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INTRODUCTION

A tax avoidance potential exists whenever U.S. persons transfer assets to, from, and between foreign corporations. Of particular concern to Congress has been the transfer by a U.S. person of the assets of a foreign branch with previously deducted losses to a foreign corporation in exchange for stock of that corporation. United States citizens, residents, and corporations are taxed by the United States on their worldwide taxable incomes.[1] Thus, the losses and profits of a U.S. corporation's foreign branch are included in computing its U.S. tax liability. Income is recognized by the U.S. corporation when the foreign branch earns it. When the foreign branch incurs a loss, the U.S. corporation benefits to the extent the loss is allowed to be recognized. The gains of a foreign subsidiary, however, will only be recognized by the U.S. parent corporation when the foreign subsidiary remits a dividend.[2] This delay between the time the foreign subsidiary earns the income and the U.S. corporation recognizes such income for U.S. tax purposes is known as deferral.[3] Thus, the U.S. corporation can defer income by preventing the foreign subsidiary from distributing a dividend.

The Internal Revenue Service [hereinafter IRS] has long recognized the potential for tax avoidance when foreign branches incorporate. For example, suppose a U.S. corporation establishes a foreign branch in Country A. During the first few years, when the branch will most likely incur operational losses, the U.S. corporation can offset its worldwide income, thereby reducing its U.S. tax liability for those years. Later, when the branch becomes profitable, it is incorporated in Country A. Due to the incorporation, the income earned by the foreign subsidiary escapes U.S. taxation until it is remitted to the U.S. parent. Thus, the pre-incorporation losses reduce the worldwide taxable income of the U.S. corporation, but the post-incorporation gains are not

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1. 2 E. OWENS & W. GIFFORD, INTERNATIONAL ASPECTS OF U.S. INCOME TAXATION 4 (1982).
2. *Id.* at 6.
3. *Id.*

included in the parent's worldwide taxable income until they are remitted as dividends.

The purpose of this article is to explain and evaluate § 367(a)(3)(C), the foreign branch loss recapture provision of the Deficit Reduction Act of 1984 [hereinafter DEFRA].[4] Part I covers the history of § 367 of the Internal Revenue Code, concluding with the early attempts to solve the "foreign loss branch" tax avoidance problem.[5] Next, the codification of foreign branch loss recapture by DEFRA, § 367(a)(3)(C), is examined in Part II. This Part continues with a detailed technical and policy analysis of the recently issued temporary regulations under § 367(a)(3)(C) which specify how the IRS will administer the recapture provision. Finally, the article proposes statutory and regulatory changes designed to further the policies underlying § 367(a)(3)(C).

I
HISTORY OF SECTION 367

A. Transactions Covered

Congress first attempted in 1932 to prevent tax-free transfers of appreciated property to foreign corporations by U.S. persons.[6] The 1932 legislative history gives an example of the intended application of § 367: American citizen ("*A*") owned $10,000,000 worth of Corporation X stock which he had originally purchased for $1,000,000. *A* organized a Canadian corporation to which he transferred the Corporation X stock in a tax-free exchange. The Canadian corporation then sold the stock. The $9,000,000 capital gain was exempt from both Canadian and U.S. taxation. Afterwards, the Canadian corporation transferred the cash it had received from the stock sale to a newly organized U.S. corporation ("Corporation Y") in another tax-free exchange. Finally, the Canadian corporation distributed the stock of Corporation Y to *A* in a tax-free reorganization. The result of these transactions was that *A* had control of the $10,000,000 cash without having paid any tax.[7]

In addition to tax-free transfers to a foreign corporation, § 367 has always applied to outbound, inbound, and foreign-to-foreign transfers. Outbound transfers "include exchanges involving transfers of property to a foreign corporation, the liquidation of a U.S. subsidiary into a foreign parent, the acquisition of a U.S. corporation's assets by a foreign corporation in a qualified reorganization and the acquisition of stock in a U.S. corporation by

4. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (1984).

5. The pre-1954 Internal Revenue Code predecessors to section 367 were Revenue Act of 1932, ch. 209, § 112(k), 47 Stat. 198; Revenue Act of 1934, ch. 277, § 112(i), 48 Stat. 705; Revenue Act of 1936, ch. 690, § 112(i), 49 Stat. 1681; Revenue Act of 1938, ch. 289, § 112(i), 52 Stat. 489; and Internal Revenue Code of 1939, ch. 1, § 112(i), 53 Stat. 40.

6. Pugh, *Developments in the Application of Section 367(a) to Transfers of Property to Foreign Corporations*, 22 SAN DIEGO L. REV. 227, 228 (1985).

7. S. REP. NO. 665, 72d Cong., 1st Sess. (1932), *reprinted in*, 1939-1 C.B. (Part 2) 496, 515.

a foreign corporation in a type 'B' reorganization."[8] Inbound transfers "include (i) the liquidation of a foreign corporation into a domestic parent; (ii) the acquisition of assets of a foreign corporation by a domestic corporation in a type 'C' or 'D' reorganization; and (iii) the acquisition of stock in a foreign corporation by a domestic corporation in a type 'B' reorganization."[9] Examples of foreign-to-foreign transfers "include . . . the acquisition of stock of a controlled foreign corporation by another foreign corporation which is controlled by the same U.S. shareholders as the acquired corporation . . . and . . . a transfer of property by one controlled foreign corporation to its foreign subsidiary."[10]

Section 367 denies corporate status to any foreign corporation which is a party to an outbound, inbound, or foreign-to-foreign transfer, in an otherwise tax-free exchange under §§ 332, 351, 354, 356 or 361.[11] Since the foreign corporation is not considered a corporation for these purposes, the tax-free status of the exchange is lost.

This article will focus on the transfer by a U.S. person of a foreign branch with previously deducted losses to a foreign corporation in exchange for stock of that corporation.[12] Such an exchange is an outbound transfer which would automatically qualify for § 351 tax-free treatment if it were not for the application of § 367.[13]

B. Pre-1976 Section 367

By 1975, the law and administration of § 367 had evolved into a unique system. Whenever a U.S. person contemplated a transfer falling within the terms of § 367, it had to seek IRS approval. In 1975, § 367(a) provided that:

> [I]n the case of any of the exchanges described in section 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 . . . that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.[14]

Thus, rulings from the Secretary were mandatory and had to be obtained before the transfer occurred.[15] Furthermore, it was generally believed that

8. STAFF OF THE JOINT COMMITTEE ON TAXATION, 94th CONG., 2d SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976 260 (Jt. Comm. Print 1976).

9. *Id.* at 264.

10. *Id.*

11. I.R.C. § 367(a). [All references to I.R.C. in this Article, unless otherwise indicated, are to sections of the Internal Revenue Code of 1986.]

12. *See, e.g.*, Hershey Foods Corp. v. Commissioner, 76 T.C. 312 (1981), *appeal dismissed* (3d Cir. 1981).

13. No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368(c)) of the corporation. I.R.C. § 351(a) (1986). Tax Reform Act of 1971, Pub. L. No. 91-681 (1971).

14. I.R.C. § 367(a), *amended by* Tax Reform Act of 1976, Pub. L. No. 94-455 (1976).

15. General Explanation of the Tax Reform Act, *supra* note 8, at 261.

such rulings were not reviewable.[16] The subjective test of the statute was supplemented by Revenue Procedure 68-23 which provided guidelines describing fact situations where favorable and adverse § 367 rulings would ordinarily be given.[17]

This advance ruling procedure under Revenue Procedure 68-23 apparently degenerated into a routine slotting of a transaction into the fact pattern it most resembled.[18] Some transfers were accorded tax-free treatment. For example, when property was to be transferred from one foreign corporation to another foreign corporation, a favorable ruling would be issued.[19] Other transfers were not deemed to be "in pursuance of [plans] having as one of [their] principal purposes the avoidance of Federal income taxes" only if toll charges were paid.[20] For example, when a foreign corporation was to be liquidated into its domestic parent corporation, a favorable ruling would only be issued if the parent agreed to include in its gross income, as a dividend, the accumulated earnings and profits of the foreign corporation which were attributable to the parent corporation's stock in the foreign corporation.[21] Other transfers, however, always received adverse rulings. These included § 351 transfers to foreign corporations of "tainted" property, such as inventory,[22] accounts receivable,[23] installment obligations,[24] stocks or securities,[25] and certain intangibles.[26] It was felt that the principal purpose of these transactions was the avoidance of federal income tax.

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16. *Id. But see* Gerli & Co. v. Commissioner, 668 F.2d 691 (2d Cir. 1982) (reversal of the IRS imposition of a toll charge on an inbound transfer occurring in 1965).

17. Rev. Proc. 68-23, 1968-1 C.B. 821; *modified by* Rev. Proc. 77-17, 1977-1 C.B. 577; *amplified by* Rev. Proc. 81-41, 1981-2 C.B. 605, Rev. Proc. 80-14, 1980-1 C.B. 617, Rev. Proc. 76-20, 1976-1 C.B. 560 (these were known as "the guidelines").

18. General Explanation of the Tax Reform Act, *supra* note 8, at 281.

19. Rev. Proc. 68-23, 1968-1 C.B. 821, § 3.02(2).

20. The term "toll charge" was used by the IRS and taxpayers to describe the tax assessed as a condition for a favorable section 367 ruling.

21. *See* Rev. Proc. 68-23, *supra* note 19, at § 3.01(1).

22. *Id.* at § 3.02(1)(a)(i).

23. *Id.* at § 3.02(1)(a)(ii).

24. *Id.*

25. *Id.* at § 3.02(1)(a)(iii).

26. *See* Rev. Proc. 68-23, *supra* note 19, at § 3.02(1)(b)(iii)-(iv). One set of commentators have identified four IRS rationales for considering an asset "tainted." These four rationales are:

> 1. an asset was likely to be sold or susceptible to immediate sale by the foreign transferee (e.g. stocks or securities);
>
> 2. the U.S. transferors had generated deductible expenses in the U.S. in creating the asset and the transfer abroad would place the income to be generated by the asset beyond the reach of U.S. taxing jurisdictions, thus causing a mismatching of income and deductions for U.S. tax purposes (e.g. U.S. patent or trademark);
>
> 3. the assets were generating, or could generate, passive income that could be earned directly by the U.S. taxpayer (e.g. dividends, rents, or royalties); or
>
> 4. the asset was mature but no income recognition had occurred (e.g. inventory or receivables).

Yang & Nelson, *Post-Reconstruction § 367: New Rules and New Dangers*, 17 TAX ADVISER 102, 103 (Feb. 1986).

Section 351 transfers of "non-tainted" property to a foreign corporation did receive a favorable ruling if the property transferred was to be used by the transferee foreign corporation in the active conduct of a trade or business and the foreign corporation would "have need for a substantial investment in fixed assets in such business or [would] be engaged in the purchase and sale abroad of manufactured goods."[27] In cases where "tainted" and "non-tainted" assets were to be transferred in the same transaction, a favorable ruling would be issued, but with complete recognition of gain as to the "tainted" assets.[28]

Revenue Procedure 68-23 provided that its guidelines did not establish any safe harbor because the IRS could "issue an adverse ruling if, based on all the facts and circumstances of a case, it [was] determined that the taxpayer [had] not established that tax avoidance [was] not one of the principal purposes of the transaction."[29] In addition, Revenue Procedure 68-23 created a presumption of tax avoidance if the transaction did not meet the guideline standards. Although the taxpayer was "free to establish that based on all the facts and circumstances . . . a favorable ruling . . . should be issued,"[30] in practice the taxpayer was seldom able to rebut the presumption of tax avoidance.[31]

C. Tax Reform Act of 1976

Congress identified several weaknesses in the § 367 system and revamped it in the Tax Reform Act of 1976.[32] The first weakness was that the advance ruling system caused undue delay to taxpayers. Second, unwarranted taxation often resulted when taxpayers mistakenly failed to get advance rulings. Third, "the IRS required a U.S. shareholder to include certain amounts in income as a toll charge even though there was no present tax avoidance purpose . . . only the existence of a potential for future tax avoidance."[33] Fourth, an advance ruling was unreviewable. Last, the IRS had inappropriately set policy by administrative ruling rather than through regulation. Congress concluded that, under the present system, a favorable ruling would be granted only in the narrow circumstance where the U.S. tax on accumulated earnings and profits (in the case of inbound transfers) or the U.S. tax on potential earnings from liquid or passive investment assets (in the case of outbound transfers) was paid or preserved for future payment.[34]

Dissatisfied with these weaknesses, Congress used the Tax Reform Act of 1976 to revamp the § 367 system. One of the most significant changes was

27. Rev. Proc. 68-23, *supra* note 19, at § 3.02(1).
28. *Id.* at § 3.02(1)(d).
29. *Id.* at § 2.02.
30. *Id.*
31. Pugh, *supra* note 6, at 229.
32. Tax Reform Act of 1976, Pub. L. No. 94-455, 90 Stat. 1520 (1976).
33. General Explanation of the Tax Reform Act, *supra* note 8, at 258.
34. *Id.*

to drop the mandatory ruling requirement for inbound and foreign-to-foreign transfers.[35] Generally, these transfers were to be considered tax-free unless the IRS promulgated contrary regulations. The Act also modified the ruling requirements for outbound transfers so that a ruling need only be requested within 183 days after the beginning of the transfer.[36] Furthermore, the IRS could issue regulations exempting certain outbound transfers.[37] Finally, the taxpayer was afforded judicial review under § 7477. If a taxpayer received an adverse ruling or a conditional ruling, or if the IRS failed to make a ruling upon a formal request, the taxpayer could seek a declaratory judgment by the Tax Court.[38] Upon deciding that the IRS determination was unreasonable, the Tax Court would issue its own order.[39]

D. 1976-1984 — The Turbulent Years

1. The Declaratory Judgment Procedure Produces Reversals of IRS Policy

The right to seek review of § 367 rulings created by the Tax Reform Act of 1976 had an immediate effect.[40] The Tax Court dealt the IRS a crushing blow in the first case brought under § 7477, *Dittler Brothers, Inc. v. Commissioner*.[41] First and most significantly, the court interpreted "principal purpose" to mean "first-in-importance."[42] Thus, "unless the avoidance of federal income taxes was a purpose that was first-in-importance," an outbound transfer was tax-free.[43] Basically, the court adopted the definition of principal purpose set out in the regulations under § 269.[44] The implication of this definition was that unless a tax avoidance purpose was greater in importance than any business purpose, § 367(a) would not prevent a tax-free outbound transfer of property.[45] In addition to restrictively defining principal

35. I.R.C. § 367(b) (1986) (unchanged since Tax Reform Act of 1976).

36. I.R.C. § 367(a) (1977), *amended by* DEFRA (Deficit Reduction Act), Pub. L. No. 98-369, 98 Stat. 494 (1984).

37. *Id.*

38. I.R.C. § 7477 (1977), *amended by* DEFRA, Pub. L. No. 98-369 (repeal applicable to transfers . . .)(1984).

39. *Id.*

40. *Id.*

41. Dittler Brothers, Inc. v. Commissioner, 72 T.C. 896 (1979), *aff'd mem.*, 642 F.2d 1211 (5th Cir. 1981).

42. *Id.* at 915.

