a material distortion of income in the context of the Code Sec. 1248 amount arising from the conversion of E&P that would have been recognized as ordinary income into capital gain.[28] If a transaction were likely to distort the income materially by converting ordinary income into capital gain, the Code Sec. 1248 amount would have to be included to ensure that the United States could tax the E&P that gave rise to the carryover attributes at the then-higher ordinary income rates.

More recently, Treasury addressed its view of Code Sec. 367(b)'s purpose in Notice 2016-73.[29] Treasury and the IRS issued Notice 2016-73 on December 2, 2016, announcing their intention to modify the amount of an income inclusion required in certain cross-border triangular nonrecognition reorganizations. With respect to Code Sec. 367(b)'s purpose, the Notice provides as follows:

> Sections 1.367(b)-4 and 1.367(b)-4T apply to certain acquisitions by a foreign corporation of the stock or assets of a foreign corporation (referred to in those regulations and this notice as the "foreign acquired corporation") in an exchange described in section 351 or in a reorganization described in section 368(a)(1). Sections 1.367(b)-4T(b) and 1.367(b)-4(b)(1) provide that, if the potential application of section 1248 cannot be preserved following the acquisition of the stock or assets of a foreign corporation by another foreign corporation in an exchange subject to section 367(b), then certain exchanging shareholders of the foreign acquired corporation must include in income as a dividend the section 1248 amount attributable to the stock of the foreign acquired corporation exchanged. However, the scope and purpose of the grant of authority in section 367(b) are not limited to the preservation of section 1248 amounts, and the regulations thereunder are not limited to requiring an inclusion of the section 1248 amount with respect to the stock of a foreign acquired corporation exchanged. Section 367(b) provides the Treasury Department and the IRS broad authority to issue regulations applicable to nonrecognition transactions that are "necessary or appropriate to prevent the avoidance of Federal income taxes," including regulations that prescribe "the circumstances under which gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both."

At first blush, this description does not seem all that helpful. When one examines the underlying transactions Treasury sought to address, its view of Code Sec. 367(b)'s purpose comes into focus. In particular, the notice provides that:

> The Treasury Department and the IRS are aware that taxpayers are engaging in transactions *designed to repatriate earnings and basis of foreign corporations without incurring U.S. tax* by exploiting the section 367(a) priority rule, as modified by the 2014 notice. (emphasis added).[30]

In other words, Treasury was concerned that taxpayers were repatriating E&P without triggering an all earnings and profits inclusion. Treasury illustrates its concern with an example in which U.S. Parent ("USP"), a domestic corporation, wholly owns Foreign Parent ("FP"), a foreign corporation. USP also owns U.S. Subsidiary ("USS"), a domestic corporation. FP owns Foreign Subsidiary ("FS"), another foreign corporation. Importantly, FP has no E&P, and FS has substantial E&P. USS owns Foreign Target ("FT"), a foreign corporation. In a tax-free triangular reorganization under Code Sec. 368(a)(1)(B), FS purchases FP stock from FP in exchange for cash and/or a note and uses the FP stock to acquire all of the stock of FT from USS. On a later date, in a transaction Treasury describes as "purportedly unrelated to the FT reorganization," FP would engage in an inbound tax-free reorganization subject to Reg. §1.367(b)-3. In the subsequent inbound reorganization FP becomes a domestic corporation that is a member of USP's domestic consolidated return group. When FP joins USP's consolidated return group, FP brings with it the cash and/or the note FP acquired from FS in exchange for the FP stock that FS used to acquire FT in the triangular reorganization. As such, the subsequent transaction repatriates cash. Given the interaction of the coordination rules in Code Sec. 367, and the fact that FP has no E&P, the transaction did not result in an all earnings and profits inclusion. Right or wrong, Treasury's view is that the transaction allowed a taxpayer to repatriate cash without an inclusion for the associated E&P that gave rise to the cash. Taxpayers, on the other hand, might argue that the transaction is perfectly appropriate because FS retains all of its E&P, and thus Treasury still has an opportunity to tax the E&P at a later date. The important point here is that Treasury once again confirmed that Code Sec. 367(b)'s purpose is to preserve the United States' ability to tax the E&P.

