# Code Section 367(b): Where Do We Go From Here?

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## Introduction

The reports of deferral’s death have been greatly exaggerated. It cannot be denied that the Tax Cuts and Jobs Act (the “**TCJA**”)[[2]](#footnote-3) made dramatic changes to the taxation of U.S. shareholders with respect to the income and earnings of their foreign subsidiaries. Before the TCJA, except for a few items of passive or mobile income under subpart F of the Code,[[3]](#footnote-4) the foreign-source income of a controlled foreign corporation (“**CFC**”) was generally exempt from U.S. tax until repatriated to its shareholders. The TCJA generally eliminated this system of deferral for corporate U.S. shareholders of CFCs, by taxing these shareholders currently, albeit a lower rate, on their share of most categories of CFC income under the new global intangible low-taxed income (“**GILTI**”) regime, while exempting under Code Sec. 245A any dividends out of earnings and profits (“**E&P**”) not otherwise picked up under GILTI or subpart F (such E&P, “**untaxed E&P**”). But, as in the case of the six-foot tall statistician who drowned in a lake with an average depth of only two feet,[[4]](#footnote-5) generalities can be dangerous. Not all CFC E&P attributable to corporate U.S. shareholders can be repatriated tax-free. And individual U.S. shareholders of CFCs fared even less well than their corporate counterparts under the TCJA. Not only are these individuals taxed immediately with respect to the general foreign income of their CFCs at their marginal tax rate, any dividends they receive out of untaxed E&P are also taxable. It sucks to be human.

Congress enacted Code Sec. 367(b) in 1976 to backstop deferral in the context of nonrecognition transactions governed by subchapter C of the Code. Absent Code Sec. 367(b), these transactions could effectively convert a “deferral of tax” into a “forgiveness of tax”[[5]](#footnote-6) and ordinary income into capital gain.[[6]](#footnote-7) In furtherance of this policy, the regulations under Code Sec. 367(b) (the “**367(b) regulations**”) require certain exchanging shareholders to recognize income on the importation of basis and E&P in inbound nonrecognition transactions or upon the loss of Code Sec. 1248 shareholder status in foreign-to-foreign nonrecognition transactions. While the provisions of the TCJA did not eliminate deferral, changes to the tax law since the enactment of Code Sec. 367(b), including, but not limited to the TCJA, have significantly limited its scope and its benefits, and thus also the importance of provisions intended to backstop it. As a result, some commentators have suggested that the 367(b) regulations be significantly narrowed or eliminated.[[7]](#footnote-8) Indeed, Treasury and the IRS have indicated that they are studying these regulations in light of changes to the Code in the TCJA, particularly the enactment of Code Sec. 245A.[[8]](#footnote-9)

If the 367(b) regulations were not already in existence, few would advocate that Treasury and the IRS add the project to its priority guidance plan. But they do exist, and therefore it behooves us to ask whether they remain fit for purpose. To do this, we must review the history, law, and principles underlying Code Sec. 367(b) and the regulations thereunder, as well as the many statutory and regulatory developments that impact the efficacy of these regulations.

Part II of this report traces the evolution of rules of Code Sec. 367(b) from the enactment of its statutory predecessor to the issuance of the final 367(b) regulations. Part III continues with a discussion of the current regulations and the recent developments, including the TJCA, that have impacted their effectiveness to achieve their stated goals. In this discussion, we focus on the core operative rules in Reg. §1.367(b)-3 (“**B3**”), relating to inbound nonrecognition transactions, and Reg. §1.367(b)-4 (“**B4**”), relating to foreign-to-foreign nonrecognition transactions. In Part IV, we consider approaches that Treasury and the IRS should consider to better align these rules to the post-TCJA U.S. international tax system. In Part V, we conclude with a closing thought.

## How Did We Get Here?

### Deferral

A U.S. taxpayer generally must pay Federal income taxes on its worldwide income, whether earned in the United States or abroad. However, a foreign subsidiary of a taxpayer is generally treated as a separate person for tax purposes.[[9]](#footnote-10) Prior to 1962, the United States did not generally impose tax on the foreign-source income of a foreign subsidiary until earnings were paid to its U.S. shareholders as a dividend. However, a dividend out of this untaxed E&P, when eventually paid, would give rise to ordinary income, the tax rates for which have historically been significantly higher than capital gains rates, albeit, in the case of certain domestic corporate shareholders, potentially offset by a deemed paid credit under former Code Sec. 902.

#### Subpart F

Congress enacted Code Secs. 951 to 965 (“**subpart F**”)[[10]](#footnote-11) in the Revenue Act of 1962 to address concerns with deferral of certain passive or mobile income (“**subpart F income**”) [[11]](#footnote-12) of “American controlled” foreign corporations.[[12]](#footnote-13) Specifically, under subpart F, any U.S. shareholder that owns stock (within the meaning of Code Sec. 958(a))[[13]](#footnote-14) in a foreign corporation on the last day on which the corporation is a CFC must include in its gross income its *pro rata* share of the corporation’s subpart F income (such inclusion, a “**subpart F inclusion**”).[[14]](#footnote-15) In general, a U.S. shareholder’s *pro rata* share of subpart F income is the amount of E&P attributable to subpart F income that would be distributed with respect to the CFC stock that the shareholder owns (within the meaning of Code Sec. 958(a)) if, on the last day in its taxable year on which the corporation is a CFC, the corporation had distributed all its E&P *pro rata* to its shareholders.[[15]](#footnote-16)

A CFC is a foreign corporation in which more than 50 percent of the vote or value (within the meaning of Code Sec. 958(a) or (b)[[16]](#footnote-17)) is owned by U.S. shareholders.[[17]](#footnote-18) A U.S. shareholder is a U.S. person that owns (within the meaning of Code Secs. 958(a) or 958(b)) ten percent or more of the vote or value of a foreign corporation.[[18]](#footnote-19) This U.S. shareholder limitation in subpart F was intended as a “*de minimis* rule [that] prevents the attribution of the undistributed income back to the shareholders where their interest is small and their influence on the corporation’s policy is presumably negligible.”[[19]](#footnote-20)

Code Secs. 959 and 961 provide rules intended to ensure that subpart F income is included in a U.S. shareholder’s income once, and only once. Specifically, E&P of a foreign corporation that are attributable to amounts which are, or have been, included in the gross income of the U.S. shareholder under Code Sec. 951(a) (“**previously taxed E&P**” or “**PTEP**”) are not included again when later distributed or when the amount would be included under Code Sec. 951(a)(1)(B) in the gross income of the shareholder (or successor), including by reason of distributions through a chain of ownership described in Code Sec. 958(a).[[20]](#footnote-21) Further, a U.S. shareholder’s basis in stock of a CFC, and the basis of property of a U.S. shareholder by reason of which the shareholder is considered under Code Sec. 958(a)(2) as owning stock of a CFC, is increased by the amount required to be included under Code Sec. 951, and decreased by amounts excluded under Code Sec. 959(a) on the distribution of PTEP.[[21]](#footnote-22) Under regulations prescribed by the Secretary, similar basis adjustments are to be made to basis in stock in lower-tier CFCs owned indirectly (within the meaning of Code Sec. 958(a)(2)) by a U.S. shareholder, but only for the purposes of determining the amount included under Code Sec. 951 in the gross income of such U.S. shareholder.[[22]](#footnote-23)

#### Code Sec. 1248

Congress also enacted Code Sec. 1248 as part of the Revenue Act of 1962. While subpart F was intended to limit the scope of deferral, Code Sec. 1248 was intended to limit its benefits. Even after the introduction of subpart F, a shareholder could defer U.S. tax on most of its CFC’s income by delaying the payment of a dividend. However, once that dividend was paid, the shareholder would recognize ordinary income, taxable at the shareholder’s marginal rate; *i.e.*, the same rate that would have applied if the CFC’s income had instead been earned directly by the shareholder. However, Congress became concerned that shareholders could effectively “repatriate” untaxed E&P of a CFC at lower capital gain rates, rather than higher ordinary income rates, through a taxable sale or taxable liquidation of the CFC.[[23]](#footnote-24) While Congress would permit taxpayers to delay recognizing CFC income, changing its character, once recognized, was a bridge too far. Code Sec. 1248 was enacted to impose the “full U.S. tax” on income earned abroad, once repatriated, by whatever means (including constructively through a taxable sale or exchange).[[24]](#footnote-25)

Code Sec. 1248, if applicable, recharacterizes a shareholder’s gain on the sale of stock of a foreign corporation as a dividend to the extent of the E&P attributable to that stock. Code Sec. 1248 applies to the sale of the stock of a foreign corporation by a U.S. person that owns (within the meaning of section 958(a) or (b)) ten percent or more of the total combined voting power of the foreign corporation at any time during the five-year period ending on the date of the sale or exchange and at the time of such ownership the foreign corporation was a CFC (such shareholder, a “**1248 shareholder**”).[[25]](#footnote-26) A dividend under Code Sec. 1248 does not reduce E&P, but the E&P taken into account in computing the dividend under Code Sec. 1248 are treated as PTEP.[[26]](#footnote-27) The principles of Code Sec. 1248 also apply to sales by CFCs of lower-tier foreign corporations.[[27]](#footnote-28)

The E&P of a foreign corporation that may be attributed to a 1248 shareholder are the post-1962 E&P accumulated by the foreign corporation during the period or periods such stock was held (or was considered as held by reason of the application of Code Sec. 1223, and taking into account Reg. §1.1248-8) by such shareholder while such corporation was a CFC, but excluding PTEP and E&P attributable to income effectively connected to a U.S. trade or business (“**effectively connected income**” or “**ECI**”) (such E&P, “**1248 E&P**”).[[28]](#footnote-29) In addition, 1248 E&P attributable to stock in an upper-tier foreign corporation owned (within the meaning of Code Sec. 958(a)) by a 1248 shareholder includes the 1248 E&P of a lower-tier foreign corporation that such shareholder owns indirectly (within the meaning of Code Sec. 958(a)(2)) through such upper-tier foreign corporation, if the shareholder owns (within the meaning of Code Sec. 958(a) and (b)) ten percent or more of the total combined voting power of the lower-tier foreign corporation at any time during the five-year period ending on the date of the sale or exchange when the lower-tier foreign corporation was a CFC.[[29]](#footnote-30) The amount of E&P attributable to stock in a foreign corporation owned by a 1248 shareholder is generally equal to the sum of the 1248 E&P accumulated by the foreign corporation during the holding period of the taxpayer, multiplied by the percentage that the number of shares of stock owned by the shareholder bears to the total number of shares in the foreign corporation outstanding during that period.[[30]](#footnote-31)

#### U.S. and 1248 Shareholders

As discussed above, the concepts of “U.S. shareholder” and “1248 shareholder” are critical for purposes of applying subpart F and Code Sec. 1248, respectively. They are also important concepts for purposes of applying the 367(b) regulations. For this reason, it is important to understand that, while most U.S. shareholders are 1248 shareholders, and *vice versa*, these terms are not co-terminus.

For instance, a U.S. shareholder could own ten percent of the value of a CFC or ten percent of the voting power of a foreign corporation, and in neither case be a 1248 shareholder, because a 1248 shareholder must own, or have owned, ten percent or more of the voting power of a corporation that is, or was, a CFC. Further, it is possible that a 1248 shareholder of a CFC is not a U.S. shareholder of the CFC on the date of a sale or exchange, if such shareholder was a U.S. shareholder at any point during the previous five-year period while the foreign corporation was a CFC. In addition, while the subpart F rules apply only to CFCs, Code Sec. 1248 can apply with respect to a shareholder’s sale or exchange of stock of a foreign corporation that is not a CFC at the time of such sale or exchange, if such foreign corporation was a CFC at any point during the five-year period preceding the transaction while the shareholder owned ten percent or more of its voting power. Therefore, while it is common shorthand to speak of Code Sec. 1248 as applying to the sale of CFC stock by U.S. shareholders, the terms “CFC” and “U.S. shareholder” are rarely used in Code Sec. 1248 and the regulations thereunder in reference to the corporation whose stock is sold and the U.S. person selling it.[[31]](#footnote-32)

### Guidelines

Congress enacted the predecessor to Code Sec. 367 in the Revenue Act of 1932.[[32]](#footnote-33) Section 112(k) provided that, for purposes of determining the gain recognized in an exchange or distribution afforded nonrecognition involving foreign corporations, “a foreign corporation shall not be considered a corporation unless, prior to such exchange or distribution, it has been established to the satisfaction of the Commissioner that such exchange or distribution is not in pursuance of a plan having one of its principal purposes the avoidance of Federal income taxes.” Congress enacted this provision to prevent the tax-free transfer of appreciated stock or securities to foreign corporations.[[33]](#footnote-34) This section subsequently became section 367 in the 1954 Code without material change.[[34]](#footnote-35)

In 1968, the IRS released Revenue Procedure 68-23, which set forth guidelines that the IRS would consider in providing an advance ruling that the principal purpose of the transaction was not one of Federal tax avoidance (the “**guidelines**”).[[35]](#footnote-36) The guidelines included many of the elements that would eventually be included in the 367(b) regulations, including, under certain circumstances, requiring an exchanging shareholder to include in its income as a dividend its share of the untaxed E&P of an acquired foreign corporation in order to obtain a favorable ruling. However, unlike the 367(b) regulations, the guidelines did not purport to bind either the IRS or the taxpayer; they merely outlined the circumstances in which the IRS would “ordinarily” or “generally” issue a favorable ruling. Indeed, *in lieu* of accepting any “toll charge” described in the guidelines, a shareholder could effectively elect gain recognition by merely failing to obtain an advance ruling.

As is relevant to B3 and B4, favorable rulings would generally be provided under the following circumstances and conditions:

* A domestic corporation (a “**domestic parent corporation**”) acquires the assets of a foreign corporation in a complete liquidation under Code Sec. 332 (an “**inbound liquidation**”) and the domestic parent corporation agrees to include in its gross income, as a dividend for its taxable year in which the distribution in liquidation occurs, the portion of the accumulated E&P, if any, of the foreign corporation for all taxable years of such foreign corporation properly attributable[[36]](#footnote-37) to such domestic parent corporation’s stock in such foreign corporation.[[37]](#footnote-38)
* A domestic corporation acquires the assets of a foreign corporation in an asset reorganization under Code Sec. 368 (an “**inbound reorganization**” and, with an inbound liquidation, an “**inbound nonrecognition transaction**”), and
  + (1) the shareholders of the foreign corporation agree to include in their gross income, as a dividend deemed, for their taxable year in which the exchange of stock occurs, the portion of the E&P, if any, of the foreign corporation properly attributable under Code Sec. 1248 to such shareholders’ stock in such foreign corporation which would have been includible in their gross income under Code Sec. 1248 if at the time of such acquisition the stock of such foreign corporation was exchanged in a taxable exchange, and
  + (2) a domestic corporation that owns 20 percent or more of the outstanding stock of the foreign corporation (“**20-percent domestic corporate shareholder**”) agrees to include in its gross income as a dividend, for its taxable year in which the exchange of stock occurs, its portion of the accumulated E&P, if any, of the foreign corporation for all taxable years of such corporation properly attributable to the stock in which such domestic corporation owns in such foreign corporation.[[38]](#footnote-39)
* A domestic corporation acquires the stock of a foreign corporation in a reorganization under Code Sec. 368 (an “**inbound stock reorganization**”).[[39]](#footnote-40)
* A foreign corporation transfers property to another foreign corporation in an asset reorganization under Code Sec. 368 (a “**foreign-to-foreign asset reorganization**”), if the acquired foreign corporation is a CFC at the time of the reorganization or at any time within the prior five-year period, the shareholders of such corporation agree to include in their gross income, as a dividend for their taxable year in which the reorganization occurs, the portion of the E&P, if any, of the acquired foreign corporation properly attributable under Code Sec. 1248 to such shareholders’ stock in such corporation which would have been includible in their gross income under Code Sec. 1248 if at the time of such acquisition the stock of such corporation was exchanged in a taxable exchange.[[40]](#footnote-41)
* Stock of a foreign corporation is acquired in exchange for stock of another foreign corporation in a reorganization (“**foreign-to-foreign stock reorganization**” and a foreign-to-foreign stock reorganization and foreign-to-foreign asset reorganization, each a “**foreign-to-foreign reorganization**”) and immediately after the exchange (1) the acquiring foreign corporation is controlled (within the meaning of Code Sec. 954(d)(3)) by a person or persons who immediately prior to such exchange controlled the acquired foreign corporation and (2) the acquired foreign corporation meets the requirements of the exception of Code Sec. 954(c)(4)(A)(i) (“**same country exception**”) and (ii). Further, if the acquiring foreign corporation is not a CFC, the shareholders of the acquired foreign corporation agree to include in their gross income, as a dividend for their taxable year in which the exchange of stock occurs, the portion of the E&P, if any, of the acquired foreign corporation properly attributable under Code Sec.1248 to such shareholders’ stock in such acquired foreign corporation which would have been includible in their income under Code Sec. 1248 if at the time of such acquisition the stock of such acquired foreign corporation was exchanged in a taxable exchange.[[41]](#footnote-42)
* Stock of a foreign corporation is acquired in exchange for stock of another foreign corporation in a foreign-to-foreign stock reorganization and immediately after the exchange the shareholders of the acquired corporation do not own directly or indirectly, within the meaning of Code Sec. 958, more than 50 percent of the total combined voting power of the acquiring foreign corporation. Moreover, if the acquiring foreign corporation is not a CFC, shareholders of the acquired foreign corporation agree to include in their gross income as a dividend for their taxable year in which the exchange of stock occurs, the portion of the E&P, if any, of the acquired foreign corporation properly attributable under Code Sec. 1248 to such shareholders' stock in such acquired foreign corporation which would have been includible in their income under Code Sec. 1248 if at the time of such acquisition the stock of such acquired foreign corporation was exchanged in a taxable exchange.[[42]](#footnote-43)

