Code Sec. 367(b): Where Do We Go from Here?

By Gary Scanlon and Elena Madaj*

Wolters Kluwer®

I. Introduction

The reports of deferral's death have been greatly exaggerated. It cannot be denied that the Tax Cuts and Jobs Act (the "TCJA")[1] made dramatic changes to the taxation of U.S. shareholders and their foreign subsidiaries. Before the TCJA, except for a few items of passive or mobile income subject to the anti-deferral provisions of subpart F of the Code,[2] 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 at a lower effective rate and with the benefit of foreign tax credits,[3] on their share of most categories of CFC income under the new global intangible low-taxed income ("GILTI") regime under Code Sec. 951A, while exempting under Code Sec. 245A any dividends paid out of foreign earnings and profits ("E&P") not otherwise picked up under GILTI or subpart F through a dividends received deduction (a "245A DRD"). 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] 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 significantly less well than their corporate counterparts under the TCJA. Not only are these individuals taxed immediately on the general foreign income of their CFCs at their marginal tax rate under GILTI without the benefit of foreign tax credits, any dividends they receive paid out of untaxed E&P are also taxable. It sucks to be human.[5]

Congress enacted Code Sec. 367(b) in 1976 to backstop deferral in the context of nonrecognition transactions governed by the provisions of subchapter C of the Code.[6] Absent Code Sec. 367(b), these transactions could effectively convert a "deferral of tax" into a "forgiveness of tax"[7] and ordinary income into capital gain.[8] 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 "1248 shareholder status" in certain "foreign-to-foreign" nonrecognition

GARY SCANLON is a Principal in the International Tax Group of the Washington National Tax practice of KPMG LLP. **ELENA MADAJ** is a Senior Manager in the International Tax Group of the Washington National Tax practice of KPMG LLP.

 © 2023 KPMG LLP AND ITS AFFILIATES. ALL RIGHTS RESERVED.

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 the scope of deferral and any benefits derived therefrom, and thus, by extension, the importance of any *anti*-deferral provision enacted to police it. As a result, some commentators have suggested that the 367(b) regulations be significantly narrowed or even eliminated.[9] Indeed, Treasury and the IRS have indicated that they are studying these regulations in light of changes to the Code made by the TCJA, particularly the enactment of Code Sec. 245A.[10]

In this report, we focus on the core provisions in the 367(b) regulations, namely the 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 II of this report, we describe the rules in B3 and B4, including other provisions in the 367(b) regulations that are relevant to B3 and B4. In Part III, we trace the evolution of the rules of Code Sec. 367(b) from the precursor of the statutory rule to the issuance of the final regulations under Code Sec. 367(b), and then survey recent developments, including the TCJA, that have had an impact on the relevance and the efficacy of the 367(b) regulations since the enactment of Code Sec. 367(b). In Part IV, we describe the stated principles of the 367(b) regulations and reframe these principles in a manner that is more consistent with the tax policy objectives of the regulations. In Part V, we consider various approaches that Treasury and the IRS could adopt to better align the 367(b) regulations to the post-TCJA U.S. international tax system in light of the principles underlying the 367(b) regulations and developments since the enactment of Code Sec. 367(b). Finally, in Part VI, we provide some closing thoughts.

II. Where Is Here?

A. B3

B3 applies to acquisitions 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 (an "inbound liquidation") or an asset acquisition described in Code Sec. 368 (an "inbound asset reorganization" and, with an inbound liquidation, an "inbound asset transaction").[11] B3 prescribes consequences for both the domestic acquiring corporation and any shareholder of the foreign acquired corporation that is a U.S. person[12] (or a foreign corporation with a U.S. shareholder (a "foreign corporate U.S. shareholder"))[13] that exchanges or surrenders its stock in an inbound asset transaction (an "exchanging shareholder"). A "U.S. shareholder" is a U.S. person that owns (within the meaning of Code Sec. 958(a) or (b))[14] ten percent or more of the vote or value of a foreign corporation.

With respect to the corporate-level consequences, B3 provides rules for the carryover of certain tax attributes to a domestic acquiring corporation by modifying the application of Code Sec. 381.[15] Net operating losses ("NOLs") and capital loss carryovers of the foreign acquired corporation are eligible to be inherited by the domestic acquiring corporation only to the extent that the underlying deductions of losses were allowable under chapter 1 of subtitle A of the Code.[16] In other words, only an NOL or capital loss carryover that is effectively connected with a U.S. trade or business (or that is attributable to a permanent establishment, in the context of an applicable U.S. income tax treaty) is eligible to be inherited by the domestic acquiring corporation.[17] E&P not included as a deemed dividend under B3 are eligible to be carried over from the foreign acquired corporation to the domestic acquiring corporation only to the extent such E&P (or deficit) are attributable to effectively connected income ("ECI") (or a U.S. permanent establishment, in the context of an applicable U.S. tax treaty).[18] All other E&P of the foreign acquired corporation are eliminated.[19]

As for the shareholder-level consequences, the treatment of an exchanging shareholder under B3 depends on whether the shareholder is a U.S. shareholder (or a foreign corporate U.S. shareholder) or is a U.S. person that is not a U.S. shareholder. For all purposes of the 367(b) regulations, including for purposes of determining the shareholder-level consequences of an inbound asset transaction under B3, stock owned by a foreign partnership is treated as owned by its partners.[20] Therefore, the shareholder-level consequences under B3 of an inbound asset reorganization with a shareholder that is a foreign partnership depends on the identity of its partners.[21] In contrast, the shareholder-level consequences of an inbound asset reorganization of a foreign acquired corporation with a U.S. shareholder that is a domestic partnership is determined under the B3 rules applicable to U.S. shareholders, regardless of the identity of its partners.[22]

An exchanging shareholder that is a U.S. shareholder or a foreign corporate U.S. shareholder includes in income, as a deemed dividend, its all E&P amount with respect to its stock in the foreign acquired corporation.[23] The "all E&P amount" with respect to stock in a foreign acquired corporation is the net positive E&P, if any, attributable to the stock.[24] The all E&P amount is determined without

regard to the amount of the gain that would be realized on a sale or exchange of the stock in the foreign acquired corporation and generally without regard to the E&P of lower-tier foreign corporations.[25] A foreign corporation's E&P are determined using principles substantially similar to those applicable to domestic corporations, excluding E&P described in Code Sec. 1248(d).[26] E&P are attributed to the stock in the foreign acquired corporation under the principles of Code Sec. 1248 and the regulations thereunder, except that, for this purpose, such attribution is made 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).[27] If the exchanging shareholder is a foreign corporate U.S. shareholder, for purposes of attributing E&P of the foreign acquired corporation to stock in the foreign acquired corporation under the principles of Code Sec. 1248, the foreign corporate U.S. shareholder's holding period in the stock is determined by reference to the period that the U.S. shareholders of the foreign corporate U.S. shareholder held (directly or indirectly) an interest in the foreign acquired corporation.[28]

There are two rules in B3 for an exchanging shareholder that is a U.S. person but not a U.S. shareholder (a "small shareholder") depending on the value of its stock in the foreign acquired corporation on the date of the inbound asset transaction. A small shareholder that owns stock in the foreign acquired corporation with a fair market value of at least $50,000 is required to recognize gain (but not loss) with respect to the stock in the foreign acquired corporation.[29] However, to the extent that the foreign acquired corporation provides the small shareholder with information to substantiate the shareholder's all E&P amount and the shareholder complies with certain notice requirements, the small shareholder may elect to include its all E&P amount (the "all E&P election").[30] A small shareholder that owns stock in the foreign acquired corporation with a fair market value of less than $50,000 does not recognize income or loss as a result of the exchange (the "*de minimis* exception").[31]

B3 does not apply to, or with respect to E&P and basis attributable to, exchanging shareholders that are foreign persons, other than foreign corporate U.S. shareholders.

B. B4

B4 applies to a 1248 shareholder that is an exchanging shareholder in a transaction in which a foreign corporation (a "transferee foreign corporation") acquires the stock in a foreign corporation in an exchange described in Code Sec. 351 or the stock in or assets of a foreign corporation in a reorganization under Code Sec. 368(a) (each, a "foreign-to-foreign transaction").[32] As is relevant here, B4 requires an income inclusion to an exchanging shareholder if a foreign-to-foreign transaction results in the loss of 1248 shareholder status.[33] A "1248 shareholder" is a U.S. person that owns (within the meaning of Code Sec. 958(a) or (b)) ten percent or more of the total combined voting power of a 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.[34] In general, a foreign-to-foreign transaction results in the loss of 1248 shareholder status with respect to an exchanging shareholder if two conditions are satisfied.[35] First, immediately before the foreign-to-foreign transaction, the exchanging shareholder is either (i) a U.S. person that is a 1248 shareholder of the foreign corporation immediately before the exchange or (ii) a foreign corporation, and a U.S. person is a 1248 shareholder with respect to such foreign corporation and with respect to the foreign acquired corporation (such foreign corporation, a "foreign corporate 1248 shareholder").[36] Second, immediately after the foreign-to-foreign transaction, either (i) the stock received by the exchanging shareholder is not stock in a CFC as to which the exchanging shareholder (or in the case of an exchanging shareholder that is a foreign corporate 1248 shareholder, the 1248 shareholder with respect to such foreign corporate 1248 shareholder) is a 1248 shareholder, or (ii) the foreign acquiring corporation is not a CFC as to which the exchanging shareholder (or in the case of an exchanging shareholder that is a foreign corporate 1248 shareholder, the 1248 shareholder with respect to such foreign corporate 1248 shareholder) is a 1248 shareholder.[37]

If an exchanging shareholder loses 1248 shareholder status in a foreign-to-foreign transaction, the shareholder must include in gross income as a deemed dividend its 1248 amount with respect to the foreign acquired corporation.[38] An exchanging shareholder's "1248 amount" is the net positive E&P (if any) that would be attributable to the stock in the foreign acquired corporation and includible in income as a dividend under Code Sec. 1248 if the shareholder sold the stock.[39] In contrast to the all E&P amount, the 1248 amount is gain-limited and takes into account E&P of lower-tier foreign corporations attributable to the stock.

B4 does not apply to transfers of stock in a foreign corporation by a 1248 shareholder to a domestic corporation in an exchange described in Code Sec. 351 (an "inbound 351 exchange") or in a reorganization described in Code Sec. 368 (an "inbound stock reorganization," and, with an inbound 351 exchange, an "inbound stock transfer"),

notwithstanding that an inbound stock transfer results in the exchanging shareholder losing its status as a 1248 shareholder. Specifically, the 1248 shareholder (or a foreign corporate 1248 shareholder) receives stock in a corporation (*i.e.*, the domestic acquiring corporation) with respect to which such shareholder is not a 1248 shareholder (or, in the case of an exchanging shareholder that is a foreign corporate 1248 shareholder, a 1248 shareholder of the foreign corporate 1248 shareholder is not a 1248 shareholder). However, in the case of an inbound stock transfer, the E&P of the foreign acquired corporation attributable to the stock owned by the 1248 shareholder immediately before the inbound stock transfer are attributed to the stock acquired by the domestic acquiring corporation for purposes of applying Code Sec. 1248 (and the 367(b) regulations) to a subsequent disposition of the stock in the foreign acquired corporation.[40] So, while the 1248 shareholder of the foreign acquired corporation immediately before the inbound stock transfer loses its status as a 1248 shareholder as a result of the transfer, Code Sec. 1248 continues to apply with respect to the foreign acquired corporation in the hands of the domestic acquiring corporation, thus preserving 1248 shareholder status as a whole. Further, similar to B3, B4 does not apply to transfers of stock by exchanging shareholders that are foreign persons, other than foreign corporate 1248 shareholders.

C. Treatment of Deemed Dividends

As described above, each of B3 and B4 require an exchanging shareholder to include in its gross income an amount as a deemed dividend. A deemed dividend under the 367(b) regulations is treated as a dividend for all purposes of the Code.[41] Therefore, a deemed dividend included in the gross income of a corporate U.S. shareholder may be eligible for a 245A DRD,[42] and a deemed dividend included in the gross income of an individual may qualify as qualified dividend income ("QDI") under Code Sec. 1(h)(11).[43]

Special rules specific to B3 and B4 apply for deemed dividends received by a CFC. A deemed dividend of a 1248 amount included in the gross income of a foreign corporate 1248 shareholder under B4 is excluded from foreign personal holding company income ("FPHCI").[44] However, an all E&P amount included in the gross income of a foreign corporate U.S. shareholder is treated as FPHCI under B3, since the deemed dividend is not eligible for an exception to FPHCI under either Code Sec. 954(c)(3)(A)(i) (the "same country exception")[45] or Code Sec. 954(c)(6) (the "look-thru exception").[46] Therefore, if a foreign corporate U.S. shareholder is a CFC, a U.S. shareholder of the CFC may be required to include its *pro rata* share of the all E&P amount into gross income as a subpart F inclusion.

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.[47] The 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).[48] However, the basis that an exchanging shareholder takes in stock received can also be decreased under Code Sec. 1059 if the deemed dividend is an extraordinary dividend and the exchanging shareholder did not hold the stock in the foreign acquired corporation for more than two years before the inbound asset transaction.[49]

If an exchanging shareholder that is a U.S. person includes in income a deemed dividend under the 367(b) regulations, 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[50] from the appropriate foreign corporation that is attributable (under the principles of Code Sec. 1248) to the exchanged stock.[51] The exchange gain or loss recognized by an exchanging shareholder that is a U.S. person increases or decreases the shareholder's adjusted basis in the stock in the foreign corporation.[52] If an exchanging shareholder is a foreign corporation (*i.e.*, a foreign corporate U.S. shareholder or a foreign corporate 1248 shareholder), PTEP is treated as distributed to the shareholder for all purposes (*i.e.*, the PTEP moves up to the shareholder).[53]

III. How Did We Get Here?

A. 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 U.S. tax purposes.[54] 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 paid out of this untaxed E&P, when eventually paid, would give rise to ordinary income.[55]

1. Subpart F

Congress enacted subpart F of the Code in the Revenue Act of 1962[56] to address concerns with the deferral of

certain passive and mobile income of "American controlled" foreign corporations.[57] Specifically, under Code Sec. 951(a), any U.S. shareholder that owns stock (within the meaning of Code Sec. 958(a)) in a foreign corporation on the last day on which the corporation is a CFC must include in gross income its *pro rata* share of the corporation's subpart F income.[58] Congress adopted this U.S. shareholder limitation in subpart F 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."[59]

In general, a U.S. shareholder's *pro rata* share of a CFC's subpart F income is equal to the amount of the CFC's E&P attributable to subpart F income that would be distributed with respect to stock in the CFC that the U.S. 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.[60] However, a U.S. shareholder's *pro rata* share of subpart F income can be reduced by reason of distributions received by any other person during the year with respect to the stock in the foreign corporation owned by the shareholder.[61]

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 earnings and profits" 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).[62] Further, a U.S. shareholder's basis in stock in 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 in 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.[63] 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.[64]

2. Code Sec. 1248

Congress also enacted Code Sec. 1248 as part of the Revenue Act of 1962.[65] 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 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 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.[66] While Congress would permit taxpayers to delay recognizing most of their CFC income, changing the character of such income upon an effective repatriation was a bridge too far. Code Sec. 1248 was enacted to impose "full U.S. tax" on income earned abroad, once repatriated, by whatever means (including constructively through a taxable sale or exchange).[67]

Code Sec. 1248, if applicable, recharacterizes a 1248 shareholder's gain on the sale of stock in a foreign corporation as a dividend to the extent of the E&P attributable to that stock.[68] 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.[69] The principles of Code Sec. 1248 also apply to sales by CFCs of lower-tier foreign corporations.[70]

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 (such E&P, "1248 E&P"). However, 1248 E&P excludes certain categories of E&P, most importantly PTEP and E&P attributable to ECI, other than ECI exempt from taxation (or subject to a reduced rate of tax) pursuant to a U.S. tax treaty ("ECI E&P").[71] 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.[72] In general, the amount of E&P attributable to a 1248 shareholder's stock in a foreign corporation is equal to the sum of the 1248 E&P

accumulated by the foreign corporation during the holding period of the shareholder, 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.[73]

3. U.S. and 1248 Shareholders

The "U.S. shareholder" concept in subpart F is critical to the application of B3, whereas the "1248 shareholder" concept in Code Sec. 1248 is equally important to the application of B4. While there is significant overlap between persons that are U.S. shareholders and persons that are 1248 shareholders, these terms are not co-terminus.

For starters, status as a U.S. shareholder is determined by reference to vote *or* value, whereas 1248 shareholder status is determined by reference solely to voting power.[74] In addition, while a U.S. shareholder is subject to subpart F only with respect to a foreign corporation that is a CFC, a U.S. shareholder of a foreign corporation that is not, and has never been a CFC, is still a U.S. shareholder within the meaning of Code Sec. 951(b), and thus subject to B3. In contrast, a U.S. person can be a 1248 shareholder only with respect to a foreign corporation that is, or has been, a CFC.

For the foregoing reasons, caution in the use of terminology is warranted when discussing the persons and corporations subject to subpart F, Code Sec. 1248, and the 367(b) regulations. In particular, while it is common to equate, in the context of B4, a 1248 shareholder with a U.S. shareholder and a foreign acquired corporation with a CFC, it is possible that the exchanging shareholder is not a U.S. shareholder and the foreign acquired corporation is not a CFC.[75]

B. Development of the 367(b) Regulations

1. Code Sec. 367

Congress enacted the predecessor to Code Sec. 367 in the Revenue Act of 1932.[76] Code Sec. 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 as one of its principal purposes the avoidance of Federal income taxes."[77] Congress enacted this provision to prevent the tax-free transfer of appreciated stock or securities to foreign corporations.[78] This section subsequently became Code Sec. 367 in the 1954 Code without material change.[79]

2. Guidelines

In 1968, the IRS released Rev. Proc. 68-23,[80] which set forth guidelines that the IRS would follow in providing an advance ruling that the principal purpose of a transaction was not one of Federal tax avoidance (the "guidelines"). 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 deemed dividend its share of the untaxed E&P of a foreign acquired 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 described the circumstances and conditions under which the IRS would "ordinarily" or "generally" issue a favorable ruling. Indeed, in lieu of accepting any "toll charge" described in the guidelines, an exchanging 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 acquired the assets of a foreign corporation in an inbound liquidation, provided that the domestic acquiring corporation agreed to include in its gross income as a deemed dividend the portion of the accumulated E&P, if any, of the foreign corporation for all taxable years of such foreign corporation properly attributable[81] to such domestic parent corporation's stock in such foreign corporation.[82]
- A domestic corporation acquired the assets of a foreign corporation in an inbound asset reorganization, provided that
  - the shareholders of the foreign acquired corporation agreed to include in their gross income as a deemed dividend 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 in such foreign corporation was exchanged in a taxable exchange,[83] and
  - a domestic corporation that owned 20 percent or more of the outstanding stock in the foreign acquired corporation (a "20-percent corporate U.S. shareholder") agreed to include in its gross income as a dividend its portion of the accumulated E&P, if any, of the foreign corporation for all taxable years of such corporation properly attributable to the domestic corporation's stock in such foreign corporation.[84]

- A domestic corporation acquired the stock in a foreign corporation in an inbound stock reorganization.[85]
- A foreign corporation transferred property to another foreign corporation in an asset reorganization under Code Sec. 368 (a "foreign-to-foreign asset reorganization"), if the foreign acquired corporation was a CFC at the time of the reorganization or at any time within the prior five-year period, provided that the shareholders of such corporation agreed to include in their gross income the portion of the E&P, if any, of the foreign acquired 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 in such corporation was exchanged in a taxable exchange.[86]
- Stock in a foreign corporation was acquired in exchange for stock in another foreign corporation in a reorganization (a "foreign-to-foreign stock reorganization") and immediately after the exchange, (1) the foreign acquiring corporation was controlled (within the meaning of Code Sec. 954(d)(3)) by a person or persons who immediately prior to such exchange controlled the foreign acquired corporation, and (2) the foreign acquired corporation met the requirements of the same-country exception, provided that, if the foreign acquiring corporation was not a CFC, the shareholders of the foreign acquired corporation agreed to include in their gross income the portion of the E&P, if any, of the foreign acquired corporation properly attributable under Code Sec. 1248 to such shareholders' stock in such foreign acquired corporation which would have been includible in their income under Code Sec. 1248 if at the time of such acquisition the stock in such foreign acquired corporation was exchanged in a taxable exchange.[87]
- Stock in a foreign corporation was acquired in exchange for stock in another foreign corporation in a foreign-to-foreign stock reorganization and immediately after the exchange the shareholders of the acquired corporation did not own directly or indirectly, within the meaning of Code Sec. 958, more than 50 percent of the total combined voting power of the foreign acquiring corporation, provided that, if the foreign acquiring corporation was not a CFC, the shareholders of the foreign acquired corporation agreed to include in their gross income as a dividend the portion of the E&P, if any, of the foreign acquired corporation properly attributable under Code Sec. 1248 to such shareholders' stock in such foreign acquired corporation which would have been includible in their income under Code Sec. 1248 if at the time of such acquisition the stock in such foreign acquired corporation was exchanged in a taxable exchange.[88]

In the context of a foreign-to-foreign asset reorganization or a foreign-to-foreign stock reorganization (each, a "foreign-to-foreign reorganization"), the amount of any deemed dividend required under the guidelines was 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 B4. Similarly, the deemed dividend received by a domestic parent corporation in an inbound liquidation and a 20-percent corporate U.S. shareholder in an inbound asset reorganization, which was determined by reference to 1248 E&P *of the foreign acquired corporation* attributable to the stock for *all* taxable years[89] and without regard to E&P of foreign subsidiaries under Code Sec. 1248(c)(2),[90] corresponds to the "all E&P amount" in B3.[91]

For a 20-percent corporate U.S. shareholder to have an inclusion under the guidelines, it does not appear that the foreign acquired corporation needed to be a CFC. In contrast, the amount of the deemed dividend received in an inbound asset reorganization by U.S. persons that owned less than 20 percent of the foreign acquired corporation 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).[92] Therefore, it appears that, for any U.S. person other than a 20-percent corporate U.S. shareholder to include a deemed dividend by reason of an inbound asset reorganization in order to obtain an advance ruling under the guidelines, the person must have been a 1248 shareholder at the time of the transaction and thus the foreign corporation must have been a CFC at the time of the transaction or within the preceding five-year period.