(b) Code Sec. 1248

Congress introduced Code Sec. 1248 in the Revenue Act of 1962. The underlying principle of Code Sec. 1248 is very similar to that of Code Sec. 367(b), though Code Sec. 1248 applies to taxable transactions and Code Sec. 367(b) applies to certain subchapter C nonrecognition transactions. The committees stated that the objective of Code Sec. 1248 was to impose the full U.S. federal income tax when income earned abroad was repatriated.[31] At the time Code Sec. 1248 was introduced, the ordinary income tax rate was roughly double the capital gains tax rate.[32] Due to the massive differential in tax rates, U.S. taxpayers had a powerful incentive to sell non-U.S. subsidiaries that had significantly appreciated in value. Ordinarily, a sale of a foreign subsidiary would give rise to capital gain. Conversely, if the taxpayer had caused the subsidiary to make a distribution, the income would have been treated as a taxable dividend under Code Sec. 301 to the extent of the E&P and would be taxed as ordinary income and not at the preferential capital gains rate. Subject to Code Sec. 367(a), taxpayers with a longer time horizon might have possibly contributed appreciated assets to a CFC in a tax-free transaction under Code Sec. 351. Upon the sale or liquidation of the subsidiary, any gain recognized from the sale would be taxed at the lower capital gains tax rate. Despite Congress' purpose to impose the full U.S. federal income tax on repatriated income, Code Sec. 1248 actually became a beneficial section for taxpayers because the deemed dividend under Code Sec. 1248 could have been fully offset by now-repealed Code Sec. 902 foreign tax credits ("FTC").

A U.S. person is a Code Sec. 1248 shareholder if the person owns 10 percent or more of the total combined voting power of all classes of stock entitled to vote at any time during the five-year period ending on the date of the sale or exchange when the corporation was a CFC.[33] If a person who is a Code Sec. 1248 shareholder sells or exchanges stock in a CFC, the gain the Code Sec. 1248 shareholder recognizes on the stock will be considered a deemed dividend to the extent the E&P attributable to the stock of the CFC, and the CFC's subsidiaries.[34]

When a Code Sec. 1248 shareholder sells or exchanges stock in a CFC, all of the E&P the CFC and its disposed of affiliates have accumulated is taxed at ordinary income rates as a deemed dividend. Once the lower-tier subsidiaries are gone, the United States also loses its opportunity to tax the lower-tier subsidiaries' E&P as ordinary dividend income under Code Sec. 301. If Code Sec. 1248 did not include the E&P of lower-tier subsidiaries, taxpayers could entirely avoid Code Sec. 1248 by holding all their CFCs through foreign holding companies.

(c) The Regulations Under Code Sec. 367(b)

The regulations underlying Code Sec. 367(b) further support the idea that the purpose of Code Sec. 367(b) is to preserve the United States' ability to tax a CFC's E&P.

(i) Inbound Transactions. Under Reg. §1.367(b)-3(b), a domestic corporation must include in income as a deemed dividend an amount equal to the all earnings and profits amount when the domestic corporation receives the assets of a CFC in either a Code Sec. 332 liquidation or a Code Sec. 368(a)(1) asset acquisition.

Reg. §1.367(b)-2(d) states that the all earnings and profits amount is the net positive E&P (if any) of a foreign corporation, without regard to the amount of gain that would be realized on a sale or exchange of the stock of the foreign corporation.[35] The Code Sec. 951 amount, which includes subpart F income under Code Sec. 951A(a) and global intangible low-taxed income ("GILTI") under Code Sec. 951A(f), is excluded from the E&P for Code Sec. 367(b) purposes because Congress already imposed immediate U.S. federal income tax on subpart F income and GILTI under rates Congress deemed appropriate.[36] There is no need to include these amounts in the all earnings and profits amount. Otherwise, this E&P would be subject to double taxation. The all earnings and profits amount also does not include the E&P of lower-tier foreign corporations.[37] Excluding the E&P of lower-tier foreign corporations makes sense because those entities are still offshore and, importantly, under the control of the U.S. Shareholder. The United States may tax this E&P when the taxpayer repatriates it to the United States (*e.g.*, through a Code Sec. 301 dividend). Thus, the United States maintains the ability to tax this E&P and no further steps are required to preserve U.S. taxing jurisdiction.

The underlying purpose of Code Sec. 367(b) can be clearly illustrated by looking at a few examples.[38]

Example 1.

Domestic Corporation ("DC") owns 100 percent of a Dominican Republic subsidiary's ("FS1") stock by both vote and value. FS1 is a CFC. FS1 owns cacao farms in the Dominican Republic and harvests cacao pods from their trees. While the cacao pods FS1 cultivates produce delicious chocolate, DC decides that it would rather go into the business of growing tulips. Since tulips would be hard to grow in the warm climates of the Dominican Republic, DC decides to liquidate FS1 in a Code Sec. 332 liquidation. FS1 distributes all of its property to DC and the FS1 stock held by DC is canceled. DC must include in income as a deemed dividend the all earnings and profits amount from FS1 because once FS1 is liquidated, its E&P might not be subject to U.S. federal income tax at the corporate level. DC, on the other hand, is not taxed on any unrealized gain on assets that FS1 had held. Assume that the cacao farms that FS1 grew its cacao pods on have tripled in value since FS1 bought the land. DC will not be taxed on the increase in value of the cacao farms because the land is still under DC's ownership. DC will realize a taxable gain on the increased value of the land when it decides to sell or exchange the cacao farms, and the United States can tax the untaxed appreciation in the assets at that time (*see* Figure 1).

Example 2.

