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SECTION 367: AN ENIGMA*

INTRODUCTION

Section 367 of the Internal Revenue Code of 1954 was enacted in its original form in 1932¹ in order to close what Congress considered to be a serious tax loophole available to domestic corporations and individuals carrying on business through the use of foreign corporations or contemplating the use of foreign corporations to realize large gains without paying taxes.² The loophole resulted from the operation of the nonrecognition provisions of the Code dealing with the organization and reorganization of corporations. By using these provisions, individuals and corporations—both foreign and domestic—could transfer greatly appreciated property and unrealized profits on a tax-free basis to a new corporation organized in countries where certain transactions, e.g., sales of capital assets, were either taxed at low rates or not at all. An example would be the transfer of appreciated American stock and equipment to a corporation in Canada in a transaction which qualified for nonrecognition treatment under section 351. Thereafter, the Canadian corporation could sell the stock and equipment at little or no tax cost because Canada does not impose a capital gains tax.³ The Canadian corporation could then dissolve into its parent American corporation in a tax-free liquidation under section 332. By using these several steps, the American corporation could sell the appreciated property with none of the tax consequences that would be imposed upon a similar transaction taking place solely within the United States. Concerned with this type of activity, Congress enacted what is now section 367 in order to stop the use of “tax haven” countries in world-wide

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¹ Section 112(k) of the INT. REV. CODE of 1932, ch. 209, 47 Stat. 198 is almost identical to the section of section 367 (see text accompanying note 18, *infra*). Any reference to section 367 in the text of this article will be to the form found in the INT. REV. CODE OF 1954 [hereinafter cited as IRC].

² “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. . . . [T]he committee is convinced that the existing law may afford opportunity for substantial tax avoidance.” To prevent this avoidance the committee suggested the proposed amendment, i.e., section 367. Ways and Means Committee, H.R. Rep. No. 708, 72nd Cong., 1st Sess. (1932) cited in 1939-1 CUM. BULL. 457; S. Rep. No. 665, 72nd Cong., 1st Sess. (1932) cited in 1939-1 CUM. BULL. 496.

³ BNA, 45-2d Tax Management Portfolio at A-11 (1964) (Canada).

corporate planning.⁴ The section provides, in essence, that the non-recognition provisions of the Code shall not apply to organizations of foreign corporations and corporate reorganizations involving foreign corporations unless the Commissioner rules, prior to the transaction, that tax avoidance is not a principal purpose of the transaction.

This section immediately became a great stumbling block to individuals and corporations doing business or planning to do business in foreign countries. Since 1932, however, other changes have taken place, some of which partially alleviate the necessity of such a stringent statute,⁵ and others which may make recognition of gain more costly⁶ or make compliance with the statute more difficult.⁷ The language of the statute itself has created several problems of interpretation. The fact that there is apparently no judicial review of the Commissioner's rulings under section 367 has enhanced his power in this area, giving him a bargaining position which is perhaps unwarranted. Furthermore, under the current provisions of the Code, there are many cases where a taxpayer might want to have a particular transaction taxed, thereby reaping some of the benefits of a step-up in basis, extra foreign income to increase the maximum foreign tax credit under sections 901 and 904, etc. As the provision is now being interpreted, such an election on the part of the taxpayer may be difficult to achieve.

I. JUDICIAL AND LEGISLATIVE CHANGES IN THE TAX LAW WHICH MAY SUPPLEMENT, COMPLEMENT OR OTHERWISE AFFECT THE OPERATION OF SECTION 367.

Since its enactment in 1932, there have been many legislative and judicial developments which on the one hand make section 367 less

⁴ See note 2 *supra*.

⁵ For example, if appreciated property were transferred to a foreign corporation and promptly sold, the income would probably be subpart F income and taxed directly to the United States shareholder. See sections 951 and 954 of the IRC.

⁶ For example, certain gains previously recognized as long term capital gains may now be taxed as ordinary income under IRC §§ 1248 and 1249.

⁷ An example is the preferential treatment given in some situations to investment in less developed countries, *e.g.*, the lack of a gross-up in determining the foreign tax credit. In opposition to such incentive is the policy of the Commissioner to equate lower taxes of a foreign country and plans to incorporate in such a country under one of the nonrecognition sections with tax avoidance on the part of the taxpayer. See generally HEARINGS ON H.R. 5 BEFORE THE COMMITTEE ON WAYS AND MEANS, 86th Cong., 1st Sess. (1959). See also Siegel, *Section 367 of the Internal Revenue Code and Its Relationship to the Taxation of Certain Transactions Involving Foreign Corporations*, 22 *FED. B.J.* 109 (1962).

necessary to combat abuse, and which, on the other hand, make recognition of gain more costly to the taxpayer.

There is the possibility that the Commissioner does not really need section 367 in his fight against tax avoidance in this area when he is armed with such statutory weapons as sections 269 and 482 and subpart F, and with the judicial refinement of the step transaction and business purpose doctrines. In *Gregory v. Helvering*,⁸ for example, the court held that where the formation of a corporation had no business purpose and where the corporation served no function other than to convert ordinary income into capital gain, the existence of the corporation would be disregarded. There is little doubt that the *Gregory* case would apply to the example first given—the transfer of assets to Canada, sale, liquidation and transfer of cash back to the parent corporation in the United States. There, the taxpayer did indirectly what could have been done directly, and the court could strike down the various steps with the use of the step transaction doctrine, and consider the transaction as a single sale of assets by the parent corporation, and tax it as such.

The *Gregory* case would cover situations of obvious tax abuse, but not all cases. If the foreign corporation in the above example were kept alive as a holding company, for example, *Gregory* might not apply, but the foreign personal holding company provisions of subpart F would probably cause the income of the subsidiary to be taxed directly to the United States parent.

While section 367 may therefore seem less necessary than before, recognition of gain arising from noncompliance with its requirements may be more costly than ever. In 1962, provisions were enacted to help fill loopholes which had arisen as the result of using foreign corporations.⁹ These apparently were in addition to section 367 and its requirements, since once a foreign corporation was established, there were other ways to avoid or to reduce United States taxes.

Section 1248 acts to discourage the retention of earnings and profits in a controlled foreign corporation until the date of liquidation, when

⁸ 293 U.S. 465 (1935).

⁹ Revenue Act of 1962, P.L. 87-834, 76 Stat. 960. For a full discussion of the effect of this Revenue Act on international transactions, see Ross, *The Impact of the Revenue Act of 1962 on Reorganizations and Other Rearrangements Involving Foreign Corporations*, 22 N.Y.U. INST. ON FED. TAX. 761 (1964).

such profits could be distributed in exchange for the stock of the corporation and result only in capital gain for the shareholder, even if the gain was recognized. This section provides that the gain realized by certain United States persons on the sale, exchange or redemption of stock or on the liquidation of a foreign corporation is to be treated as a dividend to the extent of the accumulated post-1962 pro rata share of earnings and profits of the foreign corporation. This rule applies only if the corporation was a "controlled foreign corporation" during the past five years and the taxpayer owned ten percent or more of its voting power.

The operation of this section can be illustrated by applying it to the example set forth in the introduction. Section 1248 applies to a section 301 distribution or section 331 liquidation, turning capital gain into ordinary income.¹⁰ Therefore, if at the point of liquidation of the Canadian corporation, the transaction were not treated as a section 332 liquidation but rather as a section 331 liquidation, the United States parent corporation would realize and recognize a gain.¹¹ Moreover, the gain would be treated as a dividend to the extent of the post-1962 earnings and profits, which in this instance will be the profits from the sale of the assets transferred. The dividend may qualify for the "deemed paid" credit of section 902,¹² but in any event, some tax-avoidance will have been stopped. Accordingly, while a taxpayer may have been willing to recognize gain on the liquidation of a foreign subsidiary prior to 1962 on the theory that the recognized gain would be a capital gain, the taxpayer may not be willing to recognize such gain if it is to be treated as ordinary income.¹³

Section 1249 provides that gain from the sale or exchange of a patent or invention, a copyright, secret formula or process to any foreign corporation controlled by a United States person, which is recognized, shall be treated as ordinary income. Accordingly, while a taxpayer prior to 1962 may have been willing to transfer technology to

¹⁰ IRC § 1248(a).

¹¹ This might happen in the event an unfavorable ruling were issued by the Commissioner.

¹² B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS 354 (2d ed. 1966).

¹³ In answer to many appeals the Commissioner promulgated guidelines for the benefit of taxpayers applying the rulings under section 367 in REV. PROC. 68-23, 1968-1 CUM. BULL. 821.

