Check-the-Box Planning in Cross-Border Transactions

By
Paul W. Oosterhuis*

Introduction

The check-the-box regulations have introduced numerous planning opportunities in cross-border transactions. Many are not troubling from a policy perspective. Others raise questions about whether some specific limitation on check-the-box planning (whether by legislation or regulation) is appropriate, or whether such planning instead exposes substantive deficiencies in the tax law that apply to actual transactions as much as check-the-box transactions.

This article describes variations on three types of check-the-box planning strategies used in international transactions, discusses the technical issues they raise under present law and analyzes whether or not from a policy perspective the results under present law should be altered by regulation or legislation. As a general matter, the article adopts the view that a check-the-box transaction should be analyzed in the same manner as the actual transaction that the check-the-box transaction parallels. However, to stimulate discussion, it emphasizes the perspective that, in some circumstances, U.S. international tax rules are based in part upon premises about the anticipated foreign tax consequences of a transaction. In these circumstances, it may be appropriate to analyze check-the-box transactions, which by definition have no foreign tax consequences, differently than parallel actual transactions.

Code Sec. 351 Incorporations of Foreign Corporations

Description of Basic Transaction

An example of a check-the-box planning strategy is that of a U.S. corporation ("U.S. Corp") that invests in a new electrical generating plant in country A, which provides a lengthy tax holiday. U.S. Corp establishes a newly formed country A limited liability entity, contributes significant equity to the entity and elects for the entity to be disregarded for U.S. tax purposes. The entity borrows substantial amounts from third parties to finance the plant.

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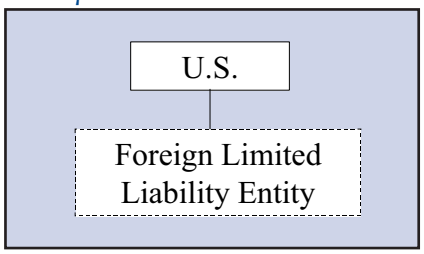
Example 1



U.S. Corp uses losses resulting from interest expense and depreciation in the early years of the plant's operations. Once the business becomes profitable, U.S. Corp makes a new election to treat the foreign entity as a corporation for U.S. tax purposes. As a result, after including in income any loss recapture and other amounts required under Code Sec. 367(a), U.S. Corp obtains the benefit of deferral on subsequent earnings from the plant that are not subpart F income and enjoys the benefit of the country A tax holiday without offsetting U.S. tax.

Issues Under Present Law

This election to convert the foreign entity from a disregarded entity to a corporation for U.S. tax purposes raises questions about whether any Code Sec. 351 business purpose requirement is met, and whether the IRS could assert that the principle purpose of the transaction was tax avoidance, and thus invoke Code Sec. 269(a)(1) to deny the intended tax results.

Code Sec. 351 Business Purpose Requirement

While Code Sec. 351 itself and the regulations thereunder do not contain a specific business purpose requirement, the IRS takes the position that such a requirement exists, albeit at a relatively low threshold compared to tax-free reorganizations.[1] The courts have at times applied a business purpose requirement to deny Code Sec. 351 treatment, resulting in the transferor either recognizing gain, not being able to claim losses, or being treated as continuing to be the owner of the transferred property.[2] But, in these situations, generally the transferred property was held very briefly by the transferor and/or the transferee, there was a pre-arranged plan to dispose of the property, the transferee corporation was a shell whose existence was transitory, and/or the transfer primarily benefited the transferor.[3] None of these factors are present when a U.S. corporation that has been operating a foreign trade or business contributes that business to a foreign corporation in order to defer tax on an uncertain amount of income going forward. As a result, if U.S. Corp instead transferred the power plant to a second, controlled foreign limited liability entity that had elected to be treated as a corporation for U.S. tax purposes, the transfer would clearly pass muster under Code Sec. 351, notwithstanding its tax motivation.

The question instead presented by this hypothetical is whether accomplishing the same tax result by checking the box on an entity that existed since the initiation of the business can also satisfy any business purpose requirement, given that a tax election inherently has only tax effects.