In the context of a foreign-to-foreign reorganization, the amount of the dividend required under the guidelines is determined by reference to the amount of the dividend that would be recognized under Code Sec. 1248 if the stock were sold or exchanged, which corresponds to the term “1248 amount” in current B4. In contrast, in respect to a domestic parent corporation in an inbound liquidation and a 20-percent domestic corporate shareholder in an inbound reorganization, the amount of the dividend is determined by reference to 1248 E&P attributable to the stock for *all* taxable years,[[43]](#footnote-44) and without regard to E&P of foreign subsidiaries under Code Sec. 1248(c)(2), corresponding to the “all E&P amount” in the temporary regulations and B3, discussed below.[[44]](#footnote-45)

For a 20-percent domestic corporate shareholder to have an inclusion under the guidelines, it does not appear that the acquired foreign corporation needs to be a CFC. In an inbound reorganization, for shareholders other than a 20-percent domestic corporate shareholder, the amount of the dividend was equal to the amount of the dividend that such shareholder would have recognized in a sale or exchange under Code Sec. 1248, except without regard to E&P of foreign subsidiaries under Code Sec. 1248(c)(2).[[45]](#footnote-46) Therefore, it appears that, for a shareholder other than a 20-percent domestic corporate shareholder or domestic parent corporation to have an inclusion in an inbound nonrecognition transaction, the shareholder must be a 1248 shareholder of a foreign corporation that is, or was, a CFC.

In no case did the guidelines impose a toll charge on a U.S. person that was neither a U.S. shareholder or a 1248 shareholder (a “**small shareholder**”).[[46]](#footnote-47)

### Code Sec. 367(b)

Congress amended Code Sec. 367 in the Tax Reform Act of 1976 to eliminate the advance ruling requirement for inbound and foreign-to-foreign transactions and to codify many of the principles underlying the guidelines. In the House Report accompanying the Tax Reform Act of 1976 (the “**1976 House Report**”), Congress discussed how the statutory standard of Code Sec. 367 had evolved “through administrative interpretation into a requirement generally that tax-free treatment be permitted only if the U.S. tax on accumulated [E&P]…is paid or is preserved for future payment.”[[47]](#footnote-48) While Congress “generally approve[d] the standard applied by the IRS” in the guidelines, the 1976 House Report identified several problems that had arisen with respect to the advance ruling requirement in prior Code Sec. 367, including that the requirement could cause undue delay for transactions, that transactions in scope of the guidelines could occur without the knowledge of U.S. shareholders of the foreign corporation, that the toll charge applied where there was no tax avoidance but only the potential for future tax avoidance, and that taxpayers could not litigate unfavorable rulings in court.[[48]](#footnote-49) For these reasons, Congress wanted to replace the advance ruling requirement with “clear and certain regulations.”[[49]](#footnote-50)

To address these problems, section 367 was amended to establish separate rules for outbound transfers of property by a U.S. person (Code Sec. 367(a)) and other transfers, including inbound nonrecognition transactions and foreign-to-foreign transactions (Code Sec. 367(b)). For these “other transfers,” Congress replaced the advance ruling requirement with the general rule that a foreign corporation is treated as 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.[[50]](#footnote-51) Code Sec. 367(b)(2) provides that the regulations to be issued by Treasury and the IRS—

shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing—

(A) the circumstances under which—

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

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

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

In authorizing regulations, Congress “recognized that the present rules were necessarily highly technical and largely procedural…to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings.” However, Congress warned that “unnecessary barriers to justifiable and legitimate business transactions should be avoided.”[[51]](#footnote-52)

### Temporary Regulations

The first comprehensive set of regulations under Code Sec. 367(b) were released in 1977 as temporary regulations (the “**temporary regulations**”).[[52]](#footnote-53) The temporary regulations provided a complex set of rules which generally require either (1) an immediate US tax upon the repatriation of undistributed foreign earnings or where the application of Code Sec. 1248 could not be preserved or (2) where the application of Code Sec. 1248 could be preserved, attribution of various amounts (*e.g.*, the “1248 amount,” or “all E&P amount”) from the stock surrendered to the stock received.

The temporary regulations generally adopted the guidelines, with minor modifications described below. As is relevant to B3 and B4, the 1977 temporary regulations applied in the following manner:

* If a domestic corporation acquires the assets of a foreign corporation in an inbound liquidation, the domestic corporation either (1) includes as a deemed dividend the all earnings and profits amount (“**all E&P amount**”)[[53]](#footnote-54) with respect to its stock of the foreign corporation or (2) recognizes gain with respect to its stock of the foreign corporation.[[54]](#footnote-55)
* If a domestic corporation acquires the assets of a foreign corporation in an inbound asset reorganization—
  + A non-corporate 1248 shareholder includes in gross income as a deemed dividend the 1248 amount with respect to its stock of the foreign corporation.[[55]](#footnote-56)
  + A corporate 1248 shareholder either (1) includes in gross income as a deemed dividend the all E&P amount with respect to its stock of the foreign corporation or (2) recognizes gain with respect to its stock of the foreign corporation.[[56]](#footnote-57)
  + A foreign corporate shareholder adds to its E&P or deficit the E&P of the foreign corporation attributable to its 1248 shareholders (“**1248(c)(2) amount”**).[[57]](#footnote-58)
* If a domestic corporation acquires the stock of a foreign corporation in a reorganization under Code Sec. 368—
  + A 1248 shareholder includes in gross income as a deemed dividend the 1248 amount with respect to its stock of the foreign corporation.[[58]](#footnote-59)
  + A foreign corporate shareholder adds to its E&P or deficit the 1248(c)(2) amount of the foreign corporation.[[59]](#footnote-60)
* If a foreign corporation acquires the assets or stock of a foreign corporation in a foreign-to-foreign reorganization—
  + A 1248 shareholder that receives stock of a foreign corporation which is not a CFC or stock of a CFC as to which the 1248 shareholder is not a 1248 shareholder includes in income the 1248 amount with respect to its stock of the foreign acquired corporation.[[60]](#footnote-61)
  + A foreign corporate shareholder that receives stock of a foreign corporation which is not a CFC or stock of a CFC with respect to which a 1248 shareholder of the foreign corporate shareholder is not a 1248 shareholder adds to its E&P or deficit the 1248(c)(2) amount of the foreign acquired corporation.[[61]](#footnote-62)

The most significant changes in the temporary regulations from the guidelines were (1) the reduction to a ten percent threshold for corporate 1248 shareholders to be required to include in gross income the all E&P amount with respect their stock in a foreign acquired corporation in an inbound asset reorganization, (2) the inclusion of E&P of foreign subsidiaries in the 1248 amount recognized by a non-corporate 1248 shareholder in an inbound asset reorganization, and (3) the requirement that 1248 shareholders include in gross income the 1248 amount with respect to their stock in a foreign acquired corporation in an inbound stock reorganization. The preamble to the temporary regulations did not elaborate on the policy or principles that informed these modifications.

### Proposed Regulations

In 1991, Treasury and the IRS issued proposed regulations (the “**proposed regulations**”) and removed substantially all of the 1977 temporary regulations.[[62]](#footnote-63) Unlike the guidelines and the preamble to the temporary regulations, the preamble to the proposed regulations articulated the principles of Code Sec. 367(b) taken into account in the development of the proposed regulations. The preamble identified four principles: (1) the prevention of the repatriation of earnings or basis without tax (the “**repatriation principle**”); (2) the prevention of material distortion in income (the “**distortion principle**”); (3) the minimization of complexity (the “**complexity principle**”); and (4) the permissibility of deferral (the “**deferral principle**”). These principles informed subsequent issuances of regulations under Code Sec. 367(b), including the final regulations issued in 2000 (the “**final regulations**”),[[63]](#footnote-64) the preamble to which further elaborated on them.

#### Repatriation principle

On the repatriation principle, the preamble to the proposed regulations explained:

One of the principles of the proposed regulations under section 367(b) is that the repatriation of a United States person’s share of earnings and profits of a foreign corporation through what would otherwise be a nonrecognition transaction (for example, a liquidation of a foreign subsidiary into its domestic parent in a transaction described in section 332, or an acquisition by a domestic corporation in a reorganization described in section 368) should generally cause recognition of income by the foreign corporation’s shareholders. A domestic acquirer of the foreign corporation’s assets should not succeed to the basis or other tax attributes of the foreign corporation except to the extent that the United States tax jurisdiction has taken account of the United States person’s share of the earnings and profits that gave rise to those tax attributes.[[64]](#footnote-65)

In the preamble, Treasury and the IRS further elaborated that, to prevent the repatriation of E&P without tax, “[t]he proper measure of the earnings and profits that should be subject to tax is the all earnings and profits amount.” [[65]](#footnote-66) Therefore, the proposed regulations expanded the approach in the prior guidance applicable to inbound nonrecognition transactions, requiring that all U.S. shareholders, not just corporate U.S. shareholders (or 20 percent domestic corporate shareholders under the guidelines, in the case of inbound asset reorganizations), include in gross income as a deemed dividend the all E&P amount in an inbound nonrecognition transaction.[[66]](#footnote-67) Also, consistent with the repatriation principle, the proposed regulations generally eliminated the rule in the temporary regulations that implicitly permitted taxpayers to elect taxable exchange treatment in *lieu* of including an all E&P amount in an inbound nonrecognition transaction.[[67]](#footnote-68)

However, the proposed regulations departed from the principle that shareholders ought to include their all E&P amount in two situations. First, the proposed regulations provided a U.S. shareholder an election to recognize the gain (but not loss) that it realizes with respect to its stock in the foreign acquired corporation, in *lieu* of including its all E&P amount (a “**taxable exchange election**”).[[68]](#footnote-69) However, if a taxable exchange election is made, the proposed regulations required a reduction in asset basis (or other tax attributes) of the foreign acquired corporation to which the domestic acquiring corporation would otherwise succeed in an amount equal to the excess of the all E&P amount over the gain recognized.[[69]](#footnote-70)

Second, the proposed regulations required small shareholders to recognize the gain (but not loss) realized with respect to their stock in the foreign acquired corporation.[[70]](#footnote-71) The preamble explained that gain recognition without attribution reduction, rather than an inclusion of an all E&P amount, was an appropriate measure for small shareholders based on administrative concerns:

Such a United States person may not own a sufficient interest in the foreign acquired corporation to obtain the relevant earnings and profits information needed to compute the all earnings and profits amount with respect to the stock that it exchanges. Similarly, the foreign acquired corporation may not have adequate information about such a shareholder’s realized gain to compute the proper attribute reduction.[[71]](#footnote-72)

Interestingly, though the preamble explains the “departure” from an all E&P inclusion in the case of small shareholders, nowhere does it explain the proposed regulations’ departure from the nonrecognition approach for small shareholders under the guidelines and the temporary regulations.

#### Distortion principle

On the distortion principle, the preamble to the proposed regulations explained:

Another objective of the regulations under section 367(b) is to prevent the occurrence of a material distortion in income. For this purpose, a material distortion in income includes a distortion relating to the source, character, amount or timing of any item, if such distortion may materially affect the United States tax liability of any person for any year. Thus, for example, the regulations generally operate to prevent the avoidance of provisions such as section 1248 (which requires inclusion of certain gain on the disposition of stock as a dividend). For this purpose, the concept of ‘avoidance’ includes a transaction that results in a material distortion in income even if such distortion was not a purpose of the transaction.[[72]](#footnote-73)

Consistent with the distortion principle, the proposed regulations generally followed the approach in the temporary regulations in requiring an inclusion of a 1248 amount when, after a nonrecognition transaction, Code Sec. 1248 can no longer apply to an exchanging shareholder’s sale of the stock of the foreign acquiring corporation.[[73]](#footnote-74)

It should be noted that, while the rules applicable to inbound nonrecognition transactions are generally discussed in the context of the repatriation principle, they are also intended to address the distortion principle. The preamble to the final regulations addresses the dual function of these rules:

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.[[74]](#footnote-75)

#### Complexity principle

On the complexity principle, the preamble to the proposed regulations explained:

The regulations under section 367(b) also generally attempt to minimize complexity to the extent not inconsistent with principles (1) and (2), in order to reduce taxpayer compliance burdens and the Treasury’s administrative costs, and to improve enforcement of the tax laws. In addition, in some cases the regulations adopt a rule that has the effect of minimizing complexity even though the rule is to some extent a departure from principles (1) and (2). In those instances in which minimizing complexity results in a departure from principles (1) and (2), the taxpayer is sometimes treated more favorably and sometimes less favorably than if the regulations had not taken complexity into account.[[75]](#footnote-76)

Consistent with the complexity principle, in response to comments, the proposed regulations eliminated the attribution regime of the temporary regulations. Instead, the proposed regulations either required an inclusion of an exchanging shareholder’s 1248 amount if the transaction “is of a type that is relatively likely to result in a material distortion in income,” or, if the transaction was not of such a type so that an inclusion was required, Code Sec. 1248(a) would apply to post-transaction exchanges “without attempting to keep track of the particular earnings, and profits attributable to a particular shareholder as under the attribution regime of the temporary regulations.”[[76]](#footnote-77)

#### Deferral principle

On the deferral principle, the preamble to the proposed regulations explained that “to the extent not inconsistent with principles (1), (2), and (3), the regulations under section 367(b) generally do not operate to accelerate the recognition of income that is realized but which would not otherwise be recognized by reason of a nonrecognition provision of the Internal Revenue Code.”[[77]](#footnote-78)

### Final Regulations

The 1991 proposed regulations were largely finalized in the 2000 final regulations, with certain modifications. First, as discussed above, the proposed regulations would have allowed U.S. shareholders to make a taxable exchange election in order to recognize gain with respect to the stock in the foreign acquired corporation in lieu of including the all E&P amount in income as a deemed dividend in exchange for a reduction to attributes to the extent the all E&P amount exceeded the gain recognized.[[78]](#footnote-79) This taxable exchange election was not adopted in the final regulations on the grounds that it was (1) inconsistent with the policy of Code Sec. 367(b) that the shareholder inclusion should be calculate by reference to the all E&P amount, (2) added substantial complexity by requiring coordination between the electing shareholders and the acquiring corporation to determine the attribute reductions, and (3) and potentially unfair to the un-electing taxpayer, who economically bears some of the sour and none of the sweet.[[79]](#footnote-80) On this last point, the preamble provided the following example:

