REFLECTIONS ON SECTION 367(b) REGULATIONS AND INBOUND TRANSACTIONS

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Abstract

Cross-border combinations of U.S. and foreign public companies are unusual but happen from time to time. Our broad and often arbitrary anti-inversion rules discourage such transactions utilizing a foreign parent company for the combined group. But using a U.S. parent company can also be painful to the foreign company shareholders. Our section 367(b) regulations require gain recognition for the foreign company's material shareholders subject to U.S. tax. That seems to be a high price to pay for the pleasure of bringing the foreign corporate group into the U.S. tax net.

Much has been discussed and written about the section 367(b) regulations that compel this result since the regulation's finalization in 2000 and especially since the enactment of the 2017 Tax Cuts and Jobs Act. This article reflects our exploration into what led the original regulation writers down the path they took and suggests that maybe they were wrong in their thinking. Our hope is that it will stimulate a broader discussion of the goals of the section 367(b) regulations as applied to inbound transactions and how they should be implemented in the current regime of section 245A deductions and GILTI and Subpart F inclusions.

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> "A domestic acquirer of [a] foreign corporation's assets should not succeed to the basis or other tax attributes of the foreign corporation except to the extent that the United States tax jurisdiction has taken account of the United States person's share of the earnings and profits that gave rise to those tax attributes."
>
> – 1991 Preamble to Proposed section 367(b) Regulations[1]

> "In general, a United States person obtains tax basis only for amounts which have been included in income."
>
> – Charles I. Kingson[2]

> "It is absolutely necessary that effect on earnings be governed by basis."
>
> – William D. Andrews[3]

I. INTRODUCTION

Cross-border combinations of U.S. and foreign public companies are unusual but happen from time to time. Our broad and often arbitrary anti-inversion rules discourage such transactions utilizing a foreign parent company for the combined group.[4] But using a U.S. parent company can also be painful to the foreign company shareholders. Consider a transaction that for foreign corporate and tax law reasons is best accomplished by merging the foreign parent company directly into the U.S. acquiring parent company in a manner described in section 368(a)(1)(A). In a purely domestic context, the merger would be a tax-free transaction to the shareholders of the acquired company. Our section 367(b) regulations override that treatment and require gain recognition for the foreign company's material shareholders subject to U.S. tax.[5] That seems to be a high price to pay for the pleasure of bringing the foreign corporate group into the U.S. tax net.

Much has been discussed and written about the section 367(b) regulations that compel this result since the regulation's finalization in 2000 and especially

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1 1991 Proposed Regulations, 56 Fed. Reg. 41993, 41995 (Aug. 26, 1991).

2 Charles I. Kingson, *The Theory and Practice of Section 367*, 37 N.Y.U. Ann. Inst. on Fed. Tax'n § 22.03[7][c] (1979).

3 William D. Andrews, *"Out of Its Earnings and Profits": Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403, 1408 (1956).

4 *See* I.R.C. § 7874. Unless otherwise specified, all "section" references contained herein are to the U.S. Internal Revenue Code of 1986, as amended, (the "Code") and all "Regulation section" and "Treas. Reg. §" references are to the U.S. Treasury regulations promulgated thereunder. References to proposed regulations are designated as "Prop. Treas. Reg. §," and references to temporary regulations are designated as "Temp. Treas. Reg. §." Citations to preambles of regulations are noted accordingly where applicable.

5 *See* Treas. Reg. § 1.367(b)-3.

since the enactment of the 2017 Tax Cuts and Jobs Act ("TCJA"). Several of us at Skadden wrote Treasury and the Internal Revenue Service ("IRS") in the summer of 2021 urging them to revisit the regulation.[6] A New York State Bar report,[7] was issued in June 2022 also urging reconsideration. Gary Scanlon of KPMG published an article in TAXES—the Taxes Magazine[8] and led an International Tax Institute panel on the topic in March 2023.[9] Bret Wells published a law review article a few months later,[10] and the UF Tax Incubator project published its recommendations in a Tax Notes International special report in August 2024.[11]

There seems to be a consensus among these commentators that Treas. Reg. § 1.367(b)-3 as applied to less-than-10% U.S. shareholders[12] is inappropriate after both the 2004 enactment of section 362(e) and particularly after the TCJA.[13] Some of us came to wonder whether the regulations were even appropriate at their original adoption in 1991. We assumed they were because the original thinking behind the regulation was driven by Charles Kingson, who was a legendary tax lawyer of that time.[14] And it was validated by subsequent commentators including the Dolan et

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[6] Paul W. Oosterhuis & Moshe Spinowitz, *Firm Urges IRS to Reconsider Inbound Transaction Rules*, 2021 TAX NOTES TODAY INT'L 185-20 (Aug. 25, 2021).