Assume the same starting facts as Example 1. However, now assume that FS1 owns 100 percent of the stock of a Dutch subsidiary ("FS2"). When FS1 is liquidated in a Code Sec. 332 liquidation, DC will only include in income a deemed dividend the all earnings and profits amount from FS1, not FS2. FS2 is still a CFC in the eyes of the U.S. government and its E&P is still preserved within the corporation. The United States retains the power to tax FS2's E&P when it distributes a dividend to DC. Once again, DC will not be taxed on any unrealized gain on FS1's appreciated assets because DC still owns those assets. DC will realize a taxable gain on the increased value of the assets when it decides to sell or exchange the assets, and the United States can tax the appreciation in the assets at that time (*see* Figure 2).

(ii) Foreign-to-Foreign Transactions. The second type of transaction Code Sec. 367(b) governs is a foreign-to-foreign transaction. Under Reg. §1.367(b)-4(b)(1), when a foreign corporation acquires the stock or assets of

FIGURE 1.

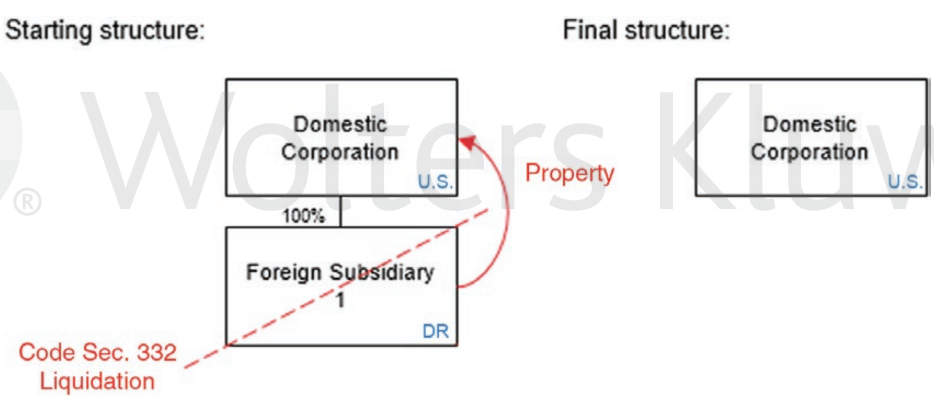
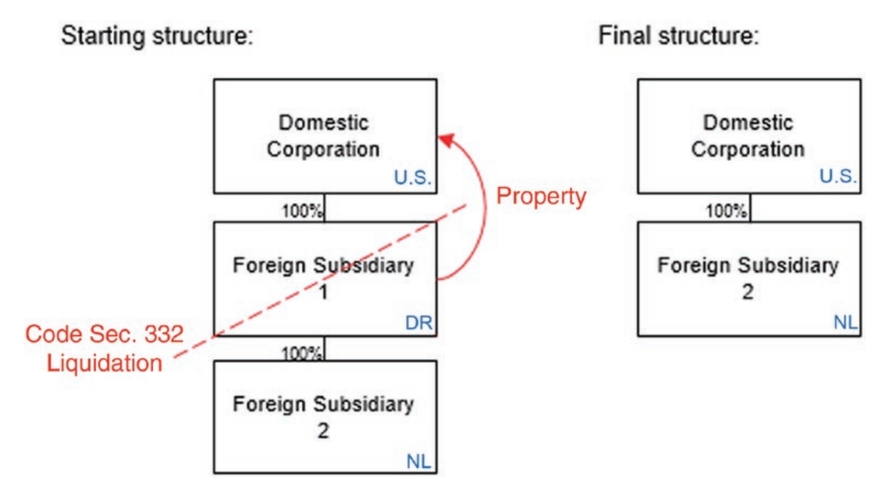


FIGURE 2.



another foreign corporation in a Code Sec. 351 exchange or through a Code Sec. 368 reorganization, then the exchanging shareholder must include in income as a deemed dividend the Code Sec. 1248 amount attributable to the stock or assets exchanged where two conditions are satisfied. The first condition for an inclusion is that, immediately before the exchange, the exchanging shareholder is a U.S. person that is a Code Sec. 1248 U.S. shareholder with respect to the foreign acquired corporation or the exchanging shareholder is a foreign corporation and a U.S. person is a Code Sec. 1248 U.S. shareholder with respect to both the exchanging shareholder and the foreign acquired corporation.[39] The second condition for an inclusion is that, immediately after the exchange, the stock received is not stock in a CFC or the U.S. Shareholder ceases to be a U.S. Shareholder with respect to either the foreign transferee corporation or the foreign acquired corporation.[40] When these two conditions are satisfied after an exchange, a U.S. person that might have had a Code Sec. 1248 inclusion on a disposition will now hold stock that will not give rise to a Code Sec. 1248 inclusion on a future disposition. By requiring an inclusion of the Code Sec. 1248 amount in this context, Code Sec. 367(b) acts as a backstop for Code Sec. 1248.