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a controlled subsidiary for stock even though the transfer resulted in a capital gains tax, the transfer will be less appealing if the gain realized is taxed as ordinary income. Obtaining a favorable section 367 ruling prior to a section 351 transfer or a section 332 liquidation may therefore be more urgent than ever.¹⁴

The depreciation recapture rules of section 1245 and 1250 also enhance the value of nonrecognition in section 332, section 351 and section 361 transfers since exchanges qualifying under such sections are immune from the depreciated recapture rules.¹⁵

Another major effect of the Revenue Act of 1962 is the possibility of a required ruling in transactions which previously were thought not to require a ruling. This includes the liquidation of a second tier foreign corporation into a first tier foreign corporation. Previously, since neither foreign corporation touched the United States, a ruling was not required. However, with the advent of subpart F income, the consequences of such transactions have changed, resulting in the necessity of a prior ruling. Revenue Ruling 64-157¹⁶ has stated that when a second tier subsidiary was liquidated into a first tier subsidiary (both foreign corporations), a ruling must be obtained if the gain which would otherwise be recognized would amount to subpart F income to

¹⁴ Sections 1491-1493 also underscore the necessity of obtaining a favorable ruling in some section 351 exchanges. The sections were enacted at the same time as section 367. Presumably at that time they were not to overlap, but rather their coverage was intended to be mutually exclusive. Section 1491 imposes a 27½ percent excise tax on the amount of the appreciation in securities contributed to the capital of a foreign corporation. Section 1492 makes the tax inapplicable if a ruling is obtained stating that the transfer is not in pursuance of a plan "having as one of its principal purposes" the avoidance of Federal income taxes. Section 1494 provides for a refund of the tax if the taxpayer can prove after the transfer that there was no tax avoidance purpose, if the taxpayer failed to get a ruling beforehand. These sections apply to contributions of securities to foreign corporations. On their face they do not apply to transfers to foreign corporations for stock in section 351 exchanges. Nevertheless the Internal Revenue Service has ruled that such contributions to capital by a controlling shareholder constitute an exchange, rather than a contribution, with the result that a section 367 ruling must be obtained. See text accompanying notes 37 to 41, *infra*. If the ruling is upheld the taxpayers might be required to recognize a gain and also pay the excise tax of sections 1491-1493. If the ruling is not upheld section 1491 rather than section 367 would apply to contributions not involving exchanges. Moreover, no prior ruling would have to be obtained by the taxpayer because of the operation of section 1494. The tax imposed, however, might be greater than if the transfer were taxed because of failure to obtain a ruling under section 367. This would depend upon a number of factors, and the taxpayer should proceed carefully in this area.

¹⁵ Section 1246 likewise closes another gap. It taxes the sale of foreign investment company stock and treats any gain therefrom as ordinary income to the extent of the taxpayer's ratable share of the accumulated earnings and profits. This section will have limited use, however.

¹⁶ 1964-1 CUM. BULL. 139.

the United States shareholders. Therefore, each transaction involving two foreign corporations will have to be reviewed for its subpart F content.¹⁷ If a ruling were not obtained, and the Service determined that it was necessary, the tax cost might be small, but the failure of corporate tax attributes to carry over might be contrary to expectations and have an adverse effect, e.g., failure of a loss to carry over.

In sum, while the abuses Congress sought to combat in 1932 may no longer be possible in fact, even in the absence of section 367, section 367 nevertheless exists, and it has become increasingly significant in light of the fact that many gains if recognized will be recognized as ordinary income rather than as long term capital gains. Therefore, a discussion of the taxpayer's alternatives with regard to section 367 is in order, together with an exploration into its operation and the effects of obtaining a favorable or unfavorable ruling, or not obtaining a ruling at all, and business and tax reasons for either making section 367 elective or changing the structure of the provision itself.

II. OPERATION OF SECTION 367

A. *The Requirement of a Prior Ruling*

Section 367 operates to withdraw a transaction involving a foreign corporation from the nonrecognition provisions of the Internal Revenue Code of 1954 unless, prior to the exchange or reorganization, the Commissioner of Internal Revenue is satisfied that the transaction does not have as one of its principal purposes the avoidance of taxes. This requirement of a prior ruling imposes an extra burden on those taxpayers acting in good faith and can be a trap for the uninformed, as the section applies to all transactions to which a foreign corporation is a party.

Since the enactment of the original provision in 1932, its language¹⁸ has changed slightly, but its substance has not. The present wording of the provision is as follows:

¹⁷ See text accompanying notes 43 and 44, *infra*.

¹⁸ Minor clerical changes were made in 1934, H.R. Rep. No. 704, 73rd Cong., 2d Sess. (1934); S. Rep. No. 558, 73d Cong., 2d Sess. (1934). In 1954 when the Code was revised, the section was reworded slightly, but the Senate Report in its detailed discussion of the bill stated that the change in language was not intended to change the existing application of the section. S. Rep. No. 1622, 83d Cong., 2d Sess. 272 (1954).

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In determining the extent to which gain shall be recognized in the case of any of the exchanges described in sections 332, 351, 354, 355, 356 or 361, a foreign corporation shall not be considered as a corporation unless, before such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

Although other Code sections may make the taxability of a transaction turn on the tax avoidance purpose of the taxpayer involved, such determination is or can be made after the fact.¹⁹ Section 367 requires not only pure motives, but requires also that the Commissioner pass on those motives in advance of the transaction. The purpose of such advance requirement is not expressed in the legislative history of the statute. It is also difficult to derive any sound policy consideration supporting such a prior ruling requirement. The requirement effectively deprives the taxpayer of any real judicial review of the Commissioner's conclusions and thus makes enforcement much easier for the Commissioner.²⁰ However, the remedy is drastic. The taxpayer could have the burden of proof on the issue of intent even if there were no requirement of an advance ruling, and it is difficult to find any situations where the prior ruling requirement gives the Commissioner effective jurisdiction that he would not otherwise have.²¹ It would seem that the advance requirement of a ruling is an unnecessary inconvenience in current transactions.²² Although it does give the taxpayer certain knowledge as to whether the transaction will be taxed, it serves no other purpose.²³ For those taxpayers who require certainty in their tax planning, or if the transaction would be abandoned upon gain recognition, an advance ruling could be requested; but for those who intend

¹⁹ Other IRC sections making taxability turn on the tax avoidance purpose are sections 269, 482 and 1492. Section 1492 asks for advance clearance but section 1494 makes a later ruling retroactive. See note 14, *supra*.

²⁰ Kurlander, *Jurisdictional Questions Under Section 361*, 46 TAXES 730 (1963).

²¹ Eustice, *Affiliated Corporations Revised: Recent Developments Under Section 492 and 367*, 24 TAX. L. REV. 101 (1968).

²² Revenue rulings currently require at least four months to obtain, whether under a section 367 ruling or not. Goldman, *The Problem of Getting Rulings from the Reorganization Branch*, 27 J. TAXATION 341 (1967).

²³ It might also be a source of some revenue upon the issuance of an unfavorable ruling, but it is doubtful if this by itself would serve as a justification for the requirement of an advance ruling.

to carry out the transaction regardless of the possibility of a gain being recognized, and for those who purposefully intend such recognition, the requirement is a needless stumbling block.

The Commissioner has been able to administer effectively in those circumstances governed by other provisions of the Code in which a tax avoidance purpose taints the transaction, and there would appear to be no reason why this section could not also be so administered. The statute, as it now operates, may penalize those taxpayers who carry out international transactions without obtaining a ruling, either through inadvertance, ignorance of the statute, or perhaps even ignorance of the transaction itself on the part of a shareholder, even though the requisite intent is not present.²⁴ Moreover, in some circumstances, when the ruling is not requested because of the desirability of having a gain recognized, the Commissioner has in effect issued a retroactive ruling, regardless of a tax avoidance purpose in the transaction itself.²⁵ Such arbitrary actions could be avoided if the Commissioner were instead required to view the transaction after it had been accomplished, with the same type of guidelines governing his actions which are now in effect with regard to other sections.

The requirement of a prior ruling raises the question of whether the section is optional, *i.e.*, whether a taxpayer wishing to have a gain recognized may achieve such a result by the simple method of not applying for a ruling prior to the transaction. Ordinarily, in domestic transactions, if one so organizes his business affairs such that they come within the purview of the nonrecognition sections, they will apply, whether or not the taxpayer finds this favorable. Whether the same holds true in international transactions in light of the requirement of section 367 and the Service's interpretations of such transaction is doubtful.²⁶

B. Effect of Not Being "Considered as a Corporation"

Section 367 states that "a foreign corporation shall not be considered as a corporation . . ." for purposes of certain nonrecognition sections unless an appropriate prior ruling is acquired. This was most curious language to use; however, when considered in the context of

²⁴ See, *e.g.*, *Texas-Canadian Oil Corp., Ltd. v. Commissioner*, 44 B.T.A. 913 (1941).

²⁵ See, *e.g.*, Rev. Rul. 64-177, 1964-1 CUM. BULL. 141.

²⁶ See discussion in Part VI, *infra*.

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the nonrecognition provisions specified in that section, the meaning may become more apparent.

Section 332 states no gain or loss will be recognized upon receipt by certain corporations of property distributed in complete liquidation of another corporation. If such receiving corporation were not a corporation, section 332 would by its own terms become inapplicable and the transaction would become a section 331 liquidation with the resulting gain recognized to the shareholders. However, this is apparently not what happens under section 367. Rather the corporation itself is taxed.