43. STAFF OF JOINT COMMITTEE ON TAXATION, 98th CONG., 2d SESS., GENERAL EXPLANATION OF REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984 425 (Jt. Comm. Print 1984).

44. H.R. REP. NO. 432, 98th Cong., 2d Sess., 1315 (1984).

45. The Tax Court noted that the subjective tax avoidance motive of section 269 must be greater than section 367 because the relevant section 269 language is "the principal purpose." *Dittler*, 72 T.C. at 914. Yet, the court's interpretation of "principal purpose" looks very similar to the definition of "the principal purpose" set out in Treas. Reg. § 1.269-3(a)(2) (1962) ("If the principal purpose to evade or avoid Federal income tax exceeds in importance any other purpose, it is the principal purpose.").

purpose, the court also decided that substantial evidence was the proper standard for review, rather than the more deferential arbitrary or capricious standard.[46]

In a 1981 § 367 case, the Tax Court took issue with the IRS's active trade or business standard. In *Kaiser Aluminum & Chemical Corp. v. Commissioner*,[47] the taxpayer had proposed transferring stock of one foreign corporation [hereinafter QAL] to another foreign corporation [hereinafter Comalco]. The shareholders of QAL had the right to receive raw materials from QAL in proportion to their stock holdings. Since Revenue Procedure 68-23 had defined stock as a "tainted" asset,[48] the IRS refused to issue a favorable ruling. The Tax Court reversed, finding that the IRS's determination of tax avoidance was not based on substantial evidence.[49] The court found that the IRS had erred in mechanically applying the guidelines of Revenue Procedure 68-23.[50] Further, the Tax Court noted that Revenue Procedure 68-23 required a facts and circumstances inquiry.[51] Based on the unusual facts of the case, the court decided that the transferred stock was more closely akin to operating assets than stock.[52] Thus, the transfer could be made tax-free.[53]

The *Kaiser* and *Dittler* cases demonstrated the major problem with the subjective principal purpose test: it required a case-by-case analysis. Since it was administratively impossible to apply the test to the facts of each case, the IRS resorted to a mechanical application of the Revenue Procedure 68-23 guidelines. As a result, the court felt compelled to review the individual facts of each case.

On the same day as the *Kaiser* decision, the Tax Court decided *Hershey Foods Corp. v. Commissioner*.[54] In this case the court seriously crippled the IRS's ability to require recapture of losses upon the incorporation of foreign branches. *Hershey Food Corp.* will be discussed below in Part II.D.2.d. First, the history of attempts to deal with the problem of foreign branch loss recapture will be introduced in the following section.

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46. Possibly, the arbitrary and capricious standard and substantial evidence standards are the same. *See* Association of Data Processing Service Organizations, Inc. v. Board of Governors of the Federal Reserve System, 745 F.2d 677 (D.C. Cir. 1984) ("In their application to the requirement of factual support, the substantial evidence test and the arbitrary or capricious test are one and the same." 745 F.2d at 683).

47. Kaiser Aluminum & Chemical Corp. v. Commissioner, 76 T.C. 325 (1981), *acq. in result*, 1982-2 C.B. 1.

48. *See supra* note 25 and accompanying text.

49. *Kaiser*, 76 T.C. at 343.

50. *Id.* at 341.

51. *Id.* at 344.

52. *Id.*

53. *Id.* at 351.

54. *Hershey Foods*, 76 T.C. at 312.

2. *Recapture of Foreign Branch Loss in the Tax Reform Act of 1976: Section 904(f)*

In 1972 the IRS first lobbied Congress to eliminate the potential tax avoidance in the foreign branch loss area.[55] This attempt failed. But, in 1976 the IRS won a partial victory when § 904(f) was enacted.

Prior to the enactment of § 904(f), a U.S. corporation which incurred a net foreign loss could use this net loss to offset its U.S. source income.[56] Therefore, in the year of the net foreign loss, some U.S. source income was not being taxed. In later years, when the corporation earned a net foreign gain, a Foreign Tax Credit [hereinafter FTC] was available.[57] Thus, over the life of the U.S. corporation, some U.S. source income was escaping U.S. taxation.[58]

To alleviate this problem, Congress enacted § 904(f).[59] This section applies when aggregate foreign losses exceed aggregate foreign gains. An analysis of § 904(f) begins with the definition of "overall foreign loss" as defined in § 904(f)(2). An "overall foreign loss" is "the amount by which the gross income . . . from sources without the United States . . . for such year is exceeded by the sum of the deductions properly apportioned or allocated thereto."[60] Section 904(f)(l) provides that in later years all or a portion of that year's foreign source taxable income (net foreign gain) will be recharacterized as U.S. source income for purposes of computing the FTC limitation.[61] By recharacterizing foreign source taxable income as U.S. source income, a lower FTC limitation results.[62]

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55. A new section 84 was proposed which would have caused recapture of start-up losses upon the transfer of assets to a foreign corporation. *General Tax Reform: Hearings Before the House Comm. on Ways and Means*, 93d Cong., 1st Sess. 6901, 7072 (1973).

56. *See, e.g.*, P. McDaniel & H. Ault, Introduction to United States International Taxation 95-96 (1981).

57. *Id.* A U.S. corporation can take a foreign tax credit ("FTC") for the foreign income taxes it pays or is deemed to have paid. I.R.C. §§ 901(a), 902(a)-(b) (1986). This credit is limited by section 904(a) to the lesser of (1) the creditable foreign taxes or (2) the FTC limitation amount calculated as follows:

$$\frac{\text{Foreign Source Taxable Income}}{\text{Total Worldwide Taxable Income}} \times \text{U.S. tax on Worldwide Taxable Income} = \text{FTC Limitation}$$

58. *See supra* note 57.

59. Congress also eliminated the per country FTC limitation. Under the per country limitation, the losses of one branch could offset the U.S. corporation's worldwide taxable income while not reducing the total FTCs available from foreign income of the other branches. H.R. Rep. No. 658, 94th Cong., 1st Sess. 225 (1975).

60. I.R.C. § 904(f)(2).

61. I.R.C. § 904(f)(1) (recharacterization is limited to the lesser of the amount of the overall loss or fifty percent (or larger percentage if the taxpayer chooses) of the current year foreign source taxable income).

62. The purpose of section 904(f) is to reduce the FTC limitation in later years in order to compensate for the fact that U.S. taxes on U.S. source income have been reduced by an overall foreign loss in an earlier year. Yang & Metz, *Hershey Foods Corp.: Diabetic Shock for the IRS*, 12 Tax Adviser 665, 667 (Nov. 1981).

Congress went one step further and required that where a branch with previously deducted losses attributable to it is disposed of, recapture of a prior year's overall loss would result. Section 904(f)(3) requires that:

> [I]f property which has been used predominantly without the United States in a trade or business is disposed of during any taxable year the taxpayer . . . shall be deemed to have received and recognized taxable income from sources without the United States in the taxable year of the disposition . . . in an amount equal to the lesser of the excess of the fair market value of such property over the taxpayer's adjusted basis in such property or the remaining amount of overall foreign losses not used under [§ 904(f)(1)] for such taxable year or any prior taxable year.[63]

The result of § 904(f) is that the § 904(f)(3) amount is recharacterized as U.S. source income by § 904(f)(l), therefore requiring recapture since the FTC is limited to that extent.[64] Also, since § 904(f)(3) dispositions include any tax-free or taxable sales or exchanges,[65] an incorporation of a foreign branch falls within its scope. Furthermore, the proposed regulations under § 904(f) provide that the § 904(f)(3) amount "will have the same character as if the property had been sold or exchanged in a taxable transaction."[66]

As this discussion of § 904(f) demonstrates, Congress only provided tax loophole remedies when, and to the extent that, aggregate foreign losses exceeded aggregate foreign gains. Congress did not provide a statutory mechanism dealing with potential tax avoidance when foreign losses offset, but did not exceed, foreign gains.

3. *IRS Action*

a. *Revenue Ruling 78-201*

The IRS recognized the tax avoidance potential which § 904(f) did not cover: that of foreign branch losses which only offset foreign gains. In Revenue Ruling 78-201 [hereinafter R.R.] the IRS took action to prevent taxpayers from taking advantage of this situation.[67]

R.R. 78-201 concerned P, a domestic corporation, which was engaged in the manufacture and sale of plastic components for radios and televisions. In 1975, P commenced business operations in Country A by establishing a branch there. P purchased assets and transferred those assets and cash to the Country A branch. The branch suffered ordinary losses in 1975 through 1977 in the following amounts:

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63. I.R.C. § 904(f)(3)(A).

64. *Id.*

65. I.R.C. § 904(f)(3)(B)(i).

66. Prop. Treas. Reg. § 1.904(f)-2(d)(4)(i)(B) (for example, if inventory of a foreign trade or business were exchanged, ordinary income would result, whereas the exchange of land held for investment would result in capital gain).

67. Rev. Rul. 78-201, 1978-1 C.B. 91.

	Country A Branch Income (Loss)
1975	($50×)
1976	($30×)
1977	($10×)

These losses only offset foreign source gains and so were not used to offset U.S. source gains of P, thus, § 904(f) was not applicable. In late 1977, P transferred all the branch assets to a newly-created Country A corporation. The transfer met the requirements of § 351 and met the active conduct of trade or business requirement of the Revenue Procedure 68-23 guidelines.[68] P requested a favorable § 367 ruling.

The IRS employed a facts and circumstances analysis and denied a favorable ruling because of the presence of tax avoidance. The IRS ruled that "the transfer . . . of the assets of the branch to the foreign corporation will be deemed to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes within the meaning of § 367 of the Code."[69] The effect of this apparent blanket rule[70] was that the IRS agreed to issue a favorable ruling only if P agreed to recognize "as gain on the transfer an amount of ordinary foreign source income equal to the sum of the Country A branch losses previously incurred."[71] The IRS focused on two events which triggered the R.R. 78-201 result. These two events were:

1) that the pre-incorporation branch losses were taken into account by P and thereby reduced P's worldwide income subject to U.S. tax, and
2) as a result of the incorporation of the branch operations, the income to be produced by these operations would not increase P's worldwide income subject to U.S. tax.

b. *The Progeny of Revenue Ruling 78-201*

To clarify and amplify the effect of R.R. 78-201, the IRS promulgated its policy through public and private rulings.

68. *See supra* note 27 and accompanying text.

69. Rev. Rul. 78-201, *supra* note 67, at 92.

70. The evidence is inconclusive whether the IRS automatically applied R.R. 78-201 to any fact situation when a foreign loss branch was incorporated. Priv. Ltr. Rul. 81-14-402 (Jan. 12, 1981) suggests that an incorporation of a foreign loss branch only gives rise to a presumption of tax avoidance which can be rebutted by a sufficient business purpose. Yet, in Private Letter Ruling 80-01-024, the IRS indicated that neither an expectation of continued losses nor a compelling business reason would preclude application of foreign branch loss recapture. One group of commentators suggests that it was the IRS practice not to impose 78-201 recapture if the taxpayer could convince the IRS that losses would continue into the foreseeable future. Apparently, there was no tax avoidance purpose. Remeikis & Fowler, *DRA Sets New Standards for Section 367 Transfers and Codifies IRS Approach*, 62 J. TAX 232, 238 (April 1985).

One set of commentators argue that the blanket rule formulation of Revenue Ruling 78-201 in essence establishes a section 482 allocation. They argue further that such allocation is inconsistent with current IRS practice under section 482. Pesiri & Theofel, *Hershey Foods Corporation: Bittersweet Victory for the Bar*, 35 TAX LAW. 683 (1982).

71. *See* Rev. Rul. 78-201, *supra* note 67, at 92.

Revenue Ruling 80-163 In R.R. 80-163 the fact pattern was identical to that of R.R. 78-201, except that the cumulative branch losses exceeded the amount of gain that the transferor (P) would have to recognize if the branch assets were transferred in a taxable exchange.[72] Thus, the transferor might avoid requesting a § 367 ruling, forego a tax-free exchange, and recognize a smaller amount of income. The maximum amount of gain recognized on a transfer to a foreign corporation when no § 367 ruling was sought was equal to the aggregate amount of realized gains on the assets transferred, with no reduction for realized losses.[73] The issue for the IRS was whether the taxpayer could limit its liability on a taxable transfer to the aggregate of the realized gains, the amount it would pay on a taxable transfer, or whether R.R. 78-201 would require the taxpayer to recapture all its earlier losses.

The IRS ruled that it could apply R.R. 78-201 to require full recapture. Consequently, after R.R. 80-163, the common advice given to a client who was in a similar situation was to forego the § 367 ruling procedure and recognize the smaller gain equal to the aggregate realized gains of the assets transferred.[74] The IRS eventually realized the problems with its position and revoked R.R. 80-163 by R.R. 82-146.[75] Thus, the gain limitation on R.R. 78-201 recapture was equal to the aggregate realized gains of the assets transferred.[76]

Yet the rationale of R.R. 80-163 was far more important than its holding. In R.R. 80-163 the IRS explained its rationale for R.R. 78-201 recapture was to "prevent the potential mismatching of related income and losses."[77] To prevent this potential mismatching, the IRS ruled that the recapture amount should equal the full amount of losses associated with the transferred assets.

Private Letter Ruling 78-45-060 In Private Letter Ruling 78-45-060[78] the IRS permitted the taxpayer to reduce the R.R. 78-201 recapture amount by the pre-incorporation gains generated by the branch. Thus, the recapture amount was only the net pre-incorporation losses of the foreign branch.

Revenue Ruling 80-246 The facts of R.R. 80-246 were analogous to those of R.R. 78-201 except that P corporation had no foreign operations other

72. Rev. Rul. 80-163, 1980-1 C.B. 78.

73. *See supra* note 36.