[7] TAX SECTION, N.Y. STATE BAR ASS'N, AN ANALYSIS OF POTENTIAL DESIGN CHANGES TO REGULATION SECTION 1.367(b)-3 IN LIGHT OF THE TAX CUTS AND JOBS ACT, Rep. No. 1463 (2022).

[8] Gary Scanlon & Elena Madaj, *Code Sec. 367(b): Where Do We Go from Here?*, 101 TAXES 263 (2023).

[9] *See Basics of International Taxation 2023*, PRACTISING LAW INST. https://www.pli.edu/programs/basics-of-international-taxation/358873 [https://perma.cc/E4LU-HSUC] (last visited Jan. 14, 2025).

[10] Bret Wells, *Reform of Section 367(a) and Section 367(b) for a Post-TCJA Era*, 23 HOUS. BUS. & TAX L. J. 195 (2023).

[11] UF Tax Incubator, *Potential Changes to Section 367 and the Associated Treasury Regulations*, 115 TAX NOTES INT'L 905 (Aug. 5, 2024).

[12] Generally, under section 951(b), a U.S. shareholder is a U.S. person that owns (within the meaning of section 958(a) or (b)) 10% or more of the vote or value of a foreign corporation. For the remainder of this Article, we use the defined term "U.S. Shareholder" when referring to shareholders that meet such definition under section 951(b).

[13] *See, e.g.*, Scanlon & Madaj, *supra* note 9, at 267.

[14] *See generally* Charles I. Kingson, *The Theory and Practice of Section 367*, 37 N.Y.U. Ann. Inst. on Fed. Tax'n § 22.03[7][c] (1979). For a biographical overview of Kingson's career, see *In memoriam: Charles Kingson (1938–2019)*, N.Y.U. L. NEWS (Mar. 18, 2019), https://www.law.nyu.edu/news/Charles-Kingson-in-memoriam-Graduate-Tax-Program-international [https://perma.cc/8SWJ-EWRR].

al. treatise[15] and the Bruce Davis portfolio,[16] though each offering criticism. Notwithstanding that history, we thought a further exploration into the thinking of the regulation writers would be helpful in reaching a more definitive view of the regulation today and how or why it should be changed.

This article reflects our exploration into what led the original regulation writers down the path they took and whether they were wrong in their thinking. Hopefully it will stimulate a broader discussion of the goals of the section 367(b) regulations as applied to inbound transactions and how they should be implemented

[15] The treatise explains the policy rationale and critiques the regulations as follows:

> The theory of the Prior 367(b) Regulations was that: (1) a corporation funds assets with equity capital, debt, and earnings; (2) a domestic corporation receives basis for assets acquired with earnings for corporate tax purposes only if it has paid tax on those earnings; (3) the U.S. parent of a foreign subsidiary that obtained deferral on its earnings should not receive full basis for the foreign subsidiary's assets in the hands of a controlled domestic corporation in an inbound reorganization unless the U.S. parent forgoes deferral and pays U.S. corporate tax on those earnings. This theory supports in general the results of the regulations in a Section 332 liquidation of a foreign subsidiary into a U.S. parent or in an inbound reorganization of a foreign subsidiary into a domestic subsidiary of its U.S. parent. It does not, however, support the results of the regulations in inbound asset reorganizations involving a widely held foreign corporation. . . . There is thus no policy justification for requiring non-Section 1248 Shareholders to include earnings in income or to recognize gain, and that requirement defies common sense. It is inconsistent with notions of expatriation and impatriation that have been considered over the last two decades—i.e., that there should be an exit tax (Section 367(a)) when a domestic corporation expatriates and that assets should receive fair market value basis (or at least carryover basis) when they come into U.S. corporation solution. The latter result should not be contingent upon the shareholders being taxed unless they were a domestic parent corporation that was potentially subject to the Subpart F and Section 1248 regimes but nevertheless benefited from deferral. The Final Section 367(b) Regulations effectively treat the tax on the shareholders as a surrogate for corporate level tax on the foreign corporation, even though the preamble to the regulations recognizes that Section 367(b) policies are "unrelated to an exchanging shareholder's outside gain on its stock." The practical ramification of the Final 367(b) Regulations is that the domestic shareholders of a publicly held foreign corporation are taxed when the foreign corporation domesticates—somewhat like paying tax to break into jail!