Application of Code Sec. 269

The second question is whether Code Sec. 269 would, instead or in addition, apply to deny the intended tax results. As a general matter, the IRS interprets Code Sec. 269 broadly enough to apply to the acquisition of control of a corporation to reduce tax on its income. In particular, several cases apply Code Sec. 269 to the formation of a corporation for the principal purpose of tax avoidance. These cases typically involve transfers intended to obtain deductions and credits.[4] At least one case, however, considered the formation of a foreign corporation to hold a foreign joint venture interest. It held that the transaction was not subject to Code Sec. 269 because Code Sec. 269 does not apply to the tax benefit of obtaining deferral on foreign business income.[5]

More to the point, several cases refuse to apply Code Sec. 269 to acquisitions of control of corporations where Congress intended for taxpayers to obtain the tax benefits resulting from the transfer.[6] These cases provide a strong basis for concluding that an actual transfer of foreign business assets to a foreign corporation should not be subject to Code Sec. 269 given the detailed statutory rules Congress has enacted over the years governing the taxation of foreign corporations, acquisitions of foreign corporations and transfers of assets to such corporations. Nevertheless, in the case of a check-the-box transaction, where the acquisition of control and asset transfer for tax purposes is not accompanied by any actual acquisition of control and asset transfer, the nonapplication of Code Sec. 269 is not entirely clear.

Thus, even though the IRS is unlikely to assert that the intended tax consequences of an actual contribution parallel to the hypothetical should be denied under Code Sec. 269(a)(1), the question arises of whether the IRS should do so in the case of the check-the-box transaction described above.

Policy Analysis

Because check-the-box elections apply purely for tax purposes, the IRS and courts should agree that the tax consequences of a valid election are not subject to any business purpose or principal purpose type test. The IRS granted the election without restriction; requiring a business purpose or any nontax purpose to claim the associated tax consequences would merely serve to deny what the IRS plainly granted. Instead, if the IRS and the Treasury would like to alter the consequences of the election, they should do so through the terms, conditions and scope of the election itself, not by applying a business purpose or nontax purpose requirement to its consequences.

Does that mean that taxpayers should be able to avoid otherwise potentially serious issues under Code Sec. 351 or Code Sec. 269 by undertaking a transaction through a check-the-box election? This is an important question. The above example does not present this question squarely because an actual transaction would pass muster under both sections; accordingly, it is clearly appropriate to conclude that the normal tax consequences of a parallel check-the-box transaction should be allowed.

The transaction can, however, be modified to present the issue more pointedly. Suppose that during the time that the foreign entity is disregarded for U.S. tax purposes, the power plant runs into substantial financial difficulties and faces a debt restructuring. Suppose further that U.S. Corp then elects to treat the entity as a foreign corporation so that either the entity can avoid cancellation of indebtedness (COD) income for U.S. tax purposes because it qualifies for the insolvency exception[7] or, alternately, so that any COD income would not be subpart F income.[8] In this case, Code Sec. 367(a) would also apply to the deemed incorporation, but the consequences might not be substantial because any recapture of prior losses and other amounts recognized under Code Sec. 367(a) would be limited to built-in gain in the assets deemed transferred,[9] and in this circumstance, there is likely to be little or no gain. Of course, the IRS could assert that Code Sec. 482 should apply to reallocate the losses to the foreign corporation. But if the losses occurred over multiple years, and particularly if the check-the-box election occurs at the beginning of a tax year, that assertion is likely to fail.[10] Thus, by structuring the transaction in this manner, the U.S. taxpayer will have taken substantial losses in the United States but will have deferred or eliminated any offsetting COD income. By contrast, if the taxpayer actually transferred control of the assets to a separate foreign entity, one would expect the IRS to challenge the transaction on both Code Sec. 351 business purpose and Code Sec. 269 grounds.

This modified hypothetical raises in a more challenging way the question of whether the fact that the transaction is implemented through a check-the-box election, and not through an actual contribution, should result in the IRS being foreclosed from asserting successfully business and other nontax purpose arguments because the election, by definition, has no nontax effect. In theory, the answer should be no. Just as a check-the-box election should not be a basis for asserting that any associated transaction fails any business purpose or other nontax purpose requirements, so too should the fact that a transaction incorporates a check-the-box election not be a free pass to avoid any such requirements. Nevertheless, there are substantial obstacles to achieving this result.

Given that no regulatory guidance exists today, it is difficult to see the courts developing a case law doctrine that establishes some sort of principled framework applying business or other nontax purpose requirements to check-the-box transactions only when these requirements would deny the tax consequences of a parallel actual transaction. Instead, it is entirely likely that the courts would conclude that the possibility of achieving intended tax consequences through a check-the-box election effectively eliminates the requirements that otherwise might be imposed on parallel actual transactions because check-the-box elections are granted without limitation by regulations and such elections can have no business or other nontax purpose.