In the other provisions specified in section 367 the language seems less appropriate because nonrecognition does not necessarily depend on corporate existence. In section 351, for example, if property is transferred to a corporation otherwise qualifying under that section, and the Commissioner finds the requisite tax avoidance purpose, then that transferee is no longer considered to be a corporation. Section 351 therefore cannot apply. However, to say that section 351 does not apply is not to say that gain should be recognized. The transferor has exchanged property for an interest in an enterprise. If the enterprise is considered to be a partnership, the nonrecognition provisions of sections 721 to 723 would apply.²⁷

Sections 354 to 361 also all refer to transactions involving corporations in which no gain will be recognized providing the taxpayer qualifies under their provisions. Therefore, the same problem would arise in the context of a reorganization. Although it is clear that Congress intended that the transaction should be taxed if there were a tax avoidance purpose,²⁸ the wording which it used is not explicit, and could be interpreted in several ways, *i.e.*, perhaps the corporation should be considered to be a partnership if it were not a corporation. Despite these literal difficulties, section 367 might be interpreted as follows: Specific nonrecognition provisions of the Code apply only if the transferee or transferor of property involved in an exchange is a "corporation." If a prior ruling is not obtained in an international transaction the foreign corporation will not be considered a corporation for pur-

²⁷ This transaction poses another problem. In order for gain to be recognized, gain must be realized. *Helvering v. Walbridge*, 70 F.2d 683 (2d Cir. 1934). If property is transferred to something which is not a corporation, and stock is exchanged for that property, how would one value the stock of a non-corporation in determining the basis upon which gain is realized?

²⁸ See note 2, *supra*, and the text of the reports there cited.

poses of these sections. Where the nonrecognition provisions thereby become inapplicable, realized gain will be recognized gain notwithstanding the fact that nonrecognition might be achieved by designating the foreign corporation as a partnership or some other type of entity.

C. *When Rulings are Required*

Because this subject has been discussed extensively elsewhere,²⁹ the following summary is designed primarily to raise the problem. The Treasury Regulations state a foreign corporation must be involved in order for section 367 to operate.³⁰ What constitutes involvement is the subject of two differing views on the part of practitioners and the Service, and also the object of several revenue rulings.

The first view seems to come directly from the Senate report accompanying the enactment of the provision, and follows the theory that any time a foreign corporation is involved in one of the exchanges listed, the section will apply. The second view is sometimes referred to as the "same effect" test: The applicability of the section is dependent upon whether the same effect would result whether or not a foreign corporation were considered to be a corporation in determining the extent to which gain shall be recognized from the transaction.³¹ If the "same effect" follows whether or not the foreign entity is a corporation, then section 367 would be inapplicable and the nonrecognition provisions would apply, making the transaction tax-free.

Depending upon the type of transaction, there may be a difference in result, with the application of a different view. If a foreign corporation were creating a new corporation in the United States, the objective view would require the application of section 367. However, the "same effect" test would not, since if it were a foreign individual creating the new corporation in the United States, there would be no change in the operation of section 351. That is, the same effect will result whether or not it is a foreign corporation or individual organizing the corporation in the United States.

²⁹ McDonald, *Section 367—A Modern Day Janus*, 64 COLUM. L. REV. 1012 (1964); Siegel, *supra* note 7; Whitehill, *Foreign Corporate Exchanges*, 36 TAXES 622 (1958); Eustice, *Tax Problems Arising from Transactions Between Affiliated or Controlled Corporations*, 23 TAX L. REV. 451 (1968).

³⁰ Treas. Reg. § 1.367-1 (1955).

³¹ McDonald, *supra* note 29.

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Another example is the situation where an 80% owned foreign subsidiary is liquidated into a United States parent corporation. Gain would be recognized on this transaction unless section 332 applied. Here, a section 367 ruling would be needed to avoid the immediate tax regardless of which test were used. The "same effect" test would apply because of the immediate taxable gain; the objective test would apply because a foreign corporation is involved. If a wholly owned domestic corporation were to be liquidated into a French parent not otherwise engaged in United States business, under section 332, and no ruling were applied for, the objective test would require a ruling as a foreign corporation is involved. However, the same effect test would be operative only if there were a realization of gain on the transaction.³²

The "same effect" test would appear to be the only test supported by the language of the statute, and this interpretation seems to reflect the position of the Internal Revenue Service. The following rulings are based on the "same effect" test:

(1) No ruling is required when two domestic corporations, both wholly owned subsidiaries of a Canadian corporation, are merged in a statutory merger. The Service has said that it was unnecessary to obtain a favorable ruling under section 367 since the reorganization would still qualify under section 368(a)(1)(A) even if the Canadian corporation were not a corporation.³³

(2) Neither is a ruling necessary in a situation where the common stock of a foreign corporation was exchanged solely for common stock in the same foreign corporation.³⁴ Although the exchange qualified under section 368(a)(1)(E), an element of one of the provisions listed in section 367, it also qualified under section 1036 which states that no gain or loss shall be recognized by shareholders in such an exchange. Since this section is not one of those specified, the taxpayer need not obtain a favorable ruling before carrying out the contemplated exchange. The same is true when new common stock issued to replace old common stock in a change of name transaction. This, too, qualifies under section 1036 and so no ruling is required.³⁵ However, if a new entity had been incorporated, a ruling

³² The Service has advised orally, however, that this type of liquidation is probably within section 367. McDonald, *supra* note 29. This might be used to advantage, however. Section 337(c) makes section 337(a) inapplicable to a sale of assets after the adoption of a liquidation plan under section 332. However, if a corporation failed to apply for a ruling under section 367, presumably section 332 would not apply, and therefore section 337(a) would apply to any such sale and no gain or loss would be recognized.

³³ Rev. Rul. 55-45, 1955-1 CUM. BULL. 34.

³⁴ Rev. Rul. 64-156, 1964-1 CUM. BULL. 139.

³⁵ *Id.*

would have been required, since the transaction would not then qualify under section 1036.

(3) Another recent ruling involved a situation where money was the sole consideration transferred to a wholly owned foreign subsidiary in a section 351 exchange for stock. Additional stock received to cover the excess value in the exchange is considered a stock dividend which is not taxable. Therefore, since no gain is realized on the transaction, an advance ruling under section 367 is unnecessary.³⁶

A situation somewhat analogous to the transfer of money is the contribution of capital to a corporation. Ordinarily, this would not be considered a transaction which would require a section 367 ruling. However, the Service maintains otherwise when the contributor is the sole shareholder in a corporation. Revenue Ruling 64-155³⁷ states that when a taxpayer proposes to contribute appreciated property³⁸ to an existing wholly-owned foreign subsidiary, and does not receive any additional stock in return, the Service will consider this an exchange of property for stock as described in section 351. Consequently, section 367 will be applicable and gain will be recognized to the extent of the appreciation unless a favorable ruling is obtained prior to the transfer.³⁹

This is one instance, however, where the edict of the service in this area was successfully challenged. In *Werner Abegg*,⁴⁰ the taxpayer transferred securities to a wholly-owned Panama corporation. The Service claimed a deficiency, treating the contribution to capital as an exchange under section 351 and taxing the recognized gain since the

³⁶ Rev. Rul. 68-43, 1968-1 CUM. BULL. 146.

³⁷ 1964-1 CUM. BULL. 138.

³⁸ Presumably this would include such things as machinery, equipment, trademarks, patents and possibly know-how, although the ruling does not so state. If this is true, it would be an obstacle to consider when a transaction was planned without the generally "tainted" property listed in Rev. Proc. 68-23 § 3.02(1)(b), 1968-1 CUM. BULL. 824 in order to get the favorable ruling so the section 351 transfer will not be taxed, and then at a later time transfer trademarks, patents, know-how and other intangibles as a contribution to capital. It would also be a problem to face if after a foreign corporation were operating and new equipment or machinery were needed, and the parent supplied it merely by contributing it to the capital of the subsidiary. Under this ruling the transaction would be taxed since a ruling would not have been requested under section 367 since this would certainly not be considered as a section 351 transfer. Perhaps, when there is an obvious business purpose, the Service will not question the contribution to capital in this manner.

³⁹ It is possible that a contribution to capital by a shareholder of a corporation which is not wholly-owned but merely controlled may also be subject to this ruling. William M. Liddon, 22 TC 1220 (1954). That case involved a liquidation-reincorporation of two commonly controlled corporations but with different minority shareholders, and a contribution to capital was considered an exchange for purposes of section 351.

⁴⁰ 50 TC 145 (1968).

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requisite clearance under section 367 prior to the exchange was not obtained. The court, however, took a different view of the transaction.⁴¹

We hold that the securities transferred . . . constituted a contribution to capital and that section 351 is not applicable. In view of the foregoing, we need not determine whether, if section 351 were applicable, Abegg would be taxable on the gross gains without benefit of offsetting losses on the securities transferred.

It is doubtful, however, that the Service will take the approach of the Tax Court, and it is probable that rulings will continue to be required in this area, at least until the Commissioner has lost more than one suit on the issue.

In other circumstances, a transaction which appears to be tax-free under a nonrecognition section other than or in addition to one specified in section 367 may be reconstructed by the Service in such a way that the net effect results in an exchange qualifying only under one of the Code sections listed in section 367. This is somewhat analogous to the step transaction doctrine. An example is the sale of property by a corporation under a section 337 plan of liquidation to a corporation controlled by the shareholders of the selling corporation. It should be remembered that section 367 does not apply to nonrecognition under this section. Further, where the selling corporation is domestic, the applicability of that section does not depend on whether the purchaser is a corporation. Such a sale, however, could be considered a Type D reorganization when viewed in its entirety, under section 368(a)(1) in which no gain would be recognized because of the application of section 361.⁴² Since section 361 is one of the provisions covered by section 367, a favorable ruling will be necessary to avoid recognition of gain.

It can be seen from the foregoing that just when a ruling will be required is somewhat uncertain. Tax planning in this area becomes

⁴¹ *Id.* at 164.