For example, consider an inbound C, D, or F reorganization involving two U.S. shareholders of the foreign acquired corporation, one that makes the taxable exchange election (because its gain on the stock is less than its all earnings and profits amount) and one that does not. In connection with the electing shareholder’s taxable exchange election, the 1991 proposed regulations required a proportionate reduction in certain tax attributes of the foreign acquired corporation. This reduction effectively allowed the electing shareholder to transfer to the acquiring corporation the burden created by its decision not to include in income its full all earnings and profits amount and, thereby, to effectively shift a portion of this burden to the non-electing shareholder (that has already paid U.S. tax on its full share of the foreign corporation’s earnings and profits).[[80]](#footnote-81)

Further, the proposed regulations would have required all small shareholders to recognize gain.[[81]](#footnote-82) As discussed above, this rule was included based on administrative concerns, namely that the small shareholders would lack the information to compute its and the foreign acquired corporation would lack information about its shareholders’ inclusions to adjust its E&P. Commentators requested that the regulations permit small shareholders to make an election to include their all E&P amount in lieu of recognizing gain.[[82]](#footnote-83) Commentators also requested an election that would permit a domestic acquiring corporation to include in income the all E&P amounts on behalf of the small shareholders.[[83]](#footnote-84) In response to these comments, the final regulations permitted small shareholders to make an election to include their all E&P amount (the “**all E&P election**”), but only if the foreign acquired corporation furnishes such shareholders adequate information to compute their all E&P amount.[[84]](#footnote-85) However, Treasury and the IRS rejected the comment requesting an election to allow the domestic acquiring corporation to elect to include small shareholders’ all E&P amounts, citing “substantial administrative difficulties,” namely being able to determine each small shareholder’s holding period in order to calculate this cumulative all E&P inclusion.[[85]](#footnote-86)

B3 and B4 have not materially changed since the 2000 final regulations, except with respect to rules relating to the carryover of E&P and foreign taxes in inbound nonrecognition transactions that were finalized in 2006.[[86]](#footnote-87)

## Where is Here?

### Current Rules

#### B3

B3 provides rules for certain inbound nonrecognition transactions, including an acquisition by a domestic corporation (a domestic acquiring corporation) of the assets of a foreign corporation (a foreign acquired corporation) in a liquidation described in Code Sec. 332 or an asset acquisition described in Code Sec. 368 (an inbound nonrecognition transaction).[[87]](#footnote-88) In respect to the corporate-level consequences, under B3, a domestic acquiring corporation does not inherit net operating losses (“**NOLs**”), capital loss carryovers, or E&P, except to the extent attributable to ECI.[[88]](#footnote-89)

These rules also have consequences for any exchanging shareholder that is a U.S. person or a foreign corporation with a U.S. shareholder, but no consequences for other foreign shareholders. The treatment of an in-scope exchanging shareholder differs depending on whether the shareholder is a U.S. shareholder (or a foreign corporation with a U.S. shareholder) or is not a U.S. shareholder. An exchanging shareholder that is a U.S. shareholder or a foreign corporation with a U.S. shareholder includes in income, as a deemed dividend, the all E&P amount with respect to its stock in the foreign acquired corporation.[[89]](#footnote-90) The all E&P amount is defined as the net positive E&P, if any, of the foreign acquired corporation and attributable to the stock of such foreign acquired corporation.[[90]](#footnote-91) A foreign corporation’s E&P is determined using principles substantially similar to those applicable to domestic corporations, except excluding E&P described in Code Sec. 1248(d) (*e.g.*, ECI and PTEP).[[91]](#footnote-92) The E&P is attributed to the stock of the foreign acquired corporation under the principles of Code Sec. 1248 and the regulations thereunder, except that, for this purpose, without regard to the requirements of Code Sec. 1248 that are not relevant to the determination of a shareholder's *pro rata* portion of E&P (*e.g.*, without regard to whether the foreign corporation is or was a CFC, the shareholder owns or owned a ten percent or greater interest in the stock, or the E&P of the foreign corporation were accumulated in post-1962 taxable years while the corporation was a CFC).[[92]](#footnote-93) If the exchanging shareholder is a foreign corporation, the foreign shareholder’s holding period in the stock of the foreign acquired corporation is determined by reference to the period that the foreign shareholder’s U.S. shareholders held (directly or indirectly) an interest in the foreign acquired corporation.[[93]](#footnote-94)

There are two rules in B3 for small shareholders. First, a small shareholder whose stock in the foreign acquired corporation has a fair market value of more than $50,000 is required to recognize gain (but not loss) with respect to the stock of the foreign acquired corporation.[[94]](#footnote-95) To the extent that the foreign acquired corporation provides the exchanging shareholder with information that substantiates the shareholder’s all E&P amount and the exchanging shareholder complies with certain notice requirements, the exchanging small shareholder may elect to include in income the all E&P amount (the “**all E&P election**”).[[95]](#footnote-96) An exchanging small shareholder whose stock in the foreign acquired corporation has a fair market value of less than $50,000 does not recognize gain or loss as a result of the exchange (the “***de minimis* exception**”).[[96]](#footnote-97)

#### B4

B4 provides rules for certain foreign-to-foreign nonrecognition transactions, including if a foreign corporation (transferee foreign corporation) acquires the stock or assets of a foreign corporation (foreign acquired corporation) in an exchange described in Code Sec. 351 or a reorganization under Code Sec. 368(a) in which both the target and acquiring corporation are foreign.[[97]](#footnote-98) In general, an exchanging shareholder may be required to include in income as a deemed dividend the 1248 amount associated with the stock of the foreign target corporation transferred.[[98]](#footnote-99) An exchanging shareholder will be considered to receive a deemed dividend in the following situations: (i) the exchange results in the loss of status as a 1248 shareholder within the meaning of Reg. §1.367(b)-2(b); (ii) the shareholder receives preferred stock or tracking stock in exchange for common stock (or participating preferred stock) and certain other conditions are met; and (iii) recapitalization transactions that result in the shareholder receiving preferred stock or tracking stock in exchange for common stock (or participating preferred stock).[[99]](#footnote-100)

The 1248 amount is defined as the net positive earnings and profits (if any) that would be attributable to the stock of the transferred foreign corporation and includible in income as a dividend under section 1248 if the shareholder sold the stock.[[100]](#footnote-101) A 1248 shareholder generally is defined as a U.S. person (including a domestic corporation) that owns ten percent or more of the voting stock of a foreign corporation as any time during the five-year period ending on the date of the disposition when such foreign corporation was a CFC.[[101]](#footnote-102) For purposes of determining 1248 shareholder status, stock owned directly, indirectly under Code Sec. 958(a), and constructively under Code Sec. 958(b) is taken into account.

An exchange results in the loss of 1248 shareholder status if the exchanging shareholder is either a U.S. person that is a 1248 shareholder of the foreign corporation immediately before the exchange or a foreign corporation with respect to which a U.S. person is a 1248 shareholder, and immediately after the exchange, either (i) the stock received is not stock in a CFC as to which the exchanging shareholder (or in the case of an exchanging foreign corporation, the 1248 shareholder with respect to such corporation) is a 1248 shareholder or (ii) the foreign acquiring corporation is not a CFC as to which the U.S. transferor (or in the case of an exchanging foreign corporation, the 1248 shareholder with respect to such foreign corporation) is a 1248 shareholder.[[102]](#footnote-103) B4 does not apply to transfers of stock of a foreign corporation by a 1248 shareholder to a domestic corporation. The domestic corporation inherits the 1248 E&P with respect to the foreign acquired corporation under Reg §1.1248-8. Similar to B3, there are no consequences to, or with respect to E&P and basis attributable to, foreign shareholders other than foreign corporations with a U.S. shareholder.

#### Treatment of Deemed Dividends

As described above, B3 and B4 require an exchanging shareholder to include in its gross income an all E&P amount or the 1248 amount, respectively, as a deemed dividend. A deemed dividend under the 367(b) regulations is treated as a dividend for all purposes of the Code. Therefore, a deemed dividend included in the gross income of a corporate U.S. shareholder may be eligible for 245A DRD for an inclusion, and a deemed dividend included in the gross income of an individual U.S. shareholder may qualify as qualified dividend income (“**QDI**”) under Code Sec. 1(h)(11). As for deemed dividends received by an exchanging shareholder that is a CFC, a Code Sec. 1248 amount included in the gross income of a CFC as a deemed dividend is excluded from FPHCI.[[103]](#footnote-104) However, an all E&P amount included in the gross income of a CFC is treated as FPHCI, since the deemed dividend is eligible for neither the same country exception[[104]](#footnote-105) nor the look-through exception under Code Sec. 954(c)(6) (the “**look-through exception**”).[[105]](#footnote-106)

A deemed dividend under B3 or B4 is considered received immediately before the exchanging shareholder’s receipt of consideration for its stock in the foreign corporation, and the shareholder’s basis in the stock exchanged is increased by the amount of the deemed dividend.[[106]](#footnote-107) Such basis increase is taken into account before determining the gain otherwise recognized on the exchange (for example, under Code Sec. 356), the basis that the exchanging shareholder takes in the property that it receives in the exchange (under Code Sec. 358(a)(1)), and the basis that the transferee otherwise takes in the transferred stock (under Code Sec 362).[[107]](#footnote-108)

### Other Developments Impacting Code Sec. 367(b)

#### Everything but TCJA

Code Sec. 367(b) and the regulations thereunder have not been significantly amended since the final regulations were issued in 2000. However, the tax law has evolved both during and since that time. Following are some developments that impact, directly or indirectly, the relevance and the impact of B3 and B4.

##### Convergence of rates for capital gain and dividends

The preferential rate for long-term capital gains for corporations was enacted in 1942, with an initial rate of 25 percent as compared to the top corporate tax rate of 40 percent.[[108]](#footnote-109) By 1962, the top corporate tax rate had increased to 52 percent, while the long-term capital gain rate remained at 25 percent.[[109]](#footnote-110) As of 1976, the long-term capital gain rate had increased to 30 percent, but still remained significantly lower than the top corporate income tax rate of 48 percent.[[110]](#footnote-111) Effective in 1988 for calendar year taxpayers [[111]](#footnote-112) Congress eliminated the preferential long-term capital gain rate for corporations, thus conforming the capital gain rate to the corporate tax rate. Since that time, corporate rates for capital gains and ordinary income have not diverged.

For individuals, the preferential rate for capital gains relative to ordinary income has persisted. However, in 2003, Congress enacted the QDI rules in Code Sec. 1(h)(11), which provide that QDI of an individual shareholder is subject to taxation at reduced long-term capital gain rates, rather than ordinary income rates.[[112]](#footnote-113) While QDI is taxed at capital gain rates, it is not “gain from the sale or exchange of a capital asset.”[[113]](#footnote-114) Therefore, an individual shareholder cannot offset its QDI with capital losses, except as generally permitted under Code Sec. 1211(b).[[114]](#footnote-115)

QDI is income from dividends paid by either a domestic corporation or a qualified foreign corporation. A qualified foreign corporation is any corporation that is incorporated in a U.S. possession or is eligible for benefits of a comprehensive income tax treaty if it would qualify for the benefits of the treaty with respect to substantially all of its income in the tax year in which the dividend is paid.[[115]](#footnote-116) In addition, a dividend paid by a foreign corporation with respect to stock that is publicly traded on a U.S. stock exchange is considered QDI, even if the foreign corporation is not a qualified foreign corporation.[[116]](#footnote-117) However, dividends paid by a qualified foreign corporation that is a passive foreign investment corporation (“**PFIC**”) or a surrogate foreign corporation under Code Sec. 7874 are not QDI.[[117]](#footnote-118) The QDI rules also have a holding period requirement, which modifies the Code Sec. 246(c) holding period from 45 days in a 91-day period to 60 days in a 121-day period.[[118]](#footnote-119)

##### Code Sec. 986(c) and IRS Notice 88-71

In 1986, Congress enacted Code Sec. 986(c), which taxes foreign currency gain or loss on the distribution (or deemed distribution) of PTEP. Where a CFC maintains E&P, including PTEP, in a functional currency other than the U.S. dollar, Code Sec. 986(c) requires the recognition of gain or loss if there have been movements in exchange rates between the time of the deemed distribution and the actual distribution of PTEP.[[119]](#footnote-120) Code Sec. 986(c) gain or loss is treated as ordinary income or loss from the same source as the associated income inclusion. IRS Notice 88-71 announced that regulations will provide that, solely for purposes of computing Code Sec. 986(c) gain or loss, PTEP attributable to stock “with respect to which a section 1248 transaction…is relevant” is treated as distributed immediately prior to the transaction for purposes of computing foreign currency gain or loss on the PTEP.[[120]](#footnote-121) The foreign currency income (or loss) recognized increases (or decreases) the U.S. shareholder's basis in the stock of the foreign corporation for purposes of computing gain or loss with respect to the stock in the transaction.[[121]](#footnote-122)

As is relevant to the 367(b) regulations, if an exchanging shareholder that is a U.S. person includes in income either an all E&P amount or 1248 amount under B3 or B4, then immediately prior to the exchange, solely for purposes of computing foreign currency income or loss under Code Sec. 986(c), the shareholder is treated as receiving a distribution of PTEP from the appropriate foreign corporation that is attributable (under the principles of Code Sec. 1248) to the exchanged stock.[[122]](#footnote-123) The exchange gain or loss recognized by a exchanging shareholder that is a U.S. person will increase or decrease the shareholder's adjusted basis in the stock of the foreign corporation.[[123]](#footnote-124) If an exchanging shareholder is foreign, PTEP is treated as distributed to the shareholder for all purposes (*i.e.*, the PTEP moves up to the shareholder).[[124]](#footnote-125)

##### Code Sec. 362(e)(1) and the importation of basis

In 2004, Congress enacted Code Sec. 362(e)(1), which provides that the basis of importation property will be its fair market value after the transaction if there would be an importation of a net built-in loss under Code Sec. 362(a) or (b)[[125]](#footnote-126) in a Code Sec. 351 exchange or reorganization under Code Sec. 368. A similar rule applies for transfers of importation property pursuant to a complete liquidation under Code Sec. 332.[[126]](#footnote-127)

An importation of net built-in loss occurs if the aggregate basis of importation property exceeds the fair market value of such property.[[127]](#footnote-128) Importation property is any property with respect to which any gain or loss that would be recognized on its (hypothetical) sale by the transferor immediately before the transfer would that not be subject to U.S. tax, and gain or loss that would be recognized on its (hypothetical) sale by the transferee immediately after the transfer would be subject to U.S. tax.[[128]](#footnote-129) Property transferred by a CFC in a nonrecognition transaction may be importation property, notwithstanding that gain or loss from a hypothetical sale by the CFC would be taken into account in determining a U.S. shareholder’s subpart F income or GILTI inclusion.

#### Everything about TCJA

##### Overview

On December 22, 2017, Congress passed the TCJA, which dramatically changed the U.S. system of international taxation. According to the legislative history, Congress intended to move the international tax system away from a worldwide system of taxation with deferral towards a territorial system of taxation with “appropriate safeguards”:

The Committee believes that the current tax system puts American workers and companies at a severe disadvantage to foreign workers and companies. This is primarily because the United States is one of the few industrialized countries with a worldwide system of taxation and has the highest corporate tax rate among OECD member countries. The worldwide system of taxation with deferral provides perverse incentives to keep funds offshore because dividends from foreign subsidiaries are not taxed until repatriated to the United States. The Committee believes that a territorial system with appropriate anti-base erosion safeguards, combined with a lower corporate tax rate, will make American workers and companies competitive again, and also will remove tax-driven incentives to keep funds offshore.[[129]](#footnote-130)

In reality, the TCJA did not create a territorial system with safeguards. In fact, the TCJA did not create a single international tax system, it created four distinct systems that apply to U.S. shareholders of foreign corporations, depending on the identity of the U.S. shareholder and the level of U.S. ownership with respect to the foreign corporation–

(1) a hybrid worldwide/territorial system for corporate U.S. shareholders of CFCs: a corporate U.S. shareholder is taxed immediately on most of its CFCs income under GILTI or subpart F, but then any untaxed E&P of the CFCs may be repatriated tax-free under Code Sec. 245A;

(2) a hybrid worldwide/deferral system for individual U.S. shareholders of CFCs: an individual U.S. shareholder is taxed immediately on most of its CFCs income under GILTI or subpart F, and any untaxed E&P of the CFCs are taxed upon repatriation;

(3) a territorial system for corporate U.S. shareholders of 10/50 companies: a corporate U.S. shareholder of a 10/50 company is not taxed immediately on any income of such company, and then all the untaxed E&P of the companies may be repatriated tax-free under Code Sec. 245A;

(4) a deferral system for individual U.S. shareholders of 10/50 companies: an individual U.S. shareholder of a 10/50 company is not taxed immediately on any income of such companies, but then all the untaxed E&P of the companies are taxed upon repatriation.[[130]](#footnote-131)

There is also a separate system of taxation that applies to small shareholders of foreign corporations, regardless of whether the foreign corporation is a CFC, a 10/50 company, or neither. Similar to individual U.S. shareholders of 10/50 company, a small shareholder is not taxed until it receives a dividend.