If this possibility concerns the Treasury and the IRS, they could consider establishing such a principled framework through modifications to the check-the-box regulations.[11] Presumably, establishing and implementing such a framework would entail analyzing a check-the-box transaction as if it were an actual transaction. Because check-the-box elections result in purely hypothetical transactions, this approach would raise numerous questions as to what facts would be imputed. For example, in the modified transaction to avoid COD income described above, would the hypothetical transaction involve a transfer from the disregarded foreign entity to a new foreign entity, or a transfer by U.S. Corp parallel to the actual transfer

that occurred upon initiation of the business? If the latter, would the deemed time of the transfer be when it actually occurred (when the taxpayer's proposals were relatively benign) or when the check-the-box election occurred (when the taxpayers proposals were arguably less benign)? Again, if the latter, what would be the assumed nontax implications for the financial restructuring if such a transfer had in fact occurred? Guidance would only be helpful if it provides a basis for answering these difficult questions, which it may not be able to do.

In these circumstances, it may be less problematic for the Treasury and the IRS to let the courts determine whether check-the-box planning effectively eliminates the business and other nontax purpose requirements that potentially apply to parallel actual transactions rather than providing guidance that attempts to specify how such requirements apply to check-the-box transactions. The latter approach might serve only to increase uncertainty and complicated planning strategies without changing taxpayers' behavior and tax results.

Check-and-Sell Transactions

Description of Basic Transactions

The second set of examples of check-the-box planning strategies are check-and-sell transactions. There are two general varieties. In the first, illustrated in Example 2, a first-tier CFC checks the box on a second-tier CFC to treat it as a disregarded entity. The first-tier CFC then sells the stock of the second-tier CFC to an unrelated foreign party. As a result of the election, the transaction is treated as an asset sale instead of a stock sale, meaning that the transaction does not generate subpart F income, except to the extent that selling the assets would generate subpart F income. Checking the box also changes the character of the income from the transaction to overall basket income for foreign tax credit purposes to the extent that the assets of the second-tier CFC generated overall basket income prior to the transaction.

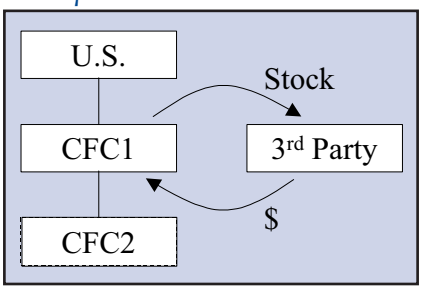
In the second type of check-and-sell transaction, illustrated in Example 3, a U.S. parent checks the box on its first-tier CFC and then sells that CFC's stock to an unrelated foreign party. As above, the U.S. parent treats the transaction as an asset sale instead of a stock sale, which changes the character of the income to overall basket income for foreign tax credit purposes to the extent that assets of the CFC generated overall basket income.[12] In addition, if the CFC has losses, the election would generally render the losses ordinary under Code Sec. 1231 instead of capital under Code Sec. 1221. However, Section 836 of the American Jobs Creation Act of 2004 (the "Jobs Act")[13] appears to limit the possibility of the U.S. parent claiming a Code Sec. 1231 loss on any of the assets transferred in such circumstances, unless sufficient Code Sec. 1221 gains exist on other assets to avoid the provision.

Issues Under Present Law

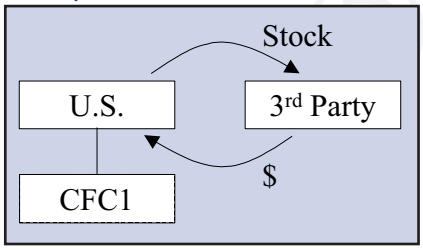
Several efforts have been made over the past few years to eliminate the intended tax consequences of these transactions. One such effort culminated in the 1999 issuance of proposed regulations that would have invalidated an election to treat a subsidiary as a disregarded entity if a 10-percent-or-greater interest in the subsidiary was disposed of within one year of the election (or one day prior to the election), and if the subsidiary had been treated as a corporation at some point during the year prior to the disposition.[14] This provision would have reversed the favorable tax consequences of both of the transactions described above. However, it was dropped when the proposed regulations were finalized in 2003, following criticism that it was overly broad and undercut the effort underlying the check-the-box regulations to promote certainty regarding entity classification. At that time, the IRS announced that instead of following the approach of the proposed regulations of changing the classification of an entity in certain situations, it would focus on ensuring that the substantive rules of the Code and U.S. tax treaties reach appropriate results, regardless of changes to an entity's classification.[15]