Reg. §1.367(b)-4(c) provides that the Code Sec. 1248 amount that a foreign corporation includes in income as a deemed dividend under Reg. §1.367(b)-4(b) will not be treated as foreign personal holding company income ("FPHCI") under Code Sec. 954(c).[41] Code Sec. 954(c) subjects, among other things, certain dividends, interest, rents, royalties and annuities to immediate tax because this income is viewed as passive, and more importantly, mobile.[42] Yet, the purpose of Code Sec. 367(b) is merely to preserve the United States' ability to tax this E&P, and not necessarily to impose immediate U.S. federal income tax. Providing an exception to Code Sec. 954(c) serves this purpose. Under this approach, instead of immediately taxing the Code Sec. 1248 amount as FPHCI, the Code Sec. 367(b) regulations simply increase the E&P of the foreign corporation by the amount of the deemed dividend in a foreign-to-foreign transaction. This approach serves the purpose of Code Sec. 367(b). To be precise, this approach preserves the United States' ability to tax the E&P sometime in the future.

The following examples explain the mechanics of how Code Sec. 367(b) governs foreign-to-foreign transactions.

Example 3.

Assume the same entities as in the examples above. DC directly owns 100 percent of FS1 stock. FS1 is a CFC and DC is a Code Sec. 1248 shareholder with respect to FS1. Foreign Corporation ("FC") is interested in entering the chocolate business and would like to acquire FS1 because of its stellar reputation in the chocolate industry for producing the best cacao pods. In a Code Sec. 351 exchange, DC exchanges 100 percent of FS1 stock in return for 60 percent of FC stock. FC is a CFC immediately after the exchange because DC owns more than 50 percent of FC. Therefore, DC will not have to include in its income a deemed dividend equal to the Code Sec. 1248 amount because it is still considered a Code Sec. 1248 shareholder with respect to FC. The outcome of this exchange makes sense because any E&P that FS1 had is still in FS1, and DC still has control over FS1 through FC. Unlike in Example 1, where FS1 liquidated and its E&P would likely escape U.S. federal income tax at the corporate level, the United States can still tax DC on FS1's Code Sec. 1248 amount in the future through FC. Since FC owns 100 percent of FS1 and is a CFC of DC, DC would not realize gain on any appreciated assets in FS1, like the cacao farms, because the land is still within the control of DC (*see* Figure 3).

Example 4.

Now assume instead that DC exchanges 100 percent of FS1 stock in return for 40 percent of the FC stock in a Code Sec. 351 exchange. DC must include in income a deemed dividend equal to the Code Sec. 1248 Amount because immediately after the exchange, FC is not a CFC. Since FS1 is no longer a CFC, it will be much harder to tax FS1's E&P. As such, subpart F and GILTI will not apply to FS1.[43] Moreover, the information reporting required for CFCs also will not apply. Specifically, FS1 will not have to file a Form 5471 with respect to FS1. Thus, the U.S. government does not have the same visibility into, or taxing power over, FS1. That does not mean that the United States can never tax the unrealized gain on FS1's assets. On the contrary, if FS1 were to sell its assets and distribute the sale proceeds to FC, and then FC distributed the sales proceeds up to DC, then DC would include the distribution in income, subject to the Code Sec. 245A DRD. From a U.S. perspective, the problem is that there is no U.S. federal income tax until FC, a non-CFC, distributes the sale proceeds. Since that might never happen, or might not happen for many years, the United States' ability to tax the unrealized gains is uncertain. Hence the

FIGURE 3.