The guidelines did not generally impose a toll charge on a small shareholder, unless the shareholder was a 1248 shareholder.[93] However, if a small shareholder failed to obtain an advance ruling, including because one or more 1248 shareholders of the foreign acquired corporation refused to agree to the "toll charge" required under the guidelines, it appears that such shareholder would have recognized gain under former Code Sec. 367.

3. Code Sec. 367(b)

Congress amended Code Sec. 367 in the Tax Reform Act of 1976[94] to eliminate the advance ruling requirement for inbound asset transactions 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 "TRA House Report"),[95] Congress observed that 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."[96] While Congress "generally approve[d] the standard applied by the IRS" in the guidelines, the TRA 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.[97] For these reasons, Congress desired that the advance ruling requirement be replaced with "clear and certain regulations."[98]

To accomplish this, Congress amended Code Sec. 367 to establish separate rules for outbound transfers of property by U.S. persons (Code Sec. 367(a)) and other transfers, including inbound asset 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."[99] 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."[100] However, Congress warned that "unnecessary barriers to justifiable and legitimate business transactions should be avoided."[101]

4. Temporary Regulations

The first comprehensive set of regulations under Code Sec. 367(b) were released in 1977 as temporary regulations (the "temporary regulations").[102] The temporary regulations provided a complex set of rules which generally required either (1) an immediate U.S. 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 temporary regulations applied in the following manner:

- If a domestic corporation acquired the assets of a foreign corporation in an inbound liquidation, the domestic acquiring corporation either (1) included as a deemed dividend its all E&P amount[103] with respect to the stock in the foreign acquired corporation or (2) recognized gain with respect to the stock in the foreign acquired corporation.[104]
- If a domestic corporation acquired the assets of a foreign corporation in an inbound asset reorganization—
  - An individual 1248 shareholder included in gross income as a deemed dividend its 1248 amount with respect to its stock in the foreign acquired corporation.[105]
  - A corporate 1248 shareholder either (1) included in gross income as a deemed dividend its all E&P amount with respect to the stock in the foreign acquired corporation or (2) recognized gain with respect to the stock in the foreign acquired corporation.[106]
  - A foreign corporate 1248 shareholder added to its E&P or deficit the E&P of the foreign acquired corporation attributable to its 1248 shareholders (the "1248(c)(2) amount").[107]
- If a domestic corporation acquired the stock in a foreign corporation in an inbound stock reorganization—
  - A 1248 shareholder included in gross income as a deemed dividend its 1248 amount with respect to the stock in the foreign acquired corporation.[108]

- A foreign corporate 1248 shareholder added to its E&P or deficit its 1248(c)(2) amount with respect to the stock in the foreign acquired corporation.[109]
- If a foreign corporation acquired the assets of, or stock in, a foreign corporation in a foreign-to-foreign reorganization—
  - A 1248 shareholder that received stock in a foreign corporation which was not a CFC or stock in a CFC as to which the 1248 shareholder was not a 1248 shareholder included in gross income its 1248 amount with respect to the stock in the foreign acquired corporation.[110]
  - A foreign corporate 1248 shareholder that received stock in a foreign corporation which was not a CFC or stock in a CFC with respect to which a 1248 shareholder of the foreign corporate 1248 shareholder was not a 1248 shareholder added to its E&P or deficit its 1248(c)(2) amount with respect to the stock in the foreign acquired corporation.[111]

The most significant changes in the temporary regulations from the guidelines were (1) requiring all corporate 1248 shareholders, not just 20-percent corporate U.S. shareholders, to have an all E&P inclusion with respect to a foreign acquired corporation in an inbound asset reorganization,[112] (2) including the E&P of foreign subsidiaries in the 1248 amount recognized by an individual 1248 shareholder in an inbound asset reorganization, and (3) requiring 1248 shareholders to include their 1248 amount with respect to 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. In any case, as under the guidelines, the temporary regulations generally did not impose any consequence on small shareholders, unless such shareholder that was a 1248 shareholder.

5. Proposed Regulations

In 1991, Treasury and the IRS issued proposed regulations (the "proposed regulations") and removed substantially all of the temporary regulations.[113] The proposed regulations expanded the approach in the prior guidance applicable to inbound asset transactions, requiring that all U.S. shareholders, not just corporate U.S. shareholders (or 20-percent corporate U.S. shareholders under the guidelines), include their all E&P amount in an inbound asset transaction.[114] Also, the proposed regulations eliminated the electivity that was implicit in both the guidelines and the temporary regulations for corporate U.S. shareholders to recognize gain in an inbound asset transaction in lieu of including their all E&P amount.[115]

However, the proposed regulations departed from the rule requiring shareholders to include their all E&P amount in two situations. First, the proposed regulations provided all U.S. shareholders (not just corporate U.S. shareholders) an election to recognize the gain (but not loss) realized with respect to its stock in the foreign acquired corporation, in lieu of including its all E&P amount (a "taxable exchange election").[116] However, if a taxable exchange election were made, the proposed regulations required a reduction in asset basis (or other tax attributes) of the foreign acquired corporation inherited by the domestic acquiring corporation in an amount equal to the excess of the electing shareholder's all E&P amount over its gain recognized.[117]

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.[118] However, the proposed regulations did not require a reduction to the attributes of the foreign acquired corporation inherited by the domestic acquiring corporation attributable to such small shareholders. The preamble cited administrative concerns for requiring small shareholders to recognize gain without any corporate-level attribute reduction, rather than include their all E&P amount:

> [A small shareholder] 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.[119]

While Treasury and the IRS explain in the preamble the reason for requiring small shareholders to recognize gain rather than an all E&P inclusion, they failed to acknowledge, and thus adequately explain, why the proposed rules departed from the nonrecognition approach for small shareholders that had been the norm under the guidelines and the temporary regulations.[120]

Consistent with the guidelines and the temporary regulations, the proposed regulations required an inclusion of a 1248 amount upon the loss of 1248 shareholder status.[121] However, 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."[122]

6. Final Regulations

In 2000, Treasury and the IRS largely finalized the proposed regulations (the "final regulations"), with certain significant modifications.[123] First, the final regulations did not adopt the taxable exchange election that would have been afforded to all U.S. shareholders on the grounds that this election (1) was inconsistent with the policy of Code Sec. 367(b) that the all E&P amount was the proper measure of income recognition, (2) added substantial complexity by requiring coordination between the electing shareholders and the acquiring corporation to determine the attribute reductions, and (3) was potentially unfair to non-electing taxpayers.[124] On this last point, in the preamble to the final regulations, Treasury and the IRS elaborated on how non-electing shareholders could end up with some of the sour and none of the sweet:

> 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).[125]

Further, the final regulations retained the proposed rule that generally required small shareholders to recognize gain, but, in response to comments, adopted the all E&P election and *de minimis* exception. Commentators had also requested an election that would permit a domestic acquiring corporation to include the aggregate all E&P amounts of small shareholders on their behalf.[126] However, Treasury and the IRS rejected this recommendation, 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.[127]

C. Developments Impacting Code Sec. 367(b)

1. Everything but TCJA

Code Sec. 367(b) has not been amended since its enactment in 1976, and B3 and B4 have not been materially revised since 2006.[128] However, the tax law has evolved significantly from the enactment of Code Sec. 367(b) in 1976, through the issuance of the final regulations in 2000, and up to the present day. Following are some developments that have impacted, directly or indirectly, the relevance and efficacy of B3 and B4.

a) 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.[129] By the Revenue Act of 1962 (*i.e.*, the enactment of subpart F and Code Sec. 1248), the top corporate tax rate had increased to 52 percent, while the long-term capital gain rate remained at 25 percent.[130] By the Tax Reform Act of 1976 (*i.e.*, the enactment of Code Sec. 367(b)), 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.[131] Effective in 1988 for calendar year taxpayers, Congress eliminated the preferential long-term capital gain rate for corporations.[132] Since that time, corporate rates for capital gains and ordinary income have not diverged.

Reflecting the reduced importance of Code Sec. 1248 upon the convergence of ordinary and capital gain rates for corporations after the TRA, Treasury and the IRS suspended the application of Code Sec. 1248(e) with respect to any sale or exchange that occurs on or after September 21, 1987, during a period when capital gains rates are equal to or higher than ordinary income rates.[133] Code Sec. 1248(e) is an anti-abuse provision that treats a sale or exchange of the stock in a domestic corporation as a sale or exchange of the stock in any foreign corporation held by the domestic corporation if the domestic corporation was formed or availed of principally to hold the stock in such foreign corporation. The IRS suspended Code Sec. 1248(e) because its application, after the repeal of the capital gains rate differential in the TRA, would generally be taxpayer-favorable; "the primary consequence of characterizing gain on CFC stock as a dividend will be the receipt of the indirect foreign tax credit that accompanies the deemed dividend."[134]

For individuals, the preferential rate for capital gains relative to ordinary income has generally persisted after the TRA. However, in 2003, Congress enacted Code Sec. 1(h)(11),[135] which provides that the QDI of an individual shareholder is subject to taxation at reduced long-term capital gain rates, rather than ordinary income rates. While QDI is taxed at capital gain rates, it is not "gain from the sale or exchange of a capital asset."[136] Therefore, an individual shareholder cannot generally offset its QDI with capital losses, except as permitted under Code Sec. 1211(b).[137]

QDI is income from dividends paid by either a domestic corporation or a qualified foreign corporation.[138] In general, a qualified foreign corporation is any corporation that is incorporated in a U.S. possession or is eligible for the 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.[139] However, for this purpose, neither a passive foreign investment corporation (as defined in Code Sec. 1297) (a "PFIC") nor a foreign corporation that became a surrogate foreign corporation (as defined in Code Sec. 7874(a)(2)(B)) after December 22, 2017, constitute qualified foreign corporations.[140] In addition, a dividend with respect to a share of stock of a qualified foreign corporation is not QDI unless the shareholder has held the stock for more than 60 days during the 121-day period straddling the ex-dividend date.[141]

Amounts treated as dividends under Code Sec. 1248 are eligible to be QDI.[142] Similarly, a deemed dividend included in the gross income of an individual under the 367(b) regulations may also qualify as QDI.[143]

b) Code Sec. 986(c) and Notice 88-71. In 1986, Congress enacted Code Sec. 986(c),[144] which taxes foreign currency gain or loss on the distribution of PTEP. Section 986(c) provides that a CFC recognizes foreign currency gain or loss with respect to a distribution of PTEP "attributable to movements in exchange rates between the time of the deemed distribution [*e.g.*, an inclusion under subpart F or GILTI] and actual distribution."[145] A "deemed distribution" for this purpose refers to an inclusion of the underlying earnings under an anti-deferral regime, such as subpart F, GILTI, or Code Sec. 1248.[146] Code Sec. 986(c) gain or loss is treated as ordinary income or loss from the same source as the associated income inclusion.[147]

The IRS in Notice 88-71[148] 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.[149] The foreign currency income (or loss) recognized increases (or decreases) the U.S. shareholder's basis in the stock in the foreign corporation for purposes of computing gain or loss with respect to the stock in the transaction.[150]

As discussed above,[151] the 367(b) regulations implement the principles of Notice 88-71 by deeming a distribution of PTEP immediately before a deemed dividend for purposes of computing foreign currency income or loss under Code Sec. 986(c).[152]

c) Loss importation provisions. In 2004, Congress enacted Code Sec. 362(e)(1),[153] which applies to the importation of built-in loss in certain nonrecognition transactions. Specifically, Code Sec. 362(e)(1) provides that the basis of "importation property" acquired by a transferee corporation in an exchange described in Code Sec. 351 or a reorganization under Code Sec. 368 will be its fair market value if, under the normal rules of Code Sec. 362(a) or (b),[154] there would be an "importation of net built-in loss."[155] A similar rule applies for transfers of importation property pursuant to a complete liquidation under Code Sec. 332.[156]

An importation of net built-in loss occurs in a transaction if the aggregate basis of importation property exceeds their fair market value immediately after the transaction.[157] Importation property is any property with respect to which (i) any gain or loss that would be recognized on a hypothetical sale by the transferor immediately before the transfer would not be subject to U.S. tax, and (ii) any gain or loss that would be recognized on a hypothetical sale by the transferee immediately after the transfer would be subject to U.S. tax.[158] Property transferred by a foreign acquired corporation in an inbound asset transaction may be importation property even if the foreign acquired corporation is a CFC and thus gain or loss from a hypothetical sale by the corporation immediately before the transaction *would* be taken into account in determining a U.S. shareholder's subpart F or GILTI inclusion.[159]

2. Everything about TCJA

a) Overview. On December 22, 2017, Congress dramatically changed the U.S. system of international taxation by enacting the TCJA.[160] According to the legislative history, a primary driver of the international tax provisions of the TCJA was to eliminate the "lock-out effect"[161] produced by deferral:

> 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.[162]

Thus, Congress intended to move the United States away from a worldwide system of taxation with deferral towards a territorial system of taxation with "appropriate base-erosion safeguards." In reality, the TCJA created four distinct systems that apply to U.S. shareholders of foreign corporations, depending on whether the U.S. shareholder is an individual or a corporation and depending on whether the foreign corporation is a CFC or a 10/50 company. The four systems of taxation are—

(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 CFC income under GILTI (subject to a deduction under Code Sec. 250) or subpart F, but then any untaxed E&P 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 CFC income under GILTI (without a deduction under Code Sec. 250) 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.[163]

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 an individual U.S. shareholder of a 10/50 company, a small shareholder of a foreign corporation is not taxed on the income of that corporation until that shareholder receives a dividend.

Each of the changes made in the TCJA relevant to the taxation of U.S. shareholders of foreign corporations are discussed below.

b) Transition tax. To transition from the deferral system of international taxation to the system prescribed by the TCJA, Congress amended Code Sec. 965 to impose a "transition tax" with respect to untaxed E&P of CFCs and certain 10/50 companies.[164] Under Code Sec. 965, as amended, U.S. shareholders of CFCs and 10/50 companies with at least one corporate U.S. shareholder were required to increase their subpart F inclusion (such inclusion, a "965 inclusion") with respect to such foreign corporations by their *pro rata* share of untaxed post-1986 E&P of such corporations calculated as of November 2, 2017, or December 31, 2017, whichever was greater.[165] A U.S. shareholder was taxed on its 965 inclusion at a blended rate consisting of 15.5 percent to the extent of its share of the foreign corporation's cash and cash equivalents and 8 percent for the remaining inclusion.[166] These rates were achieved through a deduction permitted to the U.S. shareholder under Code Sec. 965 ("965(c) deduction").

E&P of a foreign corporation attributable to a U.S. shareholder's 965 inclusion with respect to the foreign corporation are PTEP ("965(a) PTEP").[167] In addition, to the extent that a 965 inclusion with respect to a foreign corporation was reduced by reason of a U.S. shareholder's *pro rata* share of a deficit of another foreign corporation, the E&P of the first foreign corporation are also treated as PTEP ("965(b) PTEP," and, together with 965(a) PTEP, "965 PTEP").[168]

The regulations provide special rules for computing gain or loss recognized under Code Sec. 986(c) on a distribution of 965 PTEP. To the extent of a distribution paid out of 965(a) PTEP, the amount of foreign currency gain or loss under Code Sec. 986(c) is reduced in the same proportion as the reduction of the U.S. shareholder's 965(a) inclusion by the 965(c) deduction.[169] In contrast, Code Sec. 986(c) does not apply at all to distributions paid out of 965(b) PTEP.[170]

c) 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, Congress enacted Code Sec. 951A to require all U.S. shareholders of CFCs to include in gross income their "global intangible low-taxed income" with respect to their CFCs. Although "intangible income" is embedded in its name, GILTI is not limited to intangible income,

but rather is determined formulaically based on a U.S. shareholder's *pro rata* share of CFC income, except for certain excluded amounts, reduced by a "normal return" on tangible assets.

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.[171] "Net CFC tested income" is a U.S. shareholder's aggregate *pro rata* shares of the tested income of all CFCs less the U.S. shareholder's aggregate *pro rata* shares of the tested losses of all CFCs.[172] "Tested income" is the amount that a CFC's gross tested income exceeds the deductions properly allocable to gross tested income,[173] whereas "tested loss" is the amount that a CFC's deductions properly allocable to gross tested income exceed its gross tested income.[174] "Gross tested income" includes all income except ECI, amounts taken into account in determining subpart F income, amounts excluded from subpart F income by reason of an election under Code Sec. 954(b)(4) ("subpart F high-tax exception"), related party dividends, and foreign oil and gas extraction income ("FOGEI").[175] Unlike subpart F income, tested income is not limited by E&P.[176]

"Net deemed tangible income return" is the excess of ten percent of the U.S. shareholder's aggregate *pro rata* shares of the qualified business asset investment ("QBAI") of its CFCs with tested income over the amount of interest expense taken into account in determining the U.S. shareholder's net CFC tested income.[177] QBAI is the quarterly average of a CFC's adjusted bases in tangible depreciable property used in the production of tested income.[178]

While tested income is often colloquially referred to as "GILTI," not all tested income results in a GILTI inclusion. As a result, a CFC whose income is subject to GILTI may nonetheless have significant amounts of untaxed E&P. A significant source of this untaxed E&P for many taxpayers is the "normal return" from tangible assets *(i.e.*, the net deemed tangible income return). Another source arises from a U.S. shareholder's aggregate *pro rata* share of tested losses offsetting, in whole or in part, the shareholder's *pro rata* share of the tested income of one or more CFCs.

In addition, certain items are excluded from tested income in the first instance, thus creating untaxed E&P. As noted above, high-tax subpart F income excluded from subpart F income by a subpart F high-tax exception is also excluded from tested income. Similarly, high-tax income that would otherwise be gross tested income may be excluded from gross tested income by election ("GILTI high-tax exception").[179]

Subject to a taxable income limitation, a corporate U.S. shareholder is currently afforded a 50-percent deduction with respect to its GILTI and its Code Sec. 78 gross-up attributable to its GILTI.[180] Subject to the limitation under Code Sec. 904, a corporate U.S. shareholder is also permitted a foreign tax credit equal to 80 percent of the foreign taxes paid by its CFCs with respect to the shareholder's *pro rata* share of the tested income of those CFCs included in its GILTI.[181] In contrast, an individual U.S. shareholder is not generally permitted a deduction under Code Sec. 250 or a foreign tax credit under Code Sec. 960(d) with respect to its GILTI, absent an election under Code Sec. 962.[182] For all U.S. shareholders (or their successors), a GILTI inclusion is treated in the same manner as a subpart F inclusion amount for purposes of applying Code Secs. 959 and 961.[183]

d) Participation exemption

(i) In general. To move towards a territorial system, and to eliminate the "lock-out effect" of the prior worldwide system, the TCJA implemented a participation exemption through the enactment of Code Sec. 245A for dividends paid out of foreign E&P not otherwise taxed under GILTI or subpart F. Under this provision, a domestic corporation that is a U.S. shareholder ("245A shareholder") is generally entitled to a 100-percent dividends received deduction for the foreign-source portion of any dividends received from a specified 10-percent owned foreign corporation ("SFC") subject to certain additional requirements.[184] An SFC is any foreign corporation held by a 245A shareholder,[185] except that a PFIC is not an SFC unless the PFIC is a CFC with respect to the shareholder.[186] In the case of the sale or exchange by a corporate 1248 shareholder of the stock in 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.[187]

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.[188] 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 ("RICs") or real estate investment trusts ("REITs").[189] 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.[190]

There are several provisions that may disallow the 245A DRD, in whole or in part. These provisions are discussed in turn below.[191]

(ii) 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").[192] 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.[193] 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 245A shareholder with respect to the SFC at all times during such period.[194] 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(1) or Code Sec. 1223(2) (*i.e.*, a tacked holding period).[195] However, there is no rule that would "tack" status as a 245A shareholder during the relevant period, for instance, in the case where a domestic corporation acquires shares of an SFC from a 245A shareholder in an inbound stock transfer.