The next major effort to eliminate the tax benefits of check-and-sell transactions occurred in the *Dover* case.[16] In *Dover Corp.*, the facts mirrored Example 2 above. The U.S. taxpayer owned a first-tier U.K. CFC ("CFC1"), which

Example 2



Example 3



in turn owned a second-tier U.K. CFC ("CFC2") that was engaged in an elevator installation and servicing business. CFC1 sold CFC2 to an unrelated foreign party, and then requested Code Sec. 9100 relief to retroactively file an election for CFC2 to be treated as a disregarded entity for U.S. tax purposes effective immediately prior to the sale. Somewhat surprisingly, the IRS granted the taxpayer's request, but noted that its decision had no bearing on whether gain from the sale of CFC2 generated subpart F income.

Ultimately, the case was litigated, and the taxpayer claimed that the sale did not generate subpart F income because CFC1 had sold assets used in its trade or business. In support of its position, the taxpayer cited IRS guidance providing that when assets of a subsidiary are sold following its Code Sec. 332 liquidation, the subsidiary's trade or business is attributed to its parent.[17]

The IRS conceded that the transaction was an asset sale because the check-the-box election resulted in a deemed Code Sec. 332 liquidation followed by a deemed sale of CFC2's assets. But the IRS argued that the assets had not been used in CFC1's trade or business, that CFC2's trade or business should not be attributed to CFC1, and, therefore, that the proceeds still constituted subpart F income. In support of its position, the government cited *Acro Manufacturing*, which held that the sale of a subsidiary's assets used in its trade or business on the same day as its actual Code Sec. 332 liquidation resulted in capital income.[18] Contrary to existing guidance, *Acro Manufacturing* thus implied that when the assets of a subsidiary are sold shortly after its liquidation, the trade or business of a subsidiary is not attributed to its parent.

In *Dover*, the court decided in favor of the taxpayer on the basis that the IRS's position was inconsistent with its existing guidance that a subsidiary's trade or business is attributed to its parent as part of a Code Sec. 332 liquidation. While Judge Halpern declined to revisit *Acro Manufacturing*, he did note that the IRS, in effect, rejected the court's position in *Acro Manufacturing* by issuing Reg. §301.7701-2 and the guidance relied upon by the taxpayer.[19]

Policy Considerations

After the *Dover* case, therefore, there are not, as a general matter, serious questions about whether taxpayers are entitled to the intended tax consequences of check-and-sell transactions, aside from the limitation on converting capital losses into ordinary losses that was enacted as part of the Jobs Act. Nevertheless, it is worth considering whether these tax consequences are appropriate from a policy perspective.

Ordinary vs. Capital Character of Income. First, with respect to the character of any losses of the transferred first-tier CFC, it is unclear why the analysis in check-the-box cases should differ from cases like *Acro Manufacturing* in which a real liquidation occurred. Either a subsidiary's trade or business should be attributed to its parent in all transactions under Code Sec. 332, or attribution should not be permitted in certain circumstances that apply irrespective of whether the subsidiary actually liquidated or checked the box to be treated as a disregarded entity. That means that there should be no distinction between check-the-box liquidations and real liquidations.

As mentioned above, this issue may have become moot in most cases following enactment of the loss importation rules in Section 836 of the Jobs Act. That section provides that in any case in which a foreign corporation liquidates into a U.S. corporation, the distributee is a domestic corporation, and the distributee's aggregate adjusted basis in the property distributed exceeds the fair market value of the property immediately after the liquidation, the basis of each individual asset distributed instead is its fair market value at the time of the distribution. After the Act, therefore, there is only a character-related advantage to checking the box on a first-tier CFC prior to a sale if the CFC has individual asset Code Sec. 1231 losses that are in the aggregate offset by Code Sec. 1221 gains.

Foreign Tax Credit. The issue of the character of income for foreign tax credit purposes is arguably more complicated due to foreign tax considerations. In particular, the legislative history of the Tax Reform Act of 1986 indicates an intent to allocate low-taxed income to a separate basket to keep it from being sheltered by high-taxed income.[20] Gain on the sale of shares of a CFC by another local CFC (as in Example 2) is often low-taxed because most holding companies are in countries that exempt share sale gains from tax. And gain on the sale of CFC shares by a U.S. corporation (as in Example 3) is generally even less likely to bear foreign tax. By contrast, gain on an actual sale of the operating assets of a CFC (whether by another CFC or the U.S. parent) typically would be taxed at relatively high rates in the foreign jurisdiction. Because check-the-box elections do not apply for foreign tax purposes, an

argument can therefore be made that the U.S. tax result should not be changed by checking the box; actual asset sales would thus be treated differently than check-the-box asset sales.