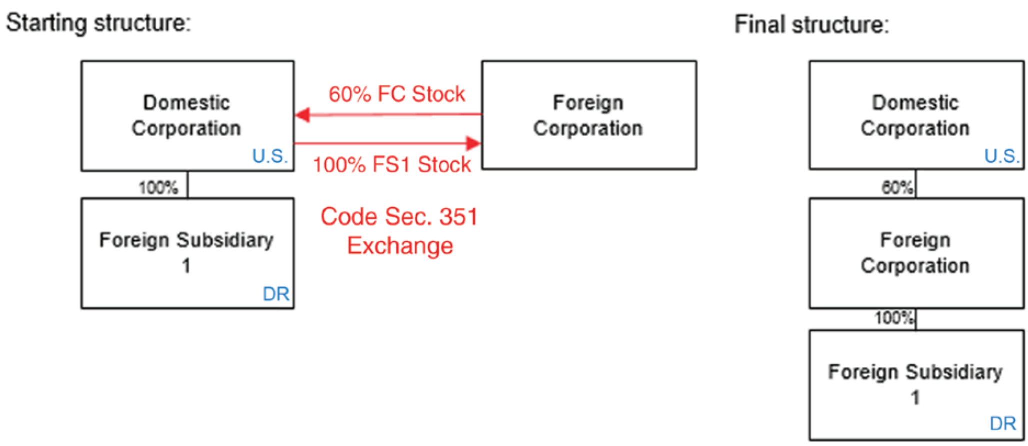
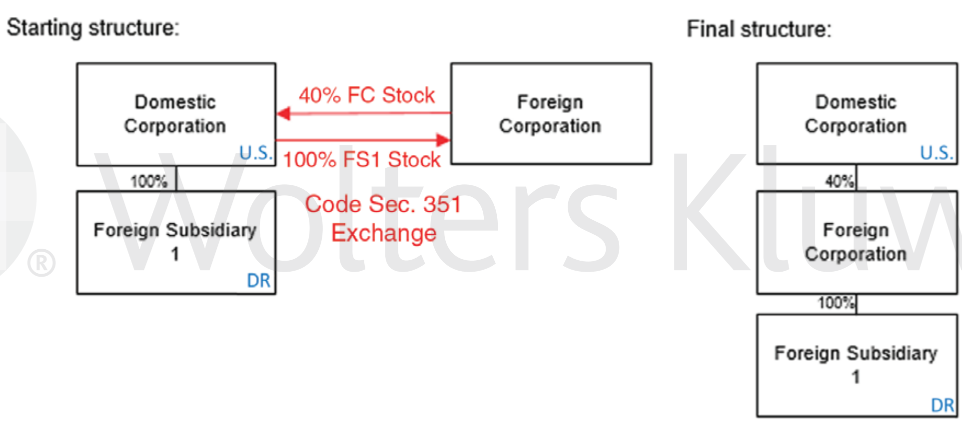


FIGURE 4.



need for Code Sec. 367(b), at least until the TCJA (*see* Figure 4).

3. The TCJA and the Quasi-Territorial System

Congress made a number of changes in the TCJA that moved the United States to a quasi-territorial system. As demonstrated below, these provisions usually either provide an exemption from U.S. federal income tax for foreign E&P or subject it to immediate U.S. federal income tax. Either way, there is no need to preserve the United States' ability to tax the E&P because, one way or another, the E&P will not be subject to further U.S. federal income tax.

3.1 Code Sec. 245A

The United States moved away from a worldwide taxation system with the introduction of section 245A in the TCJA. Under Code Sec. 245A, dividends a domestic corporation receives from foreign corporations after December 31, 2017 are eligible for a 100 percent DRD, provided the requirements for Code Sec. 245A (as outlined below) benefits are satisfied.[44] The DRD is available to the extent the dividend is foreign source income, which usually will account for the vast majority of the income. The domestic corporation must receive the dividend from a specified 10 percent-owned corporation—*i.e.*, a corporation in which the domestic corporation owns 10 percent or more of the vote or value.[45] The domestic corporation also must have held the stock with respect to which the foreign corporation remits the dividend for over 365 days during the

731-day period beginning on the date that is 365 days before the ex-dividend date, and the domestic corporation must have held at least 10 percent of the vote or value of the corporation during this period.[46] Given that the holding period requirement can be satisfied by continuing to hold the CFC, the holding period requirement is rarely a problem. The Code Sec. 245A deduction also will not apply if the U.S. Shareholder receives a hybrid dividend from a CFC.[47] Most taxpayers that have not done so already are in the process of eliminating the hybrids that give rise to hybrid deduction accounts. Lastly, pursuant to anti-abuse rules Treasury promulgated after the TCJA, the DRD is not available for certain E&P a taxpayer generates between January 1, 2018 and the start of the CFC's first taxable year beginning after January 1, 2018.[48] The impact of this final anti-abuse rule is mitigated because E&P that is subject to the rule is deemed to come out last under the regulations.[49]

It is time we recognize that these provisions have outlived their usefulness. They create significant complexity and compliance burdens for taxpayers.

Code Sec. 245A essentially has the effect of a participation exemption regime, though it is not a true participation exemption regime. A true participation exemption regime would exempt all the income received from a U.S.-owned foreign corporation. Nonetheless, receiving a 100 percent DRD is not meaningfully different from a 100 percent income exemption.

Congress enacted Code Sec. 245A to increase the competitiveness of U.S. companies and reduce incentives to keep funds offshore to avoid U.S. taxation. Code Sec. 245A and other provisions would "allow U.S. companies to compete on a more level playing field against foreign multinationals … [and] eliminate the "lock-out" effect under current law, which means U.S. businesses avoid bringing their foreign earnings back into the United States to avoid the U.S. residual tax on those earnings."[50]

The important point about Code Sec. 245A is that a deemed dividend included in income under Code Sec. 367(b) can be fully offset by the Code Sec. 245A DRD, provided the Code Sec. 245A requirements are satisfied. Except in unusual cases, the requirements for Code Sec. 245A will be satisfied. Given that a taxpayer can ordinarily fully offset the income inclusion under Code Sec. 367(b) with a corresponding Code Sec. 245A DRD, the inclusion seems pointless. The Code Sec. 367(b) inclusion will rarely have an impact on a taxpayer's actual tax liability. More importantly, Congress has changed the underlying policies of the U.S. tax regime. Until recently, there was a policy that all worldwide earnings should be subject to U.S. federal income tax and Code Sec. 367(b) was necessary to ensure that the United States could in fact do that. The current policy objective is to give taxpayers an incentive to repatriate foreign earning and invest in the United States. The regulations under Code Sec. 367(b) stand at odds with current policy because they force taxpayers to engage in unnecessary analysis, and often delay transactions that would in fact repatriate earnings and allow taxpayers to invest in the United States.