Changes made to the taxation of U.S. shareholders of foreign corporations include enacting Code Secs. 965, 245A, 951A, and repealing Code Sec. 958(b)(4), as described below.

##### Code Sec. 965 and the transition tax

To transition from the deferral system of international taxation to the system prescribed by the TCJA, Congress amended Code Sec. 965 to require U.S. shareholders of CFCs and 10/50 companies with untaxed post-1986 E&P to increase their subpart F inclusion by their *pro rata* share of untaxed post-1986 E&P of such corporations calculated as of November 2, 2017, or December 31, 2017.[[131]](#footnote-132) The Code Sec. 965 inclusion was taxed at a blended rate of 15 percent to the extent of its CFC aggregate cash position and 8.5 percent for the remaining inclusion.[[132]](#footnote-133)

##### GILTI

To prevent taxpayers from moving operations offshore to low-taxed jurisdictions and repatriating low-taxed earnings in a tax-free manner under Code Sec. 245A, the TCJA enacted the GILTI regime. Under the GILTI regime, a U.S. shareholder is required to include in its gross income its *pro rata* share of its GILTI amount for the taxable year. GILTI is the excess (if any) of a U.S. shareholder’s net CFC tested income for the taxable year over its net deemed tangible income return for the taxable year.[[133]](#footnote-134) “Net CFC tested income” is a U.S. shareholder’s *pro rata* shares of the aggregate tested income of all CFCs less the U.S. shareholder’s *pro rata* shares of the aggregate tested losses of all CFCs.[[134]](#footnote-135) “Tested income” is the amount that a CFC’s gross tested income exceeds the deductions properly allocable to tested income. Gross tested income includes all income except ECI, amounts taken into account in determining subpart F income, amounts excluded under the subpart F high-tax exception, related party dividends, and foreign oil and gas extraction income (“**FOGEI**”).[[135]](#footnote-136) Unlike subpart F income, tested income is not limited by E&P.

Certain items may reduce tested income or GILTI, creating CFC income that is not included in the gross income of a U.S. shareholder under either GILTI or subpart F, thus creating untaxed E&P described in Code Sec. 959(c)(3). First, for purposes of computing GILTI, net CFC tested income is reduced by the net deemed tangible income return, which is the excess of ten percent of the aggregate of a U.S. shareholder’s *pro rata* share of the qualified business asset investment (“**QBAI**”) for the taxable year over the amount of interest expense taken into account in determining the U.S. shareholder’s net CFC tested income.[[136]](#footnote-137) QBAI is the quarterly average of a CFC’s adjusted bases in tangible depreciable property used in the production of tested income.[[137]](#footnote-138) Tested income of one CFC may also be offset by a tested loss of another CFC with the same U.S. shareholder. A tested loss the amount that a CFC’s gross tested income is less than the deductions properly allocable to tested income. Finally, if a U.S. shareholder so elects, CFC income that is high-taxed is excluded under the GILTI high-tax exception from the definition of tested income,[[138]](#footnote-139) and thus excluded from GILTI.

##### Code Sec. 245A and the participation exemption

###### In general

To move towards a territorial system, the TCJA implemented a participation exemption in Code Sec. 245A for E&P otherwise not taxed under GILTI or subpart F. Under this provision, a domestic corporation that is a U.S. shareholder is generally entitled to a 100 percent dividends received deduction (“**245A DRD**”) for the foreign-source portion of any dividends received from a specified foreign corporation (“**SFC**”) subject to certain additional requirements.[[139]](#footnote-140) An SFC is any foreign corporation held by a domestic corporation that is a U.S. shareholder (a “**245A shareholder**”),[[140]](#footnote-141) except that a PFIC is not an SFC unless the PFIC is a CFC with respect to the shareholder.[[141]](#footnote-142) In the case of the sale or exchange by a corporate 1248 shareholder of the stock of a foreign corporation held for at least one year, any amount treated as a dividend under Code Sec. 1248 is treated as a dividend for purposes of Code Sec. 245A.[[142]](#footnote-143)

The foreign-source portion of a dividend is equal to the amount of the dividend multiplied by a fraction, the numerator of which is the undistributed foreign earnings of the SFC and the denominator of which is the undistributed earnings of the SFC.[[143]](#footnote-144) The undistributed foreign earnings are the undistributed earnings of the SFC that are not attributable to ECI or dividends from 80-percent owned domestic corporations, including regulated investment companies (“**RIC**”) or real estate investment trusts (“**REIT**”).[[144]](#footnote-145) The undistributed earnings of an SFC are the E&P of the SFC (computed in accordance with Code Sec. 964(a) and Code Sec. 986) as of the close of the year, unreduced by dividends during the year.[[145]](#footnote-146) Dividends out of undistributed earnings attributable to ECI or from 80-percent owned domestic corporations, excluding RICs and REITs (“**undistributed U.S. earnings**”), may be allowed a DRD under Code Sec. 245(a) (a “**Section 245(a) DRD**”) equal to the percent specified in Code Sec. 243.[[146]](#footnote-147) However, no Section 245(a) DRD may be received for dividends to the extent treated out of pre-acquisition E&P.[[147]](#footnote-148)

There are several provisions that may disallow the 245A DRD or, at least, eliminate the tax benefit of the 245A DRD, in whole or in part. Each of these provisions are discussed in turn below.

###### 245A holding period requirement

A 245A DRD is not allowed for any dividend on any share of stock if the 245A shareholder does not meet the holding period requirement in Code Sec. 246(c)(5) (“**245A holding period requirement**”). The 245A holding period requirement is satisfied with respect to a share if the taxpayer holds such share for 366 days during the 731-day period beginning on the date which is 365 days before the date on which such share becomes ex-dividend with respect to such dividend.[[148]](#footnote-149) For purposes of the 245A holding period requirement, a taxpayer is treated as holding stock for any period only if the distributing corporation is an SFC at all times during such period and the taxpayer is a U.S. shareholder with respect to the SFC at all times during such period.[[149]](#footnote-150) The taxpayer’s holding period with respect to the stock includes the period during which the taxpayer is treated as holding the stock under Code Sec. 1223(2) or Code Sec. 1223(3) (*i.e.*, a tacked holding period).[[150]](#footnote-151) However, there is no rule that would “tack” status as a U.S. shareholder during the relevant period, for instance, in the case where a domestic corporation acquires shares of a foreign corporation from a shareholder in an inbound nonrecognition transaction.

###### Hybrid dividends

In addition, no 245A DRD is allowed with respect to a hybrid dividend under Code Sec. 245A(e). A hybrid dividend is defined as the amount of a dividend paid that would otherwise qualify for the 245A DRD to the extent of the 245A shareholder’s hybrid deduction account (“**HDA**”) with respect to each share of stock of the CFC, determined at the close of the CFC’s taxable year.[[151]](#footnote-152) An HDA reflects the amount of hybrid deductions[[152]](#footnote-153) of the CFC allocated to a share that must be maintained by a specified owner with respect to such share.[[153]](#footnote-154) In general, a “**specified owner**” with respect to a share of CFC stock is a 245A shareholder of the CFC or an upper-tier CFC that would be a 245A shareholder if the upper-tier CFC were a domestic corporation, provided that a 245A shareholder owns (within the meaning of Code Sec. 958(a)) shares in the upper-tier CFC.[[154]](#footnote-155) If a share of CFC stock with respect to which there is an HDA is acquired, rules apply based on whether the acquirer is a specified owner. In the case of an acquirer that is a specified owner of the share immediately after the acquisition, the transferor’s HDA with respect to the share becomes the HDA of the acquirer.[[155]](#footnote-156) In the case of an acquirer that is not a specified owner of the share immediately after the acquisition, the transferor’s HDA is eliminated and accordingly is not thereafter taken into account by any person.[[156]](#footnote-157)

###### Extraordinary disposition amounts

Reg. §1.245A-5 further limits the 245A DRD by disallowing 50 percent of the 245A DRD with respect to a dividend from an SFC to the extent of the extraordinary disposition (“**ED**”) amount of such dividend.[[157]](#footnote-158) The ED amount is the amount of the dividend paid out of ED E&P, which is the sum of the net gain recognized by an SFC with respect to specified property in each ED.[[158]](#footnote-159) An “ED” is a disposition of property during the disqualified period of an SFC that is a CFC at the time of the disposition. The disqualified period is the period beginning on January 1, 2018, and ending as of the close of the taxable year of the SFC, if any, that begins before January 1, 2018, and ends after December 31, 2017.[[159]](#footnote-160) A dividend is treated as paid out of ED E&P to the extent it is treated as paid out of a U.S. shareholder’s ED account (“**EDA**”) with respect to an SFC. The EDA generally reflects the amount, at the level of the SFC, of the U.S. shareholder’s share of the ED E&P, reduced by amounts already treated as ED amounts.[[160]](#footnote-161) In determining the portion of a dividend that is from the 245A shareholder’s EDA, dividends paid out of Code Sec. 959(c)(3) E&P in excess of the EDA are deemed to be paid first (*i.e.*, distributions out of EDA are deemed paid last). If a U.S. shareholder transfers shares of an SFC with respect to which the shareholder has an EDA and the acquirer is a 245A shareholder with respect to the SFC immediately after the acquisition, the transferor’s EDA is decreased by the amount of the EDA allocated to the transferred shares. If an acquirer is not a 245A shareholder with respect to the SFC immediately after the acquisition, and the transferor transfers all of the stock of the SFC and no related party of the transferor is a 245A shareholder after the acquisition and related transaction, the transferor’s EDA is eliminated. If an acquirer is not 245A shareholder immediately after the acquisition and the transferor only transfers a portion of the stock of the SFC, the entire EDA remains with the transferor.[[161]](#footnote-162)

###### Code Sec. 1059

Code Sec. 1059 pre-dates TCJA, but was amended by the TCJA to apply to dividends afforded a 245A DRD. Code Sec. 1059 provides that, if a 245A shareholder receives an extraordinary dividend with respect to a share of SFC stock and the shareholder has not held the SFC stock for more than two years before the dividend announcement date (the “**1059 holding period requirement**”), the basis of the share is reduced (but not below zero) by the nontaxed portion of the extraordinary dividend and gain is recognized to the extent the nontaxed portion exceeds basis. The holding period requirement can be satisfied by taking into account carryover and tacked holding periods under Code Sec. 1223(1) and Code Sec. 1223(2), respectively. In general, a dividend from an SFC is an “extraordinary dividend” if the amount of the dividend is equal to or exceeds five percent (in the case of preferred stock) or ten percent (in the case of common stock) of the 245A shareholder’s basis in the share of SFC stock with respect to which the dividend is paid.[[162]](#footnote-163) The “nontaxed portion” of an extraordinary dividend equals the excess, if any, of the amount of the dividend, over the taxable portion of that dividend.[[163]](#footnote-164) The “taxable portion” of an extraordinary dividend is the portion of such dividend includible in gross income, reduced by the amount of any deduction allowable with respect to such dividend under Code Secs. 243, 245, or 245A.[[164]](#footnote-165) Under Code Sec. 1059(e), certain distributions are automatically treated as extraordinary dividends despite the fact that they might not meet the general definition of extraordinary dividend, including meeting the holding period requirement.[[165]](#footnote-166)

###### Code Sec. 961(d)

Code Sec. 961(d) provides that, if a 245A shareholder receives a dividend from an SFC, solely for purposes of determining loss on disposition by the 245A shareholder, basis in the stock of the SFC is reduced (but not below zero) by the amount of any 245A DRD allowable to the shareholder, except to the extent the basis was reduced under Code Sec. 1059.[[166]](#footnote-167) Unlike Code Sec. 1059, Code Sec. 961(d) only applies to reduce losses, but, also unlike Code Sec. 1059, there is no holding period requirement that can be satisfied to avoid its application. Congress viewed Code Sec. 961(d) as a complement to Code Sec. 1248; whereas the latter would provide an exemption to appreciation in CFC stock attributable to E&P (by deeming a dividend that will be eligible for a 245A DRD), the former would disallow loss to the extent attributable to dividends.[[167]](#footnote-168)

##### Code Sec. 958(b)(4) and downward attribution

Congress also repealed Code Sec. 958(b)(4) in the TCJA. Repealing Code Sec. 958(b)(4) turned off the constructive ownership rules in section 318(a)(3) to attribute stock from a foreign person to a U.S. person for purposes of determining U.S. shareholder and CFC status. The TCJA repealed Code Sec. 958(b)(4) to prevent a U.S. shareholder from engaging in certain out-from-under transactions that were intended to “de-control” a foreign corporation such that it was no longer a CFC after such a transaction. The repeal of Code Sec. 958(b)(4) resulted in foreign-owned foreign corporations being treated as CFCs by reason of downward attribution. In addition, pre-TCJA, similar to 1248 shareholder status, U.S. shareholder status was determined only by reference to voting power. The TCJA expanded U.S. shareholder status to include ownership of ten percent or more of the vote *or value* of a foreign corporation.[[168]](#footnote-169) These amendments significantly expanded the number of persons that constitute U.S. shareholders and the number of foreign corporations that constitute CFCs.

##### Treatment of partnerships

A foreign partnership is treated as an aggregate of its partners for all relevant international tax provisions. For purposes of any provision that cross-references Code Sec. 958(a) (*e.g.*, subpart F, GILTI, and Code Sec. 1248), stock owned by any foreign entity, including a foreign partnership, is treated as indirectly owned proportionately by its owners.

In contrast, the treatment of a domestic partnership depends on the relevant international tax provision. A domestic partnership is treated as an entity for purposes of determining whether a U.S. person (including a domestic partnership) is a U.S. shareholder, for purposes of determining whether a foreign corporation is a CFC, and for purposes of applying Code Sec. 1248[[169]](#footnote-170) and an aggregate of its partners for purposes of determining whether a dividend received by a partnership is QDI under Code Sec. 1(h)(11) or eligible for a 245A DRD,[[170]](#footnote-171) as well as for purposes of computing GILTI.[[171]](#footnote-172)

As a result, in determining whether the 367(b) regulations or Code Sec. 1248 applies with respect to a transaction, a domestic partnership may be a U.S. shareholder or a 1248 shareholder. However, whether a partner’s distributive share of the resulting dividend is afforded a DRD or QDI depends on the specific characteristics of the partner (*e.g.*, whether the partner is a 245A shareholder or an individual).

## Where Do We Go From Here?

In this section, we consider various approaches that Treasury and the IRS could consider with respect to updating B3 and B4. We make no recommendations in this report, but rather merely attempt to highlight various approaches to these core provisions that could be adopted, and identify their pros and cons.

### Eliminate B3 and B4

The first approach for consideration is whether to withdraw B3 and B4, and indeed much of the 367(b) regulations.[[172]](#footnote-173) In all candor, we do not believe that Treasury and the IRS will seriously consider this “Ctrl-A Del” option – there is nothing quite as path dependent as an anti-avoidance rule dating from the Ford administration. Therefore, we consider this merely a thought exercise that could help inform other options.