Code Sec. 246(c) also sets forth the holding period requirement to qualify for a DRD under Code Sec. 243 ("243 DRD") for dividends from domestic corporations, a 245(a) DRD for dividends from foreign corporations paid out of post-1986 undistributed U.S. earnings, and a 245(b) DRD for dividends from wholly owned foreign corporations paid out of ECI E&P.[196] In general, a taxpayer is permitted a 243, 245(a), or 245(b) DRD for a dividend on any share of common stock only if the taxpayer has held such stock for more than 45 days during the 91-day period straddling the ex-dividend date.[197] The requisite holding period is extended to 90 days during a 181-day period for dividends on any share of preferred stock.[198]

The legislative history to the TCJA does not explain the reason for providing a longer period for the 245A holding period requirement relative to the holding period requirement for 243, 245(a), and 245(b) DRDs.[199] However, Code Sec. 246(c) was originally enacted to combat "dividend stripping." A dividend strip occurs when a domestic corporation purchases stock immediately before the date the stock is "ex-dividend," *i.e.,* before the holder of the shares becomes entitled to the dividend, and then sells the stock immediately after the ex-dividend date, *i.e.*, after the holder becomes entitled to the dividend and thus the dividend is no longer reflected in the value of the stock.[200] In the transaction, the domestic corporation receives a taxable dividend, but is afforded a 243 DRD to exempt a portion of that dividend from tax, while the corporation recognizes a loss upon its subsequent sale of the stock approximately equal to the amount of the dividend.[201] As a result, the corporation generally recognizes a net tax loss on the transaction, taking into account both the dividend and the sale, equal to the amount of the 243 DRD.[202] Moreover, the domestic corporation recognizes this tax loss despite incurring no actual economic loss and assuming minimal equity risk with respect to its temporary ownership in the stock. Thus, Code Sec. 246 was intended to ensure that a corporation could not engage in a dividend strip without incurring significant equity risk, thus making the transaction less attractive as a "tax arbitrage."[203]

Notwithstanding the history of Code Sec. 246(c), there are reasons to believe that Congress did not adopt the longer 245A holding period requirement in order to address dividend-stripping concerns. First, Code Secs. 961(d) and 1059 comprehensively address any dividend-stripping concerns with respect to a 245A DRD.[204] Under Code Sec. 1059, if a 245A shareholder receives an extraordinary dividend[205] 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"),[206] 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.[207] Under Code Sec. 961(d), 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 in 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 already reduced under Code Sec. 1059.[208] Code Sec. 961(d) only applies to reduce losses,[209] whereas Code Sec. 1059, if applicable, can also increase gains. On the other hand, in contrast to Code Sec. 1059, a taxpayer cannot avoid the application of Code Sec. 961(d) by holding the affected stock for any period of time.

Second, the 245A holding period requirement is the same for preferred stock as common stock. For 243, 245(a), and 245(b) DRDs, Code Sec. 246(c) sets forth a longer holding period requirement for preferred stock than it does for the common stock.[210] This appears to reflect the concern that dividend-stripping is more likely to occur with respect to preferred stock than common stock, since the value of preferred stock is less volatile than common stock (thus, less equity risk) and the amount and timing of dividends with respect to preferred stock is more predictable. Thus, the fact that Code Sec. 246(c)(5) does not differentiate between common and preferred stock is indicative that the 245A holding period requirement was not intended to police dividend-stripping.

Finally, the 245A holding period requirement is similar to the one-year ownership requirement adopted for reduced withholding on "direct dividends" in the 2016 U.S. Model Treaty (the "Model Treaty"). Under the Model Treaty, a dividend is eligible for a reduced five percent withholding tax rate if the payee has owned at least ten percent of the vote and value of the paying corporation for the one-year period before the ex-dividend date (the "treaty ownership requirement").[211] Treasury adopted this one-year treaty ownership requirement based on a recommendation from the OECD/G20 Base Erosion and Profits Shifting ("BEPS") initiative to prevent companies from inappropriately obtaining reduced withholding on a dividend by acquiring the requisite percentage of shares of the paying corporation immediately before the dividend.[212]

The presumption underlying the treaty ownership requirement is that a shareholder should only be permitted a reduced withholding tax rate with respect to a dividend if the shareholder, indirectly, "participated" in the corporate income that gave rise to the E&P out of which the dividend is paid. This participation rationale was perhaps best articulated in a Senate report accompanying the United States-United Kingdom tax treaty,[213] which provides for a zero rate of withholding tax on dividends from companies with respect to which the shareholder owns an 80-percent interest for the 12-month period before the dividend is declared:

> Direct dividends arguably present a particularly appropriate case in which to remove the barrier of a withholding tax, in view of the close economic relationship between the payor and the payee … If the dividend paying corporation is at least 80-percent owned by the dividend-receiving corporation, it is arguably appropriate to regard the dividend-receiving corporation as a direct investor (and taxpayer) in the source country in this respect, rather than regarding the dividend-receiving corporation as having a more remote investor-type interest warranting the imposition of a second-level source-country tax.[214]

While the treaty ownership requirement in the Model Treaty requires only a ten-percent interest in the paying corporation to qualify as a direct dividend, rather than an 80-percent interest, it should be viewed as similarly differentiating between a "close economic relationship between the payor and the payee" as opposed to "a more remote investor-type interest."[215]

The legislative history makes clear that, in adopting Code Sec. 245A, Congress intended to adopt a "participation exemption."[216] Similar to the rules for direct dividends under the Model Treaty, the benefits of a 245A DRD are afforded to a shareholder only if such shareholder owns at least ten percent of the foreign corporation for a one-year period. The requirements for qualifying for a 245A DRD under the Code and reduced withholding under the Model Treaty are not identical.[217] But, the similarities between the requirements, as well as the close timing in their adoption in the Model Treaty and the TCJA, make it reasonable to infer that the ownership requirements for purposes of obtaining a 245A DRD, including the 245A holding period requirement, and the treaty ownership requirement were intended to serve a similar purpose. Under this interpretation, the 245A holding period requirement ensures that a recipient shareholder has adequately participated, or *will* adequately participate, in the dividend-paying foreign corporation's underlying income to justify a zero percent effective tax rate with respect to dividends received.

(iii) Hybrid dividends. No 245A DRD is allowed with respect to a hybrid dividend under Code Sec. 245A(e). A "hybrid dividend" is 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 in the CFC, determined at the close of the CFC's taxable year.[218] An HDA reflects the amount of hybrid deductions[219] of the CFC allocated to a share that must be maintained by a specified owner with respect to such share.[220] 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.[221]

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.[222] 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.[223] However, "if a transaction or arrangement is undertaken with a principal purpose of avoiding the purposes of" Code Sec. 245A and the regulation thereunder, the regulation authorizes "appropriate adjustments" to be made, "including adjustments that would disregard the transaction or arrangement."[224]

(iv) Extraordinary disposition amounts.[225] 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 amount ("ED amount") of such dividend.[226] The ED amount is the amount of the dividend paid out of the E&P of an SFC that is equal to the sum of the net gain recognized by an SFC with respect to specified property in each extraordinary disposition ("ED E&P").[227] An "extraordinary disposition" is a disposition of property during the disqualified period of an SFC that is a CFC at the time of the disposition.[228] 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.[229]

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 extraordinary disposition 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.[230] 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.*, dividends are deemed paid out of EDA last).[231]

If a U.S. shareholder transfers directly or indirectly 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 acquirer's EDA with respect to the transferred shares is increased by a proportionate amount of the transferor's EDA allocated to the transferred shares,[232] and the transferor's EDA is decreased by same amount.[233] In general, if an acquirer is not a 245A shareholder with respect to the SFC immediately after the acquisition, and the transferor transfers directly or indirectly all of the stock in the SFC and no related party of the transferor is a 245A shareholder after the acquisition and any related transaction, the transferor's EDA is eliminated.[234] However, "if a principal purpose of a transaction or series of transactions is to shift to another person, or to avoid, an amount of a section 245A shareholder's extraordinary disposition account with respect to an SFC or otherwise avoid the purposes of this section," the regulation authorizes appropriate adjustments to be made, "including disregarding the transaction or series of transactions."[235]

e) CFC and U.S. shareholder determination. The TCJA made three amendments that would significantly increase the number of U.S. persons that are U.S. shareholders of foreign corporations that are CFCs:

- Repeal of Code Sec. 958(b)(4): Pre-TCJA, Code Sec. 958(b)(4) prevented the constructive ownership rules in Code Sec. 318(a)(3) from attributing stock in a foreign corporation (*e.g.*, a foreign subsidiary) from a foreign person (*e.g.*, a foreign parent) to a U.S. person (*e.g.,* a U.S. subsidiary) for purposes of treating such foreign corporation (the foreign subsidiary) as a CFC. Congress repealed Code Sec. 958(b)(4)[236] to prevent a foreign-controlled U.S. shareholder from engaging in certain out-from-under transactions that were intended to "de-control" a foreign corporation such that it would no longer be a CFC after such a transaction.[237] The legislative history indicates that the repeal was not intended to apply to treat a foreign corporation as a CFC with respect to a U.S. shareholder by reason of attribution under Code Sec. 318(a)(3) to a U.S. person unrelated to such shareholder.[238] However, notwithstanding a colloquy to the contrary,[239] this limitation was not reflected in the text of the statute, and thus the repeal of Code Sec. 958(b)(4) effectively converted any foreign corporation brother-sister to a domestic entity into a CFC with respect to *all* its U.S. shareholders.
- Elimination of the 30-day rule: Pre-TCJA, a U.S. shareholder included its *pro rata share* of subpart F income of a foreign corporation that is a CFC in a taxable year only if the foreign corporation was a CFC "for an uninterrupted period of 30 days or more" in the taxable year (the "30-day rule").[240] The TCJA eliminated the 30-day rule, replacing "for an uninterrupted period of 30 days or more" with "at any time."[241]
- Change to the definition of U.S. shareholder: Pre-TCJA, a U.S. shareholder was defined as a U.S. person that owns ten percent of the voting power of a foreign corporation.[242] The TCJA expanded the definition of U.S. shareholder to mean a U.S. person that owns ten percent or more of the vote *or value* of a foreign corporation.[243]

By expanding the definitions of a CFC and a U.S. shareholder in this manner, the TCJA increased the number of foreign corporations and U.S. persons subject to the anti-deferral rules of GILTI, subpart F, Code Sec. 1248, and the 367(b) regulations.

IV. Returning to the Fundamentals

A. Principles Articulated

In the preamble to the proposed regulations, Treasury and the IRS identified four principles taken into account in the development of those regulations: (1) the prevention of the

repatriation of E&P or basis without tax (the "repatriation principle"); (2) the prevention of a material distortion in income (the "distortion principle"); (3) the minimization of complexity (the "complexity principle"); and (4) the permissibility of deferral (the "deferral principle"). The preamble to the final regulations further elaborated on these principles. Each of these principles is described in more detail below.

1. Repatriation Principle

On the repatriation principle, Treasury and the IRS 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.[244]

The repatriation principle implicates both corporate-level and shareholder-level concerns. On the dual function of B3, Treasury and the IRS explained:

> 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.[245]

To prevent the tax-free repatriation of E&P through basis importation under subchapter C's carryover provisions, "[t]he proper measure of the earnings and profits that should be subject to tax is the all earnings and profits amount."[246] This all E&P 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."[247]

2. Distortion Principle

On the distortion principle, Treasury and the IRS 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.[248]

3. Complexity Principle

On the complexity principle, Treasury and the IRS explained:

> The regulations under section 367(b) also generally attempt to minimize complexity to the extent not inconsistent with principles (1) and (2) described above, 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) described above. 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.[249]

4. Deferral Principle

On the deferral principle, Treasury and the IRS explained that "to the extent not inconsistent with principles (1), (2), and (3) described above, the regulations under section 367(b) generally do not operate to accelerate the

Wolters Kluwer

recognition of income that is realized but which would not otherwise be recognized by reason of a nonrecognition provision of the Internal Revenue Code."[250]

B. Principles Reframed

In the preamble to the proposed regulations, Treasury and the IRS highlighted four principles underlying the 367(b) regulations but did not suggest that these principles were weighed or balanced. On the contrary, the complexity and deferral principles are explicitly relegated to secondary principles, as they are followed only "to the extent not inconsistent with the" repatriation and distortion principles.[251] Thus, while articulated as four principles, the repatriation and distortion principles are clearly the primary principles of the 367(b) regulations. Having reduced the primary 367(b) principles from four to two, we can now endeavor to reduce these principles even further, from two to one.

In the preambles to the proposed and final regulations, Treasury and the IRS framed the repatriation principle and the distortion principle as mutually exclusive, with the former guiding B3 and the latter informing B4. The distortion principle, at a high level, is easily understood; "a material distortion in income" is manifestly a bad tax policy outcome. The repatriation principle, in contrast, takes some unpacking. According to the preamble to the proposed regulations, it's the principle that a domestic acquiring corporation "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."[252] But nowhere in the preambles to the proposed or final regulations do Treasury and the IRS articulate a single unifying theory to explain *why* a domestic acquiring corporation should not succeed to such attributes tax-free.

The government's failure to articulate a single unifying theory for the repatriation principle emanates principally from the non-existence of a single unifying theory for the repatriation principle. In fact, there are several different tax policy concerns underpinning the repatriation principle, and the policy concern implicated in any particular transaction depends on the type of transaction and the identity of the exchanging shareholders. And all these policy concerns lead right back to the distortion principle.

In describing the distortion principle, Treasury and the IRS explained that a "material distortion in income includes a distortion relating to the source, character, amount or timing" of an item.[253] B4 is generally intended only to address one type of distortion; in the case of a transaction resulting in a loss of 1248 shareholder status, a tax-free exchange would, absent the application of B4, result in a distortion of *character—i.e.*, any income from a subsequent disposition of the stock would be capital gain rather than dividend income, as determined under Code Sec. 1248.[254] However, a "character distortion" is only one type of distortion within the meaning of the 367(b) regulations. B3, in fact, addresses not only a distortion in *character*, but also a distortion relating to *amount* (an "amount distortion") and *timing* (a "timing distortion"). So, while Treasury and the IRS articulate the repatriation principle as a principle separate and distinct from the distortion principle, the repatriation principle is better viewed as merely a specific application of the distortion principle in the context of an inbound asset transaction.

B3 addresses all the "interrelated shareholder-level and corporate-level components" (*i.e.*, distortions) of an inbound asset transaction through the single mechanism of an all E&P inclusion. In contrast, the relevant provisions of the guidelines and the temporary regulations tailored different toll charges for each transaction depending on the identity of the shareholders to address each of these distortions separately. The three distortions encompassed within the repatriation principle are discussed in more detail below.

1. Amount Distortion

In the preamble to the final regulations, Treasury and the IRS asserted that the all E&P inclusion "prevents the conversion of a deferral of tax into a forgiveness of tax."[255] This concern is most clearly implicated in the case of an inbound liquidation. Pre-TCJA, if a domestic parent corporation could acquire the assets of its foreign subsidiary through an inbound liquidation, the domestic parent corporation would inherit the deferred E&P of the foreign acquired corporation tax-free,[256] rather than receive the E&P through a taxable dividend.[257] Further, because the domestic parent corporation would take a carryover basis in the assets acquired from the foreign subsidiary,[258] rather than an exchanged basis determined by reference to its the domestic parent corporation's basis in the stock of the foreign subsidiary,[259] the domestic parent corporation would inherit the foreign subsidiary's basis in its assets created from the deferred E&P, and the stock gain realized but not recognized by the domestic parent corporation upon the liquidation of the foreign subsidiary would not be reflected in any asset in the hands of the domestic acquiring corporation. Thus, this stock gain would be permanently eliminated. Accordingly, absent the application of B3, pre-TCJA, an inbound liquidation would result in a *permanent* distortion in the *amount* of income recognized by the domestic parent corporation,

generally equal to the amount of untaxed E&P that such domestic parent corporation inherited from the foreign acquired corporation.[260] Thus, in all iterations of the 367(b) guidance—the guidelines, temporary regulations, and proposed and final regulations—this potential for a permanent distortion in amount was addressed through the mechanism of an all E&P inclusion.[261]

But an amount distortion can also be facilitated by an inbound asset reorganization, such as a reorganization under Code Sec. 368(a)(1)(F) (an "F reorganization"), if the foreign acquired corporation has one or more domestic corporate shareholders that exchange their stock in the foreign acquired corporation tax-free for stock in the domestic acquiring corporation.[262] In this case, each domestic corporate shareholder takes an exchanged basis in the stock in the domestic acquiring corporation,[263] and thus the realized but unrecognized gain in the stock in the foreign acquired corporation continues to be reflected in the stock in the domestic acquiring corporation in the hands of the domestic corporate shareholder immediately after the transaction. However, if the domestic acquiring corporation and its domestic corporate shareholder are members of the same affiliated group within the meaning of Code Sec. 1504(a), it is unlikely that such gain will ever be recognized.[264] Furthermore, subsequent dividends paid out of the untaxed E&P of the foreign acquired corporation inherited by the domestic acquiring corporation may either be eliminated in consolidation[265] or be entitled to a 243 DRD.[266] In the former case, there is a complete elimination of taxable income, while in the latter there is only a partial elimination. However, each case involves a permanent distortion in the amount of income, in whole or in part.[267] For this reason, both the guidelines and the temporary regulations required certain domestic corporate shareholders to include their all E&P amount in inbound asset reorganizations.[268]

An amount distortion, however, is not implicated in an inbound asset reorganization to the extent the foreign acquired corporation is owned by individual shareholders. In that case, the realized but unrecognized gain in the shareholders' stock in the foreign acquired corporation is preserved in their stock in the domestic acquiring corporation, and such shareholders also continue to be subject to tax on the full amount of any dividend paid by the domestic acquiring corporation post-transaction. For this reason, neither the guidelines nor the temporary regulations required individual shareholders, even individuals that were 1248 shareholders or U.S. shareholders, to include their all E&P amount in gross income.[269] In contrast, the final regulations require all U.S. shareholders, even individual U.S. shareholders, to include their all E&P amount.[270]

2. Character Distortion

An inbound asset transaction, like a foreign-to-foreign transaction, can also result in a character distortion. In any inbound asset transaction in which a 1248 shareholder is an exchanging shareholder, the transaction results in the loss of 1248 shareholder status, since Code Sec. 1248 cannot apply to any subsequent disposition by such shareholder of the stock in the domestic acquiring corporation (in the case of an inbound asset reorganization) or the assets of the foreign acquired corporation (in the case of an inbound liquidation). Indeed, every inbound stock transfer of a foreign acquired corporation involving an exchanging shareholder that is a 1248 shareholder also results in the shareholder losing its 1248 shareholder status with respect to the transferred stock. However, in that case, the domestic acquiring corporation generally steps into the shoes of the 1248 shareholder with respect to the E&P attributable to the transferred stock.[271] As a result, in an inbound stock transfer, there is a potential distortion to the character of the income of the *exchanging shareholder*, but no potential character distortion *with respect to the transferred stock*, since the domestic acquiring corporation would be required to include in its gross income the E&P of the foreign acquired corporation as a dividend upon a subsequent disposition of the transferred stock.[272]

Both the guidelines and the temporary regulations addressed this character distortion in the context of an inbound asset reorganization by requiring an individual 1248 shareholder to recognize its 1248 amount.[273] The temporary regulations further addressed the shareholder-specific character distortion that occurs in an inbound stock transfer, but only in the context of an inbound stock reorganization (and not an inbound 351 exchange).[274] In contrast, the final regulations address the character distortion solely in the context of inbound asset transactions and through the imposition of an all E&P inclusion on all U.S. shareholders, whether corporate or individual.

3. Timing Distortion

As discussed above, an inbound asset transaction can result in an amount distortion with respect to domestic corporate shareholders, including domestic corporate shareholders that are small shareholders ("small corporate shareholders").[275] Further, an inbound asset transaction can result in a character distortion with respect to 1248 shareholders, including individual 1248 shareholders.[276] But an inbound asset transaction can result in neither an amount distortion nor a character distortion with respect to small shareholders that are individuals ("small individual shareholders").[277] Nonetheless, the final regulations require gain recognition or an all E&P inclusion (if an all

E&P election is made) for all small shareholders, including small individual shareholders, unless the *de minimis* exception applies.

If an inbound asset transaction can result in neither an amount distortion nor a character distortion with respect to a small individual shareholder, what is the purpose of applying B3 to these shareholders at all? Consider the following example:

> In Year 1, Group, a collection of U.S. individuals, none of which are U.S. shareholders or 1248 shareholders, form FS, a foreign corporation that is not a CFC, contributing minimum capital to FS on formation. In Year 2, FS earns $100 and uses the money to buy a machine. In Year 3, FS transfers all of its assets, including the machine, to USS, a domestic corporation, in an inbound asset reorganization, pursuant to which Group members receive stock in USS.

This example does not result in any *amount* distortion, because any gain in the FS stock owned by members of the Group is preserved in the members' USS stock received in exchange therefor,[278] and the E&P of FS inherited by USS continue to be available for distribution as fully taxable dividends to Group members after the transaction.[279] Since FS is wholly owned by individual shareholders, no layer of corporate-level tax exists to be preserved, and thus inbounding the E&P cannot result in a "forgiveness of tax" by reason of nonrecognition or a 243 DRD. There is also no potential character distortion; none of the U.S. individuals are 1248 shareholders of FS, and thus the transaction cannot result in the loss of 1248 shareholder status.

It is possible that, if FS were resident in a jurisdiction that did not have a comprehensive tax treaty with the United States, the inbound asset reorganization could result in the conversion of future dividends from non-QDI to QDI. However, this is neither an amount distortion—the amount of income subject to tax will not change—nor a character distortion—a dividend is ordinary income, regardless of whether it qualifies as QDI—but rather merely a change in the tax rate to which the dividend income is subject. Moreover, such a reduction in the tax rate could also be achieved if the United States and FS's jurisdiction were to enter into a comprehensive tax treaty, or if FS migrated into a jurisdiction that already had such a treaty with the United States, assuming FS becomes eligible for benefits thereunder. In neither case would the 367(b) regulations apply, nor does it seem prudent for the 367(b) regulations to police the conversion of non-QDI to QDI, generally.