74. Kalish & Siboni, *367 — Outbound Transfers: Incorporation of Foreign Branch Losses — The Aftermath of Revenue Ruling 78-201*, 40 N.Y.U. INST. ON FED. TAX § 47.02 (1982).

75. Rev. Rul. 82-146, 1982-2 C.B. 84.

76. Foreign Loss Branch recapture will be used synonymously with 78-201 recapture.

77. *See supra* note 72. Also, *see supra* note 26, item 2. Many commentators saw FLB recapture as differing sharply from past IRS section 367 activity. In the past, the IRS had concerned itself with preserving the U.S. tax on liquid or passive investment assets. The IRS had embarked on a new route by concerning itself with mismatches of past losses and future earnings. *See, e.g.*, Lashbrooke, *Recapture of Past Foreign Branch Losses on Transfer of Branch Assets to a Foreign Corporation*, 4 NW. J. INT'L. LAW & BUS. 359 (1982).

78. Priv. Ltr. Rul. 78-45-060 (Aug. 14, 1978).

than the Country A branch.[79] Therefore, the branch losses offset U.S. source income, causing § 904(f) to apply. Upon incorporation of the branch, both § 904(f)(3)(A) and R.R. 78-201 required gain recognition on the same pre-incorporation losses because the statutory provision and the ruling had overlapping applications.[80] The issue for the IRS was whether the gain recognized under § 904(f)(3)(A) could reduce the R.R. 78-201 recapture amount. The IRS ruled that such a reduction was proper.

The ruling was also significant because the IRS further refined its rationale for foreign branch loss recapture. After noting that the income to be produced by the incorporated branch would only be indirectly attributable to the pre-incorporation losses, the IRS concluded that "[t]he effect of the incorporation will therefore be a mismatching of revenue, deductions, and credits, when income is finally produced."[81]

The Complete Business Concept — Revenue Ruling 80-247 Revenue Ruling 80-247 involved a different factual situation than the prior public rulings.[82] In the ruling, P, a domestic corporation, was engaged in the exploration, development, and sale of mineral properties in the United States. P owned mineral properties in Country A and in 1977 established a branch there to conduct mineral exploration, development, and property sales activities. The branch incurred losses of $100X in each year from 1977 through 1979. The losses only offset foreign gains. On January 1, 1980, P transferred the majority of the branch's assets to a newly-formed Country A corporation. Mineral properties in Country A that had no commercial value were not transferred, but were abandoned as worthless. The pre-incorporation losses attributable to the transferred assets equaled $200X while the losses attributable to the abandoned assets equaled $100X. The issue for the IRS was whether R.R. 78-201 required that the losses attributable to the abandoned assets be recaptured.

The IRS decided that such losses must be recaptured. The IRS reasoned that all of the properties, both those transferred and those abandoned, constituted a single complete business operation, and that the business, not the specific parcels of property, had incurred the losses. Moreover, P incorporated the business of the branch. Thus, all of the losses, including those attributable to the abandoned property, were subject to recapture.[83]

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79. Rev. Rul. 80-246, 1980-2 C.B. 125.

80. *See* Kalish & Siboni, *supra* note 74, at § 47.02.

81. Rev. Rul. 80-246, *supra* note 79, at 126. The IRS routinely asserted that the incorporated branch would eventually produce profits equal to the pre-incorporation losses.

82. Rev. Rul. 80-247, 1980-2 C.B. 127.

83. In Revenue Ruling 80-247, the IRS refined its mismatching of income and loss rationale "to include the idea of a 'complete business' being transferred." Kalish & Siboni, *supra* note 74, at § 47.02.

Separate Business Concept-Revenue Ruling 81-82 In R.R. 81-82, the IRS expanded the separate business concept in the context of R.R. 78-201 recapture.[84] In R.R. 81-82, P, a domestic corporation, was engaged in the manufacture and sale of clothing and plastic components. In 1977, P started various business operations in Country A. Division 1 produced clothing. Division 2 manufactured plastic components in the eastern province of Country A, while Division 3 manufactured the same plastic components in the western province. Division 4 manufactured television components. Division 5 assembled television sets from the components produced by Division 4. Each division was separate for financial reporting and accounting purposes. From 1977 through 1979 the divisions had the following earnings (losses):

	Div. 1	Div. 2	Div. 3	Div. 4	Div. 5
1977	$100X	($100X)	$50X	($100X)	($100X)
1978	100X	(100X)	50X	(100X)	(100X)
1979	100X	(100X)	50X	(100X)	(100X)

The losses offset foreign gains of P.

Additionally, Divisions 2 and 3 had common purchasing, accounting, personnel, and record-keeping departments. Further, the two divisions shared a common sales force, headquarters staff, and management team. Also, they had identical manufacturing facilities and processes and substantial identity of customers and distributional channels. Divisions 4 and 5 had common purchasing, accounting, record-keeping, and headquarters staff departments. Also, the two divisions had a substantial identity of employees, operational facilities, and managements. Division 4 sold all of its output to Division 5 while Division 5 purchased all of its materials from Division 4.

On January 1, 1980, P transferred Divisions 1, 2, 3, and 4 to a newly-formed Country A corporation. The two issues for the IRS were: 1) whether the R.R. 78-201 recapture amount could be reduced by the amount of pre-incorporation gains of Divisions 1 and 3, and 2) whether Division 5's losses had to be recaptured. In deciding the first issue, the IRS relied on the separate business rationale. The IRS ruled that pre-incorporation gains could only offset pre-incorporation losses if the gains were earned by the same business which incurred the losses. Thus, R.R. 78-201 required that individual branches be considered separately. Only if there was a sufficient relationship between two or more branches could they be grouped together as a single business so that profits and losses of those particular branches would be offset.

To determine whether particular branches constituted a single business, the IRS ruled that a facts and circumstances inquiry must be conducted. Fortunately, the IRS provided some guidance for determining when business operations do not constitute separate businesses. Generally, "business operations . . . do not constitute separate businesses . . . if there is a substantial

84. Rev. Rul. 81-82, 1981-1 C.B. 127.

identity of products, customers, operational facilities, operational processes, accounting and record-keeping functions, managements, employees, distribution channels, sales and purchasing forces, and headquarters staffs."[85]

In applying this test, the IRS concluded that Divisions 2 and 3, though located in different parts of Country A, were one separate business. Thus, Division 3's gains could offset Division 2's losses and reduce the R.R. 78-201 recapture amount. Likewise, the IRS determined that Divisions 4 and 5 constituted a single business. The IRS also ruled that Division 1 was a separate business; therefore, Division 1's gains could not offset the other divisions' losses.

In regard to the second issue, the IRS decided that Division 5's losses had to be recaptured. The IRS relied on the complete business concept in R.R. 80-247 for the proposition that a domestic transferor of a foreign loss branch must recognize the pre-incorporation losses incurred by the foreign loss branch's business, not just the losses attributable to the assets transferred. The recapture of Division 5's losses flows logically from the holding of R.R. 80-247. Although R.R. 81-82 differed from R.R. 80-247 in that the transferor continued to use the assets which it did not transfer, the IRS decided this difference was irrelevant. Had the IRS decided this issue differently, taxpayers could avoid 78-201 recapture for loss incurred in such assets merely by not abandoning them.

Consolidated Entities — Revenue Ruling 81-89 In R.R. 81-89, the IRS applied the R.R. 78-201 recapture concept to consolidated entities.[86] Revenue Ruling 81-89 concerned two domestic corporations, P and S. Both were engaged in the manufacture and sale of plastic components for U.S. and foreign radio and television manufacturers. In 1977, each established a separate and independent Country A branch to engage in the same plastic components business activity. The products produced by the two branches generated the following earnings and losses from 1977 through 1979:

	P's Country A Branch	S's Country A Branch
1977	($200X)	$100X
1978	(200X)	100X
1979	(200X)	100X

P used Country A branch losses to offset its foreign gains.

On January 1, 1979 a type "B" reorganization was effectuated, whereby P acquired all of the stock of S.[87] P and S filed a consolidated return for 1979. Also, during 1979 the two Country A branches were integrated in much the same manner as Divisions 2 and 3 in R.R. 81-82.[88] Among other things, they had common accounting personnel, a common sales force, and

85. *Id.* at 129.
86. Rev. Rul. 81-89, 1981-1 C.B. 129.
87. I.R.C. § 368(a)(1)(B).
88. *See supra* notes 84-85 and accompanying text.

substantial identity of customers, distribution channels, employees, operational facilities, and operational processes. On January 1, 1980, the assets of the two Country A branches were transferred to a newly-created Country A corporation. The issue for the IRS was whether the pre-incorporation gains of S's Country A branch could offset the losses of P's Country A branch and thus reduce the R.R. 78-201 recapture amount.

The IRS ruled that only upon the integration of the two branches did the branches constitute a single business.[89] Therefore, the IRS concluded that the 1979 gain of S's Country A branch could offset the 1979 loss incurred by P's Country A branch. The 1977 and 1978 gains of S's Country A branch could not reduce the 78-201 recapture amount. This result is consistent with the separate business approach of R.R. 81-82.

4. *The Tax Court Decision* — Hershey Foods Corporation v. Commissioner

In *Hershey Foods Corp. v. Commissioner*, decided in 1981, the Tax Court destroyed the IRS position on R.R. 78-201 recapture.[90] In *Hershey*, the taxpayer, Hershey Foods Corp. ("Hershey"), had operated a Canadian subsidiary from 1962 through June 1970. In July 1970, Hershey converted the Canadian subsidiary into a branch and operated it as such through 1978. During this period, the Canadian branch incurred cumulative losses of approximately 5.5 million dollars. These losses only offset foreign gains. On November 30, 1977, Hershey purchased all of the stock of Y & S Candies, Inc. ("Y & S"), a New York corporation. Y & S had conducted a profitable Canadian branch since 1908.

During 1978, Y & S organized a new Canadian corporation, Fred Thompson Sales, Ltd. Fred Thompson purchased all the assets of a Canadian candy distributorship. For various reasons, the Canadian government imposed many restrictions on Fred Thompson, the last of which was that Hershey and Y & S should transfer their respective Canadian branch assets to Fred Thompson. To comply with the Canadian authorities, and for other business reasons, Hershey decided to transfer the Hershey and Y & S branches.[91]

Hershey sought a favorable § 367 ruling on the transfer of the two branches to Fred Thompson. In conjunction with the ruling, Hershey agreed to pay a toll charge to reflect any realization of income with respect to the transferred raw material and work in process inventories. Even though the active trade or business requirements of the Revenue Procedure 68-23 guidelines were met,[92] the IRS issued an unfavorable ruling. As in R.R. 78-201,

89. It was also important to the IRS that a consolidated return for 1979 had been filed.

90. *Hershey Foods*, 76 T.C. at 312.

91. Other business reasons for the transfer advanced by Hershey were: to facilitate Canadian borrowing and thus reduce the risk of exchange losses, to reduce Canadian tax liability, to allow for more efficient administration, and to eliminate duplicate services. *Id.* at 316.

92. *See supra* note 27 and accompanying text.

the IRS held that the proposed transaction had tax avoidance as one of its principal purposes.[93] The IRS agreed to issue a favorable ruling only if Hershey agreed to include in its foreign source taxable income, in the year of transfer, the 5.5 million dollars of cumulative losses of its Canadian branch less any profit the Y & S branch earned after November 30, 1977.[94] Hershey sought Tax Court review under the declaratory judgment procedure of IRC § 7477.[95]

The Tax Court held that the IRS had unreasonably determined the issue of tax avoidance.[96] Moreover, the Tax Court found that no tax avoidance potential existed in the proposed transaction.[97]

The IRS argued that a presumption of tax avoidance arose because a historically unprofitable branch was being incorporated in a foreign country.[98] As in the progeny of R.R. 78-201,[99] the IRS argued that the result of the foreign loss branch incorporation would be a mismatching of losses and income. Therefore, Hershey's income was not being clearly reflected.[100] The court discredited this clear reflection of income argument by observing that, if the court were to accept the IRS position viewing "the Hershey Canadian branch's entire history as one event,"[101] then a violation of the annual accounting system would result.[102] Additionally, the court identified this clear reflection of income argument as a tax benefit rule argument in disguise.[103] The court opined that the tax benefit rule only applied where there was a prior tax benefit followed by a "recovery of property that once was the subject of an income tax deduction."[104] Since there was no recovery in this case, the tax benefit rule did not apply.[105]

The court also observed that the U.S. does not assert taxing jurisdiction over foreign corporations. The court saw R.R. 78-201 recapture as a tax on the future operating income of a foreign corporation. Accordingly, the court determined that the IRS had unreasonably used its power under § 367.[106]

Further assailing the IRS position, the court identified R.R. 78-201 as an unwarranted extension of § 367's historical application.[107] Prior to R.R.