KEVIN D. DOLAN ET AL., U.S. TAXATION OF INTERNATIONAL MERGERS, ACQUISITIONS & JOINT VENTURES ¶ 13.06[2][c] (2024).

[16] *See* Bruce Davis, *Other Transfers Subject to Section 367(b), (d) or (e)*, BLOOMBERG TAX MGMT. PORTFOLIO No. 920-3d ("Thus, were it not for §367(b), a domestication transaction such as an inbound liquidation or inbound reorganization of a foreign corporation could provide an opportunity in some cases to avoid U.S. tax on the repatriation of foreign corporate E&P attributable to income with respect to which a U.S. shareholder has enjoyed deferral. A principal purpose of §367(b) is to prevent such a domestication transaction from effectively converting deferral into forgiveness of U.S. tax on foreign corporate income and E&P"). Note, that, Bruce Davis's portfolio has been revised and superseded by Layla J. Asali, *Transfers Subject to Section 367(b), (d) or (e)*, BLOOMBERG TAX MGMT. PORTFOLIO No. 6120-1st (2025) ("Section 367(b) was originally enacted to prevent taxpayers from using an otherwise tax-free domestication transaction such as an inbound liquidation or inbound reorganization of a foreign corporation to altogether avoid U.S. tax on the repatriation of foreign corporate E&P attributable to income with respect to which a U.S. shareholder has enjoyed deferral.").

in the current regime of section 245A deductions and GILTI and Subpart F inclusions.[17]

We first give a brief history of the regulations and then focus on the treatment of inbound asset reorganizations of foreign corporations under section 368(a)(1)(A), (C), (D) and (F) ("Inbound Asset Reorganizations"). Next, we compare the treatment of shareholders in Inbound Asset Reorganizations with shareholders making tax-free exchanges of stock of foreign corporations for stock of domestic corporations under sections 351 and 368(a)(1)(B) ("Inbound Stock Reorganizations"). We then describe the implications of the above on inbound liquidations of foreign corporations under section 332 ("Inbound Liquidations," and together with Inbound Asset Reorganizations and Inbound Stock Reorganizations, "Inbound Transactions").

II. THE HISTORY OF THE SECTION 367(b) INBOUND ASSET REORGANIZATION REGULATIONS

The current version of section 367(b) was enacted in 1976[18] as part of broader legislation to replace the prior requirement that in-scope exchanges of stock and or assets establish "to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes."[19] The legislation provided Treasury authority to draft regulations "necessary or appropriate to prevent the avoidance of Federal income taxes."[20] The goal of the legislation was not to apply a different standard from the pre-existing "guidelines" of Rev. Proc. 68-23 ("Revenue Procedure Guidelines"),[21] which outlined the circumstances under which the IRS would issue favorable private letter rulings, but to codify its standards in regulations so that taxpayers could apply the rules themselves and not be required to seek an IRS ruling.[22]

Because the key rules are not found in the statute itself, it's important to understand the various sets of regulations issued under section 367(b); how they changed over time; and how they operate today. Preambles can give us clues into the underlying principles of a set of rules. Accordingly, below we summarize the various sets of regulations issued under section 367(b), highlighting differences in the various iterations, and noting where Treasury and the IRS provided an explanation in the preambles.

A. 1997 Temporary Regulations

[17] This article does not deal with the intersection of the section 367(b) regulations and passive foreign investment companies.
[18] Tax Reform Act of 1976, Pub. L. No. 94–455, § 1042(a), 90 Stat. 1634 (1976) (amending I.R.C. § 367 (1954)).
[19] Rev. Proc. 68-23, 1968-1 C.B. 821.
[20] I.R.C. § 367(b)(1).
[21] Rev. Proc. 68-23. This legislation was first proposed less than two years after Tax Analysts successfully secured the release of redacted private letter rulings, thus ending, in the experience of one of the authors, the oligopoly of D.C. boutique tax firms in this area.
[22] *See* Scanlon & Madaj, *supra* note 9, at 269–70.