⁴² By viewing the transaction in its entirety, it could be considered a divisive reorganization because it falls directly within the wording of IRC 368(a)(1)(D): "a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor . . . is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356; . . ." A case in point is Retail Properties, Inc., 23 CCH Tax Ct. Mem. 1463.

just as uncertain in many instances. It is submitted that some clarification in this regard would be helpful.

D. The Question of Jurisdiction

The preceding discussion shows that a prior ruling should be unnecessary where the effect is the same whether or not the foreign corporation is considered a corporation. A prior ruling may also be thought to be unnecessary where corporate status is significant under United States law, but where there is an apparent lack of United States jurisdiction. For example, where a second tier foreign subsidiary is merged into a first tier foreign subsidiary, the United States might not be able to tax the gain of the first tier subsidiary whether or not gain is recognized under United States law as an abstract matter. It is not always an easy matter to determine whether the United States has jurisdiction, however. Rulings have indicated that the possibility of future tax consequences in a transaction will be enough to make section 367 operative if a foreign corporation is involved, thereby adding considerable scope to the section.⁴³ This shift of position seems to have been the result of the 1962 changes in taxing foreign income. Prior to that time only transactions in which realized gains were immediately taxable were covered. Subsequently those transactions which involved only foreign corporations were also covered because of the possibility of subpart F income. Revenue Ruling 64-157 requires a favorable ruling when a second tier foreign subsidiary is liquidated into a first tier foreign subsidiary when there is a possibility of gain from subpart F income. If it is certain that there will be no subpart F income, then presumably a ruling would not be required. However, this places a risk on the United States shareholder, since determining whether the ex-

⁴³ Rev. Rul. 64-157, 1964-1 CUM. BULL. 139 stated that when a second tier subsidiary was liquidated into a first tier subsidiary (both foreign corporations) a ruling must be obtained if the gain which would otherwise be recognized would amount to subpart F income to the United States shareholders. However, in Rev. Rul. 64-158, 1964-1 CUM. BULL. 140, which considered a C type reorganization of two foreign corporations where no ruling had been issued, merely stated that the transaction would be regarded as tax-free, with all attendant tax attributes. This appeared to be without regard to any gain in the transactions. These two rulings appear to be divergent.

Furthermore, with the promulgation of the recent guidelines, the Service seems to have changed its mind again, at least with regard to a second-tier liquidation into a first tier corporation. The guidelines state that a favorable section 367 ruling will be issued in such a circumstance. IRC § 3.01(3). Whether or not this is intended to override Rev. Rul. 64-157 is yet to be seen.

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clusions or exceptions will apply cannot be done with certainty until the end of the year.⁴⁴ Therefore, it has become necessary to review any such foreign transaction to determine the subpart F income content.⁴⁵

It is still not clear, however, just what view the Commissioner is taking with regard to most transactions over which the United States has no immediate or apparent taxing jurisdiction, but where recognition of gain may be relevant under subpart F or upon a subsequent repatriation from a foreign subsidiary.

E. When Favorable Rulings Can Be Obtained

Rulings will not issue when the requisite tax avoidance purpose is found in the plan submitted to the Commissioner for approval. Until the promulgation of new guidelines in Rev. Proc. 68-23⁴⁶ there was little information available to help determine just when a transaction would receive a favorable ruling—a few published rulings for isolated circumstances, but more often many rumors and unsubstantiated generalizations. The uncertainties involved in foreign incorporation and international corporate reorganizations covered by section 367 caused much criticism and these guidelines were issued as the result of many appeals on the part of those working in the area of international transactions.⁴⁷

The guidelines are a fairly comprehensive tallying of what will usually receive a favorable ruling and what will not. They state that “a taxpayer shall be free to establish that based on all the facts and circumstances of the taxpayer’s case a favorable ruling under section 367 . . . should be issued, notwithstanding a contrary statement or implication contained in the guidelines.”⁴⁸ Therefore, the taxpayer will still find himself concerned with what constitutes a tax avoidance purpose.

As noted above, there is little to rely upon in predicting what con-

⁴⁴ REV. RUL. 64-157, 1964-1 CUM. BULL. 139.

⁴⁵ Lamp, *Recent Section 367 Rulings: Their Effect on Reorganization of Foreign Companies*, 22 J. TAXATION 240 (1964).

⁴⁶ 1968-1 CUM. BULL. 821.

⁴⁷ See, e.g., Whitehill, *supra* note 29; and Statement of Charles W. Stewart, Pres. of Machinery & Allied Products Institutes and Chairman of the Council for Technological Advancement, HEARING ON H.R. 5 BEFORE HOUSE WAYS AND MEANS COMMITTEE, 86th Cong., 1st Sess. 141 (1959).

⁴⁸ REV. PROC. 68-23, 1968-1 CUM. BULL. 821, 822.

stitutes a tax avoidance purpose. The generalizations about unpublished rulings indicate a favorable ruling would be withheld once the Commissioner determined that a particular transaction would in fact avoid taxes. He seems to be saying that there is a tax avoidance purpose if, in fact, tax avoidance results, and that perhaps his determination is not affected by the presence or absence of a business purpose in the plan submitted.⁴⁹

An article by Frances Rapp⁵⁰ stresses the fact that the taxpayer must not only show that a strong business purpose is present; he must also show affirmatively that a tax avoidance purpose is *not* present.⁵¹ This can be done, she states, by showing the advantages of a foreign corporation carrying on a business—that it is more economical, in line with a general expansion, fulfills a need for resident managers, etc. Further, a lack of tax avoidance can also be shown partly by demonstrating that the taxes will be similar.⁵²

In addition to what the guidelines say about issuing favorable rulings, there are other nebulous generalizations. One is that the Service will generally hold that the prohibited purpose is present if the transactions result in any significant deferral of United States taxes.⁵³

⁴⁹ McDonald, *supra* note 29; Siegel, *supra* note 7.

⁵⁰ Rapp, *Section 367 Rulings: How the IRS Regards Exchanges with Foreign Corporations*, 13 J. TAXATION 344 (1960) [hereinafter cited as Rapp].

⁵¹ Compare Rapp, *id.*, with earlier rulings: Special Rulings, Dec. 17, 1954, 37, 111 CCH (Proof of bona fide business purposes and no further investigations); Rev. Rul. 56-227, 1956-1 CUM. BULL. 183 (valid business reasons); Rev. Rul. 54-499, 1954-2 CUM. BULL. 150 (detailed sufficient business purpose). See discussion in Siegel, *supra* note 7.

⁵² Rapp, *supra* note 50, at 344.

⁵³ Siegel, *supra* note 7. See also Statement of Charles H. Kellstadt, Present, Sears, Roebuck & Co., HEARINGS ON H.R. 5, HOUSE WAYS AND MEANS COMMITTEE, 86th Cong., 1st Sess. 358 (1959) as follows:

The net effect of this ruling [denial of a favorable ruling for reorganization of South American Sears operations to effectuate needed management changes] is that the potential deferral of U.S. tax is treated as tax avoidance. We do not agree that deferral is tax avoidance within the intent of the statute so as to prevent the formation of an integrated foreign operation. The Treasury's position is a serious limitation on section 367 and makes it a closed door to many proper reorganizations.

The Treasury regards the transfer of funds from one operating company to another without the imposition of U.S. tax as tax avoidance. Our objection to the Treasury's position is its excessive emphasis on tax deferral possibilities. . . . The Treasury has made a very difficult problem for the taxpayers. How can a taxpayer prove to the satisfaction of the Commissioner what it might or might not do in the future? If the Commissioner once makes a determination that any potential deferral will constitute avoidance, the present statute forecloses taxpayers from revamping their foreign structure.

See also discussion in Tillinghast, *Taxation of Foreign Investment: A Critique of the Boggs Bill*, 16 TAX L. REV. 81, 88 (1960); Statement of David A. Lindsay, Assistant to

Where property is to be used in a country other than that of incorporation, a bad purpose is usually inferred, particularly if there is a low tax rate in the country of intended use. (This generalization appears in concrete form in the guidelines.) The transfer of stock of directly owned foreign subsidiaries to a foreign holding company subsidiary of an American parent corporation is considered to have tax avoidance as one of its principal purposes.⁵⁴ It has also been stated that the Commissioner will not only look at the possibility of tax avoidance in the exchange at hand, but will also consider the past operation of any corporation or United States taxpayer involved.⁵⁵ Anytime, of course, that the Service finds tax avoidance to be one of the principal purposes of the exchange, a favorable ruling will be denied.

These are only a few of the generalizations which appear in this area from various sources. There are others. One who is planning a transaction which needs a favorable ruling, or one who hopes for an unfavorable ruling can only check the current published rulings, read between the lines of the guidelines and get advice from the articles and from those who have had the experience of dealing with the Commissioner.⁵⁶

Because of the tremendous uncertainty in the area and the seeming arbitrariness of the Commissioner in finding the prohibited purpose in transactions, it is suggested that a change in the statute is warranted. A change in the wording from "having as *one* of its principal purposes"

the Secretary of the Treasury, HEARINGS ON H.R. 5 BEFORE THE HOUSE WAYS AND MEANS COMMITTEE, 86th Cong., 1st Sess. 39 (1959); HEARINGS, SPECIAL PROBLEMS IN CORPORATE TAXATION BEFORE THE HOUSE WAYS AND MEANS COMMITTEE, 86th Cong., 1st Sess. (1959).