93. *Hershey Foods*, 76 T.C. at 317.
94. *Id.*
95. *See supra* notes 38-39 and accompanying text.
96. *Hershey Foods*, 76 T.C. at 325.
97. *Id.* at 324.
98. *Id.* at 319.
99. *See supra* Part I.D.3.b.
100. *Hershey Foods*, 76 T.C. at 319.
101. *Id.*
102. *Id.*
103. *Id.* at 320.
104. *Id.* This was a pre-*Bliss Dairy, Inc. v. Commissioner* case. *See infra* notes 125-136 and accompanying text. One commentator argued that the tax benefit rule did not apply because there was no nexus between the pre-incorporation losses of the branch and the receipt of income in later years. Lashbrooke, *supra* note 77, at 369.
105. *Hershey Foods*, 76 T.C. at 321.
106. *Id.*
107. *Id.*

78-201, the IRS had been primarily concerned with the transfer of assets "that might carry passive income which could just as easily be earned or realized in the United States" or the transfer of assets which carry "income which had essentially already been earned."[108] But, R.R. 78-201 went beyond that initial concern and looked to currently unearned, future operating income as the income upon which the tax was being avoided.[109]

The Tax Court delivered the knock-out punch when it held that Congress had pre-empted the IRS from recapturing foreign branch losses under § 367.[110] The court observed that in enacting the Tax Reform Act of 1976, Congress had sought to stop the abuses in the foreign loss area. Congress repealed the per country FTC limitation, required recharacterization of foreign source income as U.S. source income for FTC limitation purposes by § 904(f)(1), and required that overall foreign losses be recaptured upon the disposition of foreign branch assets by § 904(f)(3)(A).[111] The court concluded that the combined effect of these three steps was to ensure that, in the long run, foreign source losses can only reduce foreign source income.[112] Therefore, the court concluded that "Congress [had] carefully studied the tax consequences of foreign losses and [had] enacted comprehensive legislation to prevent any tax benefits previously allowed which Congress felt were unwarranted."[113]

Of major importance to the court was its concern that R.R. 78-201 recapture resulted in double taxation.[114] The court concluded that R.R. 78-201 recapture caused the foreign branch losses to be counted twice. Losses counted when the losses were first realized by reducing the FTC limitation, and again when the losses were recharacterized as additional foreign source income under R.R. 78-201.[115]

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108. *Id.*

109. *Id.*

110. Several commentators agreed that Congress had pre-empted IRS action. *See* Kalish & Siboni, *supra* note 74, at § 47.02 (these commentators believe that the IRS, by issuing Revenue Ruling 80-246, acknowledged that Congress had acted in the foreign loss area. This "recognition ultimately proved to be the downfall of Revenue Ruling 78-201 in the courts."); Lowry, *Review of the Tax Court's Decision in Hershey Foods Corporation*, 60 TAXES 224, 233 (March 1982) (Congress did not define tax avoidance as a mere increase in FTC carryover). *But see* Pesiri & Theofel, *supra* note 70, at 696 (these commentators argue that Congress has not pre-empted IRS action. Congress' intention in enacting the Tax Reform Act of 1976 was to prevent FTC abuse. On the other hand, 78-201 was aimed at preventing the shifting of income and loss between related entities); Daley, *Incorporating the Loss Branch After Hershey Foods*, 8 INT'L TAX J. 45, 60 (1981) (concluding that Congress in enacting the Tax Reform Act of 1976 may not have intended to preclude treatment under section 367).

111. *Hershey Foods*, 76 T.C. at 321-22.

112. *Id.* at 323.

113. *Id.* at 324.

114. *Id.*

115. *Id. Compare* Yang & Metz, *supra* note 62, at 669 (concluding that 78-201 causes double counting of income — gain included in transferor's taxable income at time of recapture and later upon the remittance of a dividend by the incorporated branch).

The Tax Court did not discuss the possibility that the application of R.R. 78-201 might also produce a double tax benefit. When the losses were originally incurred, they reduced Hershey's worldwide taxable income without recapture by § 904(f)(3) because no excess loss reducing U.S. source income was present in that year. If the loss had been recaptured pursuant to R.R. 78-201, the increase in foreign source taxable income would then have increased Hershey's FTC limitation.

5. Aftermath of Hershey

a. IRS Response

The IRS never acquiesced to the *Hershey* decision.[116] In fact, just a few weeks after the Tax Court rendered its opinion, the IRS issued R.R. 81-82 [117] and 81-89.[118]

In its private rulings, the IRS continued to focus on the two key events of R.R. 78-201: (1) the pre-incorporation foreign branch losses which reduced the transferor's worldwide income subject to U.S. tax, and (2) the incorporation of the branch removing its future earnings from inclusion in the transferor's worldwide income.[119] If these two conditions were present, a rebuttable presumption of tax avoidance arose.[120] Yet, after *Hershey*, the IRS appeared to be more amenable to taxpayers' rebuttal evidence. For example, in Private Letter Ruling 84-35-021,[121] although the two key factors identified in R.R. 78-201 were present, the IRS reversed an earlier decision and held that, based on all the facts and circumstances, the transfer was not in pursuance of a plan having tax avoidance as one of its principal purposes.[122]

The IRS responded to some of the *Hershey* court's criticisms of its application of § 367 through further private rulings. The IRS insisted that R.R. 78-201 focused on the recapture of past deductions, not on the taxation of future, unearned operating income of the incorporated branch.[123] It maintained that the Internal Revenue Code permits deduction of the pre-incorporation branch losses only because of the expectation that the branch will eventually earn profits in equal amounts. Furthermore, the IRS insisted that the scope of § 367 was not limited to the taxation of untaxed earnings or appreciation. Rather, the IRS maintained that the language of § 367 gave the

116. Priv. Ltr. Rul. 85-48-031 (Aug. 30, 1985).
117. *See supra* notes 84-85 and accompanying text.
118. Yang & Metz, *supra* note 62, at 669. *See also supra* notes 86-89 and accompanying text.
119. Priv. Ltr. Rul. 84-27-066 (Apr. 3, 1984).
120. *Id.*
121. Priv. Ltr. Rul. 84-35-021 (May 22, 1984).
122. *Id. But see* Priv. Ltr. Rul. 85-48-031 (Aug. 30, 1985) (IRS denied a favorable ruling because the business reasons cited for the transfer were not sufficiently compelling to overcome the presumption of 78-201).
123. Priv. Ltr. Rul. 84-27-066 (Apr. 3, 1984).

IRS the power to tax the entire exchange and not merely to focus on only certain classes of property.[124]

b. Reformulation of the Tax Benefit Rule Breathes Life into Revenue Ruling 78-201

In 1983 the U.S. Supreme Court reformulated the tax benefit rule in *Bliss Dairy, Inc. v. Commissioner*.[125] This reformulation allowed the IRS to treat R.R. 78-201 as a type of tax benefit rule and to continue to apply it despite the *Hershey* ruling.

In *Bliss Dairy,* the taxpayer, Bliss, purchased feed for its dairy business which it expensed under § 162.[126] Shortly thereafter, and before the feed was consumed, Bliss liquidated. Bliss distributed the assets of the dairy to its shareholders who continued to operate the dairy business. The issue before the Court was whether the tax benefit rule required Bliss to recognize as income, in the year of transfer, the fair market value of the remaining feed it had expensed before the date of liquidation. The Court decided that the tax benefit rule applied, thereby requiring recognition (or recapture).

The tax benefit rule set out by the Court was that "unless a non-recognition provision of the Internal Revenue Code prevents it, the tax benefit rule ordinarily applies to require the inclusion of income when events occur that are fundamentally inconsistent with an earlier deduction."[127] The Court reasoned that the basic purpose of the tax benefit rule was "to achieve rough transactional parity in tax . . . and to protect the Government and the taxpayer from the adverse effects of" the annual accounting system.[128] Furthermore, the tax benefit rule will "cancel out an earlier deduction only when a careful examination shows that the later event is indeed fundamentally inconsistent with the premise on which the deduction was initially based."[129] An event is fundamentally inconsistent with an earlier deduction if the deduction would have been foreclosed had the event occurred within the same taxable year.[130]

In applying the tax benefit rule, the Court first determined that a § 162 deduction is predicated on the consumption of the asset in a trade or business.[131] Second, the Court decided that any conversion of an expensed item to non-business use would be a fundamentally inconsistent event.[132] The

124. *Id.*
125. 460 U.S. 370 (1983).
126. "There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ." I.R.C. § 162(a).
127. *Bliss Dairy*, 460 U.S. at 373.
128. *Id.* at 384.
129. *Id.*
130. *Id.* at 384-85.
131. *Id.* at 396.
132. *Id.*

Court concluded that distribution of the expensed feed to the Bliss shareholders upon liquidation was analogous to a conversion to personal use.[133] Thus, the tax benefit rule applied[134] and the Court determined that it had priority over § 336 which does not require recognition of gain or loss upon liquidation.[135] Therefore, the Court held that Bliss had to include in income the fair market value of the remaining feed at the date of the liquidation.[136]

The IRS wasted little time in using the *Bliss Dairy* formulation of the tax benefit rule to its advantage in the R.R. 78-201 context. In Private Letter Ruling 84-27-066, the IRS decided that R.R. 78-201 applied to the incorporation of a foreign partnership which was owned by U.S. persons and which had incurred net losses used by the U.S. partners to reduce their worldwide taxable income. The IRS bolstered its position by relying on *Bliss Dairy*. According to the IRS, the incorporation of the partnership was fundamentally inconsistent with the recognition of the prior branch losses by the U.S. partners.[137]

Apparently, the IRS was suggesting that if the incorporation had occurred in the same taxable year as the losses, it would have foreclosed the deduction. Yet, pre-incorporation deductions depend on the assumption that the assets will be consumed in the partnership's business. Therefore, even if consumption occurs while the business is in corporate form, there is no conversion of the property to personal use as was the case in *Bliss Dairy*.[138] Thus, *Bliss Dairy* does not seem to require application of the tax benefit rule to the R.R. 78-201 fact situation. However, the enactment of the Deficit Reduction Act made the applicability of *Bliss Dairy* to R.R. 78-201 a largely academic question.

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133. *Id.* at 397.

134. *Id.*

135. I.R.C. § 336(a). "Except as provided in subsection (b) of this section and in section 453B (relating to disposition of installment obligations), no gain or loss shall be recognized to a corporation on the distribution of property in complete liquidation." Note, the 1986 Act has changed § 336 in that complete liquidation is no longer tax free.

136. *Bliss Dairy*, 460 U.S. at 403.

137. One commentator argued that the *Bliss Dairy* tax benefit rule formulation could not extend to 78-201 because:

> 1. A § 351 incorporation is a mere change in form from direct ownership of property to indirect ownership.
>
> 2. A § 351 transaction receives favorable treatment by the courts.
>
> 3. The IRS has indicated that the tax benefit rule would only be imposed to recoup deductions that represent the costs of acquiring an unconsumed, short-lived asset. In 78-201 recapture, the only asset that relates to prior deductions is goodwill which is not a short-lived asset.

Willens, *Foreign Branch Corporations: Does Bliss Dairy Warrant a Re-examination of Hershey Foods?*, 15 TAX ADVISER 2, 4-6 (Jan. 1984).

138. This conclusion is similar to the Willens theory, *supra* note 137, in that all that occurs in the incorporation of a FLB is a mere change in ownership of the property from direct ownership to indirect ownership.

II
DEFRA — REVENUE RULING 78-201 CODIFIED

A. Problems with Section 367(a)

In enacting DEFRA in 1984, Congress again revamped § 367(a) for several reasons. Primarily, Congress was dissatisfied with the principal purpose test. Congress disagreed with the Tax Court's interpretation of "principal purpose" as being a purpose "first in rank, authority, importance, or degree."[139] Congress believed that the Tax Court's narrow interpretation of § 367(a) made it difficult for the IRS to restrict "the types of tax avoidance transfers that the provisions of [§ 367(a)] were . . . intended to combat."[140] Congress further observed that the Tax Court's interpretation threatened "to undermine the utility of § 367, with the result being an incentive for foreign investment."[141] Besides clarifying its intentions, Congress sought to bring "a substantial degree of regularity to the ruling process."[142]

Second, Congress was upset with the IRS guidelines covering the transfer of intangibles. Revenue Procedure 68-23 allowed U.S. persons to develop intangibles, *e.g.*, patents, in the United States and to deduct research and development expenses.[143] After completing development, the U.S. person could transfer the intangible tax-free to a foreign corporation as long as the foreign corporation was engaged in an active trade or business.[144] The profits generated by the intangible would only be taxed when the foreign corporation remitted a dividend.[145] Thus, U.S. persons could deduct the research and development expenses of the intangible from their worldwide taxable income, but defer gain recognition.[146]

Third, Congress was unhappy with the Tax Court decision in *Hershey Foods*. Congress observed that an opportunity for double benefits exists in the situation where foreign branches incur losses that only reduce other foreign gains.[147] Congress felt that the present § 367 was incapable of dealing with this potential tax avoidance.[148] Further, Congress believed that R.R. 78-201 was consistent with present § 367[149] and thus implied that § 367 was not preempted by § 904(f). Significantly, Congress acknowledged that in some cases the recognition of foreign branch losses may produce no tax benefit because

139. H.R. REP. NO. 432, 98th Cong., 2d Sess. 1315 (1984); *see also supra* notes 41-44 and accompanying text.
140. H.R. REP. NO. 432, *supra* note 139, at 1315.
141. *Id.*
142. *Id.* at 1318.
143. *Id.* at 1316.
144. *Id.*
145. *See supra* notes 2-3 and accompanying text.
146. H.R. REP. NO. 432, *supra* note 139, at 1316.
147. *Id.* at 1317.
148. *Id.* at 1317-18.
149. *Id.* at 1318.

such losses also reduce the FTC limitation by reducing foreign source income.[150] Congress concluded that in cases where no tax benefit results recapture may not always be appropriate.[151]

Fourth, Congress was dissatisfied with the mandatory ruling requirement for outbound transfers.[152] Congress observed that "many taxpayers [considered] the ruling requirement burdensome, and the requirement [was placing] a steadily increasing demand on [the IRS] as outbound transfers have increased in number."[153]

Finally, Congress disliked the advantageous position of the taxpayer in requesting § 367 rulings and in seeking declaratory judgments under § 7477. The taxpayer could structure the facts upon which such decisions were based.[154]

B. DEFRA Provisions

To alleviate these problems with § 367, Congress restructured § 367(a) in the Deficit Reduction Act.[155] Congress also added § 367(d) to cover

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150. *Id.*
151. *Id.*
152. *See supra* note 14, 35 and accompanying text.
153. H.R. REP. No. 432, *supra* note 139, at 1318.
154. *Id.* at 1318-19.
155. I.R.C. § 367 provides in part:

(a) TRANSFERS OF PROPERTY FROM THE UNITED STATES.—

(1) GENERAL RULE.— If, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation . . . .

(3) EXCEPTION FOR TRANSFERS OF PROPERTY USED IN THE ACTIVE CONDUCT OF A TRADE OR BUSINESS.—

(A) IN GENERAL. — Except as provided in regulations prescribed by the Secretary, paragraph (1) shall not apply to any property transferred to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States.

(B) PARAGRAPH NOT TO APPLY TO CERTAIN PROPERTY. — Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to any—

(i) property described in paragraph (1) or (3) of section 1221 (relating to inventory and copyrights, etc.),

(ii) installment obligations, accounts receivable or similar property,

(iii) foreign currency or other property denominated in foreign currency,

(iv) intangible property (within the meaning of section 936(h)(3)(B)), or

(v) property with respect to which the transferor is a lessor at the time of the transfer, except that this clause shall not apply if the transferee was the lessee.