The first regulations governing inbound transactions were issued as temporary regulations in 1977 (the "1977 Temporary Regulations").[23] They largely followed the Revenue Procedure Guidelines,[24] distinguishing between circumstances in which the application of section 1248[25] could be preserved and those where it could not. In principal part, the 1977 Temporary Regulations provided for (1) the attribution of various amounts (the "All E&P Amount"[26] or the section 1248 Amount) from the stock surrendered to the stock received where the section 1248 taint could be preserved or (2) the recognition of gain where the section 1248 taint could not be preserved.

The 1977 Temporary Regulations applied as follows to undistributed corporate foreign earnings in Inbound Transactions:

- Where a domestic corporation acquired the assets of a foreign corporation in an Inbound Liquidation under section 332, the domestic corporation was required to either (1) include in gross income as a deemed dividend the All E&P Amount attributable to its stock of the foreign corporation or (2) recognize gain with respect to its stock of the foreign corporation.[27]
- Where a domestic corporation acquired the assets of a foreign corporation in an Inbound Asset Reorganization under section 368, the consequences depended on whether the exchanging shareholder was a non-corporate section 1248 Shareholder, a domestic corporate section 1248 Shareholder, a foreign corporate shareholder, or a U.S. person that was not a section 1248 Shareholder:
    - A *non-corporate* section 1248 Shareholder was required to include in gross income as a deemed dividend the section 1248 Amount attributable to such shareholder's stock of the foreign corporation;[28]
    - A *domestic corporate* section 1248 Shareholder was required to either (1) include in gross income as a deemed dividend the All E&P

[23] 1977 Temporary Regulations, 42 Fed. Reg. 65152 (1977).

[24] *Id.* The most significant departure from the Revenue Procedure Guidelines was the reduction from a 20% to a 10% threshold for corporate section 1248 Shareholders (defined below) to be required to include certain amounts in gross income. The preamble to the 1977 Temporary Regulations did not offer an explanation for this or other departures from the Revenue Procedure Guidelines.

[25] Where applicable, section 1248 generally recharacterizes a shareholder's gain on the sale of stock of a foreign corporation as a dividend to the extent of the earnings and profits ("E&P") of the foreign corporation (and, in some cases, of lower-tier foreign subsidiaries) attributable to that shareholder (such amount, the "section 1248 Amount"). Section 1248 applies to the sale of stock of a foreign corporation by a U.S. person that owns (within the meaning of section 958(a) or (b)) 10% or more of the total combined voting power of the foreign corporation at any time during the five-year period ending on the date of the sale or exchange if the foreign corporation was a controlled foreign corporation ("CFC") at any time during that five-year period (such shareholder, a "section 1248 Shareholder") and only applies to the E&P of the foreign corporation while it is a CFC.

[26] There have been various tweaks to the definition of All E&P under the regulations, but generally under Treas. Reg. § 1.367(b)-2(d) and as used here, the All E&P Amount is the net positive E&P of the foreign acquired corporation (but not the E&P of the subsidiaries of the foreign acquired corporation) attributable to a shareholder's ownership in the foreign corporation.

[27] Temp. Treas. Reg. § 7.367(b)-5T (1977).

[28] Temp. Treas. Reg. § 7.367(b)-7T(c)(1)(i) (1977). Under the 1977 Temporary Regulations, the section 1248 Amount recognized by a non-corporate section 1248 Shareholder in an Inbound Asset Reorganization included the E&P of lower-tier foreign subsidiaries, which inclusion was a significant departure from the Revenue Procedure Guidelines.