3.2 Code Sec. 951A

The TCJA also introduced Code Sec. 951A, which functions to tax U.S. Shareholders on any GILTI at a minimum tax of 10.5 percent.[51] Under Code Sec. 951A, a U.S. Shareholder of a CFC will be subject to immediate U.S. federal income tax on the excess of the U.S. Shareholder's net CFC tested income for the taxable year, over the shareholder's net deemed tangible income return for the taxable year.[52] A U.S. Shareholder's net CFC tested income equals the excess, if any, of the sum of the shareholder's *pro rata* share of the tested income of each CFC with respect to which the shareholder is a U.S. Shareholder for the taxable year, reduced by the sum of the shareholder's *pro rata* share of the tested loss of each CFC with respect to which the shareholder is a U.S. Shareholder for the taxable year.[53] Tested income is the excess of the CFC's gross income, subject to certain exclusions, over the deductions properly allocable to the gross income.[54] Tested income does not include (i) U.S. source income effectively connected with a U.S. trade or business ("ECI"), (ii) subpart F income, (iii) income excluded from subpart F under the high-tax exception to subpart F, (iv) dividends received from a related person, and (v) any foreign oil and gas extraction income.[55] ECI, subpart F income oil and gas extraction income are excluded from tested income because they have already been subject to current U.S. federal income tax. Income that qualifies for the high-tax exception is excluded because Congress made the policy decision not to tax this income since it has already been subject to a foreign tax rate that is at least 90 percent of the U.S. federal income tax rate. Lastly, dividends from a related person are excluded from tested income because any such income would have been treated as tested income (or exempt, *e.g.*, due to being high-taxed) in the hands of the party distributing the dividend. Thus, this exclusion generally avoids double counting.

As noted above, a U.S. Shareholder's net tested income with respect to a CFC is reduced by the U.S. Shareholder's deemed tangible income return. The taxpayer's deemed tangible income return equals 10 percent of the shareholder's *pro rata* share of the qualified business asset investment ("QBAI") of each CFC with respect to which the shareholder is a U.S. Shareholder for the taxable year, reduced by certain interest expense.[56] QBAI with respect to a CFC means the average of the corporation's aggregate adjusted basis as of the close of each quarter of the taxable year in its specified tangible property used in a trade or business and of a type with respect to which amortization deductions under Code Sec. 167 are allowable.[57] Specified tangible property is simply property used to produce tested income.[58]

As this calculation demonstrates, despite its name, GILTI does not only tax intangible income. GILTI operates as a minimum tax on the profits of CFCs and will often include income derived from tangible property.[59] Similarly, CFCs that are engaged in low margin businesses that produce a return below 10 percent are exempt from GILTI under current law, whether they have any intangible income or not.

To the extent that Code Sec. 245A did not make Code Sec. 367(b) superfluous, Code Sec. 951A does. Pursuant to subpart F and section 951A, all income that a CFC generates is subject to immediate U.S. federal income tax unless Congress has made the policy decision to exempt the income from U.S. federal income tax. As demonstrated above, the exclusions from tested income exist for a few reasons. The income may be already be subject to U.S. federal income tax, including the income within tested income which could lead to double counting, or, in the case of high taxed income, Congress made the choice to exempt it. The only income left out of this equation is a CFC's deemed tangible return. Congress has specifically made the policy choice to exempt this income from U.S. federal income tax. Thus, now that Code Sec. 951A is in place, through one regime or another, Congress has imposed immediate U.S. federal income tax on all of the income a CFC generates that Congress wishes to tax. Between them, ECI, subpart F and GILTI generally subject the majority of a CFC's income to immediate tax. Accordingly, there is no need for Code Sec. 367(b) to preserve the United States' ability to tax the E&P.