While there is no potential distortion in amount or character, there is a potential distortion in timing. Specifically, absent the application of B3, the Group members' gain in the stock in the foreign acquired corporation is deferred, while the basis in the assets of the foreign acquired corporation that reflects the E&P which, in whole in part, gave rise to the deferred stock gain is "repatriated" tax-free to the United States. Upon completion of the inbound asset transaction, this imported basis is immediately available to create deductible expenses (for example, depreciation expense) that could reduce USS's taxable income. This can be viewed as a timing distortion, since USS (and indirectly the Group members) may be able to obtain a U.S. tax benefit for the basis in the machine before the Group members "pay" for that basis, *i.e.*, incur a U.S. tax liability with respect to the E&P that created such basis by reason of a dividend or sale of the stock.[280] This is akin to an employee using funds in a traditional 401(k) to produce deductible expenses before such funds are ever subject to tax.[281]

But there is only a timing concern to the extent that one treats the underlying E&P and basis of the foreign corporation as attributable to small individual shareholders in the first place. Subject to the loss importation rules of Code Secs. 334(b)(2) and 362(e)(1),[282] it is not inherently problematic that E&P and basis of a foreign corporation that has never been subject to U.S. tax is brought into the U.S. tax net. Thus, a foreign subsidiary owned, directly and indirectly, solely by foreign persons can generally migrate into the United States without any immediate U.S. tax consequence and, assuming no aggregate built-in loss in the assets, the domestic acquiring corporation would be given full credit for the foreign acquired corporation's asset basis, determined under U.S. tax principles, in computing its U.S. taxable income.[283] Rather, an inbound asset transaction is only problematic if untaxed E&P and basis is being "repatriated" to the United States.

The term repatriation is itself defined as "the act or process of restoring or returning someone or something to the country of origin, allegiance, or citizenship."[284] As applied in the context of B3, "repatriation" implies that the E&P and asset bases of a foreign acquired corporation effectively are, and have always been, attributes of the corporation's U.S. owners, but for the fact that these owners had used the artifice of a foreign corporation to defer recognition. This construct is generally consistent with Congress's skeptical view of the relationship between "an American-controlled" foreign corporation and its U.S. owners, but only as it pertains to the U.S. owners that are "U.S. shareholders." Congress expressly limited subpart F to U.S. shareholders to "prevent[] 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."[285] So, it is entirely reasonable to view the E&P and basis of a foreign corporation "attributable" to its U.S. shareholders and thus as being repatriated to the United States in an inbound asset transaction. From that perspective, it could be judged inappropriate for the U.S. shareholder to defer gain recognition with respect to stock exchanged in an inbound asset transaction, while also permitting the domestic acquiring corporation to use the untaxed E&P and basis inherited from the foreign acquired corporation to create immediate deductions against U.S. income, which in turn would provide an indirect benefit to the U.S. shareholder in its capacity as a shareholder of the domestic acquiring corporation.

The justification for extending this treatment to small individual shareholders is much less obvious. While subpart F and Code Sec. 367(b) are not intended to address identical policy concerns, the drafters of the guidelines and the temporary regulations, consistent with the U.S. shareholder limitation in subpart F, limited inclusions under Code Sec. 367(b) to 1248 shareholders. As discussed above in connection with the 245A holding period requirement,[286] at some level of ownership, there is a sufficiently "close economic relationship" between a shareholder and a corporation to justify treating the assets and income of such corporation as that of the shareholder. Like Congress with respect to subpart F, the drafters of the guidelines and temporary regulations appear to have concluded that the proper level of ownership is ten percent—at or above that threshold, a U.S. owner ought to be attributed the assets and income of its corporation, whereas below that threshold, the U.S. owner should be respected as a person separate and apart from the corporation. Indeed, Congress, in enacting TCJA, again landed on a ten-percent threshold in adopting the "participation exemption" of Code Sec. 245A, as did Treasury in 2016 in adopting the rules for direct dividends in the Model Treaty.[287]

In contrast, the final regulations attribute a foreign corporation's E&P to even small shareholders, and thus require those small shareholders to recognize income upon the "repatriation" of such E&P.[288] In the preamble to the proposed and final regulations, Treasury and the IRS never explain their departure from the historic approach to small shareholders (*i.e.*, from nonrecognition to recognition), other than indirectly through a general articulation of the repatriation principle.

V. 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.

A. Withdraw or Suspend B3 and B4

The first approach for consideration is to withdraw B3 and B4, and indeed much of the 367(b) regulations.[289] In all candor, we doubt that Treasury and the IRS will seriously consider withdrawing the 367(b) regulations—there is nothing quite as path dependent as an anti-avoidance rule dating back to the Ford administration. In lieu of withdrawal, a more palatable approach might be to suspend the operation of B3 and B4 (and potentially other rules in the 367(b) regulations) for as long as conditions persist that reduce the rules' importance (*e.g.*, rate parity between capital gains and ordinary income and the existence of Code Sec. 245A). A suspension of B3 and B4 would be similar to the suspension of Code Sec. 1248(e) upon the convergence of capital gains and ordinary income rates for corporations under the TRA.[290]

The arguments for elimination or suspension are different for B3 and B4 because the distortions that these rules are intended to address are different. 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, domestic corporations can generally repatriate much more of their CFCs' untaxed E&P without residual U.S. tax through ordinary distributions. For most multinational groups, the vast majority of their CFC E&P is likely to be PTEP (from GILTI, subpart F income, or Code Sec. 965) or untaxed E&P eligible for a 245A DRD.[291]

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 be paid upon repatriation ("deferral E&P") are not rare for some taxpayers. Because individuals cannot obtain a 245A DRD, all untaxed E&P attributable to an individual U.S. shareholder are deferral E&P. Treasury and the IRS might reasonably conclude that it's appropriate to continue to apply B3 to an individual U.S. shareholder in an inbound asset transaction to police the potential character and timing distortions resulting therefrom.[292]

Further, even corporate U.S. shareholders can have deferral E&P. For instance, a corporate U.S. shareholder may have an EDA or HDA with respect to a CFC, or may not have satisfied the 245A holding period requirement with respect to the CFC at the time of the inbound asset transaction, or the CFC could have E&P attributable to dividends from 80-percent owned domestic corporations—in all these cases, distributions from the

Wolters Kluwer

CFC would not be afforded a 100 percent DRD under Code Sec. 245A.[293] Thus, while the magnitude of the concern motivating B3 in the context of corporate U.S. shareholders has been greatly diminished by the enactment of the TCJA, there still remains some potential for converting a "deferral of tax" into a "forgiveness of tax" through an inbound asset transaction.

The arguments in favor of withdrawing or suspending B4 are perhaps more persuasive. B4 is intended to prevent a distortion in character.[294] But, in preventing a character distortion, B4 itself creates a timing distortion by overriding the nonrecognition rules of subchapter C to compel an immediate income inclusion. While this trade-off may have been necessary pre-TCJA under a "last bite of the apple" theory, for the reasons discussed below, Treasury and the IRS might reasonably conclude that that apple is no longer worth biting.[295]

The distortion principle is not meant to address all distortions, but only those distortions that "materially affect the United States tax liability of any person for any year." For most of the 20th century, accelerating income to police a character distortion could be justified on the grounds that such distortion might otherwise result in a material distortion of income, because of the 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. Since 1988, corporate rates on capital gains and ordinary income have been identical. While individuals still generally enjoy a significant capital gain preference – with a top marginal individual tax rate set of 37 percent,[296] as compared to the highest tax rate on long-term capital gains, including the net investment income tax, of 23.8 percent[297] – since the enactment of the QDI rules in Code Sec. 1(h)(11) in 2003, individual 1248 shareholders are often indifferent as to whether they recognize capital gain or dividend income on the sale of CFC stock.[298] In other words, there is often nothing to gain from an exchanging shareholder converting dividend income from a foreign corporation into capital gain with respect to stock in a domestic corporation. This was precisely the reason that Treasury and the IRS suspended the operation of Code Sec. 1248(e).[299]

However, there are also several counterarguments to eliminating B4. First, 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 in the last 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 remain significant amounts of non-QDI dividend income, the conversion of which into capital gain could produce a tax benefit.

Second, absent B4, a 245A shareholder could eliminate an HDA or EDA, and thereby effectively convert dividends that would be denied a 245A DRD into 245A-eligible dividends. If a 245A shareholder transfers all of the stock in a CFC in a nonrecognition transaction to a foreign corporation that is not a CFC, but is an SFC, the shareholder's HDA with respect to the foreign acquired corporation would be eliminated because (1) the shareholder transferred all of its stock in the foreign acquired corporation and (2) the foreign acquiring corporation is not a CFC immediately after the transaction and thus not a specified owner.[300] Similarly, assuming that no related party of the transferring 245A shareholder is a 245A shareholder of the foreign acquiring corporation after the transaction, the 245A shareholder's EDA with respect to the foreign acquired corporation would be eliminated because (1) the shareholder transferred all of its stock in the foreign acquired corporation and (2) the foreign acquiring corporation is not a domestic corporation and thus not a 245A shareholder.[301] As a result, any dividends paid by the foreign acquiring corporation to the 245A shareholder, including dividends ultimately paid out of the E&P of the foreign acquired corporation, would be eligible for a 245A DRD. In this example, the foreign-to-foreign transaction is indeed the "last bite at the apple," and thus an inclusion of a 1248 amount under B4 may be appropriate.

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 above,[302] foreign currency gain or loss with respect to PTEP is recognized under Code Sec. 986(c) upon distribution (or deemed distribution) of the PTEP.[303] Code Sec. 986(c) gain or loss is treated as ordinary income or loss from the same source as the associated income inclusion.[304] If an exchanging shareholder that is a U.S. person includes in income its all E&P amount or 1248 amount under B3 or B4, respectively, 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.[305] This foreign currency gain or loss

will increase or decrease the shareholder's adjusted basis in the stock in the foreign corporation,[306] 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 that currently exists offshore, by reason of Code Sec. 965, subpart F, and GILTI, 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.

B. Exclude Small Shareholders from B3

The second approach for consideration would be to exclude small shareholders from B3.[307] Small shareholders were not required to pay a toll charge under either the guidelines or the temporary regulations.[308] The proposed regulations, without explanation, expanded B3 to apply to small shareholders.[309] It may be time to reconsider that decision.

First, arguably, extending B3 to small shareholders was not the right decision even in 1991. An inbound asset reorganization involving small individual shareholders results in a "repatriation" only if the E&P and basis of the foreign acquired corporation can be attributed to small shareholders.[310] 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.[311] 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."[312]

The policy rationale for not attributing subpart F income to small shareholders applies with equal force 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 specific and aggregate U.S. ownership, the Code will no longer give effect to the separate legal existence of a foreign subsidiary and will instead impute the income of the subsidiary directly to its shareholders. 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. For this reason, it is appropriate to call the forbearance of current taxation of a U.S. shareholder on its foreign subsidiary's income "deferral." But it is not the deferral system that relieves a small shareholder of current tax—it's the realization principle.[313] 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. In either case, there has just been no current accretion to wealth.

Admittedly, an inbound asset reorganization involving a small corporate shareholder can result in an amount distortion.[314] Before the inbound asset reorganization, the small corporate shareholder would not be eligible for a 245A DRD for dividends paid by the foreign acquired corporation. After the inbound asset reorganization, the small corporate shareholder would be eligible for a 243 DRD for dividends paid by the domestic acquiring corporation.[315] But, even in that case, an amount distortion only occurs if, and to the extent, the domestic acquiring corporation pays dividends to the exchanging shareholder out of E&P acquired from the foreign acquired corporation. If the small corporate shareholder were to dispose of its stock in the domestic acquiring corporation in a taxable transaction before any such dividend is paid, the exchanging shareholder would recognize all of its gain in the stock in the foreign acquired corporation, preserved in the inbound asset reorganization in the stock in the domestic acquiring corporation, without any benefit of a DRD.

Even if one concludes that it is generally good tax policy to address a distortion in amount in the case of small corporate shareholders, or a distortion in timing in the case of all small shareholders, the imposition of an all E&P inclusion on small shareholders itself creates a timing distortion, by overriding the nonrecognition rules of subchapter C. Moreover, requiring a small shareholder to recognize gain, except in the unlikely event that the shareholder can obtain the requisite information to make an all E&P election, will often accelerate more income than the amount of E&P and basis being repatriated in the inbound asset reorganization. The reason for this is that the unrealized gain in the stock of the foreign acquired corporation immediately before the inbound asset transaction reflects not only the untaxed E&P of the foreign acquired corporation, but also the unrealized appreciation in the assets of the foreign acquired corporation, as well as the untaxed E&P and unrealized asset appreciation in any *subsidiary* of the foreign acquired corporation, the E&P and assets of which are not repatriated in the inbound asset transaction.[316] For this reason, if the all E&P amount is

"the proper measure of the earnings and profits that should be subject to tax,"[317] stock gain is a wholly inappropriate proxy for that purpose.[318]

Even if it was the correct decision to extend B3 to small shareholders in 1991, circumstances have changed to 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.[319] The importance of the loss importation rules should not be overstated; Code Sec. 362(e)(1) does not prevent the importation of *all* basis created by untaxed E&P, just the basis that is in excess of fair market value. But, at least, the provision ensures that all property "imported" into the United States through an inbound asset transaction either has an aggregate built-in gain or at least not an aggregate built-in loss. As a result, over time, an inbound asset transaction, even without the application of B3, should generally expand, not erode, the U.S. tax base.

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, corporate U.S. shareholders enjoyed the benefit of a deemed paid foreign tax credit under Code Sec. 902 by reason of the application of B3; small shareholders could not avail themselves of a foreign tax credit. However, 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,[320] are generally benefited by this inclusion under current law. Assuming such shareholders satisfy the 245A holding period requirement and the 1059 holding period requirement, and the 245A DRD is not otherwise limited,[321] an exchanging shareholder that is required to include its all E&P amount into gross income by reason of an inbound asset reorganization would not be taxed on the deemed dividend, while receiving the benefit of an increase in its basis in the stock in the domestic acquiring corporation by the amount of the deemed dividend.[322] Indeed, from the guidelines to current law, the tables have turned for small shareholders and corporate U.S. shareholders.

B3's punitive treatment of small shareholders (along with individual U.S. shareholders) relative to corporate U.S. shareholders creates unnecessary friction in third-party acquisitions by favoring certain acquisition structures in a manner that serves no discernible U.S. tax policy objective. In the TRA House Report, Congress cautioned Treasury and the IRS, in drafting regulations, that "unnecessary barriers to justifiable and legitimate business transactions should be avoided."[323] In that regard, 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, and small shareholders and individual U.S. shareholders cannot, the current rules incentivize a particular type of acquisitive inbound structure. Specifically, a domestic corporation that would otherwise acquire the assets of a foreign corporation in an inbound asset reorganization (a "one-step inbound transaction") can obtain better treatment under the 367(b) regulations for the shareholders of the foreign acquired corporation if the acquisition is instead structured as an inbound stock transfer followed by an inbound asset transaction of the foreign acquired corporation (a "two-step inbound transaction"). While an inbound asset transaction of the foreign acquired corporation within one year of the inbound stock transfer would likely fail the 245A holding period requirement, a domestic acquiring corporation could still obtain a 245A DRD with respect to non-liquidating distributions immediately after the inbound stock transfer, because the 245A holding period requirement would also take into account the domestic acquiring corporation's ownership of the stock of the foreign acquired corporation *after* the dividend. As one commentator noted, the preferential treatment under B3 of two-step inbound transactions over one-step inbound transactions can create unnecessary friction in a deal when, for local law reasons, it is preferable to effect the acquisition through the means of a one-step inbound transaction.[324] While excluding small shareholders would not solve this problem entirely (the tax treatment of individual U.S. shareholders would still depend on the choice of acquisition structure), it would at least ameliorate it.[325]

C. Exclude Non-245A Shareholders from B3 by Election

An all E&P inclusion under B3 can be a boon to corporate U.S. shareholders, *i.e.*, 245A shareholders; such shareholders may not only be afforded a 245A DRD with respect to their all E&P inclusion, such inclusion, in an inbound asset reorganization, increases the corporate U.S. shareholders' basis in the stock in the domestic acquiring corporation. Pre-TCJA, B3 was necessary to prevent corporate U.S. shareholders from inappropriately converting ordinary income into capital gain; post-TCJA, B3 ensures that corporate U.S. shareholders do not inadvertently convert their 245A-eligible income (dividends from SFCs) into 245A-*in*eligible income (gains on domestic acquiring corporation stock).

But for individual U.S. shareholders and small shareholders, income recognition under B3 can be catastrophic, particularly in a cashless transaction in which the shareholders are not provided the funds to satisfy the resulting U.S. tax liability. For small individual shareholders in an inbound asset reorganization, there is no potential for a distortion in either amount or character.[326] Similarly, for individual U.S. shareholders, the transaction cannot result in a distortion in amount and, since the enactment of the QDI rules, the potential for a character distortion to materially affect the shareholder's U.S. tax liability is greatly reduced. The distortion mostly likely implicated in an inbound asset reorganization with respect to U.S. shareholders or small individual shareholders is one of timing, *i.e.*, the domestic acquiring corporation inherits the basis in the assets of the foreign acquired corporation before the U.S. owners of the foreign acquired corporation have incurred a U.S. tax liability.[327]

Because the timing distortion arises from tax attributes inherited by the domestic acquiring corporation, particularly basis, it can be addressed through a reduction to these attributes. Therefore, an approach would be to permit an election that, if made, would exclude small shareholders and individual U.S. shareholders ("non-245A shareholders") from the application of B3. 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 sum of the all E&P amounts that non-245A shareholders would otherwise be required to include under B3 (the "aggregate all E&P amount" and 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"). No 245A DRD would be permitted with respect to amounts included in the gross income of a domestic acquiring corporation by reason of the proxy inclusion election.[328] In either case, a non-245A shareholder's basis in the domestic acquiring corporation would be increased by its share of the aggregate all E&P amount in order to eliminate the potential for double taxation.

In the preamble to the final regulations, Treasury and the IRS rejected the proposal to allow a domestic acquiring corporation to include an aggregate all E&P amount on behalf of its 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.[329] 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.[330] 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.[331]

In the preamble to the final regulations, in the context of discussing the reasons for not finalizing the proposed taxable exchange election, Treasury and the IRS also cited to the inherent unfairness of permitting U.S. shareholders avoid their all E&P inclusion, by shifting their U.S. tax burden, at least indirectly and in part, to the non-electing shareholders in the form of reduced corporate attributes. This is also a concern in the case of the attribute reduction election and the proxy inclusion election outlined in this proposal. However, Treasury and the IRS could provide that this election can be made solely by the domestic acquiring corporation, so that the corporation can determine whether, on balance, its shareholders benefit from the election. Further, the effect of this rule would be to equalize, to some extent, the treatment under B3 of an exchanging shareholder that is a non-245A shareholder with that of a 245A shareholder, which, assuming the 245A holding period requirement is met,[332] would obtain the benefit of a 245A DRD.

For purposes of this proposal, "non-245A shareholders" would include domestic partnerships to the extent that such partnerships are owned by non-245A shareholders. A domestic partnership can be a U.S. shareholder and a 1248 shareholder for purposes of B3 and B4, respectively, though the consequence of any resulting income inclusion is determined at the partner-level.[333] For example, a domestic partnership that is an exchanging shareholder in an inbound asset reorganization may have an all E&P inclusion with respect to the foreign acquired corporation, but whether a partner is taxed on its distributive share of the partnership's all E&P inclusion depends on whether such partner is a 245A shareholder or a non-245A shareholder.

D. Apply B3 and B4 Solely to Non-245A E&P

Another proposal would be to modify B3 and B4 to apply solely with respect to dividends paid out of E&P that, for a reason other than the 245A holding period requirement or the identity of the recipient shareholder, cannot satisfy the requirements for a 245A DRD (such E&P, "non-245A E&P"). Non-245A E&P would include E&P of a foreign acquired corporation to the extent of an HDA or an

EDA or domestic dividend E&P of the foreign acquired corporation.[334]

Limiting the application of B3 solely to non-245A E&P would eliminate much of the transactional electivity of B3 under current law. As discussed above,[335] if a domestic corporation were to acquire the assets of a foreign corporation in a one-step inbound transaction (*e.g.*, a reorganization of the foreign acquired corporation into the domestic acquiring corporation), the U.S. shareholders of the foreign acquired corporation would include their all E&P amount and its small shareholders would, absent an all E&P election, recognize gain with respect to their stock in the foreign acquired corporation. However, this income recognition by the U.S. owners of the foreign acquired corporation under B3 can generally be avoided by structuring the transaction as a two-step inbound transaction. Specifically, if the domestic acquiring corporation were to acquire the foreign acquired corporation in an inbound stock transfer, the U.S. owners of the foreign acquired corporation would be afforded nonrecognition. Furthermore, except to the extent of non-245A E&P, the assets of the foreign acquired corporation could be repatriated tax-free through an inbound asset transaction or non-liquidating distributions, assuming in each case that the domestic acquiring corporation successfully navigates the 245A holding period requirement.

This proposal would largely conform the treatment of a one-step inbound transaction with that of a two-step inbound transaction; in either case, neither the shareholders of the foreign acquired corporation (in the one-step inbound transaction) nor the domestic acquiring corporation (in the two-step inbound transaction) would recognize gain or be required to include an all E&P amount with respect to the stock in the foreign acquired corporation except to the extent of any non-245A E&P attributable to such stock. These transactions could be conformed even further by requiring the domestic acquiring corporation in a one-step inbound transaction, rather than the shareholders of the foreign acquired corporation, to include the non-245A E&P of the foreign acquired corporation as a deemed dividend.