(C) TRANSFER OF FOREIGN BRANCH WITH PREVIOUSLY DEDUCTED LOSSES. — Except as provided in regulations prescribed by the Secretary, subparagraph (A) shall not apply to gain realized on the transfer of the assets of a foreign branch of a United States person to a foreign corporation in an exchange described in paragraph (1) to the extent that—

intangibles.[156]

Most significantly, Congress removed the subjective principal purpose test of § 367(a). The general rule of § 367(a)(1) made taxable all outbound transfers of property in connection with an exchange described in §§ 332, 351, 354, 355, 356, or 361.[157] Section 367(a)(1) continues to recognize gain and not loss.[158]

(i) the sum of losses—

(I) which were incurred by the foreign branch before the transfer, and

(II) with respect to which a deduction was allowed to the taxpayer, exceeds

(ii) the sum of—

(I) any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer, and

(II) the amount which is recognized under section 904(f)(3) on account of the transfer.

Any gain recognized by reason of the preceding sentence shall be treated for purposes of this chapter as income from sources outside the United States having the same character as such losses had . . . .

Note the Tax Reform Act of 1986 removed the reference to § 355 from § 367(a)(1).

156. I.R.C. § 367(d):

SPECIAL RULES RELATING TO TRANSFERS OF INTANGIBLES.—

(1) IN GENERAL. — Except as provided in regulations prescribed by the Secretary, if a United States person transfers any intangible property (within the meaning of section 936(h)(3)(B)) to a foreign corporation in an exchange described in section 351 or 361—

(A) subsection (a) shall not apply to the transfer of such property, and

(B) the provisions of this subsection shall apply to such transfer.

(2) TRANSFER OF INTANGIBLES TREATED AS TRANSFER PURSUANT TO SALE OF CONTINGENT PAYMENTS.—

(A) IN GENERAL. — If paragraph (1) applies to any transfer, the United States person transferring such property shall be treated as—

(i) having sold such property in exchange for payments which are contingent upon the productivity, use, or disposition of such property, and

(ii) receiving amounts which reasonably reflect the amounts which would have been received—

(I) annually in the form of such payments over the useful life of such property, or

(II) in the case of a disposition following such transfer (whether direct or indirect), at the time of the disposition. The amounts taken into account under clause (ii) shall be commensurate with the income attributable to the intangible.

(B) EFFECT ON EARNINGS AND PROFITS. —For purposes of this chapter, the earnings and profits of a foreign corporation to which the intangible property was transferred shall be reduced by the amount required to be included in the income of the transferor of the intangible property under subparagraph (A)(ii).

(C) AMOUNTS RECEIVED TREATED AS UNITED STATES SOURCE ORDINARY INCOME. — For purposes of this chapter, any amount included in gross income by reason of this subsection shall be treated as ordinary income from sources within the United States.

157. In DEFRA, Congress shifted the balance in favor of stricter rules and revenue raising in the § 367 area. Remeikis & Fowler, *supra* note 70, at 239.

158. *See infra* Part II.D.1.

Congress replaced the subjective test with an objective active trade or business exception set out in § 367(a)(3)(A).[159] An outbound transfer of property "to a foreign corporation for use by such foreign corporation in the active conduct of a trade or business outside of the United States"[160] will not be subject to the general rule of § 367(a)(1). Congress intended that this objective exception would produce greater predictability of results.[161]

Congress, however, retained the concept of "tainted" assets. In § 367(a)(3)(B), Congress listed categories of assets that could not qualify for the active trade or business exception. Generally, the list included the same assets that the Revenue Procedure 68-23 guidelines had identified as "tainted."[162]

The new subsection, 367(d), assesses a special toll charge on all outbound § 351 or § 361 transfers of intangibles, including those to be used exclusively in foreign countries. Generally, § 367(d) requires the transferor to be treated as if the intangible were sold "in exchange for payments which are contingent upon the productivity, use, or disposition of such property . . . ."[163] Each year, over the useful life of the intangible, the transferor must include in income an amount which reasonably reflects what would have been received, based upon the productivity or use of the intangible.[164] Moreover, if the transferor disposes of his stock in the foreign corporation or the foreign corporation disposes of the intangible, then the transferor must include in income what would have reasonably been received for the intangible at the time of disposition.[165] All income recognized under § 367(d) is U.S. source ordinary income.[166]

Congress also eliminated the mandatory ruling requirement for outbound transfers, making it similar to prior treatment of inbound and foreign-to-foreign transfers.[167] In its place, Congress added § 6038B which requires the U.S. person making an outbound transfer to notify the IRS. If the IRS is not notified, a penalty equal to twenty-five percent of the gain realized on the transfer will be imposed, unless the U.S. person can show reasonable cause for the failure to furnish the information.[168] Also, because the taxpayer is not

159. H.R. REP. NO. 432, *supra* note 139, at 1315-16.

160. I.R.C. § 367(a)(3)(A).

161. H.R. REP. NO. 432, *supra* note 139, at 1318.

162. Stock and securities were dropped from the "tainted" asset group while foreign currency was added. Pugh, *supra* note 6, at 242-44.

163. I.R.C. § 367(d)(2)(A)(i).

164. I.R.C. § 367(d)(2)(A)(ii)(I).

165. I.R.C. § 367(d)(2)(A)(ii)(II). *See also* Pugh, *supra* note 6, at 244; Cooper, *Outbound Transfers of Intangibles - Section 367*, 4 BOSTON U. J. TAX LAW 63, 77-78 (1986). The 1986 Tax Act amended § 482 to require that transferors of intangibles (where the transfer occurred after December 31, 1986) recognize income commensurate with the income of the intangible.

166. I.R.C. § 367(d)(2)(C).

167. A taxpayer can still request a private ruling for a § 367 outbound transfer. IRS Announcement 85-95, 1985-27 I.R.B. 18.

168. I.R.C. § 6038B(b).

required to obtain a ruling, Congress eliminated the § 7477 declaratory judgment procedure.[169]

Finally, Congress codified R.R. 78-201 in § 367(a)(3)(C). This provision and the temporary regulations pertaining to it are examined in detail in the following sections of this article.

C. Section 367(a)(3)(C) — Transfer of a Foreign Branch with Previously Deducted Losses

In codifying R.R. 78-201 Congress differentiated it from the active trade or business exception of § 367(a)(3)(A). The general rule of § 367(a)(3)(C) is that the active trade or business exception "shall not apply to gain realized on the transfer of the assets of a foreign branch of a United States person to a foreign corporation in [a § 332, 351, 354, 356, or 361 exchange] to the extent [provided by this section]."[170] However, with the qualifying language "[e]xcept as provided in regulations prescribed by the Secretary," Congress granted the IRS some discretion to interpret § 367(a)(3)(C). The language left open how much discretion the IRS obtained.

When the transfer of a foreign branch comes under § 367(a)(3)(C) the amount of gain recognized is the sum of losses which were incurred by the branch before the transfer and were allowed as a deduction to the transferor, reduced by the sum of 1) "any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer," and 2) any gain recognized on the transfer under § 904(f)(3). All recaptured amounts under § 367(a)(3)(C) are treated as foreign source gains.

From the language of the statute, it is unclear whether Congress sought to treat § 367(a)(3)(C) as a type of tax benefit rule. All that Congress required for the recapture of branch losses is that they be incurred before the transfer and be allowed as a deduction to the transferor. These requirements for recapture are in stark contrast to the § 111(a) requirement that the prior reduction must have "[reduced the] income subject to tax" for the tax benefit rule to apply.[171]

Congress codified R.R. 80-246 by allowing a reduction for gain recognized on the transfer under § 904(f)(3).[172] Thus, Congress eliminated the problem of overlap between 904(f)(3) and § 367(a)(3)(C).[173]

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169. *See supra* note 38.

170. I.R.C. § 367(a)(1).

171. I.R.C. § 111(a) provides that: "Gross income does not include income attributable to the recovery during the taxable year of any amount deducted in any prior taxable year to the extent such amount did not reduce income subject to tax." (amended by the 1986 Tax Reform Act to "did not reduce the amount of tax imposed by this chapter").

172. *See supra* notes 79-81 and accompanying text.

173. *But see* Pesiri, *Current and Quotable*, 26 TAX NOTES 798 (Feb. 25, 1985) (warning that the current statutory language allows for section 367(a)(3)(C) to have priority over section 904(f)(3) and suggesting an amendment to § 904(f)(3) to cure this problem).

Finally, the provision concerning the reduction in the recapture amount for "any taxable income of such branch for a taxable year after the taxable year in which the loss was incurred" is ambiguous.[174] The literal interpretation of this phrase is that a branch taxable gain year can reduce the recaptured amount, but only if such branch taxable gain year follows a loss year. For example, if the branch incurred losses in years one through seven and had gains in years eight and nine, only the gain in year eight could reduce the amount recaptured.[175] This result is contrary to what the IRS previously expressed in Private Letter Ruling 78-45-060[176] and is inconsistent with R.R. 81-82, in which the IRS permitted pre-incorporation gains earned by a profitable division to offset losses incurred by a loss division.[177]

Recognizing this contradiction with established IRS policy and the anomalous results produced by the statutory provision, the IRS, through the promulgation of the temporary regulations of § 367(a), allowed all gains recognized through the close of the taxable year of the transfer to reduce the recapture amount.[178]

Even though the statute allows the IRS some discretion, it is unclear to what extent the IRS could exercise such extensive discretion. Barring amendment of the statute, reduction of recapture by prior branch gains will be dependent upon administrative grace. The IRS could justify revoking the relevant temporary regulation by asserting that it was conforming to the statute. To foreclose this possibility, Congress should amend § 367(a)(3)(C)(ii)(I) to read "any taxable income of such branch for any taxable year from the inception of such branch through the close of the taxable year of the transfer."

D. Section 367(a)(3)(C) Temporary Regulations

Recognizing this ambiguity in the statute, the IRS temporary regulations allow all gains recognized through the close of the taxable year of the transfer to reduce the recapture amount.[179]

1. Gain Limitation

The limitation on the amount of gain that can be recognized under § 367(a)(3)(C) is set out in § 367(a)(1) and § 1.367(a)-1T(b)(3) of the temporary regulations.[180] Generally, the temporary regulations call for an asset-by-

174. *See* Mogenson & Sparagna, *Outbound Transfers - An Analysis of the New Regulations Under Section 367*, 15 J. INT'L TAX MGMT. 271, 290-91 n.107 (1986) (identifying a technical flaw in § 367(a)(3)(C)(ii)(I) which was corrected in Temp. Treas. Reg. § 1.367(a)-6T(e)(2)).

175. The original House and Senate versions of section 367(a)(3)(C) did not have provisions permitting any reduction in the recapture amount for branch gains. H.R. REP. NO. 432, *supra* note 139, at 1315; S. REP. NO. 169, 98th Cong., 2d Sess. 364-65 (1984).

176. Priv. Ltr. Rul. 78-45-060 (Aug. 14, 1978).

177. *See supra* notes 84-85 and accompanying text.

178. Temp. Treas. Reg. § 1.367(a)-6T(e)(2) (1986).

179. *Id.*

180. Temp. Treas. Reg. § 1.367(a)-6T(c)(2) (1986), *referencing* 1.367(a)-1T(b)(3) (1986).

asset analysis[181] which produces anomalous results in the context of § 367(a)(3)(C).

Section 367(a)(1) considers a transfer a taxable exchange only "for purposes of determining the extent to which gain shall be recognized on such transfer." Thus, if a gain asset (fair market value at the date of transfer exceeds adjusted basis) is transferred to a foreign corporation, the gain must be recognized unless an exception applies. But, if a loss asset (adjusted basis exceeds fair market value at the date of transfer) is transferred, the loss is *not* recognized.[182] Therefore, the § 367(a)(3)(C) limitation is equal to the sum of the gains on the gain assets transferred and is not reduced by the losses on the loss assets.[183] For example, if the incorporated branch consisted of two assets, one with a $30 built-in gain, and the other with a $30 built-in loss, the gain limitation would be $30. This gain limitation is the same as that expressed in R.R. 82-146.[184]

Apparently, this asset-by-asset analysis of § 367(a)(1) resulted from the long-standing intent of Congress and the IRS that the built-in gains of "tainted" assets not be reduced by the built-in losses on "non-tainted" assets. Yet, this asset-by-asset analysis is ill-suited for determining the gain realized on the transfer of a branch. A branch is a going concern; it earns profits and incurs losses in the operation of its business. Therefore, some type of going concern valuation is more appropriate for determining the gain limitation for § 367(a)(3)(C), rather than the present asset-by-asset approach.

A going concern valuation approach would be consistent with R.R. 80-247.[185] As explained earlier, in R.R. 80-247 the IRS required that all pre-incorporation losses of the branch be recaptured even though some of the assets, which produced one-third of the losses, were abandoned and thus not transferred to the foreign corporation. The IRS's rationale was that there was a complete business, that the business and not the specific parcels of property had incurred the pre-incorporation losses, and that it was the business that was being incorporated. A going concern valuation would recognize the branch as a business, rather than a collection of separate assets. R.R. 81-82 provides additional support for a going concern valuation.[186] R.R. 81-82 concerned five business operations, "divisions", which were all owned by the same person. When four of the divisions were incorporated, the IRS required that the pre-incorporation losses of a fifth division be recaptured because it was part of a complete business, the rest of which had been transferred.

181. Temp. Treas. Reg. § 1.367(a)-1T(b)(3)(i) (1986).

182. Temp. Treas. Reg. §§ 1.367(a)-1T(b)(1), (b)(3)(ii) (1986).

183. Temp. Treas. Reg. § 1.367(a)-1T(b)(3)(i) (1986). For purposes of § 367(a)(3)(C), unlike other provisions of § 367(a), goodwill and going concern value are considered assets. Temp. Treas. Reg. §§ 1.367(a)-6T(c)(3) (1986). *See infra* note 187 and accompanying text.

184. *See supra* note 75 and accompanying text.

185. *See supra* notes 82-83 and accompanying text.

186. *See supra* note 84 and accompanying text.

The temporary regulations implicitly recognize the going concern nature of the transfer of a branch because they require that goodwill be considered as an asset. Goodwill is defined in the temporary regulations as "the residual value of a business operation conducted outside the United States after all other tangible and intangible assets have been identified and valued."[187] The way to compute goodwill is by determining the going concern value of the branch and subtracting the fair market value of the other assets. Using a going concern valuation method to determine the gain limitation for § 367(a)(3)(C) requires subtracting the adjusted basis of the assets transferred from the going concern value of the firm. Thus, the built-in gain for the branch business as a whole is the gain limitation. If this gain limitation exceeds the gain limitation computed on an asset-by-asset basis, there is no cause for alarm. The amount of recapture will always be limited to the pre-incorporation deductible losses of the branch.