The arguments for elimination are different for B3 and B4, because the policies underlying these rules are different.[[173]](#footnote-174) For B3, the argument is that the TJCA, through the transition tax, GILTI, and Code Sec. 245A, effectively repealed deferral. It is certainly true that, after the TCJA, companies, in general, can repatriate much more of their CFC E&P tax free through ordinary distributions. For most multinational groups, the vast majority of E&P of their CFCs is likely to be PTEP (from GILTI, subpart F income, or Code Sec. 965) or untaxed E&P eligible for a 245A DRD.[[174]](#footnote-175)

But, as we noted in the introduction, while deferral may be on life-support, it’s not quite dead yet. Individual U.S. shareholders still benefit from deferral with respect to the untaxed E&P of their CFCs, and, by reason of the GILTI high-tax exception, along with QBAI and tested losses (and FOGEI, for taxpayers in the oil and gas industry), untaxed E&P on which U.S. tax will only be paid upon repatriation (“**deferral E&P**”) are not rare for some taxpayers. Because individuals cannot obtain a 245A DRD, all untaxed E&P of an individual U.S. shareholder are deferral E&P. But even corporate U.S. shareholders can have deferral E&P. For instance, a corporate U.S. shareholder could have an EDA or HDA with respect to a CFC, or not have satisfied the 245A holding period requirement with respect to the CFC, or the CFC could have pre-acquisition U.S. E&P, *i.e.,* E&P from ECI or 80 percent-owned domestic corporations – in all these cases, distributions from the CFC would be denied a 245A DRD.[[175]](#footnote-176) Thus, while the magnitude of the concern motivating B3 has been greatly diminished, it is not unreasonable for the government to believe that B3 still has a role to play.[[176]](#footnote-177)

The argument in favor of withdrawing B4 is perhaps more persuasive. The argument is that, if B4 is intended to prevent a “material distortion” in the context of nonrecognition transactions, then the cure is arguably worse than the disease under current law. As indicated in the preamble to the proposed regulations, a material distortion for this purpose can include “a distortion relating to the source, character, amount or *timing* of any item.”[[177]](#footnote-178) Based on this definition, B4 is itself distortive; by overriding subchapter C with respect to a cashless nonrecognition transaction, B4 is distorting the timing of the shareholder’s income. Nevertheless, for most of the last 50 years, this distortion in timing could be justified as necessary to prevent a more material distortion in character, more material insofar has such a distortion historically created a permanent difference arising from the preferred rates afforded capital gain relative to ordinary income.

But recent developments have significantly diminished the relevance of character in determining tax liability. As discussed above, since 1988, corporate rates on capital gains and ordinary income have been identical. Individuals still generally enjoy a significant capital gain preference, with a top marginal individual tax rate set of 37 percent,[[178]](#footnote-179) as compared to the highest tax rate on long-term capital gains, including the net investment income tax, of 23.8 percent.[[179]](#footnote-180) But even for individuals, the enactment of Code Sec. 1(h)(11) in 2003 often makes individual 1248 shareholders indifferent as to whether they recognize capital gain or dividend on the sale of CFC stock. Assuming the dividend qualifies as QDI, the dividend, like gain from the sale of stock, may be subject to lower long-term capital gain rates.[[180]](#footnote-181)

The counterargument, however, is that character is not just about the applicable tax rate. In particular, while QDI is taxed at the same rate as long-term capital gain, QDI is still not “gain from the sale of a capital asset,” and therefore cannot be offset by capital losses, including capital loss carryforwards. As anyone who has tax loss harvested their portfolio this year can attest, the restrictions on deducting capital loss renders QDI not quite as valuable as “real” capital gain. Also, even if most dividends from foreign corporations are QDI, there still remains significant amounts of non-QDI dividend income the conversion of which into capital gain could produce a tax benefit.

Further, while congressional concern about the conversion of dividend income into capital gain may have motivated the enactment of Code Sec. 367(b), a provision enacted ten years later may have become a more important consideration for B4 and the distortion principle. As discussed in Part III.B.1.b of this report, foreign currency gain or loss with respect to PTEP is recognized under Code Sec. 986(c) upon distribution (or deemed distribution) of the PTEP. Code Sec. 986(c) gain or loss is treated as ordinary income or loss from the same source as the associated income inclusion. If an exchanging shareholder that is a U.S. person includes in income either an all E&P amount or 1248 amount under B3 or B4, then immediately prior to the exchange, solely for purposes of computing foreign currency income or loss under Code Sec. 986(c), the shareholder is treated as receiving a distribution of PTEP from the appropriate foreign corporation that is attributable (under the principles of Code Sec. 1248) to the exchanged stock. This foreign currency gain or loss will increase or decrease the shareholder's adjusted basis in the stock of the foreign corporation, effectively ensuring that the gain or loss in the stock attributable to the foreign currency gain or loss is taken into account as ordinary income or loss, rather than capital gain. Given the sheer amount of PTEP sloshing about currently in the international tax system, and the volatility of exchange rates in the current market, the ability of B4 (and B3) to backstop Code Sec. 986(c) – something that could not have been envisioned by the drafters of Code Sec. 367(b) – has become significantly more important in preventing nonrecognition transactions from causing a material distortion.

### Exclude small shareholders from B3

The second approach for consideration is whether to exclude small shareholders from B3.[[181]](#footnote-182) As discussed above, small shareholders were entirely excluded from having to pay a toll charge under the guidelines and the temporary regulations.[[182]](#footnote-183) Without commenting on this change, the proposed regulations expanded B3 to apply to small shareholders. It may be time to reconsider this decision.

First, arguably, extending B3 to small shareholders was not the right decision even in 1991. As discussed extensively above, the statutory purpose of B3 fundamentally is to backstop deferral. In this regard, Congress did not view “deferral” as encompassing all foreign corporations and all their shareholders. Rather, as explained in the House report on the Revenue Act of 1962, “deferral” referred specifically to the failure to impose U.S. tax on the income of U.S. shareholders and their “American controlled” foreign corporations until repatriation.[[183]](#footnote-184) As the legislative history makes clear, Congress intended the U.S. shareholder limitation to be a “*de minimis* rule [that] prevents the attribution of the undistributed income back to the shareholders where their interest is small and their influence on the corporation’s policy is presumably negligible.”[[184]](#footnote-185)

The policy rationale for not attributing subpart F income to small shareholders holds equally for not attributing E&P to small shareholders – in either case, it’s not *their* income or E&P. A foreign corporation is a separate person. At some level of aggregate U.S. ownership, and in specific, ownership by a single person, the Code will cease to give effect to the “personhood” of a foreign subsidiary and will instead impute the income of the subsidiary to its shareholder(s). Congress decided the threshold at which the Code will cease to give full effect to the separateness of a foreign corporation vis-à-vis a shareholder, and thus created the U.S. shareholder and CFC concepts. It is not the deferral system that relieves a small shareholder of current tax – it’s the realization principle.[[185]](#footnote-186) The tax on a shareholder that owns 0.00001 percent of a publicly traded foreign corporation is not being “deferred” any more than future, unaccrued interest on a bond is deferred.

Treasury and the IRS, in issuing guidance under Code Sec. 367(b), have never been concerned with the repatriation of E&P and basis attributable to a foreign shareholder that is not a CFC.[[186]](#footnote-187) The reason for this is that, to the extent that the E&P and basis is attributable to a non-CFC foreign shareholder, the E&P and basis cannot be “repatriated” (*i.e.*, brought *back* to the United States) when the foreign corporation engages in an inbound nonrecognition transaction. It can be argued that it would be equally inappropriate to attribute the E&P of that foreign acquired corporation to a small shareholder in such a manner as to treat that E&P and basis as being “brought back” to the United States.

In that respect, even if one concludes that requiring small shareholders to include in their gross income an all E&P amount is consistent with the repatriation principle, it is arguably inconsistent with the distortion principle. As the preamble to the final regulations made clear, B3 is intended to perform double duty – to prevent both a tax-free repatriation of untaxed E&P and basis, but also to prevent material distortion of shareholder income. In the case of a U.S. shareholder that is also a 1248 shareholder, an inclusion of a deemed dividend as a result of an inbound nonrecognition transaction is necessary to prevent a material distortion – *i.e.*, to prevent the conversion of dividend into capital gain. There is no potential for a distortion – material or otherwise – in respect to an exchanging shareholder that is a small shareholder. In that case, the only potential distortion is from converting *future* dividends that do not qualify for QDI (because the foreign acquired corporation is not a qualified foreign corporation) to QDI. Indeed, it is B3 as applied to the small shareholder, not the inbound nonrecognition transaction, that is causing a material distortion of income, by overriding the nonrecognition rules of subchapter C, and by causing the shareholder to recognize gain, an inaccurate proxy for its attributable E&P, except in the unlikely event that it can obtain the requisite information to make an all E&P election.[[187]](#footnote-188) Weighing the repatriation principle against the distortion principle, one could argue that the distortion created by B3 accelerating the income of small shareholders is a greater harm than the benefit to the U.S. fisc of B3 policing the “repatriation” of E&P attributable to such shareholders.

Even if it was the correct decision to extend B3 to small shareholders in 1991, circumstances have changed to perhaps justify re-assessing that decision. First, to the extent that B3 is intended to police importation of basis attributable to U.S. investors, including small shareholders, the enactment of Code Sec. 362(e) in 2004 ameliorates *some* of that concern.[[188]](#footnote-189) More importantly, it ensures that all property “imported” into the United States through inbound nonrecognition transactions either has an aggregate built-in gain or at least not an aggregate built-in loss. As a result, over time and in the aggregate, inbound nonrecognition transactions, even without the application of B3, will expand the U.S. tax base.[[189]](#footnote-190)

Further, while the TCJA did not change the actual treatment of small shareholders, the TCJA has changed the treatment of such shareholders *relative* to corporate U.S. shareholders. Pre-TCJA, there was a difference in the treatment of corporate U.S. shareholders versus small shareholders under B3, insofar as corporate U.S. shareholders benefited from FTCs, but the TCJA has greatly increased that disparity, rendering B3 particularly punitive to small shareholders. In fact, corporate U.S. shareholders, once the only exchanging shareholders to be required to include their all E&P amount in gross income under the guidelines and the temporary regulations,[[190]](#footnote-191) are generally benefited by this inclusion under current law. Assuming such shareholders satisfy the 245A holding period requirement and 1059 holding period requirement, and the 245A DRD is not otherwise limited,[[191]](#footnote-192) an exchanging shareholder that is required to include its all E&P amount into gross income by reason of an inbound asset reorganization would receive the benefit of an increase in its basis in the stock of the domestic acquiring corporation by the amount of the deemed dividend.[[192]](#footnote-193)

Finally, in the 1962 House Report, Congress cautioned Treasury and the IRS, in drafting regulations, that “unnecessary barriers to justifiable and legitimate business transactions should be avoided.”[[193]](#footnote-194) Arguably, the treatment of small shareholders in inbound nonrecognition transaction has become an “unnecessary barrier” in third-party transactions. As commentators have noted recently, the potential application of B3 to the individual U.S. shareholders and the small shareholders of the foreign acquired corporation operates as an unnecessary impediment to normal business combinations.[[194]](#footnote-195) Because corporate U.S. shareholders may avail themselves of the 245A DRD with respect to dividends, including a deemed dividend of an all E&P amount (assuming the 245A holding period requirement is satisfied), taxpayer can obtain better treatment under the 367(b) regulations if they can structure an acquisition of a foreign target as an inbound stock acquisition, followed by a subsequent inbound nonrecognition transaction of the domestic acquiring corporation. While an inbound nonrecognition transaction of the foreign acquired corporation within one year of the stock acquisition would likely fail the 245A holding period requirement under current law, commentators have requested that Treasury and the IRS consider a rule that would permit the domestic acquiring corporation to satisfy the 245A holding period requirement after the transaction, by continuing to hold the assets of the foreign acquired corporation.[[195]](#footnote-196) If this design change were made, and small shareholders were not generally excepted from the application of B3, this change would further compel taxpayers to structure acquisitions as stock transactions for no compelling policy reason.[[196]](#footnote-197)

### Elective exclusion for non-245A shareholders

Treasury and the IRS should also consider an election that, if made, would exclude small shareholders and individual U.S. shareholders (“**non-245A shareholders**”) from the requirement to include in gross income their all E&P amount. This election could be made contingent on either of the following two conditions: (1) the tax attributes of the foreign acquired corporation inherited by the domestic acquiring corporation are reduced to the extent of the aggregate all E&P amounts that such shareholders would otherwise be required to include (the “**aggregate all E&P amount**”) (the “**attribute reduction election**”), or (2) the aggregate all E&P amount is included in the gross income of the domestic acquiring corporation (the “**proxy inclusion election**”). If a proxy inclusion election were permitted, for purposes of determining whether the domestic acquiring corporation qualifies for the 245A DRD on its aggregate all E&P amount, consistent with suggestions by the 2022 NYSBA report and the Skadden letter, the domestic acquiring corporation could be deemed to satisfy the 245A holding period requirement through a retention, directly or indirectly, of substantially all of the assets of the foreign acquired corporation for at least one year following the acquisition. However, it should be acknowledged that the effect of this rule would permit the inclusion of the aggregate all E&P amount to qualify for the 245A DRD, except to the extent of E&P attributable to dividends from 80-percent owned domestic corporations, including RICs and REITs; small shareholders and individual US shareholders, because they are not 245A shareholders, would lack an EDA or HDA with respect to the foreign acquired corporation, and E&P attributable to ECI are not included in the all E&P amount because such E&P is specifically excluded.[[197]](#footnote-198) Alternatively, the rule could explicitly provide that the domestic acquiring corporation is denied the 245A DRD, effectively causing this election merely to shift the burden of the tax from the shareholders to the domestic acquiring corporation. Such an approach may be appropriate, given that the domestic acquiring corporation inherits the asset basis that reflects the E&P which gives rise to the tax.[[198]](#footnote-199) Obviously, to the extent that the inclusion of the all E&P amount shifts from the shareholders to the domestic acquiring corporation, the shareholders would not be afforded an increase to the basis in their stock in the corporation.

In the preamble to the final regulations, Treasury and the IRS rejected the proposal to allow domestic acquiring corporations to include an aggregate all E&P amount on behalf of their small shareholders on grounds of “substantial administrative difficulties,” namely the difficulty in determining each small shareholder’s holding period in order to calculate the amount of the inclusion.[[199]](#footnote-200) The preamble to the final regulations cites similar informational challenges in the context of explaining why the taxable exchange election of the proposed regulations was not finalized, which election would have required attribute reduction.[[200]](#footnote-201) While these administrative challenges have not been solved in the two decades since the issuance of the final regulations, they can be addressed through various assumptions. For instance, as outlined in the Skadden letter, it could be assumed that, except as otherwise established, all non-§245A shareholders are U.S. persons and all such persons have owned their stock for five years.[[201]](#footnote-202)

In the context of not finalizing the taxable exchange election, Treasury and the IRS also cited to the inherent unfairness of an election by U.S. shareholders to avoid including their all E&P amount being economically borne, at least indirectly and in part, by the non-electing shareholders. This is undoubtedly true in the case of the attribute reduction election and the proxy inclusion election. However, it could be provided that this election can only be made by the domestic acquiring corporation itself, so that the corporation can determine whether, on balance, its shareholders benefit from the election. Further, the effect of this rule would be to balance out the treatment of exchanging shareholders that are 245A shareholders, which, assuming they satisfy the 245A holding period requirement,[[202]](#footnote-203) would obtain the benefit of a 245A DRD, and those exchanging shareholders that are not 245A shareholders and thus would be fully taxable on the inclusion of their all E&P amount.