⁵⁴ Peel, *Tax Aspects of Doing Business Abroad*, 37 TAXES 1107 (1959). This attitude is present when a currently internationally operating concern wishes to make such a transfer to a holding company. However, the same attitude is not reflected when an organization is first opening its field of international operations by creating a holding company and then expanding. Obviously, this approach discriminates against those who pioneered in international transactions and who are already well-established in foreign countries, but with obsolete operations. Statement of Milton C. Lightner, Chairman, Singer Manuf. Co., HEARINGS ON H.R. 5, HOUSE WAYS AND MEANS COMMITTEE, 86th Cong., 1st Sess. 286 (1959).

⁵⁵ McDonald, *supra* note 29.

⁵⁶ One commentator has made the comment: "The broad powers of the Revenue Service make prediction virtually impossible; some practitioners feel that results fluctuate with the personal opinions of the individuals considering each particular application." Tillinghast, *supra* note 53, at 88. See also Letter from the Chairman to Members of the American Bar Association Committee on Taxation of Foreign Income, 2/26/60. "Moreover, it is believed that administrative policy in this area fluctuates in accordance with personal views of individuals who from time to time have responsibility for issuing rulings under section 367."

to "having as *the* principal purpose" would clarify the situation somewhat, and give the Commissioner less power in the administration of the provision. The courts have generally defined "the principal purpose" to mean a purpose which exceeds in importance any other purpose.⁵⁷ Then, in determining whether the bad purpose was present, an incidental tax effect of a transaction would not taint the whole plan, as it apparently does now. Furthermore, if very strong business purposes were present, and were in fact the motivating factors, the plan could be carried out, regardless of the fact that some tax benefit may be derived. The effect of the statute would then be to prohibit those transactions which were taken for apparently tax avoidance reasons, and permit those which were supported by sound business policy—the purpose of the provision in the first place.

III. THE PRIOR RULING IN PRACTICE—BACK AND FORTH WITH THE COMMISSIONER

Section 367 requires a prior ruling from the Commissioner stating he is satisfied that the submitted plan does not have as a principal purpose the avoidance of taxes. Upon receipt of such a ruling, the taxpayer can carry out the plan with no adverse tax effects.⁵⁸ If an unfavorable ruling is received, any gain realized in the international transaction will be recognized and taxed.⁵⁹ What happens if no ruling is requested is somewhat ambiguous.⁶⁰ Although the statute would appear to demand a prior ruling, the Commissioner has been somewhat inconsistent in that regard, and in the consequences applied to any given taxpayer.

Three different situations are possible in the operation of section 367. A taxpayer can apply for and receive a favorable ruling; he can receive an unfavorable ruling; or he can fail to apply at all. The consequences to the taxpayer will differ depending upon which course he chooses to follow.

⁵⁷ *Malat v. Riddell*, 383 U.S. 569 (1966).

⁵⁸ However, the regulations warn that if the plan is not carried out as submitted, the favorable ruling will be withdrawn. Treas. Reg. § 1.367-1 (1955).

⁵⁹ This would appear to follow from the wording of IRC § 367.

⁶⁰ See discussion in part III C.

A. Favorable Ruling

Application for and receipt of a favorable ruling is the usual course a taxpayer will plan to follow, if possible. In order to obtain a ruling the taxpayer must submit a plan of corporate organization or reorganization to the Commissioner of Internal Revenue.⁶¹ The need for business purposes in the plan has already been discussed. Upon receipt of a letter confirming a favorable ruling from the Commissioner, the taxpayer is free to go ahead with the transaction, keeping in mind, however, that any deviation from the plan submitted may constitute a new plan, and therefore the previous favorable ruling may be withdrawn,⁶² and the taxpayer would have to begin the process again.

B. Unfavorable Ruling

Upon receipt of an unfavorable ruling, the taxpayer may nevertheless continue with his plan, knowing that the consequence will be a recognition of gain. Perhaps the knowledge of this result will cause the taxpayer to reconsider the plan itself or discard it entirely. Although the statute and regulations do not make clear the exact tax consequences, it would seem that the Commissioner will treat the transaction in its entirety as a taxable one, and allow all the collateral side effects to take place.⁶³

There are no effective legal restraints upon the delegate in making determinations under section 367 as to the existence of a tax avoidance purpose, in that, for all practical purposes, unlimited discretion has been granted by the statute.⁶⁴ Nevertheless, if a taxpayer receives an unfavorable ruling, he may request the Assistant Commissioner (Technical) to convene an informal review board.⁶⁵ Generally, the taxpayer or his representative may not appear before the board; however, the

⁶¹ Treas. Reg. § 1.367-1 (1955).

⁶² See generally Siegel, *supra* note 7. See also Treas. Reg. § 1.367-1 (1955).

⁶³ Whether the gain recognized will be capital or ordinary will depend upon many factors, some of which are the operation of other Code sections. Sections 1245 through 1250 may apply to the transaction, turning what would ordinarily be capital gain into ordinary income. This result may in turn affect the taxpayer's decision regarding whether to carry out the planned transaction. See discussion *supra*, under part I. With regard to collateral side effects, see Part V, *infra*.

⁶⁴ Nearly all commentators appear to share this opinion. See McDonald, *supra* note 29; Siegel, *supra* note 7; Lamp, *supra*, note 45.

⁶⁵ The board consists of the Assistant Commissioner, the Director of the Income Tax Division and a representative of the Chief Counsel of the Internal Revenue Service. Kurlander, *supra* note 20.

board determines whether the unfavorable ruling was warranted based on the ruling request, briefs or supplemental information filed by the taxpayer, memoranda prepared by the Reorganization Branch, and any relevant prior published and unpublished rulings of the Service. If it decides a favorable ruling should have been issued, the unfavorable ruling will be revoked and a new favorable ruling issued. Beyond this, there is no procedure for appealing a review board decision.⁶⁶

There are no cases where a taxpayer has attempted to overturn an unfavorable ruling under section 367 on the ground that the prescribed purpose was not actually present. Apparently the only scope of judicial review in that regard is abuse of discretion by the delegate, and as one commentator has pointed out, a taxpayer would be unwise to seek review on that ground.⁶⁷

C. *Failure to Apply for a Ruling*

1. *Inadvertent Failure or Lack of Knowledge of Transaction*

There are some situations when the taxpayer fails to apply for a ruling either because it does not know of the existence of section 367 (and this could happen when it is essentially a foreign corporation with effective connections with the United States) or because the taxpayer does not in fact know of the existence of the transaction. The latter circumstance could arise in the case of a shareholder of a corporation planning to carry out an international transaction which does not need shareholder approval. It would probably arise more frequently in the case of a domestic shareholder and a foreign corporation. Whether or not the Commissioner would force the consequences of such a lack of ruling upon a shareholder in the United States has not been answered, but under the wording of the statute he clearly could.⁶⁸

One of the early cases was *Texas-Canadian Oil Corp., Ltd. v. Commissioner*.⁶⁹ This involved a transfer of assets for stock—a section 351 transaction. No one involved had done anything to establish to the satisfaction of the Commissioner that the exchange was not in pursuance of a tax avoidance plan, and in fact the taxpayer in question had no information or knowledge concerning the exchange until

⁶⁶ *Id.*

⁶⁷ Eustice, *supra* note 29.

⁶⁸ See discussion in Siegel, *supra* note 7, regarding this situation.

⁶⁹ 44 B.T.A. 913 (1941).

after its execution. Further, those connected with the exchange were unaware of the section requiring a ruling by the Commissioner. When they did learn, statements were submitted, in order to comply retroactively. The Commissioner, relying on the language of the statute, refused to issue such a retroactive ruling and taxed the transaction.

The court stated: "In our opinion the Commissioner did not err in the view that he had no authority to make it [the determination] upon application made after the reorganization."⁷⁰ The case would appear to stand for the proposition that a ruling cannot be made retroactively, whatever the reasons for absence of application in the first place. The Commissioner has no statutory authority to issue such a ruling.

2. *Deliberate Failure to Obtain a Ruling*

Upon the basis of the statute and the court's statement in *Texas-Canadian Oil* that a failure to get a ruling cannot be corrected retroactively, the Commissioner should be obligated to take the same position whenever the taxpayer fails to obtain a ruling. However, such is not the case.

The Internal Revenue Service appears to take two positions when a taxpayer deliberately fails to apply for a section 367 ruling. The first is based upon a theory of step transaction and a recharacterization of the transaction. The second relies upon the theory that only the government can invoke the statutory requirements which are intended solely for the protection of the government. In other words, a taxpayer cannot use section 367 for his own benefit by failing to get a ruling in order to achieve some other objective by having a particular transaction taxed, *i.e.*, section 367 is a "one-way" street.

The use of the recharacterization theory was applied successfully in *Hay v. Commissioner*,⁷¹ which is perhaps the only case authority which the Service has in pursuing its "one-way" street philosophy regarding section 367 and its application. In this instance, the taxpayer, formerly a United States national, became a British subject in an attempt to escape estate and income taxes. In doing so, he organized a Bahamian corporation to which he transferred all the stock of his

⁷⁰ *Id.* at 918.