2. *Previously Deducted Losses*

The starting point for computing the amount of § 367(a)(3)(C) recapture is the determination of the ordinary and capital losses of the branch for each pre-incorporation taxable year. These losses are called the previously deducted branch ordinary loss [hereinafter PDBOL] and the previously deducted branch capital loss [hereinafter PDBCL].[188] These losses are defined as "the total ordinary loss and total capital loss that were realized by the foreign branch in that taxable year prior to the transfer and that were reflected on a U.S. income tax return."[189]

The one glaring weakness of this definition is that it fails to take into consideration losses incurred by the branch during the year of transfer but before the date of transfer. The statute seems to require that such losses be recaptured up to the date of transfer as it focuses on losses incurred "before the transfer," not only on losses incurred in years prior to the transfer.[190] Thus, the temporary regulations should be rewritten to require recapture of branch losses incurred in the year of transfer before the date of transfer.

3. *Tax Benefit Rule of the Temporary Regulations*

A recurrent theme throughout the temporary regulations is that there will be no recapture of foreign branch losses if the U.S. transferor has not and will not obtain a U.S. tax benefit for the foreign branch losses.[191] Generally, the temporary regulations do not require recapture "if due to the existence of the . . . loss, the U.S. transferor did not receive a benefit from other provisions

187. Temp. Treas. Reg. § 1.367(a)-1T(d)(5)(iii) (1986).
188. Temp. Treas. Reg. § 1.367(a)-6T(d)(1) (1986).
189. *Id.*
190. I.R.C. § 367(a)(3)(C)(i)(II).
191. Mogenson & Sparagna, *supra* note 174, at 282. The IRS first adopted this approach in Private Letter Ruling 85-51-026.

(*e.g.*, foreign tax credit. . .) which the U.S. transferor may have been able to utilize had it not incurred the foreign branch losses."[192] The temporary regulations seem to equate a tax benefit with a reduction, due to foreign branch losses, of the total U.S. income taxes paid by the U.S. transferor over its lifetime. The following sections discuss four types of reductions to PDBOL and PDBCL made because of a failure to receive a tax benefit.

a. Expired Net Ordinary Loss

The first reduction to a PDBOL is for an expired net ordinary loss. The PDBOL for each branch loss year is to be reduced "by the amount of any expired net ordinary loss with respect to that branch loss year."[193] Generally, a net ordinary loss is defined as a net operating loss.[194] As an example of what this regulation is designed to accomplish, assume the following facts: Branch A incurred an ordinary loss of $100 while the U.S. transferor, without considering Branch A's loss, had a net ordinary loss of $500 in year 1, and no carryback of the net ordinary loss was possible. Also, assume the branch and the U.S. transferor incurred no gains or losses for years 2 through 16. Branch A was incorporated in year 17. In year 1, the $100 ordinary loss did not produce any reduction in the U.S. income taxes paid by the U.S. transferor, and the U.S. transferor was unable to utilize the branch loss in later years. Moreover, the net ordinary loss carryover of $600 ($100 + $500) expired at the end of year 16.[195] Thus, since the net ordinary loss of Branch A in year 1 produced no reduction in U.S. taxes paid by the U.S. transferor and the ordinary loss has expired, no recapture of the $100 is required.

Additionally, the temporary regulations allow a reduction in PDBOLs for "[e]xpired net ordinary losses arising in years other than the branch loss year . . . only to the extent that the [PDBOL] exceeds the [net ordinary loss], if any, incurred by the transferor in the branch loss year."[196] As an example of what this regulation is designed to accomplish, assume these facts: In year 1, Branch A had no gain or loss while the U.S. transferor had a $200 net ordinary loss that could not be carried back. In year 2, the U.S. transferor, excluding Branch A's loss, had taxable income of $90 while Branch A incurred a $100 ordinary loss. Thus, for year 2 the U.S. transferor had a net ordinary loss of $10 ($90 − $100). In years 3 through 16, Branch A and the U.S. transferor incurred no gains or losses. The year 1 net ordinary loss of $200 expired at the end of year 16. Furthermore, Branch A was incorporated in year 17.

192. Mogenson & Sparagna, *supra* note 174, at 283.

193. Temp. Treas. Reg. § 1.367(a)-6T(d)(2)(i) (1986). Branch loss year is the taxable year in which the branch incurred a PDBOL and/or a PDBCL. Temp. Reg. § 1.367(a)-6T(d)(1) (1986).

194. Temp. Treas. Reg. § 1.367(a)-6T(d)(2)(ii) (1986). *See* I.R.C. § 172(c) for the definition of "net operating loss."

195. I.R.C. § 172(b)(1)(B).

196. Temp. Treas. Reg. § 1.367(a)-6T(d)(2)(i) (1986).

From these facts, it can be observed that without the $100 Branch A loss in year 2, the U.S. transferor could have utilized $90 of the year 1 net ordinary loss. Thus, $90 of the Branch A loss produced no real tax savings in that $90 of the loss merely prevented a net ordinary loss carryover from being utilized. Therefore, since $90 of the Branch A loss did not produce a U.S. tax savings to the U.S. transferor, the PDBOL for year 2 will be reduced by $90. The other $10 of the loss produced a net ordinary loss for year 2. Since the net ordinary loss for year 2 had not expired at the date of transfer, no reduction in recapture is allowed.[197] The temporary regulations' treatment of unexpired carryovers is consistent with § 111(c) which provides that "an increase in a carryover which has not expired before the beginning of the taxable year in which the recovery or adjustment takes place shall be treated as reducing tax imposed by this chapter."[198]

Overall, the temporary regulations provide fair treatment of expired branch net ordinary losses.[199] These losses produced no real tax savings to the U.S. transferor. Thus, recapture of the losses would be nonsensical because, in effect, the ordinary losses could produce a net increase in the total U.S. income taxes paid by the U.S. transferor over its lifetime. The recapture could cause an increase in U.S. taxes paid by the transferor while the losses produced no tax savings.

b. Expired Net Capital Loss

The PDBCLs of an incorporated branch are reduced for "[e]xpired net capital [losses] with respect to [the] branch loss year" and for "[e]xpired net capital losses arising in years other than the branch loss year . . . to the extent that the [PDBCL] exceeds the net capital loss, if any, incurred by the transferor in the branch loss year."[200] This regulatory provision is substantially similar to the expired net ordinary loss provision. It also treats expired net capital losses fairly. Since no real U.S. tax savings were produced, the recapture of these losses should not be and are not required.

c. Expired Foreign Tax Credits

In addition to the reduction for expired net ordinary and capital losses, the temporary regulations provide that the remaining PDBOLs and PDBCLs "for each branch loss year . . . shall be further reduced . . . proportionately by the amount of any expired foreign tax credit loss equivalent with respect to that branch loss year."[201] The foreign tax credit loss equivalent amount for

197. *Id.*
198. I.R.C. § 111(c).
199. Mogenson & Sparagna, *supra* note 174, at 283 ("By providing these tax benefit rules, the IRS has followed the legislative lead and made a very good faith attempt to provide fairness in determining the situations in which a recapture of foreign branch losses is appropriate because of a prior tax benefit received by the U.S. taxpayer.")
200. Temp. Treas. Reg. § 1.367(a)-6T(d)(3)(i) (1986).
201. Temp. Treas. Reg. § 1.367(a)-6T(d)(4)(i) (1986).

the branch loss year equals "the amount of [expired foreign tax credits] divided by the highest rate of tax to which the transferor was subject in the loss year."[202] The following example will help to explain the purpose of this provision.[203]

Suppose that in Year 1 the U.S. transferor has $100 of U.S. source income. The transferor also has two branches, A and B, which each earn $30 of foreign source taxable income and each pay $20 of creditable foreign income tax. Furthermore, the U.S. tax rate is forty percent.[204]

Example One

	U.S. Source Income	Branch A Income	Branch B Income	Total
Taxable Income	100	30	30	160
Creditable Foreign Taxes		20	20	40
U.S. Tax on Worldwide Taxable Income	$(160 \times .40)$			64
FTC Limitation	$\frac{60}{160} \times 64$			24
Total U.S. Taxes Paid	$(64-24)$			40
FTC Carryover for Year 1	$(40-24)$			16

Next, assume that the fact pattern of Example One is changed to include Branch C which had a $10 loss in Year 1.

Example Two

	U.S. Source Income	Branch A Income	Branch B Income	Branch C Loss	Total
Taxable Income	100	30	30	(10)	150
Creditable Foreign Taxes		20	20		40
U.S. Tax on Worldwide Taxable Income	$(150 \times .40)$				60
FTC Limitation	$\frac{50}{150} \times 60$				20
U.S. Tax Liability	$(60-20)$				40
FTC Carryover for Year 1	$(40-20)$				20

202. Temp. Treas. Reg. § 1.367(a)-6T(d)(4)(iii) (1986). The foreign tax credit loss equivalent determines the amount of tax benefit, in terms of a deduction, which the U.S. transferor has not received because the foreign tax credits have expired.

203. *See* Lowry, *supra* note 110, at 230; Comment, *Revenue Ruling 78-201*, 32 TAX LAW. 850, 857-58 (1979).

204. A forty percent U.S. tax rate is used to add a sense of timelessness to this article.

Therefore, Branch C's loss produced no reduction in the amount of U.S. tax paid by the U.S. transferor.[205] The only benefit of the loss was an increase in the FTC carryover from 16 to 20. The temporary regulation provides that if the increase to the FTC carryover expires unused before the transfer of Branch C, then the loss will not be recaptured. The IRS regulation is in conformity with the legislative history which noted that in certain cases no tax benefit results from a branch loss and in such cases recapture may not be proper.[206]

It should be noted that as an alternative to the temporary regulation provision, the IRS could simply have done nothing. For example, if in the year of Branch C's transfer the U.S. transferor, excluding Branch C recapture income, had creditable taxes in excess of its FTC limitation of say $4, then the recapture of the $10 loss would produce no additional tax outlay just as the loss had produced no tax benefit. The increase in worldwide taxable income of $10 would both increase the U.S. tax on worldwide income and the FTC limitation by $4. In effect, the $4 of additional tax would be offset by the utilization of the $4 of FTCs. However, the temporary regulation's method is a surer way to produce fair results. Under the regulation's method, if no prior tax benefit occurred, then no increase in U.S. tax will ever result. The same cannot be said for the alternative method because it will only produce no additional U.S. tax if creditable foreign taxes exceed the FTC limitation.

The fact situations which § 1.367(a)-6T(d)(4) covers can be quite complicated. For example, suppose that in Example 2 a FTC carryover of $10 expired in year 1 and that Branch C was incorporated in year 2. This fact pattern is analogous to Private Letter Ruling 86-08-012. In that private ruling, the IRS ruled that the branch loss incurred in Year 1 ($10) must be recaptured. The IRS's rationale was that the $10 loss did not prevent the use of the FTC carryover from prior years because the U.S. transferor already had excess FTCs for Year 1. Furthermore, the increase in the FTC carryover amount of Year 1 had not expired when Branch C was transferred. Thus, the tax benefit caused by the Branch C loss, an increase in FTC carryover for year 1, might still be utilized after the transfer. Therefore, recapture was required.

The IRS decision in this ruling was correct as no other tax benefit was prevented by the loss and the increase to the FTC carryover had not expired. Thus, the decision was consistent with the current temporary regulations and § 111(c). To provide additional guidance to taxpayers, a few more examples such as the fact pattern of Private Letter Ruling 86-08-012, should be set out in the temporary regulations.

205. *See* Comment, *supra* note 203, at 858-59 (R.R. 78-201 is overly broad and a toll charge should only be assessed when a tax benefit flows from the incorporation of a branch).

206. *See supra* notes 150-151 and accompanying text.

d. Expired Investment Tax Credits

In addition to the reduction for expired net ordinary losses, net capital losses, and foreign tax credits, the PDBOLs and the PDBCLs are "reduced . . . proportionately by the amount of any expired investment credit loss equivalent with respect to that branch year."[207] "The amount of the investment tax credit loss equivalent . . . is 85 percent of that investment credit divided by the highest rate of tax to which the transferor was subject in the loss year."[208]

This provision is quite similar to the expired FTC provision.[209] But, one major difference between the two provisions is that the investment tax credit [hereinafter ITC] provision is limited to eighty-five percent of the expired ITC divided by the highest rate of tax. The eighty-five percent limitation is justified because the ITC limitation is $25,000 plus eighty-five percent of the taxpayer's net tax liability in excess of $25,000.[210]

Even though the ITC has been repealed by the Tax Reform Act of 1986,[211] the expiration of unused ITCs over the next fifteen years will continue to reduce the § 367(a)(3)(C) recapture amount.[212]

4. Other Reductions to Section 367(a)(3)(C) Recapture Amount

Finally, the temporary regulations set out five other amounts that reduce the recapture of previously deducted losses.[213] At this stage, the reductions are to the total remaining PDBOLs and the total remaining PDBCLs.[214] Where an amount represents ordinary income, the PDBOLs will be reduced first, then any excess of the amount over PDBOLs will reduce PDBCLs.[215] Where an amount represents capital gain, the PDBCLs will be reduced first, then any excess of the amount over the PDBCLs will reduce PDBOLs.[216]

a. Taxable Income

The temporary regulations permit "any taxable income recognized [by the branch] through the close of the taxable year of the transfer" to reduce the amount of recapture.[217] One set of commentators suggest as a planning device that, since gain earned through the end of the taxable year of the transfer will reduce recapture, the inventory of the incorporated branch should be

207. Temp. Treas. Reg. § 1.367(a)-6T(d)(5)(i) (1986).
208. Temp. Treas. Reg. § 1.367(a)-6T(d)(5)(iii) (1986).
209. *See supra* notes 201-206 and accompanying text.
210. I.R.C. § 38(c)(1).
211. Tax Reform Act of 1986, § 211 (1986).
212. I.R.C. § 39(a)(1)(B).
213. Temp. Treas. Reg. § 1.367(a)-6T(e)(1) (1986).
214. *Id.*
215. *Id.*
216. *Id.*
217. Temp. Treas. Reg. § 1.367(a)-6T(e)(2) (1986). *See supra* notes 174-178 and accompanying text.

retained by the U.S. transferor and sold before the close of the taxable year of the transfer.[218] These commentators may be mechanically correct in their analysis, but the U.S. transferor would still have to recognize foreign source ordinary income from the sale of the inventory. Any resulting advantages would depend upon whether the incorporated branch is earning profits and the rate of foreign tax.[219]

b. Amounts Currently Recaptured Under Section 904(f)(3)

As noted earlier, § 904(f)(3) requires recapture of overall foreign losses to the extent of the lesser of the realized gain on the property transferred or the overall foreign losses.[220] Any gain recognized under § 904(f)(3) on account of the transfer will reduce the § 367(a)(3)(C) recapture amount.[221]

To determine the amount of reduction, the character of the gain must first be determined. The proposed regulations for § 904(f)(3) require that the gain recognized by § 904(f)(3) "will have the same character as if the property had been sold or exchanged in a taxable transaction."[222] Section 367(a)(3)(C) requires that gain recaptured under it will have the same character as the prior losses.[223] Curiously, even though both sections are designed to recapture previously deducted foreign losses, they have differing characterization rules. For the purpose of consistency the two sections should have the same characterization rule to the extent possible.