To the extent of 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 245A shareholders, it would generally produce a worse result relative to current law. Under B3, 245A shareholders that are exchanging shareholders in an inbound asset transaction include their all E&P amount as a deemed dividend, but that deemed dividend is eligible for a 245A DRD. Moreover, such shareholders obtain a commensurate increase in the basis in their stock in the domestic acquiring corporation, which eliminates the gain attributable to this E&P on any subsequent disposition of the stock. In contrast, under this proposal, 245A shareholders would retain their historic basis in the stock in the domestic acquiring corporation.

The current rule that the domestic acquiring corporation does not inherit NOLs, except to the extent attributable to ECI, would be maintained under this proposal, but B3 would be amended to provide that the domestic acquiring corporation inherits all the E&P of the foreign acquired corporation, after reduction for non-245A E&P taken into account in determining a U.S. shareholder's all E&P inclusion. This change would be necessary to ensure that the E&P of the domestic acquiring corporation accurately reflect its dividend-paying capacity.

Applying B4 solely to non-245A E&P is supported by the argument that, under current law, B4 is more distortive in practice than the distortion it's intended to prevent (*i.e.,* the conversion of ordinary income into capital gain).[336] Limiting B4 only to non-245A E&P would ensure that income is only accelerated when there is a real potential for a distortion. This can occur, for instance, if a 245A shareholder exchanges stock in a CFC with respect to which the shareholder has an EDA or HDA for stock in a foreign corporation that is not a CFC, thereby eliminating the EDA or HDA.[337]

If an exchanging shareholder that is a U.S. person has an inclusion under either 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.[338] This foreign currency gain or loss is ordinary income, and results in a basis increase or decrease in the stock in 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) would be maintained.

E. Expand B3 to Inbound Stock Transfers

Finally, we consider an approach that would result in an *expansion* of B3 and B4 if Treasury and the IRS concluded that the "shifting" of E&P from non-245A shareholders to 245A shareholders violated the principles of Code Sec. 367(b). The concern intended to be addressed by this approach is that, by reason of an inbound stock transfer,

E&P of a 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 non-liquidating dividends or, after a year, through an inbound liquidation, can qualify for the 245A DRD.[339] Indeed, an inbound stock transfer followed by a tax-free repatriation of deferred E&P attributable to non-245A shareholders through a distribution or liquidation (*i.e.*, a two-step inbound transaction) can result in a character or timing distortion in the same manner as one-step inbound transaction. In either case, any asset basis of the foreign acquired corporation created from deferral E&P attributable to individual U.S. shareholders can be repatriated tax-free and made available to generate deductions against U.S. taxable income before the shareholders' stock gain is recognized.

An amount distortion can also occur in an inbound stock transfer with respect to an exchanging shareholder that is a 245A shareholder, albeit in a manner that is unfavorable to such shareholder. In the case of a 245A shareholder that exchanges stock in an inbound stock transfer, any pre-transfer gain in the foreign acquired corporation stock attributable to E&P eligible for a 245A DRD would continue to be reflected in the stock in the domestic acquiring corporation received in the inbound stock transfer. However, the 245A shareholder could no longer obtain a 245A DRD on dividends from the domestic acquiring corporation or the sale of the corporation's stock.[340] In contrast, if the inbound stock transfer resulted in an all E&P inclusion, the 245A shareholder would obtain a 245A DRD with respect to the resulting all E&P inclusion and a corresponding increase to its basis in the stock in the domestic acquiring corporation.[341] Thus, expanding B3 to inbound stock transfers would generally be beneficial to 245A shareholders.

Even pre-TCJA, an inbound stock transfer could distort an exchanging shareholder's income. For this reason, the temporary regulations required the inclusion of a 1248 amount in an inbound stock reorganization (*i.e.,* a B reorganization).[342] However, this rule was not retained in 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 Reg. §1.1248-8[343] and thus would eventually be taxed on the E&P attributable to the transferred stock as a dividend, whether as a result of a distribution, sale, or an inbound asset transaction. Therefore, basis and E&P could not be repatriated into the United States without *someone* paying tax.

Expanding B3 to apply to inbound stock transfers 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,[344] 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. Also, similar to the approach that would apply B3 solely to non-245A E&P,[345] this approach has the benefit of largely conforming the treatment of a one-step inbound transaction and a two-step inbound transaction under B3. However, whereas that other approach would conform the treatment of a one-step transaction to that of a two-step transaction, this approach would conform the treatment of a two-step transaction to that of a one-step transaction. In either transaction, under this approach, an exchanging shareholder that is a U.S. shareholder would be required to include its all E&P amount with respect to the foreign acquired corporation.[346]

There are two arguments against this approach (other than a general objection to its meanness to individual U.S. 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." As discussed above,[347] notwithstanding that Code Sec. 246 was originally enacted to address the evils of dividend-stripping, it appears that Congress intended the 245A holding period requirement to serve a different purpose, *i.e.*, as a bright-line rule delineating between participation and non-participation with respect to the underlying E&P. Under that view, upon satisfying the 245A holding period requirement, even if that satisfaction occurs after the E&P is generated, a domestic acquiring corporation should be treated as having adequately participated in the foreign acquired corporation's income to justify obtaining a 245A DRD with respect to such corporation's E&P. In that case, applying B3 to an inbound stock transfer would be inconsistent with the statutory framework of the participation exemption system.

Second, it is questionable whether Treasury and the IRS would have the authority to adopt this approach, absent a statutory amendment. 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."[348] Under that authority, Treasury and the IRS have broad discretion to draft regulations to deny nonrecognition, in whole or in part, with respect to transactions involving foreign corporations where the corporate status of the foreign corporation is a prerequisite for

Wolters Kluwer

nonrecognition. Therefore, the regulations could apply to an inbound stock transfer that is an inbound stock reorganization, because the status of the foreign corporation as a corporation in a B reorganization is necessary to satisfy the requirements for nonrecognition in Code Sec. 368(a)(1)(B).[349] Indeed, 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.[350] But, if an inbound stock transfer also, or exclusively, qualifies as an inbound 351 exchange, then nonrecognition would not depend on whether or not the foreign acquired corporation is a corporation. In that case, the stock in the foreign acquired corporation is merely "property" in the inbound 351 exchange. In other words, corporate status of a foreign acquired corporation is not relevant in an inbound 351 exchange, and thus it does not appear that Treasury and the IRS have the authority to deny nonrecognition in such a transaction.[351]

Given the many similarities between an inbound 351 exchange and an inbound stock reorganization, it would be unwise to draft a rule under the 367(b) regulations that does not apply equally to both types of inbound stock transfers. What's good for the goose must be made good for the gander.

VI. Conclusion

This has been a long journey—for you (the readers), for us (the authors), and for 367(b) (the subject). And what has this sojourn achieved? Hopefully, a deeper understanding of the principles underpinning the 367(b) regulations, as reframed in this report, and how these principles might inform future design choices with respect to those regulations. If the good folks at Treasury and the IRS can ever find the time and resources to revisit the 367(b) regulations, in between dealing with major international tax reforms, we only hope that this report may provide a roadmap, or at least a starting point, for that endeavor.

We have covered several potential design changes to the 367(b) regulations; most would narrow the scope of the rules, one would expand them, and one would eliminate or suspend the regulations altogether. We believe there are good arguments that can be marshalled for or against all of these approaches, and likely other approaches not identified in this report. But, based on the history of the 367(b) regulations, and the developments that are relevant to the regulations, there is at least one conclusion in which we believe strongly—we would exclude small shareholders, particularly small individual shareholders, from the application of B3.

The guidelines and the temporary regulations, by excluding small shareholders, implicitly did not treat the E&P and basis of a foreign acquired corporation as "attributable" to these shareholders and thus as being "repatriated" upon an inbound asset transaction. This approach is consistent with the U.S. shareholder limitation in subpart F, as well as, more recently, the 245A holding period requirement and treaty ownership requirement. In the proposed and final regulations, Treasury and the IRS never fully explained the rationale for departing from this approach, other than by articulating the repatriation principle, which "principle" is more of a conclusion than a reason.

Further, small shareholders, because of their inability to obtain the requisite information for computing their all E&P amount, will almost always be compelled to recognize gain with respect to their foreign acquired corporation stock under B3. If the proper measure of income to be recognized in an inbound asset transaction is the all E&P amount,[352] recognition of stock gain is punitive, in that it will often accelerate more income than reasonably necessary to counteract any tenuous benefit that could be obtained from the transaction. In other words, with respect to small shareholders, B3 often inflicts a more material distortion than it prevents.

Finally, imposing a toll charge on small shareholders under B3 creates unnecessary friction for genuine, cross-border business combinations. Because B3 taxes small shareholders, a domestic corporation that wishes to acquire the assets of a foreign corporation will generally be incentivized to structure such acquisition as a two-step inbound transaction rather than a one-step inbound transaction to obtain deferral for small shareholders. This same incentive exists to avoid the application of B3 to individual U.S. shareholders, which is one reason offered in support of the proposal to apply B3 only with respect to non-245A E&P.[353] But if Treasury and the IRS remain concerned with the potential distortions that could result from an inbound asset transaction involving non-245A shareholders, it would be reasonable for them to employ the U.S. shareholder concept to delineate between the E&P and basis of a foreign acquired corporation that has been "repatriated" and the E&P and basis of a foreign acquired corporation that ought not to be attributed to a U.S. person in the first place.

The amount of ink spilled on the pages of this report may feel excessive, if its primary conclusion is merely to exclude small shareholders from the application of B3. But a journey of a thousand miles begins with a single step; perhaps the next leg in the journey of the 367(b) regulations could begin with a single small step.[354]

Wolters Kluwer

* The authors would like to thank the following people for their helpful comments on the contents of this report, as well as in preparation for a panel discussion on the subject of this report at the University of Chicago's 75th Annual Federal Tax Conference: Eric Sensenbrenner, Layla Asali, Stephen Massed, Matthew Schimka, Samira Varanasi, and Daren Gottlieb. Any errors in this report are the authors' own.

[1] Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[2] Unless otherwise indicated, any reference in this report to (i) the "Code" is a reference to the Internal Revenue Code of 1986, as amended, (ii) a "Code Sec." is a reference to a section of the Code, (iii) the "regulations" is a reference to the regulations issued under sections of the Code by the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service ("IRS"), and (iv) "subpart F" is a reference to the anti-deferral provisions in Code Secs. 951 through 965, exclusive of Code Secs. 951A and 965.

[3] Code Secs. 250 and 960.

[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.

[5] Mitt Romney, while campaigning for president at the Iowa state fair in 2011, famously said that "corporations are people." Unfortunately, for Federal income tax purposes, people are not generally corporations. *But cf.* Code Sec. 962, Reg. §1.962-1 (permitting an individual U.S. shareholder to elect to be treated as a corporation for purposes of availing itself of foreign tax credits under Code Sec. 960 and the deduction for GILTI under Code Sec. 250).

[6] Any reference to "subchapter C" in this report is a reference to Code Secs. 301 through 385.

[7] *See* T.D. 8862, 65 FR 3589, 3590 (Jan. 24, 2000).

[8] *See* S. Rep. No. 94-938, at 263–264 (1976).

[9] *See, e.g.,* Stewart Lipeles *et al.*, *Did Anyone Notice the TCJA Made Code Sec. 367(b) Obsolete*?, Taxes (CCH), Jul. 2021, at 7; Bret Wells, *Reform of Section 367(a) and Section 367(b) for a Post-TCJA Era*, 23 Hous. Bus. & Tax L.J. (forthcoming 2023).

[10] *See* REG–101657–20, 85 FR 72078, 72081 (Nov. 12, 2020).

[11] Reg. §1.367(b)-3(a).

[12] A "U.S. person" is a citizen or resident of the United States, a domestic partnership, a domestic corporation, any estate that is not a foreign estate (as defined in Code Sec. 7701(a)(31)), and any trust if (i) a U.S. court is able to exercise primary supervision over the administration of the trust and (ii) one or more U.S. persons have the authority to control all substantial decisions of the trust. Code Sec. 7701(a)(30). A "person" is an individual, trust, estate, partnership, association, company, or corporation. Code Sec. 7701(a)(1).

[13] Reg. §1.367(b)-3(b)(2), *cross-referencing* Code Sec. 951(b). A domestic partnership is treated as an entity for purposes of determining whether any U.S. person (including the domestic partnership itself) is a U.S. shareholder. Reg. §1.958-1(d)(2)(i). For a more detailed discussion of the concept of a U.S. shareholder, *see* Part III.A.3 of this report.

[14] 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). 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).

[15] Code Sec. 381 provides rules for the carryover of tax attributes in complete liquidations described in Code Sec. 332 and asset reorganizations described in Code Sec. 368(a).

[16] Reg. §1.367(b)-3(e).

[17] *Id*.

[18] Reg. §1.367(b)-3(f)(1).

[19] *Id.* B3 reserves on the carryover of PTEP. *See* Reg. §1.367(b)-3(f)(2).

[20] Reg. §1.367(b)-2(k) (applying the principles of Reg. §1.367(e)-1(b)(2) and the ownership attribution rules described therein). *See also* Code Sec. 958(a)(2) (stock owned by any foreign entity, including a foreign partnership, is treated as indirectly owned proportionately by its owners) and Reg. §1.1248-1(a)(4) (providing that, for purposes of Code Sec. 1248, if a foreign partnership sells or exchanges the stock in a corporation, the partners in the foreign partnership "shall be treated as selling or exchanging their proportionate share of the stock of such corporation").

[21] A liquidation into a partnership (whether domestic or foreign) cannot qualify as a complete liquidation under Code Sec. 332, because a "complete liquidation" for this purpose only includes a liquidation of a subsidiary into another corporation that owns 80 percent (by vote and value) of the subsidiary. *See* Code Sec. 332(b). Therefore, a liquidation into a partnership cannot constitute an inbound liquidation subject to B3, regardless of the identity of the partners, absent the application of an anti-abuse rule. *See, e.g.*, Reg. §1.701-2(e)(1) (providing the IRS discretion under certain circumstances to "treat a partnership as an aggregate of its partners in whole or in part as appropriate to carry out the purpose of any provision of the Internal Revenue Code or the regulations promulgated thereunder").

[22] *See* Reg. §1.958-1(d)(2)(i) (the treatment of a domestic partnership as a foreign partnership (*i.e.*, as an aggregate of its partners) for purposes of Code Sec. 951, 951A, and 956(a) does not apply for purposes of determining whether any U.S. person (including the domestic partnership itself) is a U.S. shareholder within the meaning of Code Sec. 951(b)).

[23] Reg. §1.367(b)-3(b)(3)(i).

[24] Reg. §1.367(b)-2(d)(1).

[25] *Id.* and Reg. §1.367(b)-2(d)(3)(ii); *but cf.* Notice 2016-73, §4.03, 2016-2 CB 908 (announcing regulations that would include E&P of lower-tier foreign subsidiaries in the computation of the all E&P amount with respect to a foreign acquired corporation to the extent of the "excess asset basis" of the foreign acquired corporation). The E&P of a lower-tier foreign corporation are generally not included in determining the all E&P amount with respect to a foreign acquired corporation, because, in an inbound asset transaction of the foreign acquired corporation, such basis remains offshore and thus has not yet been "repatriated."

[26] Reg. §1.367(b)-2(d)(2)(ii). *See, supra,* Part III.B of this report for a discussion of E&P described in Code Sec. 1248(d).

[27] Reg. §1.367(b)-2(d)(3).

[28] Reg. §1.367(b)-2(d)(3)(i)(B).

[29] Reg. §1.367(b)-3(c)(2).

[30] Reg. §1.367(b)-3(c)(3).

[31] Reg. §1.367(b)-3(c)(4).

[32] Reg. §1.367(b)-4(a).

[33] Reg. §1.367(b)-4(b)(1). B4 may also require an income inclusion in certain transactions where 1248 shareholder status is retained, including certain exchanges involving the receipt of preferred stock, certain recapitalizations, and certain exchanges following inversion transactions. *See* Reg. §1.367(b)-4(b)(2), (b)(3), (e), and (f). However, these rules are beyond the scope of this report and thus are not further discussed.

[34] Reg. §1.367(b)-2(b), *cross-referencing* Code Sec. 1248(a) and Reg. §1.1248-1(a)(2). 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)) is owned by U.S. shareholders. Code Sec. 957(a). A domestic partnership is treated as an entity (and thus potentially a U.S. shareholder) for purposes of determining whether a foreign corporation is a CFC. Reg. §1.958-1(d)(2)(ii). For a more detailed discussion of the concept of a 1248 shareholder, *see* Part III.A.3 of this report.

[35] A third condition requires that an exchange pursuant to a foreign-to-foreign transaction not be a "specified exchange." Reg. §1.367(b)-4(b)(1)(i)(C). In most cases, this condition will be satisfied, since an exchange is a specified exchange only if it occurs within the ten-year period following an inversion transaction. *See* Reg. §§1.367(b)-4(e)(2) and 1.7874-12(a)(2) and (9).

[36] Reg. §1.367(b)-4(b)(1)(i)(A).

[37] Reg. §1.367(b)-4(b)(1)(i)(B).

[38] Reg. §1.367(b)-4(b).

[39] Reg. §1.367(b)-2(c).

[40] *See* Reg. §1.1248-8(b)(3)(ii).

[41] Reg. §1.367(b)-2(e)(2).

[42] Treasury and the IRS have not yet issued regulations implementing the general provisions of Code Sec. 245A confirming this result. However, regulations issued under Code Sec. 245A(e) provide that a deemed dividend of a

Wolters Kluwer

1248 amount under B4 can give rise to a hybrid dividend. *See* Reg. §1.245A(e)-1(d)(5)(i). This strongly implies that a deemed dividend under the 367(b) regulations is generally eligible for a 245A DRD, because a dividend can constitute a hybrid dividend only if a 245A DRD would otherwise be allowed for the dividend. *See* Code Sec. 245A(e)(4) and Reg. §1.245A(e)-1(b)(2). Treasury and the IRS should confirm this result in future regulations.

[43] Notice 2004-70, §4.01, 2004-2 CB 724.

[44] Reg. §1.367(b)-4(c). Treasury and the IRS explained that an immediate inclusion in the gross income of a U.S. shareholder of the foreign corporate 1248 shareholder is not necessary because the movement of the E&P to the foreign corporate 1248 shareholder as a deemed dividend "preserv[es] such earnings and profits" for taxation upon a subsequent repatriation by such foreign corporate 1248 shareholder. T.D. 8862, 65 FR 3589, 3593 (Jan. 24, 2000).

[45] Reg. §1.367(b)-3(b)(3)(i). However, it may qualify for look-thru treatment for purposes of Code Sec. 904(d). *Id*.

[46] Notice 2007-9, 2007-1 CB 401. In the preamble to the final regulations, Treasury and the IRS rejected comments that the same country exception should apply for purposes of an all E&P inclusion by a foreign corporate U.S. shareholder, 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 FR 3589, 3592 (Jan. 24. 2000). Likewise, the IRS in Notice 2007-9 provided that an all E&P inclusion cannot satisfy the look-thru exception, presumably for the same policy reasons. While beyond the scope of this report, after the enactment of TCJA, there has been an open question of whether a CFC can obtain the benefit of a 245A DRD with respect to a dividend from another foreign corporation, particularly a "10/50 company" (*i.e.*, a foreign corporation that is not a CFC but has at least one U.S. shareholder). *See* H.R. Conf. Rep. No. 115-466, at 599, n. 1486. This issue is also implicated in the case of an all E&P inclusion by a foreign corporate U.S. shareholder that is a CFC. Regardless of the government's general view regarding the availability of a 245A DRD for CFCs, there does not appear to be any justification for treating a deemed dividend of an all E&P amount to a foreign corporate U.S. shareholder as FPHCI if the E&P giving rise to such deemed dividend would qualify for a 245A DRD if distributed to a 245A shareholder of the foreign corporate U.S. shareholder. Consideration should be given to adopting for B3 a construct similar to the rules of Code Sec. 964(e)(4), *i.e.*, treating the all E&P inclusion by a foreign corporate U.S. shareholder that is a CFC as subpart F income, but then permitting a 245A shareholder of the foreign corporate U.S. shareholder a 245A DRD with respect to the "foreign-source portion" of the resulting subpart F inclusion.

[47] Reg. §1.367(b)-2(e)(3)(ii).

[48] *Id*.

[49] Code Sec. 1059(a). In the case of an inbound liquidation, the exchanging shareholder does not hold stock in the domestic acquiring corporation after the transaction because the exchanging shareholder *is* the domestic acquiring corporation (*i.e.*, the domestic parent corporation). Therefore, the basis implications of Reg. §1.367(b)-2(e)(2)(ii) and Code Sec. 1059 are irrelevant in the context of an inbound liquidation, *unless* the basis increase in Reg. §1.367(b)-2(e)(2)(ii) were treated as occurring after a basis reduction under Code Sec. 1059, in which case gain could be recognized under Code 1059(a)(2) if the deemed dividend exceeded the exchanging shareholder's basis in the foreign acquired corporation immediately before the inbound liquidation. *See* New York State Bar Association, Report 1463: An Analysis of Potential Design Changes to Regulation Section1.367(b)-3 in Light of the Tax Cuts and Jobs Act, at 18–19 (Jun. 28, 2022) (the "2022 NYSBA Report"). *See also* Part III.C.2.d.ii of this report for a more detailed discussion of Code Sec. 1059 in the context of the holding period requirement for Code Sec. 245A.