To the extent that it was not already clear that Congress was already taxing all income a CFC generates it wished to tax, the changes to the GILTI regime that the Biden Administration is proposing remove any lingering doubt. The GILTI provisions under Code Sec. 951A appear to be poised to undergo significant changes under the Biden Administration. Senate Finance Committee Chairman Wyden[60] has released a framework aiming to reform the international tax provisions of the TCJA. Under this new framework, QBAI will be eliminated for GILTI, meaning that all the income of a CFC will be subject to immediate U.S. taxation unless the income is high-taxed.[61] The GILTI rate also will be increased. The framework does not select a specific rate and only identifies a few options including (1) equaling the U.S. corporate tax rate; (2) 75 percent of the corporate income tax rate (President Biden's proposal); and (3) prior Democratic proposals for rates between 60 and 100 percent of the corporate income tax rate. The framework also creates a country-by-country system for GILTI, either by (1) creating separate GILTI foreign tax credit baskets for each country/jurisdiction where a corporation earns income; or (2) classifying global income as "low-tax" and "high-tax" and applying GILTI only to "low-tax" income. The framework suggests that a high-tax/low-tax approach would be easier to administer than a true country-by-country approach. Lastly, the framework eliminates the "perverse incentives" arising from the interaction between GILTI and the foreign tax credit limitation. In particular, the framework is concerned about the allocation and apportionment of expenses for research and management activities a taxpayer conducts in the United States. These expenses can reduce foreign source income in the GILTI basket, which would prevent taxpayers from having sufficient foreign source income to use their foreign tax credits and thereby create an incentive to conduct these activities offshore. To address this incentive, the framework proposes to treat these expenses as entirely domestic source.

4. Conclusion

Historically, Code Sec. 367(b) was important because the provision achieved Congress' policy choice to maintain a worldwide tax system with deferral. Under that regime, it was necessary to prevent tax avoidance by preserving the United States' ability to tax a CFC's E&P. By including in income a deemed dividend equal to the all earnings and profits amount, previously deferred E&P eventually would be taxed at the shareholder level and the tax attributes would carry over without distortion. Similarly, in the foreign-to-foreign context, the Code Sec. 1248 amount preserves the United States' ability to tax a CFC's E&P as ordinary income. It is time we recognize that these provisions have outlived their usefulness. They create significant complexity and compliance burdens for taxpayers. Even if there are a few very narrow cases where a taxpayer can repatriate E&P that was not tested income and will not qualify for the 100 percent DRD in Code Sec. 245A, those cases are few and far between. Taxpayers would be better off with a much narrower set of rules that truly target the remaining potential abuses, if any. We urge Treasury to recognize the compliance burden is unnecessary and to simplify or eliminate the regulations under Code Sec. 367(b). Congress has now put in place provisions to immediately tax the majority of a CFC's income *via* GILTI and permanently exempt the remainder through Code Sec. 245A. Accordingly, there is no longer any need to preserve the United States' ability to tax a CFC's E&P or otherwise police its attributes.

ENDNOTES

1 A U.S. Shareholder is a U.S. person who owns, within the meaning of Code Sec. 958(a) or (b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote or 10 percent or more of the total value of all shares of all classes of stock of such foreign corporation. Code Sec. 951(b).

2 A CFC is any foreign corporation if more than 50 percent of the total combined voting power of all stock classes or the total value of the stock is owned by a U.S. Shareholder on any day of the taxable year. Code Sec. 957.

3 Code Sec. 951A.

4 Code Sec. 250; Code Sec. 960(d).

5 H.R. Rep. No. 115-409 at 388.

6 The preamble to the proposed regulations provides as follows:

> Comments are requested as to whether further changes to §1.367(b)-4 or 1.367(b)-7, or any changes to other regulations issued under section 367, are appropriate in order to clarify their application after the repeal of section 902. In addition, the Treasury Department and the IRS are studying the interaction of §1.367(b)-4(b)(2) with section 245A and other Code provisions and considering whether additional revisions to the regulation are appropriate in light of TCJA generally. Comments are specifically requested with respect to the proposed revisions to §1.367(b)-4(b)(2), including whether there is a continuing need to prevent excessive potential shifting of earnings and profits through the use of preferred stock in light of the TCJA generally. For example, the Treasury Department and the IRS are considering, and request comments on, the extent to which, in certain transactions described in §1.367(b)-4(b)(2), (1) an exchanging shareholder who would not qualify for a deduction under section 245A could potentially shift earnings and profits of a foreign acquired corporation to a transferee foreign corporation with a domestic corporate shareholder that would qualify for a deduction under section 245A, or (2) a domestic corporate exchanging shareholder of a foreign acquired corporation with no earnings and profits could access the earnings and profits of a transferee foreign corporation.

7 H.R. Rep. No. 72-708, at 20 (1932); S. Rep. No. 72-665, at 26–27 (1932).

8 P.L. 72-154.

9 S. Rep. No. 94-938 at 261.

10 S. Rep. No. 94-938, at 263 (1976); H.R. Rep. No. 94-658, at 241 (1976).

11 While the 1982 Tax Equity and Fiscal Responsibility Act and the Deficit Reduction Act of 1984 made changes to Code Sec. 367(a), both sets of legislation did not remove any substantive provisions of Code Sec. 367(a).

12 IRM 4.61.11.3(4).

13 Code Sec. 367(d)(1) referenced to the intangible property definition in Code Sec. 936(h)(3)(B) prior to the Consolidated Appropriations Act; P.L. 115-141.