The premise of this argument is arguable, though, and thus it is not entirely persuasive. While the legislative history does talk of passive income as tending to be low-taxed, the foreign tax credit rules do not and have not put low-taxed income generally in the passive basket. Instead, the passive basket has for the most part been limited to income from investments that can easily be moved from high-taxed jurisdictions, including the United States, to low-taxed jurisdictions; the focus thus has principally been on the mobility of certain types of income. Gain on the sale of shares in direct investments, as when the shares of one CFC are sold by another CFC, is not mobile and thus by definition does not fit into that category.

From a policy perspective, it is best for the passive basket foreign tax credit rules to focus in this manner on the responsiveness of locating a type of investment in the United States versus outside the United States to foreign tax rates, rather than on the actual level of foreign tax to which the income from an investment is subject. By focusing on the responsiveness of locational decisions to foreign tax rates, the rules provide a way to harmonize the goals of capital export neutrality and capital import neutrality. When an investment can easily be moved overseas, the rules limit the ability of taxpayers to cross-credit income from the investment and thereby obtain tax benefits for doing so. When an investment cannot easily be moved, the rules permit more cross-crediting of the income associated with the investment, thereby allowing U.S. companies to be more competitive with foreign companies with respect to foreign investments whose location is unlikely to have been tax-motivated.

If this argument is accepted, limitations on check-the-box planning for foreign tax credit purposes are not appropriate. Further, if this argument is accepted, it is appropriate for the foreign tax credit rules to apply look-through rules to actual stock sales where such rules apply to dividends. This implies that U.S. taxpayers should be able to treat stock sales of CFCs as general basket income to the extent that the underlying assets of the CFC generate general basket income, irrespective of whether the stock sale was part of a check-and-sell transaction. As a corollary, Code Sec. 338(h)(16) could be repealed, a move most practitioners would clearly support.

Thus, not only are the foreign tax credit tax consequences associated with check-and-sell transactions appropriate, but they should potentially be extended through legislation to the actual sale of CFC stock.

Subpart F. At first blush, a similar argument could be applied to the question of whether income generated by a check-and-sell transaction should be subpart F income. As with the foreign tax credit rules, elements of the legislative history of subpart F could be read as suggesting that CFC income should be treated as subpart F income in circumstances where it is likely to be low-taxed. For example, this was part of the rationale for including shipping income in subpart F income.[21] But also like the foreign tax credit rules, historically subpart F has actually focused most prominently on income that is low-taxed mainly because it is mobile in nature. Indeed, this predominant focus was most recently evidenced by the repeal of the foreign base company shipping income rules in the recent Jobs Act.[22]

However, unlike the foreign tax credit rules, subpart F applies to dividends paid by lower-tier CFCs without any look-through analysis. That suggests a Congressional purpose that extends beyond that mobility of income to the notion that the time when funds are distributed from a lower-tier CFC, and thus presumably are no longer necessary in that CFC's business, is an appropriate time to end deferral. This policy is also reflected in the regulations under Code Sec. 367(b), under which deferral is appropriately terminated when a CFC is de-controlled in a reorganization transaction.[23]

These policies suggest that taxing the gains on actual sales of lower-tier CFC stock under subpart F is appropriate as the termination of the business activity that was eligible for deferral. The policies make more understandable the Treasury and the IRS's continuing concern about the use of check-and-sell transactions to avoid subpart F income. That concern could also apply to actual liquidations of lower-tier CFCs prior to any sale except for the fact that in most instances either the liquidation itself or the subsequent asset sale would be subject to the foreign tax and thus, taxpayers are less likely to undertake such transactions.

Thus, an argument can be made that legislation treating check-and-sell transactions the same as the sale of CFC shares for subpart F purposes is appropriate. As

described above, however, such treatment should not be applied for other purposes, such as foreign tax credit or income characterization purposes.