[50] PTEP is described and defined, *infra*, in Part III.A.1 of this report.

[51] Reg. §1.367(b)-2(j)(2)(i).

[52] *Id*.

[53] Reg. §1.367(b)-2(j)(2)(ii).

[54] *See Moline Properties*, SCt, 43-1 USTC ¶9464, 319 US 436, 63 SCt 1132 (1943) (holding that a corporation is treated as an entity that is separate from its owner for Federal income tax purposes).

[55] In the case of certain domestic corporate shareholders, the U.S. tax liability from such a dividend could potentially be offset by a deemed paid credit under former Code Sec. 902, before its repeal by the TCJA. *See* Pub. L. No. 115-97, §14301, 131 Stat. 2221 (2017).

[56] Pub. L. No. 87-834, 76 Stat. 960 (1962).

[57] H.R. Rep. No. 87-1447, at 57 (1962) ("1962 House Report").

[58] Subpart F income includes foreign base company income as defined in Code Sec. 954, which consists of FPHCI as defined in Code Sec. 954(c), foreign base company sales income as defined in Code Sec. 954(d), and foreign base company services income as defined in Code Sec. 954(e). *See* Code Sec. 952(a). Subpart F income of a CFC is generally limited to a CFC's current E&P. *See* Code Sec. 952(c). A U.S. shareholder also must generally include in its gross income its *pro rata* share of the increase in the earnings of a CFC invested 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).

[59] H.R. Rep. No. 87-1447, at 59 (1962).

[60] Code Sec. 951(a)(2)(A); Reg. §1.951-1(b)(1)(i) and (e).

[61] Code Sec. 951(a)(2)(B); Reg. §1.951-1(b)(1)(ii).

[62] Code Sec. 959(a) and (b). A GILTI inclusion is treated the same as a subpart F inclusion for purposes of applying Code Secs. 959 and 961. Code Sec. 951A(f); Reg. §1.951A-5(b)(1).

[63] 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).

[64] Code Sec. 961(c). No such regulations have been issued as of the date of this report.

[65] Pub. L. No. 87-834, §15(a), 76 Stat. 1041 (1962).

[66] *See* S. Rep. No. 87-1881, at 107 (1962). Congress equated a monetization of the CFC stock through a sale or exchange with a "repatriation" of the CFC's earnings.

[67] H.R. Rep. No. 87-1447, at 76-77 (1962). The 1962 House Report observed that it was also possible to repatriate E&P without incurring U.S. tax through an inbound asset transaction. However, Congress did not feel the need to address this concern in the Revenue Act of 1962 on the grounds that, under the advance ruling requirement of Code Sec. 367 at that time, an inbound asset transaction had to be pre-approved by the IRS, and the IRS generally "has been unwilling to grant such approval where there is an appreciable amount of earnings and profits accumulated in a foreign corporation." *Id*. at 76.

[68] Code Sec. 1248(a); Reg. §1.1248-1(a)(2).

[69] *See* Code Sec. 959(e).

[70] *See* Code Sec. 964(e).

[71] Code Sec. 1248(d)(1) and (4). ECI E&P and PTEP are excluded because they represent amounts that have been subject to full U.S. tax. PTEP arising from GILTI are also excluded from 1248 E&P. *See* Code Sec. 951A(f)(1)(A) and Reg. §1.951A-5(b)(1), *cross-referencing* Code Sec. 1248(d)(1).

[72] Code Sec. 1248(c)(2).

[73] Reg. §1.1248-2(e)(1) (attribution of 1248 E&P to stock in simple cases); Reg. §1.1248-3(c)(1) (attribution of 1248 E&P to stock in complex cases).

[74] Prior to the TCJA, both U.S. shareholder and 1248 shareholder status were determined solely by reference to voting power. However, the TCJA changed the definition of U.S. shareholder such that U.S. shareholder status is currently determined by reference to voting power *or value* of stock in the foreign corporation but made no corresponding change to the definition of a 1248 shareholder. *See* Part III.C.2.e of this report for a more detailed discussion of the changes made by the TCJA to the determination of U.S. shareholder and CFC status.

[75] The temporary regulations under Code Sec. 367(b) (discussed *infra* in Part III.B.4 of this report) did use the term "U.S. shareholder" in the predecessor provisions to the B4 rules. However, the temporary regulations defined such term 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), T.D. 7530, 42 FR 65152 (Dec. 30, 1977).

[76] Pub. L. No. 72-154, 47 Stat. 169 (1932).

Wolters Kluwer

[77] *Id.*

[78] *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.").

[79] Pub. L. No. 83-591, 68A Stat. 1 (1954).

[80] 1968-1 CB 821.

[81] Code Sec. 1248(a) and (b) and the regulations thereunder generally applied for purposes of determining the portion of the E&P of a foreign corporation properly attributable to a U.S. person's stock in such foreign corporation and the manner in which such portion was includible in the U.S. person's gross income. Guidelines, §4.01.

[82] *Id.*, §3.01(1).

[83] *Id.*, §3.03(1)(b).

[84] *Id*.

[85] *Id.*, §3.03(1)(e).

[86] *Id.*, §3.03(1)(c).

[87] *Id.*, §3.03(1)(f).

[88] *Id.*, §3.03(1)(g).

[89] The reference to "all" in the guidelines assumedly means that E&P for this purpose included E&P generated before December 31, 1962, and may have also included E&P generated before the foreign acquired corporation was a CFC and the exchanging shareholder was a 1248 shareholder. *See infra,* note 103 for a discussion regarding the issue of whether the all E&P amount under the temporary regulations included E&P attributable to periods in which the foreign acquired corporation was not a CFC.

[90] The guidelines provided that, for purposes of determining the deemed dividend included by an exchanging shareholder in a foreign-to-foreign reorganization, the E&P of foreign subsidiaries described in Code Sec. 1248(c)(2) were taken into account. *See* Guidelines §4.01. The implication is that such E&P were not taken into account in determining the deemed dividend received by an exchanging shareholder in an inbound asset transaction.

[91] *See* Guidelines §4.01. However, as discussed *infra* in note 103, there was some debate as to whether the definition of the all E&P amount remained consistent from the temporary regulations to the proposed regulations and ultimately the final regulations.

[92] *Id.* Thus, for such a shareholder, the dividend was an amalgam of the concept of a 1248 amount and an all E&P amount—*i.e.*, gain limited, but without E&P of lower-tier foreign subsidiaries.

[93] The guidelines would have required a small shareholder that was not a 1248 shareholder to include in gross income "as gain from the sale of a noncapital asset" on the sale of the stock in a "foreign investment company" to the extent of the E&P attributable to such stock. Guidelines, §3.03(b). *See also* Reg. §7.367(b)-6T (1977). Former Code Sec. 1246 treated a U.S. person's gain on the sale of the stock in a foreign investment company as ordinary income to the extent of its ratable share of the E&P of the foreign company. Unlike Code Sec. 1248, former Code Sec. 1246 was not limited to shareholders who held a certain percentage of stock in a foreign corporation that is, or was, a CFC. *See* former Code Sec. 1246(a). But former Code Sec. 1246 also only applied to "foreign investment companies," which were foreign companies that were registered under the Investment Company of 1940 or engaged primarily in the business of investing, reinvesting, or trading securities, commodities, or derivatives of the same. *See* former Code Sec. 1246(b). Former Code Sec. 1246 was repealed in 2004 in the American Jobs Creation Act of 2004, Pub. L. No. 108-357, §413(a)(2), (3), 118 Stat. 1506 (2004), and is not further discussed in this report.

[94] Pub. L. No. 94-455, §1042(a), 90 Stat. 1634 (1976).

[95] H.R. Rep. No. 94-658 (1975).

[96] *Id.*, at 240 (1975).

[97] *Id.,* at 240-241.

[98] *Id.* at 241.

[99] Code Sec. 367(b)(1).

[100] H.R. Rep. No. 94-658, at 241 (1975).

[101] *Id*.

[102] T.D. 7530, 42 FR 65152 (Dec. 30, 1977).

[103] 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 in the foreign corporation exchanged under the principles of Code Sec. 1248, without regard to (1) whether such E&P were 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)-2T(f) and (h)(1) (1977). It is unclear under the temporary regulations whether E&P for this purpose included E&P accumulated by a foreign acquired corporation while not a CFC. The IRS concluded in informal guidance on the temporary regulations that the all E&P amount did not include any E&P accumulated by a foreign acquired corporation while not a CFC. *See, e.g.*, LTR 8924052 (Mar. 20, 1989). Nonetheless, when the proposed regulations modified the definition of "all E&P amount" to explicitly include E&P accumulated by a foreign corporation while not a CFC, *see* Proposed Reg. §1.367(b)-2(d)(4) (1991), Treasury and the IRS labeled this change a mere clarification of "the intended scope of the term." *See* INTL-054-91, INTL-178-86, 56 FR 41993, 41996 (Aug. 26, 1991). At least one contemporaneous commentator objected to calling this revision a clarification, on the grounds that "most practitioners" interpreted the temporary regulations as not including the E&P of a foreign acquired corporation while not a CFC in the determination of an all E&P amount. *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). *But cf.* Charles I. Kingson, *The Theory and Practice of Section 367*, 37 NYU Inst. on Fed. Tax'n, ¶ 22.03[7][b][ii], 22–27 (1979) ("Kingson") (regarding the computation of an all E&P amount in the temporary regulations: "The actual requirements of Section 1248, however (that the foreign company be a controlled foreign corporation as to which the stockholder is a United States shareholder) are not intended to apply; but earnings will be attributed to a share of stock calculated as though the requirements had been met."). *See also infra*, note 106 regarding the analogous issue of whether a small corporate shareholder was required to include an all E&P amount under the temporary regulations.

[104] Reg. §7.367(b)-5T(b) (1977).

[105] Reg. §7.367(b)-7T(c)(1)(i) (1977).

[106] Reg. §7.367(b)-7T(c)(2) (1977). There was 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 domestic corporate shareholder. While the rule in Reg. §7.367(b)-7T(c)(2) (1977) was not expressly limited to exchanging shareholders that were corporate 1248 shareholders, the scope language in Reg. §7.367(b)-7T(a) (1977) provided that the entire section (*i.e.*, Reg. §7.367(b)-7T (1977)) applied 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." For purposes of the temporary regulations, the term "U.S. shareholder" meant "1248 shareholder." *See* Reg. §7.367(b)-2T(b) (1977). Nonetheless, at least one contemporaneous commentator asserted that, notwithstanding the general scope language, the rule in Reg. §7.367(b)-7T(c)(2) (1977) was intended to apply regardless of whether the exchanging shareholder was a 1248 shareholder, because the exchanging shareholder limitation in the scope paragraph "was meant to encompass only paragraphs (b) and (c)(1)" of Reg. §7.367(b)-7T (1977). Kingson, ¶ 22.03[7][c], 22–27, n. 53. The commentator further indicated that the final regulations would be changed to be consistent with his interpretation. *Id*. The temporary regulations were never finalized, and the proposed regulations, which replaced the temporary regulations, required all small shareholders, including small shareholders that were domestic corporations, to recognize gain, rather than include their all E&P amounts. *See also supra*, note 103 regarding the analogous issue of whether an all E&P amount under the temporary regulations included E&P of a foreign acquired corporation generated while the foreign acquired corporation was not a CFC.

[107] Reg. §7.367(b)-7T(c)(1)(ii) (1977).

[108] Reg. §7.367(b)-7T(c)(1)(i) (1977).

[109] Reg. §7.367(b)-7T(c)(1)(ii) (1977). The requirement that a shareholder include its 1248 amount by reason of an inbound stock transfer applied

Wolters Kluwer

only in the case of an inbound stock reorganization, and not an inbound 351 exchange. The temporary regulations do not describe the consequences of an inbound stock transfer that is both an inbound stock reorganization and an inbound 351 exchange. *Cf.* Reg. §7.367(b)-4T(b) (providing rules coordinating Code Sec. 367(a) and (b) for foreign-to-foreign transactions that qualify both as an exchange under Code Sec. 351 exchange and a reorganization under Code Sec. 368). However, in the case of overlap transactions, the IRS in at least one instance took the position in informal guidance that Code Sec. 351 should be given priority for purposes of applying Code Sec. 367. *See* LTR 8204134 (Oct. 29, 1981).

[110] Reg. §7.367(b)-7T(c)(1)(i) (1977).

[111] Reg. §7.367(b)-7T(c)(1)(ii) (1977).

[112] *See supra*, note 106 for a discussion regarding the uncertainty as to whether even small corporate shareholders were required to include their all E&P amount under the temporary regulations.

[113] 56 FR 41993 (Aug. 26, 1991).

[114] Proposed Reg. §1.367(b)-3(b) (1991). The proposed regulations were also revised to provide that a U.S. person can have an all E&P amount with respect to a foreign acquired corporation even if such person is not, and has never been, a U.S. shareholder or the foreign acquired corporation is not, and has never been, a CFC. *See* Proposed Reg. §1.367(b)-2(d)(3)(i) (1991). *See supra*, note 103 for a discussion regarding the debate on the meaning of the term "all E&P amount" under the temporary regulations.

[115] *See* 56 FR at 41996 (Aug. 26, 1991) ("The temporary regulations provide that, if a taxpayer fails to comply with the regulations' requirements, then the Commissioner will make a determination whether a foreign corporation is considered a corporation based on all the facts and circumstances. This rule is not adopted in the new regulations. Such a rule implicitly permits a taxpayer to elect whether to comply with the regulations or to seek taxable exchange treatment. When such an election is appropriate, the new regulations make the availability of a taxable exchange election explicit").

[116] Proposed Reg. §1.367(b)-3(b)(2)(iii)(A) (1991).

[117] *Id.*

[118] Proposed Reg. §1.367(b)-3(c) (1991).

[119] 56 FR at 41997 (Aug. 26, 1991).

[120] The reasons articulated by Treasury and the IRS for the recognition of income, generally, by *all* exchanging shareholders upon a repatriation of assets in an inbound asset transaction are discussed in Part IV.A.1 of this report, and a detailed analysis and critique of the taxation of small shareholder can be found in Parts IV.B.3 and V.B of this report.

[121] Proposed Reg. §1.367(b)-4(b)(1) (1991).

[122] 56 FR at 41997 (Aug. 26, 1991).

[123] T.D. 8862, 65 FR 3589 (Jan. 24, 2000).

[124] 65 FR 3589, 3592 (Jan. 24, 2000).

[125] *Id.*

[126] 65 FR at 3593 (Jan. 24, 2000).

[127] *Id.*

[128] *See* T.D. 9273, 71 FR 44887 (Aug. 8, 2006), *finalizing* REG-116050-99), 65 FR 69138 (Nov. 15, 2000) (addressing the carryover under Code Sec. 381 of certain tax attributes, such as E&P and foreign taxes, in transactions described in the 367(b) regulations).

[129] Pub. L. No. 77-753, §150, 105 56 Stat. 798 (1942). *See also* SOI Tax Stats—Historical Table 24 (1909–2010).

[130] Pub. L. No. 82-183, §121, 65 Stat. 459 (1951) (increasing the corporate tax rate to 52 percent in 1952).

[131] Pub. L. No. 91-172, §511, 83 Stat. 635 (1969) (increasing the capital gains rate to 30 percent for taxable years 1971–1974).

[132] Tax Reform Act of 1986 ("TRA"), Pub. L. No. 99-514, §311, 100 Stat. 2219 (1986).

[133] *See* Reg. §1.1248-6(d) and (e).

[134] Notice 87-64, 1987-2 CB 375. The suspension of Code Sec. 1248(e) clearly applies to corporate 1248 shareholders, because there is no rate differential for domestic corporations under current law. But the suspension is not explicitly limited to corporate 1248 shareholders. It is less clear whether, and to what extent, the suspension applies to individual 1248 shareholders after the enactment of Code Sec. 1(h)(11), which is discussed *infra* in more detail.

[135] Pub. L. No. 108-27, §302(a), 117 Stat. 760 (2003).

[136] 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).

[137] Code Sec. 1211(b) generally allows an individual a deduction for capital losses only to the extent of capital gains, except that an individual is permitted an additional deduction for the lesser of the excess of capital losses over capital gains or $3,000.

[138] Code Sec. 1(h)(11)(B)(i).

[139] Code Sec. 1(h)(11)(C)(i). *See* Notice 2011-64, 2011-2 CB 231, 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 under the treaty. Notice 2011-64, §3, 2011-2 CB 231, *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).

[140] Code Sec. 1(h)(11)(iii). A foreign corporation that is not otherwise a qualified foreign corporation may nonetheless be treated as a qualified foreign corporation with respect to a dividend paid with respect to stock of the foreign corporation that is publicly traded on a U.S. stock exchange. Code Sec. 1(h)(11)(C)(ii).

[141] Code Sec. 1(h)(11)(B)(iii)(I), *cross-referencing* Code Sec. 246(c).

[142] Notice 2004-70, §4.01, 2004-2 CB 724.

[143] *Id*. *See* Part II.C of this report for a detailed discussion of the treatment of dividends under the 367(b) regulations.

[144] Pub. L. No. 99-514, §1261, 100 Stat. 2585 (1986).

[145] Code Sec. 986(c)(1).

[146] *See* H.R. Rep. No. 99-426, at 477 (1985) (explaining that foreign currency rules, including Code Sec. 986(c), apply to "deemed distributions of subpart F income … and gain that is recharacterized as dividend income on the disposition of stock in a CFC (or former CFC)").

[147] Code Sec. 986(c)(2).

[148] Notice 88-71, 1988-2 CB 374.

[149] *Id.* at 380, §2(c).

[150] *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.

[151] *See* Part II.C of this report.

[152] *See* Reg. §1.367(b)-2(j)(2).

[153] Pub. L. No. 108-357, §836, 118 Stat. 1594 (2004).

[154] Code Sec. 362(a) and (b) provides rules for determining the basis of property received by a transferee corporation in a Code Sec. 351 exchange and in a reorganization, respectively.

[155] Code Sec. 362(e)(1); Reg. §1.362-3.

[156] *See* Code Sec. 334(b)(1)(B).

[157] Code Sec. 362(e)(1)(C); Reg. §1.362-3(c)(3) (defining a "loss importation transaction" to mean any Code Sec. 362 transaction in which the acquiring corporation's aggregate basis in all importation property received from all transferors in the transaction would exceed the aggregate value of such property immediately after the transaction).

[158] Reg. §1.362-3(c)(2)(i).

[159] *See* Reg. §1.362-3(d)(3) ("For purposes of this section, gain or loss that would be recognized by a CFC (as defined in section 957(a)) or a PFIC (as defined in Code Sec. 1297(a)) is not deemed taken into account in determining a federal income tax liability solely because it could affect an inclusion under Code Sec. 951(a) or Code Sec. 1293(a).").

[160] Pub. L. No. 115-97, 131 Stat. 2054 (2017).

[161] *See* S. Prt. No 115-20, 115th Cong., 1st Sess. at 358 (Comm. Print 2017) ("TCJA Senate Report") ("[Code Sec. 245A] would eliminate the 'lock-out' effect under current law, which means U.S. businesses avoid bringing their foreign earnings back into the United States to avoid the U.S. residual tax on those earnings.").

[162] *See* H.R. Rep. No. 115-409, at 370 (2017) (the "TCJA House Report").

[163] So much for that postcard. *See www.aei.org/economics/we-have-been-promised-a-postcard-we-didnt-get-a-postcard/*.

[164] Pub. L. No. 115-97, §14103(a), 131 Stat. 2195 (2017).

[165] Code Sec. 965(a) and (e); Reg. §1.965-1(b) and (d).

[166] Code Sec. 965(c); Reg. §1.965-3.

[167] *See* Reg. §1.965-2(c).

[168] Code Sec. 965(b)(4)(A); Reg. §1.965-2(d). Although 965(b) PTEP are treated as PTEP for all purposes of Code Sec. 959, no adjustments were made to increase a taxpayer's basis in the stock in a foreign corporation under Code Sec. 961(a) to reflect such PTEP, unless the taxpayer elected to reallocate basis from the foreign corporation with the deficit to the foreign corporation with the resulting 965(b) PTEP. *See* Reg. §1.965-2(f). Absent such election, a distribution of 965(b) PTEP to the taxpayer could result in gain recognition under Code Sec. 961(b)(2).

[169] Reg. §1.986(c)-1(b).

[170] Reg. §1.986(c)-1(c).

[171] 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, and thus is determined by reference to ownership of CFC stock within the meaning of Code Sec. 958(a) (*i.e.*, direct ownership and indirect ownership through foreign entities). Code Sec. 951A(e)(1); Reg. §1.951A-1(d). For purposes of determining a U.S. shareholder's *pro rata* share of any amount, a domestic partnership is treated as a foreign partnership, and thus partners of a domestic partnership that owns stock in a CFC are treated as owning such stock within the meaning of Code Sec. 958(a)(2). *See* Reg. §1.958-1(d)(1).

[172] Code Sec. 951A(c)(1); Reg. §1.951A-1(c)(2).

[173] Code Sec. 951A(c)(2)(A); Reg. §1.951A-2(b)(1).

[174] Code Sec. 951A(c)(2)(B); Reg. §1.951A-2(b)(2).

[175] Code Sec. 951A(c)(2)(A)(i); Reg. §1.951A-2(c)(1). However, gross tested income does include ECI that is exempt from, or is subject to a reduced rate of, U.S. tax pursuant to a U.S. tax treaty. *See* Code Sec. 951A(c)(2)(A)(i)(I); Reg. §1.951A-2(c)(1)(i), *cross-referencing* Code Sec. 952(b).