14 T.D. 9803, December 19, 2016.

15 P.L. 115-141.

16 Reg. §1.367(d)-1T(a).

17 Reg. §1.367(d)-1T(g)(5).

18 Reg. §1.367(d)-1(c)(3)(ii).

19 One could argue that Code Sec. 367(a) and (d) are also obsolete because the appreciation in the assets ultimately will be subject to U.S. federal income tax under GILTI. Given that Code Sec. 250 significantly reduces the tax rate on GILTI, Code Sec. 367(a) and (d) still seem to serve a useful purpose.

20 S. Rep. No. 94-938 at 268 (1976).

21 *Id.*

22 T.D. 8862, January 24, 2000.

23 *Id.*

24 *Id.* Treasury was not specific about the tax attributes it was concerned about when it referred to the carryover of tax attributes. Presumably, Treasury was concerned about the E&P that would be recognized as ordinary income in a dividend or on a disposition subject to Code Sec. 1248. It may also have been concerned about items such as basis in assets with a built-in gain and possibly foreign tax credits.

25 *Id.*

26 T.D. 9273, August 8, 2006.

27 *Id.*

28 *See* INTL-054-91 and INTL-178-86, 56 FR 41993.

29 Notice 2016-73, IRB 2016-52, 908 (Dec. 2, 2016).

30 Notice 2016-73 (emphasis added).

31 S. Rep. No. 87-1881, 1962-3 at 107 (1962).

32 S. Rep. No. 87-1881, 1962-3 at 108 (1962).

33 Code Sec. 1248(a)(1)-(2); as a brief reminder, a CFC is any foreign corporation if more than 50 percent of the total combined voting power of all stock classes or the total value of the stock is owned by a U.S. Shareholder on any day of the taxable year.

34 Reg. §1.1248-1; Reg. §1.1248-2.

35 Reg. §1.367(b)-2(d).

36 Reg. §1.367(b)-2(d)(2)(ii); Code Sec. 1248(d); Code Sec. 951A(f).

37 Reg. §1.367(b)-2(d)(3)(ii).

38 The examples do not discuss the fact that, since January 1, 2018, the Code Sec. 245A DRD may offset the Code Sec. 367(b) inclusion. The implications of the 100 percent DRD arising from Code Sec. 245A are discussed further below.

39 Reg. §1.367(b)-4(b)(1)(i)(A).

40 Reg. §1.367(b)-4(b)(1)(i)(B).

41 Reg. §1.367(b)-4(c). For several years now, most taxpayers did not need to rely on the exception to an income inclusion in Reg. §1.367(b)-4(c) because the Code provided look through treatment for dividends from a CFC to a related CFC in Code Sec. 954(c)(6). Congress enacted Code Sec. 954(c)(6) in 2006. *See* The Tax Increase Prevention and Reconciliation Act of 2005, P.L. 109-222, §103(b)(1). The regulation, on the other hand, dates back to 1998. *See* T.D. 8770.

42 Code Sec. 954(c) contains numerous exceptions for income that is not likely to be passive, mobile income.

43 When FS1 ceases to be a CFC, it may possibly become a passive foreign investment company ("PFIC"). *See* Code Sec. 1297. If so, the U.S. persons holding shares in FSI would be subject to possible income inclusions under the PFIC provisions.

44 84 FR 28398.

45 Code Sec.245A(c)(1); Reg. §1.245A-5(i)(2).

46 Code Sec. 246(c)(5).

47 Code Sec. 245A(e)(1).

[48] Reg. §1.245A-5(c)(3)(ii)(B); Reg. §1.245A-5(c)(3)(iii).

[49] Reg. §1.245A-5(c)(2)(i).

[50] Senate Committee on the Budget, 115th Cong., Reconciliation Recommendations Pursuant to H. Con. Res. 71, at 358.

[51] The GILTI rate is 13.125 percent when taking into account prorated foreign tax credits.

[52] Code Sec. 951A(b)(1).

[53] Code Sec. 951A(c)(1).

[54] Code Sec. 951A(c)(2)(A).

[55] Code Sec. 951A(c)(2)(A)(i).

[56] Code Sec. 951A(b)(2).

[57] Code Sec. 951A(d)(1).

[58] Code Sec. 951A(d)(2)(A).

[59] If the intent is really a minimum tax, due to expense apportionment, GILTI often will not operate in that fashion because the U.S. Shareholder will not have sufficient GILTI limitation to use the related foreign tax credits. As a result, the income may be subject to double taxation.

[60] Senators Brown and Warner also joined the framework.

[61] With respect to CFCs, the framework reasonably can be viewed as effectively shifting the United States from a quasi-territorial system to a full inclusion/worldwide system, without deferral, with a somewhat lower rate for a CFC's tested income. Nonetheless, neither the Biden Administration nor the Wyden-Brown-Warner framework acknowledges the United States would move from a quasi-territorial system to something more akin to a full worldwide system, without deferral.