Amount attributable to its stock of the foreign corporation or (2) recognize gain with respect to its stock of the foreign corporation;[29]
- A *foreign corporate* shareholder was required to add certain E&P of the foreign corporation to its own E&P, specifically the E&P that would have been subject to section 1248(c)(2) had there been a disposition of stock in a first-tier foreign corporation and the E&P for pre-1963 years that was attributable to the stock;[30] and
- A U.S. person who was not a section 1248 Shareholder was eligible for nonrecognition.[31]

B. 1991 Proposed Regulations

Fourteen years later, Treasury and the IRS issued proposed regulations that largely replaced the 1977 Temporary Regulations (the "1991 Proposed Regulations").[32] Those regulations reflected considerable thinking in the intervening period by Kingson and others about the role of deferral of earnings of foreign corporations.[33] The regulations provided a series of changes from the 1977 Temporary Regulations aimed at clarifying the scope of section 367(b), streamlining compliance, and minimizing complexity.[34]

The preamble to the 1991 Proposed Regulations articulated what Treasury and the IRS believed to be several of the "principles" of section 367(b), including those related to the acquisition of a foreign corporation's earnings by a U.S. corporation: the four principles are (1) the prevention of the repatriation of earnings or basis without tax ("Repatriation Principle"); (2) the prevention of material distortion in income ("Distortion Principle"); (3) the minimization of complexity; and (4) the permissibility of deferral.[35] The following summary focuses on the first two principles, which continue to be the two driving forces in the regulations today.

1. The Repatriation Principle

With regard to the Repatriation Principle, the preamble to the 1991 Proposed Regulations articulated the following:

> The United States generally does not tax a foreign corporation on its foreign source earnings and profits. If the foreign corporation is owned in whole or in part, directly or indirectly, by a United States person, in certain circumstances the United States does not tax the United States person on the foreign corporation's earnings and

[29] Temp. Treas. Reg. § 7.367(b)-7T(c)(2) (1977).
[30] Temp. Treas. Reg. § 7.367(b)-7T(c)(1)(ii) (1977).
[31] Temp. Treas. Reg. § 7.367(b)-7T(a)(2) (1977).
[32] 1991 Proposed Regulations, 56 Fed. Reg. 41993 (Aug. 26, 1991).
[33] *See* Charles I. Kingson, *The New Theory and Practice of Section 367*, 69 TAXES 1008 (1991).
[34] 1991 Proposed Regulations, 56 Fed. Reg. 41993, 41995 (Aug. 26, 1991). Relevant changes not discussed in detail in this article include requiring the filing of a notice by any person that realizes income in a section 367(b) exchange, and eliminating the special record-keeping requirements related to attribution of certain amounts and adjustments to E&P.
[35] *Id.* at 41995-96.

> profits until those earnings and profits are repatriated (for example, through the payment of dividends) or the United States person disposes of an interest in the foreign corporation. One of the principles of the proposed regulations under section 367(b) is that the repatriation of a United States person's share of earnings and profits of a foreign corporation through what would otherwise be a nonrecognition transaction (for example, a liquidation of a foreign subsidiary into its domestic parent in a transaction described in section 332, or an acquisition by a domestic corporation in a reorganization described in section 368) should generally cause recognition of income by the foreign corporation's shareholders. A domestic acquirer of the foreign corporation's assets should not succeed to the basis or other tax attributes of the foreign corporation except to the extent that the United States tax jurisdiction has taken account of the United States person's share of the earnings and profits that gave rise to those tax attributes.[36]

The 1991 Proposed Regulations also refined the definition of "All E&P Amount" to clarify the intended scope because, as the preamble elaborated, the regulation writers saw "[t]he proper measure of [E&P] that should be subject to tax is the [All E&P Amount]."[37] The 1991 Proposed Regulations also expanded the approach in the 1977 Temporary Regulations, requiring that all U.S. persons that were U.S. Shareholders, not just *domestic corporate* section 1248 Shareholders,[38] include in gross income as a deemed dividend the All E&P Amount in an Inbound Transaction.

The preamble noted two "departures" from the 1977 Temporary Regulations' general rule that all U.S. persons should include the All E&P Amount in an Inbound Transaction. Because of administrative concerns, the 1991 Proposed Regulations required full recognition of gain (but not loss) for small shareholders,

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[36] *Id.* at 41995.

[37] *Id*. at 41996.