⁷¹ 145 F.2d 1001 (4th Cir. 1944), *cert. denied*, 324 U.S. 863 (1945).

wholly owned California corporation, in exchange for the stock of the Bahamian corporation. Several months later, he caused the California corporation to distribute its assets to the Bahamian corporation in complete liquidation. He did not apply for a ruling on the first exchange. (Apparently the factors underlying the scheme were as follows: Distributions in complete liquidation of a United States corporation result in recognized and taxable gain even if the shareholder is a non-resident alien. However, gains on the sale or exchange of stock in such corporation by nonresident aliens are not taxed. The gain realized by Hay on his initial stock exchange was therefore not subject to tax. Despite this fact, however, the Bahamian corporation took a stepped up basis in the California corporation stock because no section 367 ruling issued. Consequently, when the California corporation distributed its assets, the Bahamian corporation realized no substantial gain because of its high basis.) The court considered the transfer to the Bahamian corporation to be the first of two steps of a single plan which culminated in the dissolution of the California corporation. Applying the step transaction type of analysis, the court stated that the taxpayer could not avoid the incidence of an income tax by splitting a transaction into nontaxable parts, if when viewed in its entirety, the transaction would have resulted in a recognizable gain, as it would have in this case if the California corporation's assets had been distributed directly to Hay or if the Bahamian corporation had taken Hay's basis in the California corporation stock. Since no actual profit was made in the first exchange of stock for stock, it was as if the taxpayer had merely shifted his property "from one pocket to another. . . ." ⁷² The court went on to say:

It is equally true that the taxing authorities may refuse to recognize the gain which arises from such a sale or exchange, at least when it is clear from the circumstances that the underlying purpose of the transaction is tax avoidance. It is no answer to say that the taxpayer did not take steps to satisfy the Commissioner under . . . [section 367] . . . that the exchange was not made pursuant to a plan for tax avoidance and hence a gain must be recognized, for it does not necessarily follow that a gain must be recognized by the Commissioner when none in fact was earned.⁷³

⁷² *Id.* at 1004.

⁷³ *Id.* at 1005.

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The court was saying that when a tax avoidance purpose is apparent, the government is not required to acquiesce in the taxpayer's form of doing business, and its decision was based on reconstruction and re-characterization in a situation which was a classic example of a step transaction. The court was not saying that failure to apply for the required ruling can be disregarded by the Commissioner even though tax avoidance may have been present. Rather it emphasized the fact that if there were no actual gain in the transaction, there was nothing for the taxing authorities to tax.

This case has been used by the Commissioner to support the rationale that even though a ruling has not been issued because of lack of application, if there is a tax-avoidance purpose, the Commissioner is free to reconstruct the transaction as tax-free.⁷⁴ It is submitted, however, that this can only be the case when the transaction itself is arranged in such a manner that reconstruction is possible. In other words, if the structure of a step transaction were not already within the exchange, then the Commissioner could not reconstruct the exchange for his own purposes. If there are business purposes present, and immediate tax avoidance is not the underlying purpose of a transaction, the taxpayer should be "free to adopt such organization of his affairs as he chooses" and not have that organization disrupted by a Commissioner acting contrary to statutory authority.

The second position of the Commissioner—that a taxpayer cannot invoke a provision for his benefit when it is in the Code merely for the protection of the government—is set forth in Revenue Ruling 64-177.⁷⁵ Because a recognition of gain in the set of circumstances presented there resulted in tax benefit to the taxpayer, the Commissioner issued a ruling retroactively, in effect making the transfer tax-free, contrary to the expectations of the parties involved. Again, there would appear to be no statutory or case authority upon which the Commissioner can base his actions.

The application of section 367 appears to be very inconsistent, depending upon the set of circumstances involved and the motives which the Commissioner ascribes to the taxpayers.⁷⁶ In some situations the

⁷⁴ Rev. Rul. 64-177, 1964-1 CUM. BULL. 141. See also McDonald, *supra* note 29.

⁷⁵ 1964-1 CUM. BULL. 141. See notes 93 and 94 *infra* and accompanying text.

⁷⁶ Tillinghast, *supra* note 53.

taxpayer is taxed when no ruling is requested, and in others the taxpayer is told his transaction will receive a retroactive ruling and therefore be tax-free. There would seem to be no basis for the seeming arbitrariness of action. Although the Commissioner appears to rely upon tax avoidance in some instances of retroactive application of the statute, he has no authority to do so under section 367, and in fact the contrary would appear to be true. If tax avoidance is present, no favorable ruling should issue. Neither has he promulgated regulations to this effect. Perhaps the solution to the difficulties of both the taxpayer and the Commissioner in this regard could be solved by amendment of the section. Many decisions rest on the application of the statute, and the consequences of the failure to apply for a ruling. If the primary result is that only gain will be recognized and collateral side effects disregarded,⁷⁷ then it is clear that changes should be made, either in the wording of the statute or the application by the Commissioner. Furthermore, any time a statute is applied inconsistently, with or without statutory basis, the opportunity for abuse is greater. In order to protect both the taxpayer and the Commissioner, an amendment or regulations would seem to be necessary.

IV. BUSINESS AND TAX REASONS IN SUPPORT OF RECOGNITION OF GAIN IN INTERNATIONAL TRANSACTIONS

In most instances, the taxpayer will prefer to operate under the nonrecognition provisions of the Code when expanding its international operations or changing current foreign operations. While section 367 provides that gain will be recognized if the corporation is not considered to be a corporation, it does not refer to any loss on a transaction. Therefore, losses will not be recognized, and if there is both gain and loss in the property transferred, it could be that the gain will be recognized with no offsetting loss (if no ruling is obtained), as each item of property transferred may be considered to have been separately exchanged.⁷⁸ This would be true if a favorable ruling were not obtained, since the nonrecognition provisions would still apply to the loss,

⁷⁷ See discussion in part V, *infra*.

⁷⁸ Rev. Rul. 67-192, 1967-2 CUM. BULL. 140. However, note that *Werner Abegg*, *supra* note 40, expressly did not deal with that question, intimating that perhaps this practice was far from settled.

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but the same provisions would not apply to the gain because of the operation of section 367.

There are, nevertheless, some cases in which the taxpayer would rather have any gain recognized and the transaction taxed at the outset. It is, of course, not the tax that would be considered advantageous, but the correlative side effects which come from having a transaction taxed. Usually these side effects are concerned with some future aspect of taxation.

One of the more obvious advantages of recognizing gain in a transaction involving equipment or other capital assets is the step up in basis of such assets transferred from a parent to a subsidiary or a subsidiary back to a parent in a section 332 liquidation. This would be particularly appealing to a corporation intending to use these same assets in its own business in the United States. In the first place, the market value of the assets would be reflected on the balance sheets, representing a more accurate picture of the taxpayer's assets. Further and more importantly, the step up would also give a new depreciation base from which ordinary income deductions can be taken, if the assets are depreciable. Such depreciation would reduce the amount of earnings in a given time period, and therefore reduce taxes to some extent. It is conceivable, therefore, that there are situations when the price of a capital gains tax would be worth the subsequent reduction of ordinary income. Even if some of the gain were treated as ordinary income under section 1245, the new basis might offset the tax cost. The same gain might also be usable if the taxpayer has excess operating loss carryover or capital loss which has not been used. In addition, in a section 332 liquidation, the parent will inherit the subsidiary's earnings and profits, and the parent by failing to obtain a ruling would also avoid this carryover.

Recognizing gain, even for these reasons, in a section 332 liquidation would generally not be desirable, however, if there were any accumulated earnings and profits to which section 1248 might apply. Its operation was explored earlier⁷⁹ but in general, the result might be ordinary income to the parent corporation to the extent of its share of earnings and profits. This would be offset somewhat by the indirect credit pro-

⁷⁹ See note 12, *supra* and accompanying text.

visions of the Code⁸⁰ but would nevertheless be an expensive result if section 1248 applies, particularly if the taxpayer is unaware of the consequences in this regard.

Under the current section 367 guidelines, earnings and profits of a corporation involved in an international transaction will still have to be recognized and treated as dividend income in order to obtain a favorable ruling.⁸¹ Since this consequence may be present in any event, then, it might be preferable to have the entire transaction taxed and be able to reap some of the benefits of a step up in basis and the use of otherwise unusable tax credits. The increase in taxes might be more than offset by future deductions from ordinary income. The presence of additional tax credit might also create an instance when a gain in a section 332 liquidation might advantageously be taxed.

One situation where the taxpayer might prefer that gain be recognized in a transaction which normally qualifies for nonrecognition treatment is when the foreign country will recognize foreign source gain, and tax it. This foreign tax can be credited against any taxes the parent corporation will have to pay in the United States. As very few foreign countries have the same type of tax-free treatment in a transaction which qualifies under section 351,⁸² this is one area where a recognized gain might be particularly beneficial. The taxpayer will be taxed upon the transfer of appreciated property to a foreign corporation in the foreign country, but since under United States law this is generally a nonrecognition transaction, the tax credit available under normal circumstances will not be available here. As far as the Service is concerned, if there is no gain, no income results.⁸³ Therefore, if the transferring corporation wishes to avail itself of the tax credit, it must have income from some other source, or carry the credit to another year when it does have income from foreign sources. If this happens to be a first venture into foreign business, the taxpayer may not have such other income, and may foresee nothing but losses for the first few years in the foreign country, so the tax credit might be lost entirely.

⁸⁰ IRC § 902.