[176] *See* T.D. 9866, 84 FR 29288, 29295 (Jun. 21, 2019) (preamble to the final regulations) (noting that "gross tested income is not subject to an E&P limitation analogous to the E&P limitation on subpart F income under section 952(c)(1)(A)").

[177] Code Sec. 951A(b)(2); Reg. §1.951A-1(c).

[178] Code Sec. 951A(d); Reg. §1.951A-3(b).

[179] *See* Reg. §1.951A-2(c)(3)(ii), and (7). Under current law, a taxpayer could separately elect (or not elect) the GILTI high-tax exception and subpart F high-tax exception, though taxpayers are under a duty of consistency to make (or not make) the GILTI high-tax exception with respect to related CFCs. *See* Reg. §1.951A-2(c)(7)(viii)(E). However, Treasury and the IRS have proposed regulations that would create a single election for both the GILTI and subpart F high-tax exceptions, effectively making it an "all-or-nothing" exception with respect to all high-taxed income among related CFCs, regardless of whether such income would otherwise be gross tested income or subpart F income. *See* REG-127732-19, 85 FR 44650 (Jul. 23, 2020).

[180] *See* Code Sec. 250(a)(1)(B). The deduction is scheduled to be reduced to 37.5 percent for taxable years beginning after December 31, 2025. Code Sec. 250(a)(3)(B).

[181] *See* Code Sec. 960(d). Because of the current 50-percent deduction for GILTI, the "GILTI rate" is generally expressed as 10.5 percent (21 percent × 50 percent). However, the GILTI rate is sometimes also expressed as 13.125 percent, which represents the foreign effective tax rate at which CFC income must be subject for a U.S. shareholder to have no residual U.S. tax liability with respect to its GILTI, taking into account Code Sec. 960(d) but disregarding Code Sec. 904 ((21 percent × 50 percent) ÷ 80 percent).

[182] *See* Code Sec. 962; Reg. §1.962-1 (permitting individual U.S. shareholders to elect to be treated as corporations for purposes of availing themselves of foreign tax credits under Code Sec. 960 and the deduction for GILTI under Code Sec. 250).

[183] *See* Code Sec. 951A(f); Reg. §1.951A-5(b)(1).

[184] Code Sec. 245A(a). The Secretary is authorized to issue regulations to afford a 245A DRD to U.S. shareholders owning stock in an SFC through a partnership. *See* Code Sec. 245A(g); *cf.* LTR 200009025 (Mar. 3, 2000) (corporate partner of LLC entitled to a 100-percent DRD under Code Sec. 245(c)(1) for its distributive share of dividends paid out of E&P attributable to foreign trade income of foreign sales corporation) and FSA 200026009 (Jun. 30, 2000) (corporate partners of a partnership that owns a foreign sales corporation are entitled to a 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).

[185] Code Sec. 245A(b)(1).

[186] Code Sec. 245A(b)(2).

[187] Code Sec. 1248(j). In addition, a sale of stock in a foreign corporation by a CFC that is recharacterized as a dividend under Code Sec. 964(e)(1) may 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 for a corporate U.S. shareholder with respect to a CFC 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).

[188] Code Sec. 245A(c).

[189] Code Sec. 245A(c)(3), *cross-referencing* Code Sec. 245(a)(5)(A) and (B). A dividend paid out of ECI E&P (for this purpose including E&P attributable to ECI subject to a reduced rate of tax, but not exempted, pursuant to a U.S. tax treaty) or E&P attributable to dividends from 80-percent owned domestic corporations, excluding RICs and REITs ("general domestic dividend E&P") (collectively, "undistributed post-1986 U.S. earnings") is allowed a DRD under Code Sec. 245(a) equal to the percent specified in Code Sec. 243 ("245(a) DRD"). Code Sec. 245(a)(1) and (5). A dividend paid out of E&P attributable to a dividend from an 80-percent owned domestic corporation that is a RIC or REIT ("RIC/REIT domestic dividend E&P" and, collectively with general domestic dividend E&P, "domestic dividend E&P") is not eligible for any 245(a) DRD. *See* Code Sec. 245(a)(5)(B) and (12) (such E&P is excluded from undistributed post-1986 U.S. earnings). Further, no 245(a) DRD is allowed for a dividend paid out of pre-acquisition E&P. *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 post-1986 earnings and undistributed post-1986 U.S. earnings of the distributing corporation). A DRD equal to 100 percent of the dividend is permitted with respect to a dividend received from a wholly owned foreign corporation which is subject to tax under chapter 1 of the Code if the dividend is paid out of E&P of a taxable year of the foreign corporation during which (a) the domestic corporation receiving the dividend owns directly or indirectly throughout such year all of the outstanding stock in the foreign corporation, and (b) all of the gross income of the foreign corporation from all sources is ECI ("245(b) DRD"). Code Sec. 245(b), Reg. §1.245-1(b).

[190] Code Sec. 245A(c)(2).

[191] In addition to the limitations described *infra*, dividends from corporations that are, or were in the taxable year immediately preceding, tax-exempt entities under Code Sec. 501 or Code Sec. 521, are not eligible for a 245A DRD. *See* Code Sec. 246(a)(1). However, this is a very narrow limitation, and therefore is not discussed further in this report.

[192] Code Sec. 246(c)(1).

[193] Code Sec. 246(c)(5)(A).

[194] Code Sec. 246(c)(5)(B).

[195] Code Sec. 1223(1) provides that when a person receives property with an exchanged basis (*i.e.*, the person's basis in the property received is determined, in whole or in part, by reference to the person's basis in the property exchanged) and the property exchanged is a capital asset at the time of the exchange, the transferee's holding period in the property received in the exchange includes the transferor's holding period in the property exchanged. Code Sec. 1223(2) provides that when a person acquires property with a carryover basis (*i.e.*, the person's basis in the property is determined, in whole or in part, by reference to the transferor's basis in the property), the person's holding period in the property acquired includes the transferor's holding period in such property. Code Sec. 246 does not explicitly provide that "tacked" holding periods are taken into account for purposes of satisfying any holding period requirement. However, Code Sec. 1223 expressly applies "for purposes of [Subtitle A]," which includes Code Sec. 246. *See* Code Sec. 1221(a). Moreover, Code Sec. 246(c)(3)(B) provides that the tacking rule under Code Sec. 1223(3) (pertaining to wash sales) does *not* apply for purposes of Code Sec. 246, implying that tacked holding periods are generally taken into account for purposes of Code Sec. 246.

Wolters Kluwer

[196] *See* Code Sec. 246(c)(1).

[197] Code Sec. 246(c)(1)(A).

[198] Code Sec. 246(c)(2).

[199] An earlier tax reform proposal during the Obama administration had proposed a 180-day holding period requirement for a 245A DRD. *See* Dave Camp, Chairman, House Ways and Means Committee, Tax Reform Act of 2014 Discussion Draft, §4001 (released Feb. 26, 2014).

[200] H.R. Rep. No. 85-775, at 14 (1957) (highlighting a second concern where a corporation is in a long and short position on the ex-dividend date).

[201] *Id.*

[202] *Id.* ("As a result [of a dividend strip], there is a recognized loss equal to the amount of the dividend income received. However, only 15 percent of the dividend income is taxed to the corporation (in effect reducing a 52-percent rate on the dividend income to 7.8 percent) while the corresponding loss is deductible in full against income taxable at 52 percent in the case of most corporate security dealers or can be offset against capital gain income taxable at 25 percent in the case of corporations which are not dealers in securities.").

[203] Code Sec. 246(c) initially prescribed only a 15-day holding period for common stock. Pub. L. No. 85-866, §18, 72 Stat. 1614 (1958). In 1984, Congress increased the requisite holding period for common stock to 45 days. *See* Pub. L. No. 98-369, §53(b), 98 Stat. 567 (1984). At the same time, Congress enacted Code Sec. 1059, discussed immediately *infra* in text, to further deter dividend stripping transactions. *See* Pub. L. No. 98-369, §53(a), 98 Stat. 565 (1984).

[204] As part of the TCJA, Congress enacted Code Secs. 245A and 961(d) and amended Code Sec. 1059 to apply to 245A DRDs. Before the TCJA, Code Sec. 1059 applied to dividends eligible for a 243 DRD, 245(a) DRD, or 245(b) DRD.

[205] 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. Code Sec. 1059(c).

[206] Code Sec. 1059(a). 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, but cannot take into account ownership after the ex-dividend date. Further, certain dividends pursuant to a redemption, particularly deemed redemptions under Code Sec. 304, are treated as *per se* extraordinary dividends without regard to whether the shareholder satisfies the 1059 holding period requirement. Code Sec. 1059(e).

[207] Code Sec. 1059(a)(2). 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. Code Sec. 1059(b)(1). 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. Code Sec. 1059(b)(2).

[208] 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).

[209] Congress viewed Code Sec. 961(d) as a complement to Code Sec. 1248; whereas the latter provides an exemption on gain recognized on the sale of CFC stock by recharacterizing the gain as a Code Sec. 245A-eligible dividend to the extent of the E&P attributable to the stock, the former disallows loss recognized on the sale of CFC stock to the extent attributable to dividends afforded a 245A DRD. *See* S. Prt. No. 115-20, 115th Cong., 1st Sess. at 360 (Comm. Print 2017) ("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.").

[210] *Compare* Code Sec. 246(c)(2) *with* Code Sec. 246(c)(1)(A). *See* Part III.C.2.d.ii of this report for a more detailed discussion on holding period requirements for DRDs.

[211] 2016 U.S. Model Income Tax Convention (2016), Art. 10, Para. 2(a).

[212] *See* Preamble to 2016 U.S. Model Income Tax Convention (2016), at 8-9 ("The 2016 Model incorporates certain...BEPS recommendations for the first time [including] ... a twelve-month ownership requirement for the five-percent withholding rate for direct dividends"), and Preventing the Granting of Treaty Benefits in Inappropriate Circumstances, Action 6—2015 Final Report, at 70, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris ("Action 6") (providing treaty ownership threshold recommendations in respect of dividends).

[213] Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and on Capital Gains, U.S.–U.K., Jul. 24, 2001, TIAS 13161.

[214] S. Exec. Rep.108-2, 108th Cong., 1st Sess. at 6–7 (Mar. 13, 2003).

[215] Indeed, Action 6 specifically notes that the "[i]nternal laws of certain OECD member countries provide for a minimum period during which the recipient company must have held the shares to qualify for exemption or relief in respect of dividends received." Action 6, at 70. This is a reference to other countries' participation exemptions for dividends, the inspiration for Code Sec. 245A.

[216] In no provision, including Code Sec. 245A, does the Code refer to a "participation exemption." However, the legislative history is replete with references to Code Sec. 245A as a "participation exemption" provision. *See e.g.*, TCJA House Report, at 370–371, 378–379, and 383; TCJA Senate Report, at 362, 392. Indeed, the TCJA itself refers to its international tax provisions with respect to outbound transactions as "Subpart A—Establishment of Participation Exemption System for Taxation of Foreign Income." Pub. L. No. 115-97, Subpart A, 131 Stat. 2189 (2017).

[217] For instance, the 245A DRD ownership requirement is satisfied if ten percent of the vote *or* value of the shares of the paying corporation are held by the recipient shareholder, whereas the Model Treaty provides that the treaty ownership requirement is satisfied only if ten percent of the vote *and* value of the shares are owned. In addition, the 245A holding period requirement can be satisfied before or after the dividend, whereas the treaty ownership requirement must be satisfied as of the date that the entitlement to the dividends is determined.

[218] Reg. §1.245A(e)-1(b)(2).

[219] 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).

[220] Reg. §1.245A(e)-1(d)(1).

[221] Reg. §1.245A(e)-1(f)(6).

[222] Reg. §1.245A(e)-1(d)(4)(iii)(A)(1).

[223] Reg. §1.245A(e)-1(d)(4)(iii)(A)(2).

[224] Reg. §1.245A(e)-1(e).

[225] Reg. §1.245A-5 also disallows a 245A DRD or the look-thru exception for a dividend that occurs in the same taxable year as an "extraordinary reduction." *See* Reg. §1.245A-5(b)(2)(ii) and (e) and (f). However, an inbound asset transaction cannot give rise to an extraordinary reduction, because such transaction causes the tax year of the CFC to close. *See* Reg. §1.245A-5(e)(2)(i)(C); *see also* Code Sec. 381(b)(1) and Reg. §1.367(b)-2(f)(4). A deemed dividend received by a 1248 shareholder under B4 pursuant to a foreign-to-foreign transaction could be denied a 245A DRD under the extraordinary reduction rules. *See* Reg. §1.245A-5(e). But it appears that a deemed dividend under B4 received by an exchanging shareholder that is a CFC would not result in FPHCI, notwithstanding the application of the extraordinary reduction rules, because B4 provides an exception to FPHCI that does not rely on the look-thru exception. *See* Reg. §1.367(b)-4(c) (providing that such deemed dividend is not FPHCI).

[226] The regulation also limits the applicability of the look-thru exception with respect to certain CFC-to-CFC dividends that constitute a "tiered

Wolters Kluwer

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). *See* Reg. §1.245A-5(d).

[227] Reg. §1.245A-5(c)(3)(i)(C).

[228] Reg. §1.245A-5(c)(3)(ii).

[229] Reg. §1.245A-5(c)(3)(iii). The disqualified period is the period in 2018 during which the income of a fiscal year CFC was subject to neither Code Sec. 965 nor GILTI. As discussed *supra* in Part III.C.2.b of this report, as part of the transition to the new international tax system implemented by the TCJA, Code Sec. 965 generally required U.S. shareholders of CFCs and certain 10/50 companies to include in their gross income an amount equal to such shareholders' *pro rata* share of such foreign companies' undistributed post-1986 E&P, with the last measurement date for such E&P being December 31, 2017. Code Sec. 965(a). In contrast, GILTI was made effective for taxable years of foreign corporations *beginning after* December 31, 2017. Pub. L. No. 115-97, §14201(d), 131 Stat. 2213 (2017). As a result, for a calendar year CFC, all income of such CFC would be subject to either the transition tax (if earned on or before December 31, 2017) or GILTI (if earned on or after January 1, 2018, the beginning of the first taxable year beginning after December 31, 2017). Thus, calendar year CFCs had no disqualified period. However, for a fiscal year CFC, any income recognized by the CFC after December 31, 2017, but before its first taxable year beginning after December 31, 2017 (*e.g.*, December 1, 2018, for a CFC with a taxable year ending November 30), would have been subject to neither the transition tax nor GILTI. Thus, during this "GILTI holiday," a taxpayer with fiscal-year CFCs could engage in transactions to step-up its CFCs' asset basis, which basis could then be used (*e.g.,* through increased amortization or depreciation) to reduce tested income and thus GILTI in future years, without incurring any additional U.S. tax cost by reason of the transaction.

[230] Reg. §1.245A-5(c)(3)(i).

[231] Reg. §1.245A-5(c)(2)(i).

[232] Reg. §1.245A-5(c)(4)(i)(A). Reg. §1.245A-5(c)(4)(i)(B) and (C) provide rules for determining the proportion of the EDA allocated to the transferred shares for this purpose.

[233] Reg. §1.245A-5(c)(4)(i)(D).

[234] Reg. §1.245A-5(c)(4)(iv)(A). *See also* T.D. 9909, 85 FR 53068, 53075 (Aug. 27, 2020) ("In these cases, the remaining balance [of the EDA] generally represents an individual's or a foreign (non-CFC) person's share of E&P of the SFC, such that, after the transfer, distributions of the E&P are unlikely to give rise to a dividend eligible for the section 245A deduction. Therefore, there is generally not a policy need to continue tracking such E&P.").

[235] Reg. §1.245A-5(c)(4)(vii); *see also* Reg. §1.245A-5(h) (the general anti-avoidance rule).

[236] Pub. L. No. 115-97, §14213, 131 Stat. 2217 (2017).

[237] H.R. Rep. No. 115-409, at 387 ("The Committee is aware of certain transactions used to avoid subpart F provisions. One such transaction involves effectuating 'de-control' of a foreign subsidiary, by taking advantage of the section 958(b)(4) rule that effectively turns off the constructive stock ownership rules of 318(a)(3) when to do otherwise would result in a U.S. person being treated as owning stock owned by a foreign person. Accordingly, such a transaction converts former CFCs to non-CFCs, despite continuous ownership by U.S. shareholders. The Committee believes this provision is necessary to render de-controlling transactions ineffective as a means of avoiding the subpart F provisions."); *see also* S. Prt. No. 115-20, 115th Cong., 1st Sess. at 382-383 (Comm. Print 2017).

[238] *See* S. Prt. No. 115-20, 115th Cong., 1st Sess. at 383 (Comm. Print 2017).

[239] Senator Perdue put forward an amendment to codify the explanation of the provision in the TCJA House Report and TCJA Senate Report regarding the limited scope of the repeal of Code Sec. 958(b)(4), but such amendment was not passed, and the explanatory language in these reports was not reflected in the Conference Report accompanying the TCJA. *See* H.R. Conf. Rep. No. 115-466, at 633 (Dec. 15, 2017). On December 19, 2017, Senator Perdue (R-GA) raised the issue on the Senate floor, stating, "I would like to confirm that the conference report language did not change or modify the intended scope [of] this statement. As you know, I filed an amendment to the Senate bill, Senate amendment No. 1666 would have codified this explanatory text of the Finance Committee report. I also want to confirm that the Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation of the bill." Senator Hatch (R-UT), Chairman of the Senate Finance Committee, responded that "[t]he Senator is correct. The conference report language for the bill does not change or modify the intended scope of the statement he cites. The Treasury Department and the Internal Revenue Service should interpret the stock attribution rules consistent with this explanation, as released by the Senate Budget Committee. I would also note that the reason his amendment No. 1666 was not adopted is because it was not needed to reflect the intent of the Senate Finance Committee or the conferees for the Tax Cuts and Jobs Act." 163 Cong. Rec. S8110 (daily ed. Dec. 19, 2017).

[240] Former Code Sec. 951(a)(1).

[241] Pub. L. No. 115-97, §14215, 131 Stat. 2218 (2017).

[242] Former Code Sec. 951(b).

[243] *See* Pub. L. No. 115-97, §14214(a), 131 Stat. 2218 (2017). Pre-TCJA, both U.S. shareholder status and 1248 shareholder status were determined solely by reference to voting power. The TCJA did not incorporate the change to the definition of a U.S. shareholder into the ownership requirement of Code Sec. 1248, and thus whether a U.S. person is a 1248 shareholder is still determined solely by reference to voting power. *See* Code Sec. 1248(a)(2).

[244] 56 FR 41993, 41995 (Aug. 26, 1991).

[245] T.D. 8862, 65 FR 3589, 3590 (Jan. 24, 2000).

[246] 56 FR 41993, 41996 (Aug. 26, 1991).

[247] T.D. 8862, 65 FR 3589, 3590 (Jan. 24, 2000).

[248] 56 FR 41993, 41995 (Aug. 26, 1991).

[249] *Id*.

[250] *Id*. at 41997.

[251] The preamble does, however, acknowledge that in some cases the regulations depart from the repatriation and distortion principles in favor of the complexity principle, providing that "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." *Id*. at 41995.

[252] *Id*.

[253] *Id*. (omission of Oxford comma in original).

[254] B4 also prevents one other distortion – a distortion in the *source* of income ("source distortion"). A transaction resulting in a loss of 1248 shareholder status may result in a source distortion since any income recognized by the exchanging shareholder from a subsequent disposition of the stock of the foreign acquiring corporation would generally be U.S. source (from the sale of stock by a U.S. person) rather than foreign source (from a dividend under Code Sec. 1248). *See* Code Secs. 865(a)(1) and 861(a)(2)(B). However, a source distortion here would generally be *unfavorable* to a taxpayer, since recharacterizing foreign source income into U.S. source income can result in a limitation to the foreign tax credit permitted to the taxpayer. *See* Code Sec. 904(a). Therefore, while B4 does, in fact, prevent a source distortion by reason of a loss of shareholder status, this should be viewed as merely a fortunate by-product of rules intended to police character distortion. *See* Code Sec. 367(b)(1) (authorizing regulations "which are necessary or appropriate to prevent the avoidance of Federal income taxes"); *cf.* Notice 87-64, 1987-2 CB 375 (suspending the application of Code Sec. 1248(e) when "the primary consequence of characterizing gain on CFC stock as a dividend will be the receipt of the indirect foreign tax credit that accompanies the deemed dividend").

[255] T.D. 8862, 64 FR 3589, 3590 (Jan. 24, 2000).

[256] *See* Code Secs. 332 and 381.

[257] *See* Code Secs. 301 and 316.

[258] *See* Code Sec. 334(b).

[259] *See* Code Sec. 358(a).

[260] To the extent that the gain in the domestic parent corporation's stock in the foreign acquired corporation reflected unrealized appreciation in the assets of the foreign acquired corporation, this unrealized gain in the assets would continue to exist in the hands of the domestic parent corporation by reason of Code Sec. 362(a). In contrast, to the extent that the domestic parent corporation had an unrealized *loss* in its stock in a foreign subsidiary that reflected an operating loss generated by the foreign subsidiary or unrealized losses in the assets of the foreign subsidiary, an inbound liquidation would create

Wolters Kluwer

an amount distortion, but the distortion in this case would be deleterious to the taxpayer because the domestic parent corporation would be sacrificing its higher "outside" basis (the basis in its stock in the foreign subsidiary) for lower "inside" basis (its basis in the assets inherited from the foreign subsidiary).