Conversions of Stock Reorganizations and Transfers into Asset Reorganizations

Description of Basic Transactions

The final set of examples of check-the-box planning strategies are conversions of stock reorganizations and transfers into asset reorganizations. One way a U.S. parent can accomplish this result, as illustrated in Example 4, is by transferring the stock of a first-tier CFC (CFC1) to another first-tier CFC (CFC2) in a manner that would qualify as a B reorganization, and then checking the box to treat CFC1 as a disregarded entity. This converts the transaction to a D reorganization. As a result, the U.S. parent can treat the transaction as a foreign-to-foreign asset transfer under Code Sec. 367(b)[24] and not an outbound stock transfer, thereby avoiding the Code Sec. 367(a) gain recognition agreement requirement.[25]

A second variety of this planning strategy, illustrated in Example 5, involves a U.S. parent transferring the stock of a first-tier CFC (CFC1) to another first-tier CFC (CFC2) in exchange for cash from CFC1, and then checking the box to treat CFC1 as a disregarded entity. Absent this election, the transfer would be treated as a Code Sec. 304/351 transaction. But after the election, the U.S. parent can treat the transfer as a Code Sec. 368(a)(1)(D) reorganization with boot. As a result, the amount of dividend income is limited to the U.S. parent's gain in CFC1; such dividend income is either sourced only to the earnings and profits of CFC1 or to the earnings and profits of CFC1 first, and the U.S. parent avoids any requirement for a gain recognition agreement.

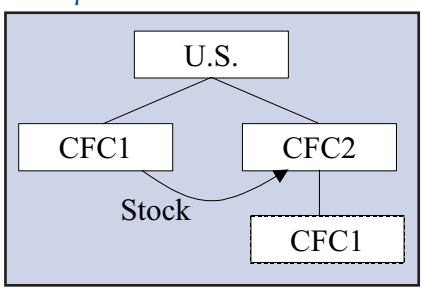
Issues Under Present Law

The intended tax results of the transactions described above are fairly well established, although the IRS has expressed some interest in revisiting the results. The IRS first applied the step-transaction doctrine to treat a share transfer followed by an effective liquidation as a transfer of assets in Rev. Rul. 67-274.[26] Since then, asset transfer treatment has effectively become black letter law, with the possible exception of situations where applying the doctrine would violate clear Congressional intent.[27] In line with this position, the IRS has acknowledged that Example 4 and 5 transactions are treated as foreign-to-foreign asset transfers, and not as U.S.-to-foreign share transfers for Code Sec. 367 purposes.[28] Nevertheless, the IRS has stated that it is considering whether to expand the application of Code Sec. 367(a) gain recognition agreement requirement to apply to such transactions where the shareholder in question is a U.S. person.[29]

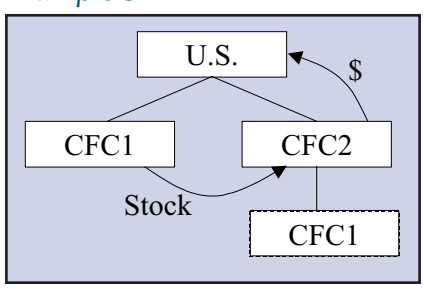
With respect to transfers described in Example 5, the IRS has also consistently ruled that any cash or other nonstock consideration received is boot in a C or D reorganization and thus governed by Code Sec. 356, not Code Sec. 304.[30] Moreover, the IRS and the courts have consistently treated a pure sale of shares followed by a liquidation as a D reorganization, at least where the target and the acquiring corporation are owned by the same shareholder so that the failure to issue any shares is meaningless.[31]

The application of Code Sec. 356 instead of Code Sec. 304 in these circumstances has several important consequences. First, the amount of any dividend resulting from the transaction is limited to the gain in CFC1's shares by reason of Code Sec. 356(a)(1). Second, Code Sec. 356(a)(2) provides that any dividend is first sourced out of CFC1's earnings and profits, and it may be limited overall to CFC1's earnings and profits.[32] Finally, while the U.S. parent can obtain any Code Sec. 902 credits attributable to a dividend from CFC1,[33] there is no authority allowing it to treat the dividend as previously taxed income under Code Sec. 959(a). There is also no authority with respect to either Code Sec. 902 credits or previously taxed income if any portion of the dividend is attributable to CFC2's shares.

Example 4



Example 5



Policy Considerations

The tax treatment of the transactions described in this section is fairly straightforward under current law. What is less clear is whether the tax results of Examples 4 and 5 are appropriate from a policy perspective.