⁸¹ Rev. Proc. 68-23 §§ 3.01(1), 3.03(1)(b), (c) and (g), and § 5; 1968-1 CUM BULL. 822 *et seq.*

⁸² BNA, 97-2d Tax Management Portfolio A-6 (1968) (Japan); BNA 136 Tax Management Portfolio A-36 (1967) (Mexico); BNA 199 Tax Management Portfolio A-37 (1968) (South Africa) (capital duty), among others.

⁸³ See generally IRC §§ 901-981 (Income From Sources Without the United States).

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If so, getting recognition of gain in the year of transfer would be a desirable thing for the taxpayer. Furthermore, it would give the taxpayer a step up in basis in the property for little or no United States tax cost. A taxpayer might also wish to recognize gain when assets are received from a foreign subsidiary, especially if the taxpayer is subject to a foreign tax on the distribution. If gain is not recognized the foreign tax may not be creditable, the parent takes a substituted basis in the assets, and may inherit the subsidiary's earnings and profits account. If gain is recognized the increase in tax may be small if recognition makes the foreign tax creditable, and the parent takes the stepped up basis in the assets received with no carryover of tax attributes.

In the area of integrated or divisive corporate reorganizations there are many collateral effects to be considered in tax planning, such as the carryover of earnings and profits, net operating losses, holding periods and bases, and carrybacks. The stepped up basis which would be achieved by a taxed transaction could be offset by a large tax on accumulated earnings and profits⁸⁴ or the loss of a net operating loss carryover. Furthermore, individual taxpayers, as shareholders, may not wish to be taxed at ordinary income rates under section 1248 upon the transaction, and may dissent in a stockholder election in which a taxed merger plan or sale of assets is presented. (This factor may not make much difference one way or another, however, since even if the transaction is tax-free under the nonrecognition sections, in order to get a favorable ruling, the taxpayers must agree to include dividend income as a condition. This condition might not be applicable if such inclusion is taxed only to the corporate taxpayer and not to the individual shareholders. In that event, there would be a difference in treatment of the shareholder taxpayers, depending upon whether the transaction was taxed or not.)

A carryover of holding periods might be important in some instances, although sections 1245 and 1250 make this less so, since depreciation often will be recaptured as ordinary gain upon the sale of the capital assets. A primary purpose for having gain recognized in a reorganization transaction may well hinge upon foreign tax law, as

⁸⁴ See discussion regarding IRC § 1248 at note 79 *supra* and text following note 92 *infra*.

it has for the other provisions specified in section 367. If the taxpayer has a large tax credit available, it would be advantageous to have the transaction taxed in the United States, thus allowing the taxpayer to utilize the credit against those taxes. The same is true if the country in which the foreign corporation is situated taxes the reorganization transaction. If it is not also taxed in the United States, the credit from that tax will not be available unless there is other foreign source income.

Another reason a taxpayer may forego a tax-free transaction is the urgency of business transactions which might not allow a taxpayer to request a ruling before proceeding with a transaction. Since current rulings require nearly four months merely to process⁸⁵ and negotiations can take over a year (sometimes with unfavorable results anyway),⁸⁶ many taxpayers may feel the wait is not warranted, particularly if the tax effect of the transaction does not have too great a bearing on the total plan.

It can be seen, then, that in some instances recognition of gain on a transaction which falls within the list specified in section 367 may be advantageous for a taxpayer. As pointed out, however, any advantages obtained derive only from the collateral effects of having a transaction taxed. If the taxpayer were unable to enjoy the other tax attributes, there would be no reason to plan the transaction in such a manner that gain would be recognized and taxed in the United States.

V. CONSEQUENCES OF GAIN RECOGNITION: WHAT HAPPENS TO THE OTHER TAX ATTRIBUTES?

The Internal Revenue Service has taken the position that the failure to comply with the provisions of section 367 in seeking an advance clearance has only one effect: Gain is recognized.⁸⁷ For all other purposes, such as those mentioned in the previous discussion, the underlying tax-free provisions still apply if the taxpayer has so ordered his business that he falls within the requirements of the nonrecognition provision, except for the fact that section 367 applies to the transaction.

⁸⁵ Goldman, *supra* note 22.

⁸⁶ Statement of Charles H. Kellstadt, President, Sears, Roebuck & Co., HEARINGS ON H.R. 5 BEFORE THE HOUSE WAYS AND MEANS COMMITTEE, 86th Cong., 1st Sess. 357-58. (1959).

⁸⁷ See generally Rapp, *supra* note 50, and McDonald, *supra* note 29.

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If indeed this is the position the Service intends to follow, it can be illustrated with an example. Assume United States parent corporation has a subsidiary in Japan which it plans to liquidate. The subsidiary has many assets at a low cost basis and the United States parent hopes to use these assets in its own operations after the liquidation. The assets have become extremely valuable and the parent feels that if it could get a stepped up basis in these assets, it would be worthwhile with regard to future depreciation deductions. Therefore, the parent fails to obtain a section 367 ruling prior to carrying out a section 332 liquidation. Upon discovering what is happening the Service tells the parent that although gain must be recognized, the transaction remains within the nonrecognition provisions for other purposes: That is, the assets will not get a stepped up basis and the earnings and profits of the subsidiary will also carry over. Therefore, the parent has suffered more than one consequence as a result of its actions. It has paid tax on the appreciation of the capital asset and now will not be able to take the stepped up basis upon their transfer.

The other position which the Service has also taken in the past, is that the taxpayer may not use section 367 for his own benefit and thus the Service issues a retroactive favorable ruling, making the transaction tax-free.⁸⁸ Even though this view also appears to be without authority, at least the consequences are not quite so severe.

The Service contends their position in either event is supported by the wording of the House and Senate Reports of 1932.⁸⁹ However, this ignores the exact wording in the former, stating that the proposed amendment "withdraws the transaction from the operation of the nonrecognition sections" only, unless section 367 is fulfilled. The Senate made the same statement, so if the interpretation given by the Service of the Senate's statement regarding the further application of the nonrecognition provisions is believed,⁹⁰ there is a basic inconsistency in the report of the Senate Finance Committee. This, however, would

⁸⁸ Rev. Rul. 64-177, 1964-1 (Part 1) CUM. BULL. 141.

⁸⁹ The House Report, cited in note 2 *supra* stated: "To prevent this avoidance the proposed amendment withdraws the transaction from the operation of the nonrecognition sections where a foreign corporation is a party to the transaction. . . ." The Senate incorporated the same sentence in its report, and stating further: "For all other purposes, including the nonrecognition of loss in any transaction described in the foregoing subsections, the tax status of a foreign corporation is not affected by the new subsection." Note 2 *supra*.

⁹⁰ See note 89 *supra*.

appear to be resolved by the final wording of the statute requiring a prior ruling in order to be tax-free, with no mention of the fact that the Commissioner could issue rulings after the fact, or that normal tax attributes would be denied.

Frances Rapp, the former head of the Reorganization and Divisive Branch of the Tax Rulings Division said section 367 "does not make any of the basis provisions of the law dependent upon a prior clearance by the Commissioner; therefore it cannot be invoked either by the Commissioner or by a taxpayer to render any basis provision of the Code inapplicable."⁹¹ This statement, of course, could mean several things: It could mean that if no ruling were obtained, the transaction would be taxable in all respects. It could also mean that although gain is recognized, the transaction is tax-free for other purposes. This latter view may be supported by the Senate Report in 1932, but does not seem to have support elsewhere except in Rev. Rul. 64-177⁹² which relies on the House Report's language.

An application of this latter view points up the irrationality of the Service's argument. Section 1248 applies to distribution and liquidations under sections 301 and 331. Nevertheless, in a section 332 liquidation which is carried out under a favorable ruling, and in such a liquidation where no ruling has been requested, earnings and profits of the liquidating corporation must be recognized as gain to the extent of the parent corporation's proportionate share. The Service has taken the position that section 1248 applies to these earnings and profits, treating them as dividend income. By requiring this result, the Service must be laboring under the idea that such liquidations are in effect section 331 liquidations since that is the only type of liquidation to which section 1248 applies. On the other hand, the Service maintains that no step up in basis is allowed and the other tax attributes carry over. This is not possible under section 331. Such a result does not appear to be supported by any logic.

There would appear to be a further flaw in the Service's reasoning in maintaining that if the transaction is not tax-free the other non-recognition provisions would still apply. The sections enumerated in section 367 apply only when the parties are corporations. Yet, that

⁹¹ Rapp, *supra* note 50, at 345.

⁹² See note 88 *supra*.

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section states the foreign corporation will not be treated as a corporation if a favorable ruling is not obtained from the Commissioner. If the foreign corporation, then, were not considered to be such, by their terms the other provisions would not apply, including those sections which are concerned with tax attributes. In addition, section 367 was enacted to deal with tax avoidance. If a corporation should realize gain, which is thereafter recognized and taxed, there has been no tax avoidance per se. The fact that taxes may be reduced in the future would appear to have little to do with the problem that Congress was attempting to reach, and to penalize a taxpayer in this regard is to punish astute business planning. This same statement is also true of tax deferral.