[261] *See* Reg. §1.367(b)-3(b)(3); Guidelines §3.01(1); Reg. §7.367(b)-5T(b) (1977).

[262] *See* Code Sec. 354(a).

[263] *See* Code Sec. 358(a).

[264] Stock gain can easily be eliminated through a complete liquidation of the domestic acquiring corporation under Code Sec. 332, including a deemed liquidation by reason of an election made under Code Sec. 338(h)(10) on a disposition of the domestic acquiring corporation. *See* Reg. §1.338(h)(10)-1(d)(4).

[265] *See* Reg. §1.1502-13(f)(2) (excluding intercompany dividends from the distributee member's gross income to the extent there is a corresponding negative adjustment under Reg. §1.1502-32 in the distributee member's basis in the stock in the distributing member). While a dividend in excess of the distributee member's basis in the stock in the distributing member would create an excess loss account ("ELA"), *see* Reg. §1.1502-32(a)(3)(ii), this ELA also can generally be eliminated tax-free through a complete liquidation of the distributing member under Code Sec. 332. *See* Reg. §1.1502-19(b)(2)(i).

[266] In general, the amount of a 243 DRD permitted to a corporate shareholder with respect to dividends from a domestic corporation depends on the shareholder's level of ownership in the distributing corporation. A corporate shareholder owning less than 20 percent (by vote or value) of the distributing corporation is entitled to a 50-percent 243 DRD. Code Sec. 243(a)(1). A corporate shareholder owning 20 percent or more (by vote and value) of the distributing corporation is entitled to a 65-percent 243 DRD. Code Sec. 243(c)(1). A corporate shareholder receiving dividends from a member of the same affiliated group is entitled to a 100-percent 243 DRD with respect to dividends paid out of E&P accumulated while the shareholder and the corporation were members of such affiliated group. Code Sec. 243(a)(3), (b).

[267] In the guidelines, the IRS did not generally provide a policy rationale for its various provisions. As an exception, the IRS explained that requiring a domestic corporate shareholder to agree to an all E&P inclusion in an inbound asset reorganization was necessary because of the shareholder's ability to obtain a 243 DRD with respect to post-transaction dividends. *See* Guidelines, §3.03(1)(b).

[268] *See* Guidelines, §3.03(1)(b); Reg. §7.367(b)-7T(c)(2) (1977). The guidelines required an all E&P inclusion by a domestic corporate shareholder only where it held 20 percent or more of the outstanding stock in the foreign corporation. With respect to the temporary regulations, there was some uncertainty regarding whether an all E&P inclusion was required for only corporate 1248 shareholders, or, alternatively, whether it applied with respect to any domestic corporate shareholder, including a small corporate shareholder. *See supra*, notes 103 and 106.

[269] *See* Guidelines, §4.01; Reg. §7.367(b)-7T(c) (1977). However, as discussed *supra* in Parts III.B.2 and III.B.4 of this report, and *infra* in Part IV.B.2 of this report, such shareholders could be required to include their 1248 amount under the guidelines and the temporary regulations.

[270] *See* Reg. §1.367(b)-3(b).

[271] *See* Reg. §1.1248-8(b)(3)(ii).

[272] However, as discussed *infra* in Part V.E of this report, post-TCJA, an inbound stock transfer arguably results in a timing distortion.

[273] *See* Guidelines, §3.03(1)(b). However, the guidelines limited the inclusion to the E&P of the foreign acquired corporation. *Id*.

[274] *See* Reg. §7.367(b)-7T(c)(1)(i) (1977).

[275] *See* Part IV.B.1 of this report.

[276] *See* Part IV.B.2 of this report.

[277] *See* Part IV.B.1 and 2 of this report.

[278] *See* Code Sec. 358(a).

[279] *See* Code Sec. 381(a)(2).

[280] This is a distortion in timing, and not in amount, because the Group members' stock gain, realized but not recognized in the transaction, is available for recognition in any future taxable disposition. It is true that this distortion in timing could become a permanent distortion (*i.e.*, an amount distortion) if a Group member dies before a taxable disposition. *See* Code Sec. 1014(a). However, any such distortion is a consequence of the rule that steps up the basis of property on death, which rule has been proposed to be eliminated on many occasions, including by the Obama and Biden Administrations. *See e.g.*, Dept of the Treasury, General Explanation of the Administration's Fiscal Year 2015 Proposals, at 160-161 (Mar. 2014); Dept of the Treasury, General Explanation of the Administration's Fiscal Year 2023 Proposals, at 30 (Mar. 2022); Dept of the Treasury, General Explanation of the Administration's Fiscal Year 2022 Proposals, at 61 (May 2021).

[281] The regulations announced in Notice 2016-73, §4.03(a), 2016 CB 908 (Dec. 2, 2016), relating to inbound asset transactions following certain triangular reorganizations effectuated to repatriate CFC earnings tax-free (so-called "'Killer B' transactions") would also address a timing distortion, but with respect to domestic corporate shareholders. Absent the rules announced in the notice, a domestic acquiring corporation could inherit assets of a foreign acquired corporation (*e.g.*, a note receivable owned by the foreign acquired corporation from a lower-tier foreign corporation) indirectly created from untaxed E&P of the lower-tier foreign corporation before such E&P is subject to U.S. tax. Pre-TCJA, the inbound asset transaction created a distortion in timing, rather than amount, since the E&P of the lower-tier foreign corporation was still available after the inbound asset transaction to fund a taxable dividend to a U.S. shareholder. Indeed, the E&P of lower-tier foreign subsidiaries involved in this transaction (*i.e.*, an inbound asset transaction following a "Killer B" transaction) would likely have been deemed repatriated under Code Sec. 965, albeit at a lower rate due to the 965(c) deduction.

[282] *See* Part III.C.1.c of this report.

[283] In the preamble to the final regulations, Treasury and the IRS did request comments on whether future regulations should generally limit the carryover of tax attributes from foreign to domestic corporations, even with respect to E&P and basis attributable to foreign shareholders. T.D. 8862, 65 FR 3589, 3590 (Jan. 24, 2000). Treasury and the IRS explained that such a limitation would "more directly implement the section 367(b) policy related to the carryover of attributes and, as a result, reduce the class of U.S. persons required to have an income inclusion in connection with an inbound nonrecognition transaction. Such a limitation would also enable the section 367(b) regulations to address the carryover of attributes attributable to a non-U.S. person's holding period." *Id*. In response to the question whether the 367(b) regulations should limit tax attributes attributable to non-U.S. persons, no, don't do that.

[284] Repatriation Definition, Merriam-Webster.com, *www.merriam-webster.com/dictionary/repatriation* (last visited Nov. 23, 2022).

[285] H.R. Rep. No. 87-1447, at 59 (1962).

[286] *See* Part III.C.2.d.ii of this report.

[287] It is true, however, that the repeal of Code Sec. 958(b)(4), discussed in Part III.C.2.e of this report, can cause a U.S. person that owns directly or indirectly (within the meaning of Code Sec. 958(a)) less than ten percent (by vote and value) of a foreign corporation to be treated as a U.S. shareholder of such foreign corporation by attribution, thus potentially requiring such shareholder to take into account a subpart F or GILTI inclusion with respect to the stock in the foreign acquired corporation that such shareholder does own directly or indirectly (within the meaning of Code Sec. 958(a)). However, as discussed *supra* in Part III.C.2.e of this report, Congress repealed Code Sec. 958(b)(4) to serve the narrow purpose of preventing potential tax benefits from certain "out-from-under" transactions. While the repeal of Code Sec. 958(b)(4) has had much broader ramifications than Congress intended, the amendment should not be imbued with equally broad policy implications.

[288] The default under B3 for exchanging shareholders that are small shareholders is gain with respect to their stock in the foreign acquired corporation, rather than an all E&P inclusion. However, the preamble to the final regulations makes it clear that Treasury and the IRS viewed the assets and E&P of a foreign acquired corporation as attributable to all the corporation's U.S. owners, including small shareholders, and that gain recognition was adopted as the general rule for small shareholders merely as a rule of convenience. *See* T.D. 8862, 65 FR 3589, 3593 (Jan. 24, 2000) ("This rule was included because of administrative concerns, since

Wolters Kluwer

small shareholders may not have sufficient information to calculate their all earnings and profits amounts. In addition, a foreign acquired corporation may not have adequate information about its small shareholders' inclusions to properly adjust its earnings and profits for the deemed dividends that would arise in these situations.").

[289] *See, e.g.,* Stewart Lipeles, *et al.*, *Did Anyone Notice the TCJA Made Code Sec. 367(b) Obsolete?*, TAXES, 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).").

[290] *See* Part III.C.1.a of this report.

[291] 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. *See en.wikipedia.org/wiki/Varsity_Blues_scandal*.

[292] However, with respect to the character distortion, the argument in favor of eliminating B4, discussed *infra*, applies with equal force to B3. In either case, there is relatively little to be gained by a shareholder in losing its 1248 shareholder status if dividends from the foreign acquired corporation are already eligible for QDI.

[293] *See* Code Secs. 245A(c)(3), 246(c)(5), Reg. §§1.245A-5(b); 1.245A(e)-1(d). A dividend paid out of RIC/REIT domestic dividend E&P would also not qualify for a 245(a) DRD. *See* Code Sec. 245(a)(5)(B) and (12). While a dividend paid out of general domestic dividend E&P may be eligible for a 245(a) DRD, the maximum 245(a) DRD permitted under current law would be equal to 65 percent of the dividend. *See* Code Secs. 245(a)(1), 245(a)(5)(B), and 243(c)(1). Therefore, withdrawing B3 could permit a taxpayer, through an inbound asset transaction, to avoid, in whole or in part, U.S. tax that would otherwise be imposed on a dividend from a foreign acquired corporation paid out of domestic dividend E&P. In general, ECI E&P of a foreign corporation are also deferral E&P with respect to a corporate U.S. shareholder, unless such dividend is from a wholly owned foreign corporation all of whose gross income is ECI and is thus eligible for a 100-percent 245(b) DRD. However, ECI E&P are generally excluded from the computation of the all E&P amount. *See* Reg. §1.367(b)-2(d)(2)(ii), *cross-referencing* Code Sec. 1248(d). Therefore, even under current law, a taxpayer could avoid any U.S. tax that would be due with respect to any dividend paid out of ECI E&P of a foreign acquired corporation through an inbound asset transaction.

[294] *See* Part IV.B.2 of this report.

[295] The authors are reminded of the joke, "What's worse than seeing a worm in your apple? Seeing half a worm in your apple."

[296] Code Sec. 1(j)(2).

[297] Code Secs. 1(h)(1)(D) and 1411(a)(1).

[298] As discussed *supra* in Part III.C.1.a of this report, 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. The Vanguard Group, the largest provider of mutual funds and the second-largest provider of exchanged-traded funds ("ETFs") in the world, estimates that, in 2022, 72.77 percent of the dividends from its Total International Stock Market ETF (VXUS) will be eligible for QDI. *See advisors.vanguard.com/tax-center/qualified-dividend-income*. 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.

[299] *See* Part III.C.1.a of this report.

[300] *See* Reg. §1.245A(e)-1(d)(4)(iii)(A)(2) and (f)(6). This assumes that the transaction is not "undertaken with a principal purpose of avoiding" the rules for hybrid dividends, and thus the anti-avoidance rule of Reg. §1.245A(e)-1(e) does not apply.

[301] Reg. §1.245A-5(c)(4)(iv)(A). For the purpose of this discussion, assume also that the transaction is not "undertaken with a principal purpose" to avoid an EDA account or "avoid the purposes of" Reg. §1.245A-5. *See* Reg. §1.245A-5(c)(4)(vii) and (h).

[302] *See* Part III.C.1.b of this report.

[303] Code Sec. 986(c)(1).

[304] *Id*.

[305] Reg. §1.367(b)-2(j)(2)(i).

[306] *Id*.

[307] This approach has been recommended for consideration by at least two commentators recently. *See* Skadden, Arps, Slate, Meagher & Flom LLP, Comments Re Treas. Reg. §1.367(b)-3, at 15–16 (Aug. 25, 2021) (the "Skadden letter"); 2022 NYSBA Report, at 5.

[308] *See* Part III.B.2 and 4 of this report. However, as discussed *supra* in note 106, there is some uncertainty as to whether the temporary regulations required all corporate shareholders, including small corporate shareholders, to include an all E&P amount in an inbound asset reorganization.

[309] *See* Part III.B.5 of this report.

[310] *See* Part IV.B.3 of this report.

[311] H.R. Rep. No. 87-1447, at 57 (1962).

[312] *Id.* at 59.

[313] *See, e.g., Eisner v. Macomber*, SCt, 1 USTC ¶32, 252 US 189, 211, 40 SCt 189 (1920) (ruling that a stock dividend received by a shareholder was not a realization event).

[314] *See* Part IV.B.1 of this report.

[315] If the small corporate shareholder owns less than 20 percent of the stock in the domestic acquiring corporation after the inbound asset reorganization, and the shareholder satisfies the holding period requirement under Code Sec. 246(c) applicable to 243 DRDs, the shareholder would be entitled to a 50-percent 243(a) DRD for dividends from the domestic acquiring corporation. *See* Code Sec. 243(c).

[316] In effect, stock gain takes into account the E&P of lower-tier foreign corporations, notwithstanding that for purposes of determining the all E&P amount of a shareholder, E&P of lower-tier foreign corporation are excluded. *See* Reg. §1.367(b)-2(d)(3)(ii).

[317] 56 FR 41993, 41996 (Aug. 26, 1991).

[318] *See* 1992 NYSBA report, at 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.").

[319] *Cf.* T.D. 9243, 71 FR 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)").

[320] Guidelines, §3.03.; Reg. §7.367(b)-5T(b) (1977). However, as discussed *supra* in Part III.B.4 of this report, there is some uncertainty as to whether small *corporate* shareholders were required to include their all E&P amount under the temporary regulations.

[321] The 245A DRD could be limited because, for example, the shareholder has an HDA or EDA with respect to the foreign acquired corporation. *See* Part III.C.2.d.iii and iv of this report.

[322] *See* Reg. §1.367(b)-2(e)(3)(ii). In the case of an inbound liquidation, there is no such increase, because the stock in the foreign acquired corporation, the basis of which is increased, is not exchanged for stock in the domestic acquiring corporation, but rather extinguished, so the basis increase is not reflected in any stock or property immediately after the transaction.

[323] TRA House Report, at 241.

[324] *See* Skadden letter, at 6–11. 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 an inbound asset transaction that followed an inbound stock transfer (*i.e.*, a two-step inbound transaction) by continuing to hold the assets of the foreign acquired corporation. *See e.g.*, 2022 NYSBA report, at 26-29;

Wolters Kluwer

Skadden letter, at 17–19. If Treasury and the IRS were to adopt this recommendation, and small shareholders were not generally excepted from the application of B3, taxpayers would be further incentivized to structure theirs acquisitions as two-step inbound transactions rather than one-step inbound transactions.

[325] If small shareholders are excluded from B3, Treasury and the IRS should provide guidance that E&P of a foreign acquired corporation attributable to small shareholders cannot be attributed to a domestic acquiring corporation as a result of an inbound stock transfer for purposes of computing the domestic acquiring corporation's all E&P amount with respect to the foreign acquired corporation. *Compare* Reg. §1.1248-8(b)(3)(ii) (providing that a domestic acquiring corporation takes into account under Code Sec. 1223(2) an exchanging shareholder's holding period with respect to the stock of a foreign acquired corporation if the exchanging shareholder is a 1248 shareholder or a foreign corporate 1248 shareholder) *with* Reg. §1.367(b)-2(d)(3)(i)(A)(1) (providing that the all E&P amount is determined "without regard to the requirements of section 1248 that are not relevant to the determination of a shareholder's pro rata portion of earnings and profits," including "without regard to whether the shareholder owned a 10 percent or greater interest in the stock"). In fact, even if small shareholders are *not* excluded from B3, Treasury and the IRS should provide guidance clarifying the treatment under Reg. §1.1248-8(b)(3)(ii) of E&P attributable to an exchanging shareholder that is a small shareholder.

[326] *See* Part IV.B of this report.

[327] *See* Part IV.B.3 of this report.

[328] The Skadden letter suggests a similar approach but would require the domestic acquiring corporation to make the election with respect to all the exchanging shareholders, not just the non-245A shareholders, and treat the domestic acquiring corporation as satisfying 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. *See* Skadden letter, at 18-19. The effect of this approach would be to permit the entire aggregate all E&P inclusion of non-245A shareholders with respect to a foreign acquired corporation to qualify for the 245A DRD, except to the extent of any domestic dividend E&P of the foreign corporation. 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 ECI E&P are not included in the all E&P amount. *See* Reg. §1.367(d)-2(d)(2)(ii), *cross-referencing* Code Sec. 1248(d)(4). In other words, this approach would be tantamount to simply permitting full repatriation of deferral E&P attributable to non-245A shareholders without U.S. tax, except where the foreign acquired corporation has domestic dividend E&P or E&P attributable to ECI that is exempted from taxation (or subject to a reduced rate of tax) pursuant to a U.S. tax treaty. The approach outlined in the Skadden letter is more similar, in practical effect, to the proposal described in Part V.D of this report, under which there would be no deemed dividend except to the extent of E&P that cannot qualify for a 245A DRD, regardless of the shareholder (*i.e.*, non-245A E&P).

[329] 65 FR 3589, 3593 (Jan. 24, 2000).

[330] *Id*. at 3592–93.

[331] *See* Skadden letter, at 18-19. A similar rebuttable presumption can be found in the rules under Code Sec. 367(a) applicable to outbound transfers of stock in a domestic corporation, under which persons who transfer stock in the domestic corporation are presumed to be U.S. persons. *See* Reg. §1.367(a)-3(c)(2).

[332] 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 in the domestic acquiring corporation received in exchange for the stock in the foreign acquired corporation, in addition to the period during which the shareholder held the stock in 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 in the foreign acquired corporation under Code Sec. 1223(1).

[333] *See* Part II.A of this report.

[334] There is some uncertainty as to whether a "nimble dividend" (*i.e.*, a dividend paid out of current E&P under Code Sec. 316(a)(2) when the corporation has an accumulated E&P deficit in excess of the current E&P) is eligible for a 245A DRD. It is anticipated that Treasury and the IRS will clarify this issue in future regulations under Code Sec. 245A, and it is hoped that such clarification will provide that a nimble dividend is eligible for a 245A DRD. However, regardless of how Treasury and the IRS intend to resolve this issue, for purposes of the proposal described here, E&P would be considered 245A E&P even if a dividend paid out of such E&P would fail to qualify for a 245A DRD solely because the dividend is nimble.

[335] *See* Part V.B of this report.

[336] *See* Part V.A of this report.

[337] *Id.*

[338] *See* Part II.C of this report.

[339] An inbound stock transfer also has the effect of "importing" basis when the stock in a CFC is acquired by a U.S. shareholder because the assets of the CFC are taken into account for purposes of determining the U.S. shareholder's GILTI inclusion. Unlike E&P that is shifted to the domestic acquiring corporation in an inbound stock transfer, however, the CFC's asset basis can only be used to reduce the domestic acquiring corporation's GILTI rather than its U.S. income. Also, it is also more difficult to utilize the basis to create immediate deductions, even to reduce GILTI, because accelerated and bonus depreciation are not available for offshore assets. *See* Code Sec. 168(g) (requiring use of alternative depreciation system for offshore tangible property).

[340] 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 stock in the domestic acquiring corporation. *See* Code Sec. 243(a)(1) and (c).

[341] *See* Part V.C of this report.

[342] Reg. §7.367(b)-7T(c)(1)(i) (1977).

[343] Reg. §1.1248-8(b)(3)(ii).

[344] *See* Reg. §1.367(b)-2(e)(3)(ii).

[345] *See* Part V.D of this report.

[346] This approach would not require a small shareholder to recognize gain. However, there is no reason that, if Treasury and the IRS continued to believe that small shareholders should continue to be subject to B3, they could not alter this approach to apply to inbound stock transfers involving small shareholders as well. However, *see* Part V.B for a discussion regarding the reasons small shareholders should be excluded for purposes of B3.

[347] *See* Part III.C.2.d.ii of this report.

[348] Code Sec. 367(b)(1).

[349] Code Sec. 368(a)(1)(B) defines a B reorganization as "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" (emphasis added).

[350] *See* Part III.B.4 of this report.

[351] Indeed, Treasury and the IRS likely also believed they lacked the authority at one point, as evidenced by the application of the temporary regulations to inbound stock reorganizations but not inbound 351 exchanges. *See also* D. Kevin Dolan and Daniel Horowitz, *Reorganizations of Foreign Corporations Under Section 367(b): Issues and Recommendations*, 38 TAX. L. REV. 321 (1982), at 327 n. 9 (indicating that regulations could require an income inclusion in the case of an inbound 351 exchange "only by an amendment of §367(b) to bring such §351 transfers within its purview").

[352] *See* Part V.B of this report.

[353] *See* Part V.D of this report.

[354] 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.

Wolters Kluwer

This article is reprinted with the publisher's permission from Taxes The Tax Magazine®, a monthly journal published by CCH Incorporated. Copying or distribution without the publisher's permission is prohibited. To subscribe to Taxes The Tax Magazine® or other journals, please call 1-800-344-3734 or visit taxna.wolterskluwer.com. All views expressed in this publication are those of the author and not necessarily those of the publisher or any other person.

Wolters Kluwer