Wherever possible, the § 904(f)(3) regulations should adopt the § 367(a)(3)(C) characterization rule. As it now stands, where both § 367(a)(3)(C) and § 904(f)(3) recapture are required, it appears virtually impossible to identify which assets are attributable to the § 904(f)(3) recapture. At best, the character of § 904(f)(3) recapture must be determined by a proration between the ordinary income and capital gain assets. Instead of this

218. Mogenson & Sparagna, *supra* note 174, at 284.

219. For example, suppose the U.S. transferor had $50,000 in recapture gain. If it recognized a $1,000 gain from the sale of retained inventory, it can offset $1,000 in recapture gain. Yet, the total amount of gain recognized by the U.S. transferor remains the same ($50,000 total gain = $49,000 recapture gain + $1,000 gain on inventory).

If all the inventory were transferred to the incorporated branch, $50,000 of recapture gain would be recognized by the U.S. transferor, while $1,000 of gain on the sale of inventory would be recognized by the incorporated branch. If the incorporated branch is in a loss position during its first year after incorporation, the worldwide tax effect would be the same whether the inventory was retained or not. Yet, if the incorporated branch was in a profit position during its first year of operation, the worldwide tax effect under the retained inventory method, would be a tax savings of $1,000 multiplied by the applicable foreign tax rate of the foreign country where the branch is incorporated.

220. *See supra* notes 63-67 and accompanying text.

221. I.R.C. § 367(a)(3)(C); Temp. Reg. § 1.367(a)-6T(e)(3) (1986).

222. Prop. Treas. Reg. § 1.904(f)-2(d)(4)(i)(B) (1986); *see supra* note 67 and accompanying text.

223. I.R.C. § 367(a)(3)(C)(ii)(II).

cumbersome process, all that need be done is to allocate the remaining previously deducted losses to the extent of the § 904(f)(3) gain.[224] For example, assume that the total remaining PDBOLs were $600, the total remaining PDBCLs were $300, and the overall foreign loss is $150, then the character of the § 904(f)(3) gain would be $100 of ordinary income and $50 of capital gain.[225]

c. Other Gains Recognized Under Section 367

The PDBOLs and the PDBCLs are further reduced by other gain recognized under § 367(a).[226] Generally, this regulation concerns "tainted" assets and provides that gain recognized due to the effect of § 367(a)(3)(B) reduces § 367(a)(3)(C) recapture.[227] The gain recognized upon the transfer of the "tainted" assets has the same character as though the assets were transferred in a taxable exchange.[228]

However, the reduction allowed by temporary regulation § 1.367(a)-6T(e)(4) does not apply to intangibles. Where both § 367(a)(3)(C) and § 367(d) apply, the branch loss recapture rule takes priority. Apparently, the gain has its character and source determined under § 367(a)(3)(C).[229] Generally, the temporary regulations provide that the "gain with respect to the transferred intangibles will first be recognized pursuant to the foreign branch loss recapture rules . . . and only the remaining unrecognized gain attributable to the intangible will be subject to the deemed royalty rules of § 367(d)."[230] The temporary regulations carry out the priority rule through a credit system.

> If income is required to be recognized under section 904(f)(3) . . . or . . . [section 367(a)(3)(C)] upon the transfer of intangible property of a foreign branch that had previously deducted losses, then the income recognized under those sections with respect to that property shall be credited against amounts

224. All that is needed to make the recommended change to section 904(f)(3) characterization of recapture is to add one sentence to the section 904(f)(3) regulations. This might read: "In cases where both section 904(f)(3) and section 367(a)(3)(C) gain recognition are required, prorate the previously deducted branch ordinary losses and previously deducted branch capital losses remaining upon application of Temp. Treas. Reg. 1.367(a)-6T(e)(3)."

225. The formula used in this calculation is as follows:

$$\text{Ordinary Income} = \frac{600}{900} \times 150$$

$$\text{Capital Gain} = \frac{300}{900} \times 150$$

226. Temp. Treas. Reg. § 1.367(a)-6T(e)(4) (1986).

227. *See* Kalish & Siboni, *supra* note 74, at § 47.02[1] ("[toll charge on 'tainted assets'] should serve to reduce the branch loss recapture as the [toll charge] eliminates any purported mismatchings of related income and losses").

228. H.R. REP. NO. 432, *supra* note 139, at 1308-09.

229. *See* Mogenson & Sparagna, *supra* note 174, at 281.

230. Mogenson & Sparagna, *supra* note 174, at 280-81.

that would otherwise be required to be recognized with respect to that same property under [section 367(d)].[231]

The amount credited to the § 367(d) account is:

$$\text{Loss Recapture Income} \times \frac{\text{Gain from Intangibles (excluding goodwill)}}{\text{Gain from all Branch Assets}}$$

As an example of how this credit system would work, assume the following facts.[232] A branch is incorporated and included among the assets transferred to the new corporation is one intangible with a fair market value of $200 and an adjusted basis of $100. All $100 of this gain which was recognized under § 367(a)(1) is recaptured by operation of § 367(a)(3)(C). Under the priority rule of the regulations, the § 367(d) account starts with a $100 credit balance. Assuming that under § 367(d) $10 of periodic income from the intangible would be recognized each year, the balance will be reduced to zero after ten years. A § 367(d) gain of $10 is recognized in year eleven and in each succeeding year.

The priority system that the IRS set up is contrary to the DEFRA Conference Report, in which Congress expressly provided that the special intangible rules should have priority over a § 367(a)(3)(C) recapture.[233] As an alternative method, the IRS could have set up the following priority system. First, the amount of gain attributable to transferred intangibles, upon the transfer of the branch assets would be determined using the § 1.367(d)-1T(g)(3) formula. Second, the § 367(a)(3)(C) recapture amount would be reduced by the calculated amount. Third, the calculated amount would then be recognized over the life of the intangibles under the normal § 367(d) rules. The difference between these approaches is that the regulation approach produces immediate recognition of foreign source gain, whereas the alternative approach produces gradual recognition of U.S. source ordinary income.[234]

The alternative approach should be adopted for the following reasons. First, it is consistent with legislative intent. Congress went to great lengths to write a special gain recognition rule for outbound transfers of intangibles. This rule should not be circumvented by administrative regulations. Second, Congress sought to deter the transfer of U.S.-developed technology abroad by requiring that all gain recognized under § 367(d) be U.S. source ordinary income. Section 367(d) gain produces both an increase in worldwide taxable income and a decrease in the FTC limitation, resulting in an increase in the amount of U.S. taxes paid by the transferor. By allowing § 367(a)(3)(C) recapture, the IRS is permitting an increase in the FTC limitation which may result in no increase in U.S. taxes paid by the transferor. Thus, the deterrent

231. Temp. Treas. Reg. § 1.367(d)-1T(g)(3) (1986).
232. This example is taken from Mogenson & Sparagna, *supra* note 174, at 280-81.
233. H.R. REP. No. 861, 98th Cong., 2d Sess. 956 (1984).
234. I.R.C. § 367(d) (provides that income recognized is U.S. source ordinary income).

effect of § 367(d) will be thwarted and increased technology outflow may result. Finally, the alternative method's avoidance of credit accounts makes administration easier.

d. Amounts Previously Recaptured under Section 904(f)(3)

The remaining PDBOLs and PDBCLs are next "reduced by the portion of any amount recognized under § 904(f)(3) upon a previous transfer of property that was attributable to the losses of the foreign branch . . . ."[235] As an example of what this provision is intended to accomplish, consider the following. Suppose that the U.S. transferor has two branches, A and B. In 1984, Branch A incurred a $1,000 loss and Branch B earned a $500 gain. The overall foreign loss of $500 for 1984 is attributable to Branch A's loss. Assume further that in 1985 an asset with $500 of built-in gain (excess of fair market value over adjusted basis) was transferred from Branch A to a foreign corporation, and that in 1987 Branch A was incorporated.

The transfer of the Branch A asset in 1985 resulted in $500 of § 904(f)(3) recapture.[236] Since the overall foreign loss was attributable to Branch A and Branch A property was transferred in 1985, upon the incorporation of Branch A in 1987 the § 367(a)(3)(C) recapture would be reduced by the $500 of § 904(f)(3) gain recognized in 1985.[237] If Branch B property had been transferred in 1985, the temporary regulations set out a formula for computing the amount of § 904(f)(3) gain which is attributable to Branch A and can be used to reduce § 367(a)(3)(C) recapture.[238]

e. Amounts Previously Recognized under Section 367(a)(3)(C)

The temporary regulations provide that the remaining "previously deducted losses shall be reduced by the amounts previously recognized under the rules of [§ 367(a)(3)(C)] upon a previous transfer of assets of the foreign branch."[239] This provision covers the situation where "if branch assets have previously been transferred in an outbound section 367(a) transaction, the amount of foreign branch loss subject to recapture at that time will not again be counted in determining the amount of foreign branch loss subject to recapture upon a subsequent transfer of branch assets."[240]

5. Loss Recaptured Under Section 367(a)(3)(C)

The PDBOL and PDBCL remaining after all deductions have been made are subject to § 367(a)(3)(C) recapture, provided that the gain limita-

235. Temp. Treas. Reg. § 1.367(a)-6T(e)(5)(i) (1986).
236. *See supra* notes 63-66 and accompanying text.
237. Temp. Treas. Reg. § 1.367(a)-6T(e)(5)(ii)(A) (1986).
238. Temp. Treas. Reg. § 1.367(a)-6T(e)(5)(ii)(B) (1986).
239. Temp. Treas. Reg. § 1.367(a)-6T(e)(6) (1986).
240. Mogenson & Sparagna, *supra* note 174, at 284.

tion is not exceeded.[241] The remaining previously deducted losses and the amounts recognized due to the effect of § 367(a)(3)(B) are added together and compared with the gain limitation. If the gain limitation exceeds the total, then the remaining previously deducted losses are recaptured. The remaining PDBOL is foreign source ordinary income. The remaining PDBCL is foreign source capital gain income. Apparently, if the total exceeds the gain limitation, then the § 367(a)(3)(C) recapture amounts, remaining PDBOL and PDBCL, are proportionately reduced until the gain limitation is reached.

If the proposed going concern gain limitation[242] were used, the mechanics would be very similar. Where the going concern gain limitation is less than the gain to be recognized under § 367(a)(3)(B), then a proportionate reduction would be made to the capital gain and ordinary income components of such gain.

6. *Basis of Stock and Assets*

The basis of the stock received in the exchange is determined by § 358(a)(1) and is increased by the gain recognized under § 367(a)(3)(C).[243] The basis of the transferred property in the hands of the transferee foreign corporation as determined by § 362(a) is also increased by the amount of the gain recognized under § 367(a)(3)(C).[244]

7. *Definition of a Foreign Branch*

Section 367(a)(3)(C) recapture requires that a foreign branch be transferred. To provide guidance, the temporary regulations define a foreign branch as "an integral business operation carried on by a U.S. person outside the United States."[245] The regulations further provide that a facts and circumstances inquiry must be conducted to determine whether the activities of a U.S. transferor constitute a foreign branch.[246] Evidence tending to prove the existence of a foreign branch includes "the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or officers of the U.S. [transferor] in carrying out business activities outside the United States."[247] A foreign branch will be found to exist "if the activities constitute a permanent establishment under the terms of a treaty between the United States and the country in which the activities are carried out."[248] Conversely, it may be possible for the U.S.

241. *See supra* notes 180-181 and accompanying text.
242. *Id.*
243. Temp. Treas. Reg. § 1.367(a)-6T(i) (1986), *referencing* Temp. Reg. § 1.367(a)-1T(b)(4)(ii) (1986).
244. *Id.*
245. Temp. Treas. Reg. § 1.367(a)-6T(g)(1) (1986).
246. *Id.*
247. *Id.*
248. *Id.*

transferor to assert that if no permanent establishment exists, then there can be no § 367(a)(3)(C) recapture.[249]

The irrebuttable presumption of a permanent establishment where the activities meet the definition in the tax treaty is consistent with the terms of the treaty and statutory law. Yet, the foreign branch definition is inconsistent with other IRC sections. Section 367(a)(3)(C) recapture is triggered when an "integral business operation" is transferred,[250] whereas § 904(f)(3) recapture is triggered when "property which has been used predominantly without the United States in a trade or business is disposed of."[251] It seems logical that "foreign branch" should be defined in terms of the conduct of a foreign "trade or business" as well as by the permanent establishment test. The term "trade or business" is pervasive throughout the Internal Revenue Code.[252] Thus, "foreign branch" should be defined as "the conduct of a trade or business carried on by a U.S. person outside the U.S."

Three advantages follow from this definition of a "foreign branch." First, the transferor will be assured that if § 367(a)(3)(C) is triggered, then § 904(f)(3) will also be triggered. Second, the transferor will only have to be concerned with two tests for § 367(a)(3)(C) recapture: 1) whether the activities constitute a permanent establishment under the terms of the appropriate tax treaty, and 2) whether the activities constitute a trade or business. Third, U.S. taxpayers can rely on substantial authority defining what constitutes a trade or business, but there is sparse guidance for what constitutes a branch.[253] For example, taxpayers could rely on the § 367(a) temporary regulations which define a trade or business as "a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit."[254] The temporary regulations for § 367(a)(3)(C) should merely reference § 1.367-2T(b)(2) and thus adopt the common trade or business test as the definition of "foreign branch."[255]

8. *When are Multiple Branches Present?*

The temporary regulations also provide some assistance in determining how many separate branches are being transferred by the U.S. transferor. Generally, the temporary regulations codify the approach of R.R. 81-82.[256]

249. *See* Priv. Ltr. Rul. 86-19-044 (Feb. 10, 1986) (IRS apparently agreed that if there is no permanent establishment there can be no 78-201 recapture).