Revenue Ruling 64-177, promulgated in 1964, exemplifies the attitude the Service has taken with regard to transactions the taxpayer wishes to have taxed. There a domestic corporation failed to secure an advance ruling under section 367 in order to obtain a stepped up basis for assets acquired from a foreign corporation in a section 332 liquidation. The Commissioner stated that the taxpayer's failure to apply for a ruling would not be used to his benefit, stating that the provisions of section 367 were not intended to afford taxpayers an option to escape the tax consequences which would follow "but for that section."⁹³ Curiously enough, the Commissioner cited the House Report as authority, although that report stated that the entire transaction was to be withdrawn from the section if the advance ruling were not obtained. The ruling went on to state:⁹⁴

Statutory requirements intended solely for the protection of the Government may be invoked only at the instance of the Government. . . . Hence, the transaction constitutes a tax-free liquidation under section 332 of the Code, and . . . the basis of the assets [cannot be stepped up].

It would appear, then, that if the taxpayer plans to have the transaction recognized and taxed because of the absence of a favorable ruling from the Commissioner, his action could have dire results. That is, the gain could be recognized with no step up in basis allowed, and the earnings and profits could either be carried over or taxed as ordinary

⁹³ *Id.*

⁹⁴ *Id.* This position is rather curious and has drawn some very strong criticism. Lamp, *supra* note 45.

income, depending upon which view the Commissioner decided to take in the particular instance. This would take away any advantage of having a taxed transaction. In situations where the taxpayer did not necessarily plan for the tax itself, such a result penalizes the taxpayer who, realizing no favorable ruling would be issued and so not applying for one, had hoped to offset the anticipated tax with the various collateral effects. Such a situation might arise when a domestic corporation is planning to begin operations in a country where the tax rates are very low, even though such corporation had sound business reasons for this move. As pointed out previously, the Commissioner tends to equate transfer to a low tax country with tax avoidance, and therefore would issue an unfavorable ruling if one were requested.⁹⁵ Rather than go through the long delay only to receive an unfavorable ruling, the taxpayer may wish to carry out its plans. If it does, the results might be other than anticipated. That is, the Service will recognize gain, but will also take the transaction out of the other applicable provisions providing for step up in basis, etc. Clearly this is a penalty which the statute does not contemplate, and cannot be supported by any rationale.

If the Commissioner should carry through with what seems to be his intent in such situations, *i.e.*, that gain will be recognized and the adjustments usually made not allowed, then the cost to the taxpayer will be very high. This is very harsh treatment, and the same would not be accorded to transactions involving only domestic corporations under similar circumstances. That is, if for some reason (perhaps tax avoidance) an exchange or distribution in a reorganization were found to be taxable, the taxpayer would be able to make the concomitant adjustments set forth in the Code. A corporation should not be treated differently because it is involved in an international transaction and the gain is recognized.

The statute indicates a ruling must be obtained prior to the exchange, or the foreign corporation will not be considered to be a corporation to the extent gain is to be recognized. It should therefore follow that if gain is to be recognized, the tax attributes should be treated accordingly. Any other consequence only results in a form of

⁹⁵ See note 43 *supra*. See generally Rapp, *supra* note 50.

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double taxation and inequality of application of the provisions of the tax law.

The new guidelines also point up another inconsistency in the Commissioner's application of section 367 in this regard. The issuance of a favorable ruling is often conditioned upon the recognition of some gain in some of the transactions which might take place. This is true with regard to tainted property and recognition of accumulated earnings and profits as dividend income.⁹⁶ If the taxpayer agrees to recognize such gain or earnings, then the Commissioner will issue a favorable ruling as to the remainder of the transaction under the nonrecognition provisions set forth in section 367. Since this type of bartering was carried on prior to the promulgation of the guidelines, this condition is nothing new.⁹⁷ Furthermore, when a taxpayer does consent to such a partially taxed transaction, the guidelines state "the character of the income or gain shall be determined, and *adjustments in basis made*" as though the assets transferred by the domestic corporation or the earnings and profits recognized were "in a taxable exchange."⁹⁸ This would appear to be a concession by the Service that adjustments would be made if an exchange were taxed. By taking this position in the new guidelines, the Commissioner may be forced to take the same position when a ruling has not been issued and a transaction is therefore subject to tax. Perhaps these guidelines are an indication that the Service will view transactions which recognize gain in this manner.⁹⁹

The policy reasons for this position are clear. Anytime a domestic corporation engages in a reorganization with another corporation and the requirements of sections 361 and 368 are fulfilled, then the transaction is accorded tax-free treatment. However, if the transaction is so ordered that it fails to qualify as one of the reorganizations listed, any gain in the transaction will be recognized and taxed. When such gain is recognized, certain other consequences flow from that fact. A

⁹⁶ Rev. Proc. 68-23 §§ 3.01, 3.02(1)(b), and 5; 1968-1 CUM. BULL. 822 *et seq.*

⁹⁷ See Eustice, *Tax Problems Arising from Transactions Between Affiliated or Controlled Corporations*, 23 TAX. L. REV. 451 (1968).

⁹⁸ See, e.g., Rev. Proc. 68-23 § 3.01(2), 1968-1 CUM. BULL. 822.

⁹⁹ The guidelines appear to be the most recent publication of the Internal Revenue Service with regard to section 367, except for a miscellaneous ruling or two. Therefore, it is difficult to say just what route the Commissioner will follow in applying the guidelines and in making determinations in transactions which do not fall squarely within their narrow limits. The dearth of information is most disappointing to anyone working in this area.

step up in basis is the normal result, together with a loss of carryover of earnings and profits or losses. Holding periods are no longer tacked.

It would only be logical, then, if the tax code is structured so that a certain transaction requires the recognition of gain, that the same tax attributes accorded to such a result in the United States should also apply to a transaction involving a domestic corporation or United States shareholders in an international transaction. This consequence should follow regardless of the underlying reasons of the taxpayer in effecting such a taxable exchange. (In fact, since section 1245, 1248, 1249 and 1250 turn into ordinary income what previously may have been capital gain, there is no great amount of tax avoidance even if section 367 is elective.) Many business transactions in the United States, whether involving corporations or not, have some tax ramifications sooner or later and few plans are made without considering the effects of these. The same should be true when the plans happen to concern a corporation dealing with a foreign corporation in the international business world.

VI. ASSUMING NORMAL TAX ATTRIBUTES OF GAIN RECOGNITION, IS SECTION 367 ELECTIVE?

Despite the foregoing discussion of the application of the statute by the Commissioner of Internal Revenue, there are many instances when the section will operate normally. This is true principally because of the burdens of administration and lack of manpower in the rulings branch of the Service. Ordinarily, if a taxpayer fails to request a ruling, the transaction will be taxed and the concomitant collateral effects will follow. As one commentator has stated:¹⁰⁰

As far as can be ascertained, the Service in the audit of returns has for many years followed the view that upon the liquidation of a foreign subsidiary into a United States parent without a Section 367 ruling, a stepped up basis is allowed. Upon the "C" type reorganization of two foreign corporations followed by the liquidation of the transferor corporation, in the absence of a Section 367 ruling, the transaction has been treated as a taxable exchange in which gain is recognized to all United States shareholders having gain; . . .

¹⁰⁰ McDonald, *supra* note 29, at 1030.

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Because of the application of the section in this manner, it is submitted that the section is essentially an elective one, whether Congress intended that result or not. That is, if the taxpayer wishes to have a certain transaction taxed, he merely need not apply for a ruling. If, however, the taxpayer determines the risk of that course of action to be too great¹⁰¹ he could instead apply for a ruling in such a manner that the plan will be in pursuance of a tax avoidance purpose and therefore receive an unfavorable ruling.

Previously this latter course of action was also rather uncertain. However, since the Commissioner has promulgated guidelines, the taxpayer can accomplish with greater ease that which was difficult in prior years. That is, by so structuring the transaction so that it falls without the narrow limits of the guidelines, the taxpayer will probably be successful in his attempt to obtain an unfavorable ruling, and thus have the international transaction taxed.

For example, the guidelines are replete with lists of property which will result in an unfavorable ruling if transferred under a plan of organization or liquidation. It would appear to be simple to include some of that tainted property into such a transfer or liquidation. This would appear to result in an unfavorable ruling, and the whole transaction would then be taxed. However, the Service might be willing to let the untainted property be transferred tax-free with a favorable ruling, and only require the tainted property to be taxed. The goal of the taxpayer would then only be partially accomplished, with the result being a substantially untaxed transaction.

A more successful application would be one which specified that property was being transferred for use in a country other than that of the foreign corporation involved in the exchange. The guidelines specifically prohibit this if a favorable ruling is to be issued.

Either route, however, has certain elements of chance. There is still some uncertainty involved and in today's business world, this is something the taxpayer would like to minimize as much as possible. Since the Commissioner has many tools in his fight against tax avoidance, and the burdens of issuing rulings under section 367 must become even greater with expansion of world trade, the obvious answer seems to lie

¹⁰¹ See discussion in part V *supra*.

in a restructuring of either section 367 or the attitude which accompanies its application.

CONCLUSION

This paper has made several suggestions regarding amendment of the statute. There are no concrete reasons for the lack of guidelines, the extraordinary power given to the Commissioner, nor the arbitrary application of the statute's provisions. These could all be corrected, to some degree at least, by a rewording of the statute, discarding the requirement of an advance ruling, expansion of the regulations and the promulgation of further guidelines. Increased publication of rulings in the area would also aid practitioners in the field. Rather than forcing the taxpayer to risk unknown consequences in electing to apply for a ruling, the taxpayer should be able to choose when a transaction should be taxed, and any abuse of this discretion would be subject to attack by a new section 367, other sections of the Code, and the various court doctrines at the Commissioner's disposal.

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