### Expand B3 to inbound stock transfers

Finally, we considered an approach that would result in an *expansion* of B3 and B4 in order to address a concern with the shifting of E&P for purposes of Code Sec. 245A by reason of a transfer of the stock of a foreign acquired corporation to a domestic acquiring corporation in a transaction qualifying for nonrecognition as a reorganization under Code Sec. 368(a) (a “**B reorganization**”) or as a contribution under Sec. 351(a) (an “**inbound stock transfers**”). The concern is that, by reason of an inbound stock transfer, E&P of the foreign acquired corporation attributable to non-245A shareholders, dividends to which cannot qualify for a 245A DRD, can be shifted to the domestic acquiring corporation, dividends to which, immediately through dividends or, after a year, through a liquidation, can qualify for the 245A DRD. This is arguably offensive to the repatriation principle, because untaxed E&P attributable to non-245A shareholders (*i.e.*, deferral E&P). For individual U.S. shareholders, this transaction also could constitute a “material distortion” to their income, because it has effectively converted dividend to capital gains.[[203]](#footnote-204)

Conversely, while not “tax avoidance,” a material distortion can also occur if the exchanging shareholder is a §245A shareholder. In that case, appreciation in the stock of the foreign acquired corporation attributable to untaxed E&P of that corporation would be reflected in the stock of the domestic acquiring corporation received in the inbound stock transfer, but the exchanging shareholder could no longer obtain the Code Sec. 245A DRD on dividends from the domestic acquiring corporation or the sale of the corporation’s stock.[[204]](#footnote-205)

Even pre-TCJA, transfers of foreign stock to domestic corporations in inbound stock transfers could be distortive to the exchanging shareholder’s income. For this reason, the temporary regulations did require the inclusion of a 1248 amount in an inbound stock transfer that qualified as a B reorganization.[[205]](#footnote-206) However, this rule was not carried forward into the proposed regulations or the final regulations. In any case, pre-TCJA, the transaction did not offend the repatriation principle because the domestic corporation inherited the 1248 E&P under §1.1248-8[[206]](#footnote-207) and thus would eventually be taxed on the E&P attributable to the transferred stock as a dividend, either as a result of a distribution, sale, or inbound nonrecognition transaction. Therefore, basis and E&P could not be repatriated into the United States without *someone* paying tax.

An approach to address this concern would have B3 applied to a direct or indirect transfer of the stock of a foreign corporation by a U.S. shareholder (whether or not a §245A shareholder), resulting in an inclusion of its all E&P amount with respect to the stock, Thus, a transfer of the stock of a foreign holding company by a US shareholder to a domestic corporation could result in an all E&P amount being included in the income of the U.S. shareholder with respect to the foreign holding company and each of its foreign subsidiaries.

This approach would ensure that undistributed E&P attributable to a 245A shareholder inures to its benefit through an increase in the shareholder’s stock basis in the domestic acquiring corporation,[[207]](#footnote-208) while not permitting deferral E&P attributable to non-245A shareholders to become Code Sec. 245A-eligible E&P by reason of a nonrecognition transaction. This approach also has the benefit of aligning, to a significant extent, the treatment under the 367(b) regulations an inbound stock transfer with an inbound asset reorganization. In either case, a U.S. shareholder would generally be required to include its all E&P amount with respect to a foreign corporation and all its subsidiaries.

There are two arguments against this approach (other than an objection to its general meanness to individual US shareholders). First, it is debatable whether it is appropriate for the 367(b) regulations to be used to “backstop” Code Sec. 245A. Arguably, the 245A holding period requirement is intended to be the sole provision intended to limit the 245A DRD with respect to “acquired E&P.” This view is supported by the existence of other “dividend-stripping” provisions that apply to Code Sec. 245A – Code Secs. 961(d) and 1059. If the 245A holding period requirement was not meant to police dividend-stripping, then arguably it was intended to apply, and occupy the field with respect to, transactions like inbound stock transfers. If that were the case, then applying B3 to an inbound stock transfer would be inconsistent with be inconsistent with the statutory framework.

Secondly, it is questionable whether Treasury and the IRS would have the authority to adopt this approach. Specifically, Code Sec. 367(b) provides that “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.”[[208]](#footnote-209) It is clear that Treasury and IRS can draft regulations for transactions involving foreign corporations where corporate status of the foreign corporation is necessary. Therefore, the regulations could apply to an inbound stock transfer that is a B reorganization, because the status of the foreign corporation as a corporation is necessary to satisfy the requirements for nonrecognition.[[209]](#footnote-210) Indeed, as discussed above in this Part II.D, the temporary regulations did require an inclusion in the case of an inbound stock transfer that qualified as a B reorganization, albeit an inclusion of a 1248 amount. But, if an inbound stock transfer also, or exclusively, qualified as an exchange under Code Sec. 351, then nonrecognition would not depend on whether or not the foreign acquired corporation is a corporation. Therefore, this approach might require an amendment to the statute to implement.

### Apply B3 and B4 solely to non-245A E&P

Finally, if Treasury and the IRS determine that E&P “shifting” from non-245A shareholders to 245A shareholders is not inappropriate, they should consider modifying B3 and B4 to apply solely with respect to dividends out of E&P that, for reasons other than the 245A holding period requirement, cannot satisfy the requirements for a 245A DRD (such E&P, “**non-245A E&P**”). Non-245A E&P would include E&P to the extent of an HDA or an EDA, or E&P attributable to 80 percent-owned domestic corporations, including RICs and REITs.

Applying B3 solely to non-245A E&P can be justified on the grounds that, if an all E&P inclusion can be avoided through a two-step inbound stock transfer followed by an inbound nonrecognition transaction after one year (or even non-liquidating distributions immediately), a single step inbound asset reorganization should also not result in an inclusion of an all E&P amount by the shareholders of the foreign acquired corporation. Therefore, under this approach, to the extent of non-245A E&P, there would be no deemed dividend of an all E&P amount, but also no commensurate increase to the basis of the stock of the exchanging shareholders. For non-245A shareholders, this would be a good result – deferral, no income. For exchanging shareholders that are 245 shareholders, it would not be a good result; whereas under current B3, they would receive a deemed dividend of an all E&P amount, and a basis increase, under this proposal they would retain their historic basis in the stock of the domestic acquiring corporation. The current rule that the domestic acquiring corporation does not inherit E&P and NOLs, except to the extent attributable to ECI, would be maintained.

Applying B4 solely to non-245 E&P is supported by the idea, as discussed above in Part IV.A, that B4 under current law is arguably more distortive in practice than the distortion its intended to prevent (*i.e.,* the conversion of ordinary income into capital gain). Limiting B4 only to non-245A E&P would ensure that income is only accelerated when there is a real potential for a distortion, which can occur when, for instance, a 245A shareholder has an HDA with respect to CFC stock, and it transfers that CFC stock to a foreign acquiring corporation that is not a CFC. As a result of that transaction, because there is no longer a specified owner of the CFC immediately after the acquisition, the 245A shareholder’s HDA is eliminated.[[210]](#footnote-211) Furthermore, any dividends paid to the 245A shareholder by the foreign acquiring corporation, including dividends ultimately sourced out of the E&P of the acquired CFC, would be eligible for a 245A DRD. This is the type of transaction in which an inclusion of a 1248 amount under B4 would be appropriate.

As discussed in more detail in Part III.B.1.b and in Part IV.A of this report, if an exchanging shareholder that is a U.S. person includes in income either an all E&P amount or 1248 amount under B3 or B4, solely for purposes of computing foreign currency income or loss under Code Sec. 986(c), the shareholder is treated as receiving a distribution of PTEP. This foreign currency gain or loss is ordinary income, and results in a basis increase or decrease in the stock of the domestic acquiring corporation received by the exchanging shareholder. The deemed distribution of PTEP and the resulting foreign currency gain or loss can have a material effect on the exchanging shareholder’s income. Therefore, even if the approach were adopted to limit B3 and B4 to non-245A E&P, the rule deeming a distribution of PTEP for purposes computing foreign currency gain or loss under Code Sec. 986(c) should be maintained.

## Conclusion

Aughhhh….