Code Sec. 367 Gain Recognition Agreements. The question of whether a gain recognition agreement (GRA) should be required in Examples 4 or 5 goes to the basic question of why the existing regulations require a GRA for U.S.-to-foreign tax-free share transfers but not for foreign-to-foreign tax-free asset transfers.

The GRA requirement for U.S.-to-foreign share transfers stems from concern that such transfers enable a subsequent sale of a foreign subsidiary with no U.S. tax consequence[34] and that, with planning, foreign tax consequences can also be avoided because most countries do not tax gain on the sale of shares of a subsidiary. Of course, the rule is much broader than the concern; as long as the transfer is to a wholly owned entity, a subsequent sale of the transferred shares would generate subpart F income equal to the gain that would have been taxed in the absence of the transfer. But where the transferor and its affiliates own less than all of the shares of the transferee, the GRA requirement seems understandable. Moreover, the current application of the GRA requirement to all share transfers may be appropriate if carving out transfers to wholly owned transferees is not be worth the complexity of ensuring that a GRA requirement is subsequently applied if the shares are later transferred to a non–wholly owned transferee.

The tax considerations with respect to foreign-to-foreign asset transfers differ. If there is a real asset transfer (*e.g.*, in an actual D reorganization) and then a subsequent sale of the assets by the transferee, the U.S. tax consequences will be the same as an asset sale prior to the transfer. The U.S. parent will have subpart F income only to the extent of gain on the sale of assets that generate subpart F foreign personal holding company income. More importantly, either the initial transfer or the subsequent sale will generally result in substantial foreign tax.[35] This may have been Congress' and the IRS's rationale for excluding foreign-to-foreign asset transfers from any GRA requirement and treating them solely under the principles of preserving deferred earnings under Code Sec. 367(b).

But if the transaction instead involves a deemed asset transfer for U.S. tax purposes but not for foreign tax purposes, as described in Examples 4 and 5, the results can be much more favorable for the U.S. shareholder. If the transferee subsequently sells the disregarded entity, it will be treated as selling assets for U.S. tax purposes, likely resulting in little or no subpart F income. And it will be treated as selling stock for foreign tax purposes, thus generally avoiding foreign tax.

Given this state of affairs, it's understandable that the Treasury and the IRS are considering conforming the GRA requirement for U.S.-to-foreign share transfers that are followed by a check-the-box liquidation to that of U.S.-to-foreign share transfers generally. Indeed, the GRA requirement should be seen as more important in this context. Unlike a share transfer with no check-the-box election, the disregarded entity shares in Examples 4 and 5 could be sold after the deemed liquidation by the wholly owned transferee, not only with little or no U.S. subpart F income to the extent the assets deemed sold do not generate subpart F income, but also with little or no foreign tax. But because, as described above, foreign tax will typically be imposed on actual asset transfers either in the asset reorganization or in the subsequent asset sale, it would seem unnecessary to apply any expanded GRA requirements to actual asset transactions.

Differences Between Code Sec. 356 and Code Sec. 304 Transactions. The differences between the treatment of property received in Code Sec. 304 transactions and boot received in C/D reorganizations also merit revisiting. These differences, however, raise important issues independent of the international context (*e.g.,* between individual shareholders and their controlled corporations) that others may be better qualified to discuss. As a general matter, from an international perspective, there does not appear to be any reason to treat the two types of transactions differently depending on whether or not a check-the-box strategy is employed. Also, from an international perspective, no particular policy goal is furthered by the different tax consequences resulting from Code Sec. 304 transactions compared to C/D reorganizations with boot. Accordingly, consideration should be given to making the two provisions consistent for both actual and check-the-box transactions.

Conclusions

This article has outlined a variety of check-the-box planning strategies employed in the international context and considered whether

the tax consequences under current law are appropriate as a policy matter. The discussion has highlighted the desirability as a general policy matter to conform the tax treatment of transactions that are close substitutes as a result of taxpayers' ability to incorporate or liquidate a CFC for U.S. tax purposes through a check-the-box election. At the same time, it has emphasized the perspective that certain U.S. international tax policies may require adjustment to take into account the fact that a check-the-box election is not treated as an incorporation or liquidation for foreign tax purposes. Over time, the importance of these issues is only likely to increase.

ENDNOTES

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1 See BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS & SHAREHOLDERS, at ¶3.17[6] (2004); *M.P. Caruth*, DC Tex. ,88-2 USTC ¶9514, 688 FSupp 1129 (finding a valid business purpose when taxpayer transferred stock of Corp. A to Corp. B four days prior to planned declaration of dividend by Corp. A).