250. *See supra* note 245 and accompanying text.

251. I.R.C. § 904(f)(3)(A).

252. *See, e.g.*, I.R.C. §§ 162(a), 195(c), 355(b), 367(a)(3)(C), 904(f)(3)(A).

253. The new branch profits tax does not define "branch" but does refer to "trade or business." I.R.C. § 884.

254. Temp. Treas. Reg. § 1.367(a)-2T(b)(2) (1986).

255. For section 367(a)(3)(C) recapture, a currently operating foreign branch must be operating before the transfer. On the other hand, the § 367(a)(3)(A) active conduct of trade or business exception is met if such trade or business is found to be operating after the transfer.

256. *See supra* note 84 and accompanying text.

The regulations provide that "[i]f a U.S. person carries on more than one branch operation outside the United States, then the rules of [§ 367(a)(3)(C)] must be separately applied with respect to each foreign branch that is transferred to a foreign corporation."[257] Thus, if two separate branches are transferred, the previously deducted losses of one branch cannot be offset by the prior gains of the other.[258] Furthermore, if a separate branch is transferred, the losses of a separate branch not transferred at such time will not be recaptured.[259] The regulations require a facts and circumstances inquiry to determine if more than one branch exists.[260] The regulations go on to state that "[i]n general, a separate branch exists if a particular group of activities is sufficiently integrated to constitute a single business that could be operated as an independent enterprise."[261] As further guidance, the regulations identify factors which suggest that nominally separate business operations constitute a single foreign branch. Such factors include "a substantial identity of products, customers, operational facilities, operational processes, accounting and record-keeping functions, management, employees, distribution channels, or sales and purchasing forces."[262] These are the same factors identified in R.R. 81-82.

The definition of "separate foreign branch"[263] is nearly co-extensive with the definition of "trade or business" set out in regulation § 1.367(a)-2T(b)(2).[264] Thus, the definition of a "separate foreign branch" is consistent with the other sections of the Internal Revenue Code, unlike the definition of "foreign branch."[265]

One important consideration not addressed by regulation § 1.367(a)-6T(g)(3) is whether nominally separate operations can be considered a single branch if they are integrated but are in different countries. For example, suppose that Division A is located in Spain and Division B in Portugal. Division A produces television components which Division B assembles into television sets. The two divisions have many of the common factors set out in the regulations, *e.g.*, employees, management, accounting, and record-keeping functions. Division A has suffered losses while Division B has earned profits. If the assets of the two divisions were transferred to a newly-created Spanish or Portuguese corporation, would the profits of Division B be allowed to offset the losses of Division A? This factual situation is analogous to the relationship between Divisions 4 and 5 in R.R. 81-82. However, the divisions in R.R. 81-82 were located in different provinces of the same country. In R.R. 81-82,

257. Temp. Treas. Reg. § 1.367(a)-6T(g)(2) (1986).
258. *Id.*
259. *Id.*
260. *Id.*
261. *Id.*
262. *Id.*
263. *See supra* note 261 and accompanying text.
264. *See supra* note 254 and accompanying text.
265. *See supra* notes 245-255 and accompanying text.

the IRS ruled that Divisions 4 and 5 constituted a single business. The IRS observed that "the profits or losses of identical or integrated operations which are located in different parts of a country, but which nonetheless constitute a single business, will be combined" for R.R. 78-201 purposes.

The holding and rationale of R.R. 81-82 lend strong support to a finding that Branches A and B constitute a single separate branch. The fact that they are in different countries does not affect the integrated nature of their operations. Thus, the regulations under § 367(a)(3)(C) should expressly provide that "business operations conducted in different countries, but sufficiently integrated, will be treated as a separate branch."[266]

9. Consolidated Group

The temporary regulations provide a rule codifying R.R. 81-89.[267] The regulations provide that:

> the activities of each of two domestic corporations outside the United States will be considered to constitute a single foreign branch if . . . [t]he two corporations are members of the same consolidated group of corporations [and the] activities of the two corporations in the aggregate would constitute a single foreign branch if conducted by a single corporation.[268]

The regulations also provide that gains will only be allowed to offset losses in years where the two U.S. corporations filed a consolidated return.[269]

The rule set out is fair. The consolidated return requirement is necessary to avoid the potential abuse displayed in R.R. 81-89, where recently affiliated U.S. corporations sought to avoid R.R. 78-201 recapture.

10. Property Not Transferred

The temporary regulations also codify the holding of R.R. 80-247.[270] The regulations provide that "[a] U.S. transferor's failure to transfer any property of a foreign branch shall be irrelevant to the determination of the previously deducted losses of the branch subject to recapture under [§ 367(a)(3)(C)]."[271]

One matter raised by the commentators is the effect of this regulation on the gain limitation.[272] They argue that the gain limitation equals the sum of the gain assets transferred to the foreign corporation; gain assets not transferred should not increase the gain limitation.[273] Even though this

266. *But see* Terr, *Outbound Transfers Under the New Regulations for Sections 367(a) and 367(d)*, 13 INT'L TAX J. 13, 28 (1987) (Terr argues that "it would seem appropriate to place a per-country limitation on the branch concept, providing that operations in different countries will not be considered to constitute a single branch.")

267. *See supra* notes 86-89 and accompanying text.

268. Temp. Treas. Reg. § 1.367(a)-6T(g)(3) (1986).

269. *Id.*

270. *See supra* notes 82-83 and accompanying text.

271. Temp. Treas. Reg. § 1.367(a)-6T(g)(4) (1986).

272. Mogenson & Sparagna, *supra* note 174, at 282.

273. *Id.*

argument makes sense, it is opposed to the rationale of R.R. 80-247. Both R.R. 80-247 and § 1.367(a)-6T(g)(4) require that all the losses of the branch be recaptured under § 367 (a)(3)(C) because the complete business is being transferred. The nontransferred assets must be treated as being transferred for gain limitation purposes as well, or the purpose of R.R. 80-247 and the regulation will be frustrated. Furthermore, Congress intended that the pre-DEFRA public rulings be given full effect in the regulations.[274] Therefore, the regulations should specify what effect the nontransferred assets have on the gain limitation.

11. Anti-abuse Rule

The temporary regulations also contain an anti-abuse rule:

> [i]f [a] U.S. person transfers property of a foreign branch to a domestic corporation for a principal purpose of avoiding [§ 367(a)(3)(C)]; and [t]he domestic corporation [retransfers such] property . . . to a foreign corporation, then, solely for the purposes of this section, that U.S. person shall be treated as having transferred the property of the branch directly to the foreign corporation.[275]

The rule sets out a rebuttable presumption for a retransfer within two years of the original transfer.[276] This presumption can be rebutted by clear evidence that the second transfer was not contemplated at the time of the first transfer and that avoidance of § 367(a)(3)(C) was not a principal purpose for the transaction.[277] In response to the Tax Court's interpretation of "principal purpose" in *Dittler Brothers,*[278] the regulations state that "[a] transfer may have more than one principal purpose."[279]

The anti-abuse rule is needed to prevent easy circumvention of § 367(a)(3)(C). Yet, because the rule provides a subjective test for applicability, it reintroduces one of the problems Congress sought to remove in enacting DEFRA. The DEFRA legislative history indicates that Congress purposefully replaced the subjective principal purpose test with the objective active conduct of a trade or business exception to improve the predictability of results in the § 367(a) context.[280] Therefore, the anti-abuse rule should be changed to include an irrebuttable presumption test. For example, the rule might provide that "if the retransfer occurs within two years of the original transfer, then § 367(a)(3)(C) applies; and, if the retransfer occurs after the close of the two year period, then § 367(a)(3)(C) does not apply."

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274. H.R. REP. NO. 861, *supra* note 233, at 956.
275. Temp. Treas. Reg. § 1.367(a)-6T(h) (1986).
276. *Id.*
277. *Id.*
278. *See supra* notes 40-46 and accompanying text.
279. Temp. Treas. Reg. § 1.367(a)-6T(h) (1986).
280. *See supra* note 142 and accompanying text.

III
PROPOSED CHANGE TO SECTION 367(a)(3)(C)

In addition to the changes proposed above, § 367(a)(3)(C) should be amended to allow for a reduction in the transferee foreign corporation's accumulated earnings and profits to the extent of the gain recognized under § 367(a)(3)(C). This would assure that foreign operations are treated equitably whether they are conducted in branch or corporate form. As this article has demonstrated, § 367(a)(3)(C) gain recognition can be viewed either as a recapture of prior deductions,[281] or the current recognition of future, unearned income.[282] Under either approach, a reduction in the transferee foreign corporation's accumulated earnings and profits, in the amount of § 367(a)(3)(C) gain must be allowed to assure equitable treatment of foreign operations conducted in branch or corporate form.

For example, consider the following facts. Suppose that in 1984 the U.S. transferor began business operations in Country A through Branch A. Branch A's deductible losses are $5,000 from 1984 through 1987. On January 1, 1988, Branch A is incorporated in Country A. The foreign corporation earns a total of $6,000 of profits from 1988 through 1990. In 1991, the foreign corporation distributes $6,000 to the U.S. transferor/parent. Under this fact pattern, since the foreign corporation will have $6,000 of accumulated earnings and profits at the date of distribution, the U.S. transferor will recognize all $6,000 as a dividend.[283]

On the other hand, suppose that the Country A operations were originally conducted by a foreign corporation as opposed to a branch. Through 1990, the foreign corporation will only have accumulated earnings and profits of $1,000 ($6000-5000). Thus, a $6,000 distribution in 1991 will cause the U.S. transferor/parent to recognize a dividend of $1,000 and a return of capital of $5,000.

If the Country A corporation receives a $5000 credit, both $6000 distributions in the above examples will result in a $1000 dividend and a $5000 return of capital. This $5,000 credit is equal to the amount of § 367(a)(3)(C) gain recognized upon incorporation. Therefore, in order to produce equal treatment, § 367(a)(3)(C) must be changed to allow for a reduction in the transferee foreign corporation's accumulated earnings and profits in the amount of the § 367(a)(3)(C) gain recognized.

IV
TAX PLANNING CONSIDERATIONS

Section 367(a)(3)(C) forces the U.S. transferor to seriously consider whether and when to incorporate a foreign branch. Commentators have

281. *See supra* note 123 and accompanying text.
282. *See supra* note 109 and accompanying text.
283. I.R.C. §§ 301, 316.

suggested that if a branch currently operates at a loss and expects losses to continue, the branch probably should remain unincorporated for the near future.[284] Section 367(a)(3)(C) still allows the U.S. transferor a timing benefit in that the branch losses may be recognized in taxable years before the recognition of gain caused by § 367(a)(3)(C).[285]

Commentators further suggest that even if a loss branch becomes profitable, it is probably better not to immediately incorporate the branch.[286] Incorporating the branch would cause immediate gain recognition under § 367(a)(3)(C), whereas if the branch is left unincorporated the gain will be recognized gradually. Probably the optimal time to incorporate a loss branch is after the branch has earned profits that offset the prior deductible losses. By spreading the recognition of gain by the U.S. parent out over a number of years, this approach produces a time value of money benefit. After earning gains that offset the prior deductible losses, the branch should be incorporated to take advantage of deferral benefits. With the introduction of the thirty-four percent corporate tax rate by the Tax Reform Act of 1986, the benefits of deferral may be severely limited.[287] Yet, deferral may still prove profitable if either the U.S. raises its corporate tax rate or other countries lower their tax rates below the U.S. corporate rate.

V
POLICY CONCERNS

The purpose of § 367(a)(3)(C) is to prevent tax avoidance. Section 367(a)(3)(C) does prevent a U.S. corporation from commencing foreign operations in branch form, deducting start-up losses, and then incorporating the foreign operations so that offsetting future gains will not be taxed. Yet, by preventing tax avoidance, § 367(a)(3)(C) may make foreign investment less attractive to U.S. corporations.

To better understand this problem, the arguments concerning the effects of deferral on the U.S. economy should be examined. Some commentators argue that if deferral were eliminated, U.S. investment would be substituted for foreign investment.[288] Others argue that eliminating deferral would result in no increase in U.S. domestic investment.[289] Accordingly, if § 367(a)(3)(C) causes increased U.S. investment as a substitute for foreign investment, then § 367(a)(3)(C) produces an acceptable policy result. But if no substitution of U.S. for foreign investment occurs, § 367(a)(3)(C) produces no benefit to the

284. Yang & Nelson, *supra* note 26, at 110.
285. *Id.*
286. *Id.*
287. Tax Reform Act of 1986, § 601 (1986).
288. *See, e.g.*, SURREY, PECHMAN & MCDANIEL (eds.), FEDERAL TAX REFORM FOR 1976: A COMPENDIUM 153-54 (1976).
289. *See, e.g.*, Taylor, *The Foreign Tax Credit, Deferral, and DISC Provisions: Casualties in a Holy War of Protectionalism?*, 16 HOUS. L. REV. 63, 83-84 (1978).

U.S. economy. Therefore, Congress should conduct a study of the substitution effects of § 367(a)(3)(C).

CONCLUSION

The purpose of § 367 is to eliminate the tax advantages associated with the practice of incorporating foreign loss branches. In this paper, the development of § 367 and, in particular, foreign branch loss recapture have been explored. Generally, in § 367(a)(3)(C) and in the temporary regulations thereunder, Congress has codified the IRS approach of R.R. 78-201 and its progeny.

Several improvements to § 367(a)(3)(C) and the temporary regulations have been suggested in this article. The most significant of these suggested changes are 1) allowing a reduction to the transferee foreign corporation's accumulated earnings and profits, 2) allowing multiple, integrated divisions located in separate countries to be considered a single branch, and 3) the use of a going concern valuation method for the gain limitation. Other useful changes are: 1) rewording the statute to make it clear that gains earned during the incorporation year and any pre-incorporation years reduce the recapture amount, 2) requiring that all losses incurred up to the date of transfer increase the recapture amount, 3) adopting the § 367(a)(3)(C) characterization rule in § 904(f)(3) regulations, 4) requiring that gains attributable to transferred intangibles be recognized under § 367(d) and not § 367(a)(3)(C), 5) adopting a "trade or business" definition of foreign branch, and 6) reformulating the anti-abuse rule as an irrebuttable presumption. If these suggestions are adopted, § 367(a)(3)(C) will be a more effective and fairer provision.