1. Gary Scanlon is a principal and Elena Madaj is a senior manager in the international tax group of the Washington National Tax practice of KPMG LLP. The information in this paper is not intended to be “written advice concerning one or more Federal tax matters” subject to the requirements of section 10.37(a)(2) of Treasury Department Circular 230. The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser. This article represents the views of the authors only and does not necessarily represent the views or professional advice of KPMG LLP. The authors would like to thank the following for their helpful comments: [YOUR NAME HERE]. [↑](#footnote-ref-2)
2. Pub. L. No. 115-97, 131 Stat. 2054 (2017). [↑](#footnote-ref-3)
3. Unless otherwise indicated, all “**§**” or “**Section**” references are to the Internal Revenue Code of 1986, as amended (the “**Code**”), or the regulations promulgated or proposed thereunder by the U.S. Department of the Treasury (the “**Treasury**” and such regulations, “**Reg.**” or “**Regulations**”). Also, all references to the “**Secretary**” are to the Secretary of the Treasury, all references to the “**IRS**” are to the Internal Revenue Service, and all references to “**Federal”** income tax are to U.S. federal income tax. [↑](#footnote-ref-4)
4. Howard Marks, co-founder of Oaktree Capital Management, once said, “Never forget the six-foot-tall man who drowned crossing the stream that was five feet deep on average.” This has evolved to sometimes describe more specifically a statistician drowning in a two-feet deep lake. We use the latter version because statisticians and lakes are funnier. Sorry, Howard. [↑](#footnote-ref-5)
5. T.D. 8862, 65 Fed. Reg. 3589, 3590 (Jan. 24, 2000). [↑](#footnote-ref-6)
6. S. Rep. No. 94-938, at 263 (1976). [↑](#footnote-ref-7)
7. *See, e.g.,* Stewart Lipeles, *et al.*, *Did Anyone Notice the TCJA Made Section 367(b) Obsolete*?, TAXES The Magazine (CCH), July 2021, at 7. [↑](#footnote-ref-8)
8. *See* preamble to proposed foreign tax credit regulations, 85 Fed. Reg. 72078, 72081 (Nov. 12, 2020). [↑](#footnote-ref-9)
9. For purposes of the Code, “person” means and includes an individual, trust, estate, partnership, association, company, or corporation. Code Sec. 7701(a)(1). *See also Moline Properties v. Comm’r*, 319 U.S. 436 (1943) (holding that a corporation is treated as an entity that is separate from its owner for Federal income tax purposes). [↑](#footnote-ref-10)
10. While Code Sec. 951A (GILTI) is also in subpart F of the Code, a reference to “subpart F” in this report should be construed as a reference to the set of rules with respect to a U.S. shareholder’s inclusion of subpart F income under Code Sec. 951. [↑](#footnote-ref-11)
11. Subpart F income includes foreign base company income as defined in Code Sec. 954, which consists of foreign personal holding company income as defined in Code Sec. 954(c) (“**FPHCI**”), foreign base company sales income as defined in Code Sec. 954(d). Code Sec. 952(a). Subpart F income of a CFC is generally limited to its current E&P. Code Sec. 952(c). [↑](#footnote-ref-12)
12. H.R. Rep. No. 87-1447, at 57 (1962) (“**1962 House Report**”). [↑](#footnote-ref-13)
13. Stock owned within the meaning of Code Sec. 958(a) is stock owned (i) directly or (ii) indirectly through a foreign entity. Code Sec. 958(a). [↑](#footnote-ref-14)
14. A U.S. shareholder of a CFC also must generally increase its gross income by its pro rata share of the increase in the earnings invested by the CFC in U.S. property for the taxable year. Code Sec. 951(a)(1)(B). Code Sec. 956 provides the operative rules that determine the amount included in income of a U.S. shareholder under Code Sec. 951(a)(1)(B). [↑](#footnote-ref-15)
15. Code Sec. 951(a)(2) and Reg. §1.951-1(e). [↑](#footnote-ref-16)
16. Stock owned within the meaning of Code Sec. 958(b) is stock owned applying the constructive ownership rules of Code Sec. 318(a), subject to certain modifications. Code Sec. 958(b). [↑](#footnote-ref-17)
17. Code Sec. 957(a). [↑](#footnote-ref-18)
18. Code Sec. 951(b). [↑](#footnote-ref-19)
19. 1962 House Report at 59. [↑](#footnote-ref-20)
20. Code Sec. 959(a) and (b). [↑](#footnote-ref-21)
21. Code Sec. 961(a) and (b). To the extent that an amount excluded from gross income under Code Sec. 959(a) exceeds the basis of the stock or other property with respect to which it is received, the amount is treated as gain from the sale or exchange of property. Code Sec. 961(b)(2). [↑](#footnote-ref-22)
22. Code Sec. 961(c). [↑](#footnote-ref-23)
23. *See* S. Rep. No. 87-1881, at 107 (1962). Congress appears to have equated a monetization of the CFC stock through a sale or exchange with a “repatriation” of the CFC’s earnings. [↑](#footnote-ref-24)
24. The 1962 House Report observed that it was also possible to repatriate E&P tax-free through nonrecognition transactions, such as a complete liquidation. However, Congress was assured that, under the advance ruling requirement of Code Sec. 367, any such repatriation had to be pre-approved by the IRS, and the IRS had demonstrated an unwillingness to grant approval where there were a large amount of earnings accumulated in a foreign corporation. [↑](#footnote-ref-25)
25. Code Sec. 1248(a) and Reg. §1.1248-1(a)(2). [↑](#footnote-ref-26)
26. Code Sec. 959(e). [↑](#footnote-ref-27)
27. Code Sec. 964(e). [↑](#footnote-ref-28)
28. Code Sec. 1248(a) and (d). [↑](#footnote-ref-29)
29. Code Sec. 1248(c)(2). [↑](#footnote-ref-30)
30. Reg §1.1248-2(e)(1). [↑](#footnote-ref-31)
31. Oddly, the temporary regulations (discussed below) did use the term “U.S. shareholder” extensively but defined it to mean “any United States person who satisfies the ownership requirements of section 1248(a)(2) or of section 1248(c)(2) with respect to a foreign corporation” (*i.e.*, a 1248 shareholder). *See* Reg. §7.367(b)-2T(b). [↑](#footnote-ref-32)
32. Pub. L. No. 72-154, 47 Stat. 169 (1932). [↑](#footnote-ref-33)
33. *See* H.R. Rep. No. 72-708, at 20 (1932) (“Property may be transferred to foreign corporations without recognition of gain under the exchange and reorganization sections of the existing law. This constitutes a serious loophole for avoidance of taxes. Taxpayers having large unrealized profits in securities may transfer such securities to corporations organized in countries imposing no tax upon the sale of capital assets. Then, by subsequent sale of these assets in the foreign country, the entire tax upon the capital gain is avoided.”) [↑](#footnote-ref-34)
34. Pub. L. No. 83-591, 68A Stat. 1 (1954). [↑](#footnote-ref-35)
35. Rev. Proc. 1968-23, 1968-1 C.B. 821. [↑](#footnote-ref-36)
36. For purposes of determining the portion of the E&P of a foreign corporation properly attributable to stock in such foreign corporation owned by a U.S. person and the manner in which such portion is includible in the gross income of a US person, the rules of Code Sec. 1248(a) and (b) and the regulations thereunder generally apply. Guidelines, §4.01. [↑](#footnote-ref-37)
37. *Id.*, §3.01(1). [↑](#footnote-ref-38)
38. *Id.*, §3.03(1)(b). [↑](#footnote-ref-39)
39. *Id.*, §3.03(1)(e). [↑](#footnote-ref-40)
40. *Id.*, §3.03(1)(c). [↑](#footnote-ref-41)
41. *Id.*, §3.03(1)(f). [↑](#footnote-ref-42)
42. *Id.*, §3.03(1)(g). [↑](#footnote-ref-43)
43. The reference to “all” in the guidelines assumedly means that E&P for this purpose includes E&P generated before December 31, 1962, and likely also includes E&P generated before the foreign corporation was a CFC and the shareholder was a 1248 shareholder. [↑](#footnote-ref-44)
44. The guidelines provide that, for purposes of determining the amount included in a foreign-to-foreign reorganizations, the E&P of foreign subsidiaries described in Code Sec. 1248(c)(2) are taken into account. *See* Guidelines§4.01. The implication is that such E&P is not taken into account in determining the E&P of a foreign corporation includible in an inbound nonrecognition transaction. [↑](#footnote-ref-45)
45. *Id.* Thus, for such a shareholder, the dividend was an amalgam of the concept of a 1248 amount and an all E&P amount – a 1248 amount but without regard to Code Sec. 1248(c)(2). [↑](#footnote-ref-46)
46. However, if a small shareholder failed to obtain an advance ruling, including because one or more 1248 shareholders of the acquired foreign corporation refused to agree to the “toll charge” required under the guidelines, it appears that such shareholder would recognize gain under former Code Sec. 367. The inability for small shareholders to avoid gain recognition in such circumstances appears to be one of the concerns motivating the elimination of the advance ruling requirement and the enactment of Code Sec. 367(b). [↑](#footnote-ref-47)
47. H.R. Rep. No. 94-658, at 240 (1975). [↑](#footnote-ref-48)
48. *Id.* [↑](#footnote-ref-49)
49. *Id.* at 241. [↑](#footnote-ref-50)
50. Code Sec. 367(b)(1). [↑](#footnote-ref-51)
51. H.R. Rep. No. 94-658, at 241 (1975). [↑](#footnote-ref-52)
52. T.D. 7530, 42 Fed. Reg. 65152 (Dec. 30, 1977). [↑](#footnote-ref-53)
53. The temporary regulations defined the “all E&P amount” as the E&P or deficit in E&P for all taxable years which are attributable to the stock of the foreign corporation exchanged under the principles of Code Sec. 1248, without regard to (1) whether such E&P was accumulated before or after December 31, 1962, and (2) the E&P of foreign subsidiaries under Code Sec. 1248(c)(2). Reg. §7.367(b)-5T(f) and (h)(1). It is unclear whether E&P for this purpose includes E&P accumulated by foreign corporations while not CFCs. On this point, IRS guidance concluded that the all E&P amount does not include E&P accumulated in a period in which the foreign acquired corporation was not a CFC). *See, e.g.* PLR 8924052 (Mar. 20, 1989). Nonetheless, when the proposed regulations changed the definition to explicitly include E&P accumulated by a foreign corporation while not a CFC, the preamble called this a mere “clarification.” 56 Fed. Reg. 41993, 41996. [↑](#footnote-ref-54)
54. Reg. §7.367(b)-5T(b) (1977). [↑](#footnote-ref-55)
55. Reg. §7.367(b)-7T(c)(1)(i) (1977). [↑](#footnote-ref-56)
56. Reg. §7.367(b)-7T(c)(2) (1977). There is some uncertainty regarding whether this inclusion of the all E&P amount was limited to corporate 1248 shareholders, or, alternatively, whether it applied with respect to any shareholder that was a domestic corporation, including a small shareholder. While the rule in Reg. §7.367(b)-7T(c)(2) (1977) is not expressly limited to domestic corporations that are 1248 shareholders, the scope rule of Reg. §7.367(b)-7(a) (1977) provides that the section applies only“[i]f the exchanging person is either a United States shareholder or a foreign corporation having a United States shareholder who is also a United States shareholder of the corporation whose stock is exchanged.” Nonetheless, at least one contemporaneous commentator asserted that this rule applied regardless of whether the exchanging shareholder was a U.S. shareholder, on the grounds that the exchanging shareholder limitation in the scope paragraph “was meant to encompass only paragraphs (b) and (c)(1)” of Reg. §7.367(b)-7 (1977) and that the rule would be corrected in the final regulations. Charles I. Kingson, *The Theory and Practice of Section 367*, 37 NYU Inst. on Fed. Tax’n, ¶ 22.03[7][c], 22-27, n.53 (1979) (“**Kingson**”) As discussed *infra*, the proposed regulations, and ultimately the final regulations, did change the analogous rule in B3 to require *all* shareholders that are U.S. persons, not just corporate U.S. shareholders, to include the all E&P amount in an inbound nonrecognition transaction. [↑](#footnote-ref-57)
57. Reg. §7.367(b)-7T(c)(1)(ii) (1977). [↑](#footnote-ref-58)
58. Reg. §7.367(b)-7T(c)(1)(i) (1977). [↑](#footnote-ref-59)
59. Reg. §7.367(b)-7T(c)(1)(ii) (1977). [↑](#footnote-ref-60)
60. Reg. §7.367(b)-7T(c)(1)(i) (1977). [↑](#footnote-ref-61)
61. Reg. §7.367(b)-7T(c)(1)(ii) (1977). [↑](#footnote-ref-62)
62. 56 Fed. Reg. 41993 (Aug. 26, 1991). [↑](#footnote-ref-63)
63. T.D. 8862, 65 Fed. Reg. 3589 (Jan. 24, 2000). [↑](#footnote-ref-64)
64. 56 Fed. Reg. 41993, 41995 (Aug. 26, 1991). [↑](#footnote-ref-65)
65. *Id*. at 41996. *See also* T.D. 8862, 65 Fed. Reg. 3589, 3590 (Jan. 24, 2000) (“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.”) [↑](#footnote-ref-66)
66. Prop. Reg. §1.367(b)-3(c)(1) (1991). The proposed regulations revised the definition of the all E&P amount from the temporary regulation “to clarify the intended scope of the term,” *i.e.*, that a U.S. person can have an all E&P amount with respect to a foreign corporation even if such person is not U.S. shareholder or the foreign corporation is not a CFC. *See* Prop. Reg. §1.367(b)-2(b)(3)(i) (1991). The preamble indicates that this “clarified definition” would be effective immediately for exchanges that occur on after August 26, 1991. *See also* Prop. Reg. §1.367(b)-2(d)(4) (1991). Commentators at the time took umbrage with calling this a “clarification” of the law as regards taking into account the E&P of a foreign corporation while not a CFC, and urged that this change should be effective on the general effective date of the proposed regulations. *See* New York State Bar Association, Report 707: Report on Proposed Section 367(a) and (b) Regulations (“**1992 NYSBA report**”), at 48 (Jan. 24, 1992) (“We believe that the interpretation of the Proposed Regulations is inconsistent with that of most practitioners. Therefore, since this interpretation represents more of a change than a clarification, we believe that it should be effective at the same time as the Proposed Regulations are generally effective.”) [↑](#footnote-ref-67)
67. 56 Fed. Reg. at 41996 (Aug. 26, 1991). [↑](#footnote-ref-68)
68. Prop. Reg. §1.367(b)-3(b)(2)(iii)(A) (1991). [↑](#footnote-ref-69)
69. *Id.* [↑](#footnote-ref-70)
70. Prop. Reg. §1.367(b)-3(c) (1991). [↑](#footnote-ref-71)
71. 56 Fed. Reg. at 41997 (Aug. 26, 1991). [↑](#footnote-ref-72)
72. *Id.* at 41995. [↑](#footnote-ref-73)
73. Prop. Reg. §1.367(b)-4(b)(1) (1991). [↑](#footnote-ref-74)
74. T.D. 8862, 65 Fed. Reg. 3589, 3590 (Jan. 24, 2000) (emphasis added). [↑](#footnote-ref-75)
75. *Id*. [↑](#footnote-ref-76)
76. *Id*. [↑](#footnote-ref-77)
77. 56 Fed. Reg. at 41997 (Aug. 26, 1991). [↑](#footnote-ref-78)
78. Prop. §1.367(b)-3(b)(2)(iii) (1991). [↑](#footnote-ref-79)
79. T.D. 8862, 65 Fed. Reg. 3589, 3592 (Jan. 24, 2000). [↑](#footnote-ref-80)
80. *Id.* [↑](#footnote-ref-81)
81. Prop. Reg. §1.367(b)-3(b)(2)(iii)(A) (1991). [↑](#footnote-ref-82)
82. 65 Fed. Reg. 3589, 3593 (Jan. 24, 2000). [↑](#footnote-ref-83)
83. *Id.* [↑](#footnote-ref-84)
84. Reg. §1.367(b)-3(c)(3). [↑](#footnote-ref-85)
85. Prop. Reg. §1.367(b)-3(b)(2)(iii)(A) (1991). [↑](#footnote-ref-86)
86. *See* T.D. 9273, 71 Fed. Reg. 44887, 44888 (Aug. 8. 2006). [↑](#footnote-ref-87)
87. Reg. §1.367(b)-3(a). [↑](#footnote-ref-88)
88. Reg. §1.367(b)-3(e), (f)(1). [↑](#footnote-ref-89)
89. Reg. §1.367(b)-3(b)(3)(i). [↑](#footnote-ref-90)
90. Reg. §1.367(b)-3(d)(1). [↑](#footnote-ref-91)
91. Reg. §1.367(b)-2(d)(2). [↑](#footnote-ref-92)
92. Reg. §1.367(b)-2(d)(3). [↑](#footnote-ref-93)
93. Reg. §1.367(b)-3(b)(3)(i)(B). [↑](#footnote-ref-94)
94. Reg. §1.367(b)-3(c)(2). [↑](#footnote-ref-95)
95. Reg. §1.367(b)-3(c)(3). [↑](#footnote-ref-96)
96. Reg. §1.367(b)-3(c)(4). Note that under the proposed regulations, all small shareholders were required to recognize gain. The final regulations added both the all E&P election and the *de minimis* exception. [↑](#footnote-ref-97)
97. Reg. §1.367(b)-4(a). This rule does not apply to transfers of stock of a foreign corporation by a 1248 shareholder to a domestic corporation. In that case, the domestic corporation inherits the 1248 E&P with respect to the foreign acquired corporation under Reg. §1.1248-8. [↑](#footnote-ref-98)
98. Reg. §1.367(b)-4(a), 1.367(b)-4(b). [↑](#footnote-ref-99)
99. Reg. §1.367(b)-4(b)(1)-(3). [↑](#footnote-ref-100)
100. Reg. §1.367(b)-2(c). [↑](#footnote-ref-101)
101. Code Sec. 1248(a)(2), (c)(2). [↑](#footnote-ref-102)
102. Reg. §1.367(b)-4(b)(1). [↑](#footnote-ref-103)
103. Reg. §1.367(b)-4(c). The preamble to the final regulations noted that the proposed regulations in general did not require an income inclusion when a 1248 shareholder retained its status. Where the exchanging shareholder was a foreign corporation (*i.e.*, a lower-tier transaction), the 1248 amount was not included in subpart F as FPHCI because “this provision permitted deferral of the section 1248 amount by preserving such earnings and profits as earnings and profits of the foreign corporation that is the exchanging shareholder.” T.D. 8862, 65 Fed. Reg. 3589, 3593 (Jan. 24, 2000). The final regulations retained this rule. [↑](#footnote-ref-104)
104. Reg. §1.367(b)-3(b)(3)(i). [↑](#footnote-ref-105)
105. IRS Notice 2007-9, 2007-1 C.B. 401. The preamble to the final regulations rejected comments that the same country exception should apply for purposes of the all E&P amount, reasoning that “unlike a dividend distribution that qualifies for the same country dividend exception, an inbound asset transfer represents a current repatriation of earnings into the United States.” 65 Fed. Reg. 3589, 3592 (Jan. 24. 2000). Likewise, Notice 2007-9 provided that an all E&P inclusion cannot satisfy the look-through exception, presumably for the same policy reasons. [↑](#footnote-ref-106)
106. Reg. §1.367(b)-2(e)(3)(ii). [↑](#footnote-ref-107)
107. *Id.* In addition, as discussed in more detail in Part III.B.1 of this report, solely for purposes of computing exchange gain or loss under Code Sec. 986(c), an exchanging shareholder that is a U.S. shareholder that is required to include in income the all E&P amount or 1248 amount, is, immediately prior to the exchange, treated as receiving a distribution of PTEP from the appropriate foreign corporation that is attributable under principles of Code Sec. 1248 to the exchanged stock. Reg. §1.367(b)-2(j)(2). [↑](#footnote-ref-108)
108. Pub. L. No. 77-753, §§150, 105 56 Stat. 798 (1942). *See* *also* SOI Tax Stats – Historical Table 24 (1909-2010). [↑](#footnote-ref-109)
109. The corporate tax rate was increased to 52 percent in 1952. Pub. L. No. 82-182, §121, 65 Stat. 459 (1951). [↑](#footnote-ref-110)
110. Pub. L. No. 91-172, §511, 83 Stat. 536 (1969) (raising the capital gains rate to 30 percent for taxable years 1971-1974). [↑](#footnote-ref-111)
111. Pub. L. No. 99-514, §301, 100 Stat. 2088 (1986). [↑](#footnote-ref-112)
112. Code Sec. 1(h)(11). [↑](#footnote-ref-113)
113. Capital gain rates apply to QDI by adding QDI to net capital gain determined without regard to Code Sec. 1(h)(11) in determining “adjusted net capital gain.” *See* Code Sec. 1(h)(3) and (11)(A). By separately adding QDI to net capital gain, the Code treats QDI as increasing the amount ultimately subject to capital gain rates, rather than as a part of the preliminary net capital gain determination based on “the excess of the net long-term capital gain for the taxable year over the net short-term capital loss for such year” under Code Sec. 1222(11). [↑](#footnote-ref-114)
114. Code Sec. 1211(b) generally allows individuals to offset capital gains with capital losses and provides an additional deduction for either the excess of capital losses over capital gains or $3,000, whichever is less. [↑](#footnote-ref-115)
115. Code Sec. 1(h)(11)(C)(i). *See* IRS Notice 2011-64, which provides a list of income tax treaties considered “comprehensive.” A foreign corporation satisfies the treaty requirement, and thus is a qualified foreign corporation, if it is a “resident” within the meaning of such term under the relevant comprehensive treaty and satisfies any other requirements of that treaty, including the requirements under the applicable limitation on benefits provision, regardless of whether it actually claims benefits of the treaty. Notice 2011-64, §3, citing H.R. Rep. No. 108-126, at 42 (2003) (Conf. Rep.) (stating that a company will be treated as eligible for treaty benefits if it “would qualify” for benefits under the treaty). [↑](#footnote-ref-116)
116. Code Sec. 1(h)(11)(C)(ii). [↑](#footnote-ref-117)
117. Code Sec. 1(h)(11)(iii). [↑](#footnote-ref-118)
118. Code Sec. 1(h)(11)(B)(iii). [↑](#footnote-ref-119)
119. Code Sec. 986(c). [↑](#footnote-ref-120)
120. IRS Notice 88-71 §2(c), 1988-2 C.B. 374, 380. [↑](#footnote-ref-121)
121. *Id.* Notably, no regulations have been issued adopting this rule, but the notice “may be relied on to the same extent as a revenue ruling or revenue procedure.” *Id.* at 374. [↑](#footnote-ref-122)
122. Reg. §1.367(b)-2(j)(2)(i). [↑](#footnote-ref-123)
123. *Id.* [↑](#footnote-ref-124)
124. Reg. §1.367(b)-2(j)(2)(ii). [↑](#footnote-ref-125)
125. Code Sec. 362 generally provides rules for determining the basis of property received by a transferee corporation in a Code Sec. 351 exchange or reorganization. [↑](#footnote-ref-126)
126. *See* Code Sec. 334(b)(1)(B). [↑](#footnote-ref-127)
127. Code Sec. 362(e)(1)(C); *See also* Reg. §1.362-3(c)(3) (defining “loss important transaction” to mean any Code. Sec. 362 transaction in which the acquiring corporation’s aggregate basis in all important property received from all transferors in the transaction would exceed the aggregate value of such property immediately after the transaction). [↑](#footnote-ref-128)
128. Reg. §1.362-3(c)(2)(i). [↑](#footnote-ref-129)
129. *See* House Report to Accompany H.R. 1, H.R. Rept. 409, 115th Cong., 1st Sess. (Nov. 13, 2017) (the “**2017** **House Report**”), Vol II, at 370. [↑](#footnote-ref-130)
130. So much for that postcard. *https://www.aei.org/economics/we-have-been-promised-a-postcard-we-didnt-get-a-postcard/* [↑](#footnote-ref-131)
131. Code Sec. 965(a). [↑](#footnote-ref-132)
132. Code Sec. 965(c). [↑](#footnote-ref-133)
133. Code Sec. 951A(b)(1). A U.S. shareholder’s *pro rata* share of any item for purposes of GILTI is determined according to rules similar to the rules in Code Sec. 951(a)(2) applicable to subpart F income. Code Sec. 951A(e)(1); Reg. §1.951A-1(d). [↑](#footnote-ref-134)
134. Code Sec. 951A(c)(1). [↑](#footnote-ref-135)
135. Code Sec. 951A(c)(2)(A). [↑](#footnote-ref-136)
136. Code Sec. 951A(b)(2). [↑](#footnote-ref-137)
137. Code Sec. 951A(d). [↑](#footnote-ref-138)
138. *See* *generally* Reg. §1.951A-2(c)(1)(iii), (3)(ii), and (7). [↑](#footnote-ref-139)
139. Code Sec. 245A(a). [↑](#footnote-ref-140)
140. Code Sec. 245A(b)(1). [↑](#footnote-ref-141)
141. Code Sec. 245A(b)(2). [↑](#footnote-ref-142)
142. Code Sec. 1248(j). In addition, a sale of stock of a foreign corporation by a CFC that is recharacterized as a dividend under Code Sec. 964(e)(1) can be eligible for a 245A DRD at the shareholder-level. *See* Code Sec. 964(e)(4). Also, while an inclusion under Code Sec. 951(a)(1)(B) by reason of a U.S. investment described in Code Sec. 956 does not qualify for a 245A DRD, the amount computed under Code Sec. 956 with respect to a CFC with a U.S. investment is reduced to the extent that the CFC’s earnings, if distributed, would qualify for a 245A DRD. *See* Reg. §1.956-1(a)(2). [↑](#footnote-ref-143)
143. Code Sec. 245A(c). [↑](#footnote-ref-144)
144. Code Sec. 245A(c)(3). [↑](#footnote-ref-145)
145. Code Sec. 245A(c)(2). [↑](#footnote-ref-146)
146. Code Sec. 245(a)(1) and (5). [↑](#footnote-ref-147)
147. *See* Code Sec. 245(a)(6) (excluding E&P earned before the ownership requirement specified in Code Sec.245(a)(2) is satisfied from the undistributed earnings and undistributed U.S. earnings of the corporation). [↑](#footnote-ref-148)
148. Code Sec. 246(c). [↑](#footnote-ref-149)
149. Code Sec. 246(c)(5)(B). [↑](#footnote-ref-150)
150. Code Sec. 1223 provides rules for determining the holding period of property. Code Sec. 1223(2) provides that when a person acquires property with a transferred basis (*i.e.*, its basis in the property is determined with reference to the basis in the hands of the transferor), the transferee’s holding period in the property includes the transferor’s holding period. Code Sec. 1223(3) provides that the holding period of a position acquired in a wash sale includes the holding period of the loss position sold in the wash sale.