2 See *S.D. Stewart*, CA-9, 83-2 USTC ¶9573, 714 F2d 977; *R.G. Kluener Est.*, CA-6, 98-2 USTC ¶50,712, 154 F3d 630; Notice 2001-17, 2001-1 CB 730.

3 See, e.g., FSA 200134008 (May 15, 2001) (including the above in a list of factors relevant to determining whether a valid business purpose is present under Code Sec. 351).

4 See *Coastal Oil Storage Co.*, CA-4, 57-1 USTC ¶9518, 242 F2d 396; *James Realty Co.*, CA-8, 60-2 USTC ¶9600, 280 F2d 394.

5 See *S. Siegel*, 45 TC 566, Dec. 27,882 (1966).

6 See, e.g., *A.P. Green Export Co.*, CtCls, 61-1 USTC ¶9103, 284 F2d 383, 151 CtCls 628, holding that Code Sec. 269 does not apply to a transfer of assets to a Western Hemisphere Trade Corporation.

7 Code Sec. 108(a)(1)(B).

8 LTR 9729011 (Apr. 11, 1997).

9 Code Sec. 367(a)(1) and (3)(C).

10 TAM 7935005 (May 18, 1979); TAM 7924003 (Feb. 26, 1979).

11 In particular, Reg. §301.7701-3(g) could be amended to provide a framework for analyzing the tax treatment of the transactions that are deemed to occur as a result of elective classification changes.

12 Of course, the transaction would require inclusion of the all earnings and profits amount under Code Sec. 367(b) and the regulations thereunder without regard to the gain recognized on the sale.

13 American Jobs Creation Act of 2004 (P.L. 108-357).

14 Proposed Reg. § 301.7701-3(d).

15 Notice 2003-46, IRB 2003-28, 53.

16 *Dover Corp.*, 122 TC 324, Dec. 55,630 (2004).

17 See, e.g., Rev. Rul. 77-376, 1977-2 CB 107; Rev. Rul. 75-233, 1975-2 CB 109; GCM 37054 (Mar. 21, 1977).

18 *Acro Manufacturing*, 39 TC 377, Dec. 25,750 (1962).

19 *Dover Corp., supra* note 16, 122 TC, at 350–52.

20 See JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 863–64 (JCS-10-97, May 4, 1987).

21 *Id.*, at 963–70.

22 Act Sec. 315 of P.L. 108-357.

23 See Reg. §1.367(b)-4(b)(1).

24 See Rev. Rul. 67-274, 1967-2 CB 141; Reg. §1.367(b)-3(a); Reg. §1.367(b)-4; BITTKER & EUSTICE, *supra* note 1, at ¶15.81[2].

25 See Reg. §1.367(b)-3(b)(1)(ii).

26 Rev. Rul. 67-274, 1967-2 CB 141.

27 See Rev. Rul. 2001-46, IRB 2001-42, 321 (analyzing whether treating a qualified stock purchase followed by a merger of the acquiring company with the target as an A reorganization rather than a purchase followed by a liquidation violated the exclusivity policy of Code Sec. 338).

28 See, e.g., LTR 9327010 (Mar. 23, 1993).

29 Notice 2003-46, IRB 2003-28, 53.

30 See, e.g., LTR 9550024 (Sept. 18, 1995); LTR 9349008 (Sept. 9, 1993); LTR 9327010 (Mar. 5, 1993); LTR 9111055 (Dec. 19, 1990); LTR 8952041 (Sept. 29, 1989).

31 See, e.g., *M.E. DeCroff*, 54 TC 59, Dec. 29,923 (1970).

32 The IRS takes the position that the acquiring corporation's E&P is also taken into account where the target and the acquiring corporation are owned by the same shareholders. See Rev. Rul. 70-240, 1970-1 CB 81. The Fifth Circuit agrees, see, *J.E. Davant*, CA-5, 66-2 USTC ¶9618, 366 F2d 874. The Tax Court has, however, held that only the target's E&P should be taken into account. See *Atlas Tool Co.*, 70 TC 86, Dec. 35,124 (1978).

33 See Rev. Rul. 74-387, 1974-2, CB 207.

34 See, e.g., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 431.

35 Most foreign jurisdictions tax residents if they transfer trade or business assets out of the jurisdiction just as they tax the sale of trade or business assets to another resident of the same or a different jurisdiction.