     Code Sec. 246(c). [↑](#footnote-ref-151)
151. Reg §1.245A(e)-1(b)(2). [↑](#footnote-ref-152)
152. A hybrid deduction of a CFC means a deduction or other tax benefit (for example, an exemption, exclusion, or credit, to the extent equivalent to a deduction) that is allowed to the CFC under a relevant foreign tax law, regardless of whether the benefit is used, or otherwise reduces tax, currently under the foreign tax law and the deduction or other tax benefit relates to or results from an amount paid, accrued, or distributed with respect to an instrument issued by the CFC and treated as stock for U.S. tax purposes, or is a deduction allowed to the CFC with respect to equity. Reg §1.245A(e)-1(d)(2)(i). [↑](#footnote-ref-153)
153. Reg §1.245A(e)-1(d)(1). [↑](#footnote-ref-154)
154. Reg §1.245A(e)-1(f)(6). [↑](#footnote-ref-155)
155. Reg. §1.245A(e)-1(d)(4)(iii)(A)(1). [↑](#footnote-ref-156)
156. Reg. §1.245A(e)-1(d)(4)(iii)(A)(2). [↑](#footnote-ref-157)
157. The regulation also limits the applicability of the look-through exception with respect to certain CFC-to-CFC dividends that constitute a “tiered extraordinary disposition account” (*i.e.*, the portion of the dividend that would be an extraordinary disposition amount if the 245A shareholder had received as a dividend its *pro rata* share of the dividend from the lower-tier CFC). Reg. §1.245A-5(d). [↑](#footnote-ref-158)
158. Reg. §1.245A-5(c)(3)(i)(C). [↑](#footnote-ref-159)
159. Reg. §1.245A-5(c)(3)(iii). [↑](#footnote-ref-160)
160. Reg. §1.245A-5(c)(3)(i). [↑](#footnote-ref-161)
161. Reg. §1.245A-5(c)(4). [↑](#footnote-ref-162)
162. Code Sec. 1059(c)(2). [↑](#footnote-ref-163)
163. Code Sec. 1059(b)(1). [↑](#footnote-ref-164)
164. Code Sec. 1059(b)(2). [↑](#footnote-ref-165)
165. Code Sec. 1059(e)(1). [↑](#footnote-ref-166)
166. In the case of a sale or exchange by a CFC of stock in another foreign corporation described in Code Sec. 964(e), “rules similar to the rules of section 961(d) shall apply.” Code Sec. 964(e)(4)(B).

     Code Sec. 246(c). [↑](#footnote-ref-167)
167. *See* Committee on the Budget, Reconciliation Recommendations Pursuant to H. Con. Res. 71, 115th Cong. 1st Sess. at 360 (S. Prt. No. 115-20) (“A participation exemption system could provide double tax benefits in certain circumstances. In particular, a distribution from a foreign subsidiary that is eligible for a DRD would reduce the value of the foreign subsidiary, reducing any built-in gain or increasing any built-in loss in the shareholder's stock of the subsidiary. Reducing gain in this manner is consistent with the application of section 1248(a) (or section 964(e)) to recharacterize gain as a dividend for which a DRD may be allowed. Increasing loss in this manner, however, creates a double U.S. tax benefit for receiving a tax-free distribution from a foreign subsidiary.”)

     Code Sec. 246(c). [↑](#footnote-ref-168)
168. *See* Code Sec. 951(b). [↑](#footnote-ref-169)
169. Reg. §1.958-1(d)(2)(i), (iii), and (iv). [↑](#footnote-ref-170)
170. *See* Code Sec. 245A(g). *See e.g.*, PLR 200009025 (Mar. 3, 2000) (corporate partner of LLC entitled to 100 percent DRD under Code Sec. 245(c)(1) for its distributive share of dividends out of E&P attributable to foreign trade income of foreign sales corporation); FSA 200026009 (June 30, 2000) (corporate partners of a partnership that owns a foreign sales corporation are entitled to 100 percent DRD under Code Sec. 245(c)(1) in connection with their distributive shares of the dividends attributable to foreign trade income paid to the partnership). [↑](#footnote-ref-171)
171. *See* Reg. §1.958-1(d)(1). [↑](#footnote-ref-172)
172. *See, e.g.,* Stewart Lipeles, *et al.*, *Did Anyone Notice the TCJA Made Section 367(b) Obsolete*?, TAXES The Magazine (CCH), July 2021, at 18. (“We urge Treasury to recognize the compliance burden is unnecessary and to simplify or eliminate the regulations under Code Sec. 367(b).”) [↑](#footnote-ref-173)
173. Though, as we noted above, B3 in fact addresses both the repatriation principle and the distortion principle. Insofar as B3 implicate shareholder-level consequences, thus implicate the distortion principle, the discussion related to B4 in this section is equally pertinent to B3. [↑](#footnote-ref-174)
174. Anecdotally, pre-TCJA, one of the authors of this report was under the impression that he would be able to put his child through college based on fees from repatriation planning; he’s now encouraging his child to consider a trade…or rowing. [↑](#footnote-ref-175)
175. *See* Code Secs. 245(a)(5), 246(c)(5), Reg §§1.245A-5(b); 1.245A(e)-1(d). [↑](#footnote-ref-176)
176. The government might also argue that “deferral E&P” includes, for purposes of this discussion, E&P attributable to small shareholders, which E&P are taxed, directly or indirectly, under B3. However, as discussed below, we do not consider E&P attributable to small shareholders to be deferral E&P, and thus believe it is inappropriate for B3 to police this E&P. [↑](#footnote-ref-177)
177. 56 Fed. Reg. at 41995, 41995 (Aug. 26, 1991) (emphasis added). [↑](#footnote-ref-178)
178. Code Sec. 1(j)(2). [↑](#footnote-ref-179)
179. Code Secs. 1(h)(1)(D) and 1411(a)(1). [↑](#footnote-ref-180)
180. As discussed above, in general, dividends from a foreign corporation may qualify for QDI if the foreign corporation is a qualified foreign corporation, which in turn depends on whether such corporation is resident in a country with which the United States has a comprehensive tax treaty. To gauge the probability that a dividend from a foreign corporation will qualify for QDI, we visited a searchable webpage with information on the percentage of the dividends from each of Vanguard’s funds, including exchange traded funds (ETFs), that are eligible as QDI. *See* <https://advisors.vanguard.com/tax-center/qualified-dividend-income>. According to information on this webpage, Vanguard estimates that, in 2022, 72.77 percent of the dividends from its Total International Stock Market ETF (VXUS) will be eligible for QDI. VXUS is a market cap-weighted index fund that tracks FTSE Global All Cap ex US Index, which measures the investment return of stocks issued by foreign corporations. That number drops to 35.51% for the Vanguard FTSE Emerging Markets ETF (VWO) and increases to 87.28 percent for the Vanguard FTSE Developed Markets ETF (VEA). The decrease and increase of QDI for VWO and VEA, respectively, reflects the fact that VWO, as an “emerging market fund,” is more heavily weighted in foreign companies based in countries with which the United States does not have a treaty, particularly South American countries like Brazil, than VEA, as a “developed markets fund,” which is more heavily weighted in companies located in countries with which the United States has entered into a comprehensive treaty, like the countries of the EU, the United Kingdom, Canada, Australia, and Korea. [↑](#footnote-ref-181)
181. *See* Skadden, Arps, Slate, Meagher & Flom LLP, Comments Re Treas. Reg. § 1.367(b)-3, at 15-16 (Aug. 25, 2021) (the “**Skadden letter**”); New York State Bar Association, Report 1463: An Analysis of Potential Design Changes to Regulation Section 1.367(b)-3 in Light of the Tax Cuts and Jobs Act, at 5 (June 28, 2022) (the “**NYSBA 2022 letter**”). [↑](#footnote-ref-182)
182. As discussed above in Parts II.B and II.D, there was some uncertainty as to whether Treasury and the IRS intended that small *corporate* shareholders be excluded from including in income their all E&P amount under the temporary regulations. [↑](#footnote-ref-183)
183. 1962 House Report at 57. [↑](#footnote-ref-184)
184. *Id.* at 59. [↑](#footnote-ref-185)
185. *See, e.g., Eisner v. Macomber*, 252 U.S. 189, 211 (1920) (ruling that a stock dividend received by a shareholder was not a realization event). [↑](#footnote-ref-186)
186. The Build Back Better Act, as passed by the House, would have enacted section 1059(g), which indeed would have effectively denied the benefit of a Code Sec. 245A DRD with respect to a dividend to the extent out of E&P earned before the foreign corporation was a CFC by treating such dividend as a *per se* extraordinary dividend for purposes of Code Sec. 1059.H.R. 5376, 117th Cong. §138148 (2021). However, this provision was not included in the final bill that became the Inflation Reduction Act of 2022. H.R. 5376, Public Law 117-169. [↑](#footnote-ref-187)
187. *See* 1992 NYSBA report, pg. 58 (“[S]hareholder-level gain may bear no relation to the all earnings and profits amount which the rules should be designed to capture. This imprecision strengthens the case that, as a policy matter, small shareholders otherwise qualifying for non-recognition treatment should not be denied such treatment by section 367(b). In our view, such shareholders are not logical persons to penalize for any tax benefits accruing to the acquiring domestic corporation.”) [↑](#footnote-ref-188)
188. *Cf.* T.D. 9243, 71 Fed. Reg. 4276, 4278 (Jan. 26, 2006) (rejecting comment requesting changes to the all E&P paradigm of B3 on the grounds that “any such revision would have to take into account recently enacted section 362(e)”). [↑](#footnote-ref-189)
189. It has been observed that B3 is primarily motivated by a concern related to the timing of income, not the amount of income. In any inbound nonrecognition transaction, unrealized gain continues to be reflected in the exchanging shareholder’s basis in the stock of the domestic acquiring corporation, which will eventually be recognized. However, pre-TCJA, if a domestic parent were able to inbound its foreign subsidiary E&P tax-free, the parent could immediately depreciate foreign subsidiary’s assets, or could use the foreign subsidiary’s cash to acquire new assets that can be depreciated. This depreciation, if accelerated, produces an immediate tax benefit, whereas the resulting gain in the assets and the gain in the stock are generally deferred. *See* Kingson, 22-27. This concern is particularly implicated when 100 percent bonus depreciation is permitted. *See* Code Sec. 168(k). [↑](#footnote-ref-190)
190. Guidelines, §3.03.; Reg. §7.367(b)-5T(b) (1977). However, as discussed above in Parts II.B and II.D, there was some uncertainty as to whether Treasury and the IRS intended that small *corporate* shareholders be excluded from including in income their all E&P amount under the temporary regulations. [↑](#footnote-ref-191)
191. Because, for example, the shareholder has an HDA or EDA with respect to the foreign acquired corporation. [↑](#footnote-ref-192)
192. *See* Reg. §1.367(b)-2(e)(3)(ii). In the case of an inbound liquidation, there is no such increase, because the stock of the foreign acquired corporation, the stock of which is increased, is not exchanged for stock of the domestic acquiring corporation, but rather extinguished, so the basis increase is not reflected in any stock or property immediately after the transaction. [↑](#footnote-ref-193)
193. H.R. Rep. No. 94-658, at 241 (1975). [↑](#footnote-ref-194)
194. Skadden letter, at 6-14. [↑](#footnote-ref-195)
195. See e.g., 2022 NYSBA report, at 26-29; Skadden letter, at 17-19. [↑](#footnote-ref-196)
196. Consideration should also be given to whether, and to what extent, a domestic acquiring corporation in an inbound stock acquisition the 1248 E&P attributable to the small shareholders under Reg. 1.1248-8 for purposes of computing the domestic acquiring corporation’s 1248 amount with respect to the foreign acquired corporation. *See* 2022 NYSBA report, at 18, note 65. [↑](#footnote-ref-197)
197. *See* Reg. §1.367(d)-2(d)(2)(ii), *cross-referencing* Code Sec. 1248(d)(4). [↑](#footnote-ref-198)
198. *See* Daub, Peter M., *Section 367 Adrift: Old Statute, New Applications*, *reprinted from* 151 Tax Notes 1207, 1219 (May 30, 2016) (“If the tax attributes are carried over to the corporation, should not the corporation include the earnings that gave rise to them?”) [↑](#footnote-ref-199)
199. 65 Fed. Reg., at 3593 (Jan. 24, 2000). [↑](#footnote-ref-200)
200. 65 Fed. Reg., at 3592-93 (Jan. 24, 2000). [↑](#footnote-ref-201)
201. A similar rebuttable presumption can be found in the Code Sec. 367(a) rules for outbound transfers of stock of a domestic corporation, under which persons who transfer stock of the domestic target in exchange for stock of the transferee foreign corporation are presumed to be U.S. persons. *See* Reg §1.367(a)-3(c)(2). [↑](#footnote-ref-202)
202. Consideration should be given to whether a 245A shareholder should be permitted to satisfy the 245A holding period requirement taking into account the period that they continue to hold the stock of the domestic acquiring corporation received in exchange for the stock of the foreign acquired corporation, in addition to the period during which the shareholder held the stock of the foreign acquired corporation. In general, the 245A holding period requirement can be satisfied *after* a dividend or deemed dividend; there does not appear to be a policy reason for preventing the 245A holding period requirement to be satisfied taking into account the holding period of stock which itself takes into account the holding period of the stock of the foreign acquired corporation under Code Sec. 1223(1). [↑](#footnote-ref-203)
203. However, see discussion above in Part IV.A of this report regarding why this might not be very distortive, if the dividend would have been QDI. [↑](#footnote-ref-204)
204. The exchanging shareholder could, however, potentially receive a 50 percent or 65 percent DRD under Code Sec. 243, depending on its percentage ownership of the domestic acquiring corporation. *See* Code Sec. 243(a)(1) and (c). [↑](#footnote-ref-205)
205. Reg. §7.367(b)-7T(c)(1)(i) (1977). [↑](#footnote-ref-206)
206. Reg. §1.1248-8(b)(3)(ii). [↑](#footnote-ref-207)
207. *See* Reg. §1.367(b)-2(e)(3)(ii). [↑](#footnote-ref-208)
208. Code Sec. 367(b)(1). [↑](#footnote-ref-209)
209. *See* Code Sec. 368(a)(1)(B) (a B reorganization is defined “the acquisition by one corporation, in exchange solely for all or a part of its voting stock …. of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition). [↑](#footnote-ref-210)
210. Reg. §1.245A(e)-1(d)(4)(iii)(A)(2). [↑](#footnote-ref-211)