[38] Prop. Treas. Reg. § 1.367(b)-3(b)(1) (1991). In their article, Gary Scanlon and Elena Madaj articulate the difference between a U.S. Shareholder and a section 1248 Shareholder as follows:

> While there is significant overlap between persons that are U.S. shareholders and persons that are 1248 shareholders, these terms are not co-terminus. For starters, status as a U.S. shareholder is determined by reference to vote *or* value, whereas 1248 shareholder status is determined by reference solely to voting power. In addition, while a U.S. shareholder is subject to subpart F only with respect to a foreign corporation that is a CFC, a U.S. shareholder of a foreign corporation that is not, and has never been a CFC, is still a U.S. shareholder within the meaning of Code Sec. 951(b), and thus subject to [Treas. Reg. § 1.367(b)-3]. In contrast, a U.S. person can be a 1248 shareholder only with respect to a foreign corporation that is, or has been, a CFC.

Scanlon & Madaj, *supra* note 9, at 268. Whether the scope of section 367 is or should be based on an application to U.S. Shareholders vs. section 1248 Shareholders can be debated, as this article will explore.

rather than an inclusion of an All E&P Amount.[39] Another departure from the general rule was the elimination of the implicit rule permitting taxpayers to elect taxable exchange treatment in *lieu* of compliance with the regulations.[40] The proposed regulations instead opted for an explicit election (a "Taxable Exchange Election") allowing a U.S. Shareholder to recognize gain (but not loss) with respect to its stock in the foreign acquired corporation (in lieu of including the All E&P Amount in gross income).[41] Where a U.S. Shareholder made such a Taxable Exchange Election, the domestic acquiring corporation was required to reduce the attributes of the foreign acquired corporation to which the domestic acquiring corporation would otherwise succeed to the extent the All E&P Amount exceeded the gain recognized.[42]

2. The Distortion Principle

Like its predecessors, the 1991 Proposed Regulations illustrate a concern with preserving the application of section 1248. In the preamble, Treasury noted this as part of a larger concern with distortions of income. The preamble to the 1991 Proposed Regulations explained the Distortion Principle as follows:

> Another objective of the regulations under section 367(b) is to prevent the occurrence of a material distortion in income. For this purpose, a material distortion in income includes a distortion relating to the source, character, amount or timing of any item, if such distortion may materially affect the United States tax liability of any person for any year. Thus, for example, the regulations generally operate to prevent the avoidance of provisions such as section 1248 (which requires inclusion of certain gain on the disposition of stock as a dividend). For this purpose, the concept of 'avoidance' includes a transaction that results in a material distortion in income even if such distortion was not a purpose of the transaction.[43]

As discussed below, this statement is important in light of what is and is not considered to be a "material distortion" under the proposed regulations.

C. 2000 Final Regulations

The 1991 Proposed Regulations were finalized in 2000 with substantial modifications "based [on] considerations of fairness, simplicity, and

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[39] 1991 Proposed Regulations, 56 Fed. Reg. 41993, 41997 (Aug. 26, 1991). The preamble does not explain what led Treasury and the IRS to abandon the nonrecognition approach for small shareholders taken in the Revenue Procedure Guidelines and the 1977 Temporary Regulations.
[40] *Id.* at 41996 ("[U]nder the new regulations the taxpayer never has the right to fail to comply with the regulations.").
[41] Prop. Treas. Reg. § 1.367(b)-3(b)(2)(iii)(A) (1991).
[42] *Id.*
[43] 1991 Proposed Regulations, 56 Fed. Reg. 41993, 41995 (Aug. 26, 1991).

administrability."[44] First, the 2000 Final Regulations did not adopt the Taxable Exchange Election with its attendant basis reduction, noting administration and fairness concerns as reasons for the rejection.[45] Second, the 2000 Final Regulations allow small shareholders to make an election to include their All E&P Amount, but only if the foreign acquired corporation furnishes such shareholders adequate information to compute that amount.[46]

The 2000 Final Regulations generally retained the 1991 Proposed Regulation definition of the All E&P Amount[47] and the requirement that all

[44] 2000 Final Regulations, 65 Fed. Reg. 3589, 3590 (Jan. 24, 2000).

[45] *Id.* at 3592. The preamble provided the following example highlighting the unfairness of the Taxable Exchange Election:

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

Id. The preamble provided various explanations as to why the All E&P Amount should be included, rather than an amount tied to a shareholder's gain, including the fact that the All E&P Amount reflected the corporate-level attributes (such as basis) of the foreign corporation and not merely shareholder-level attributes. *Id.* at 3590. At the same time that the 2000 Final Regulations were published, Treasury and the IRS also published proposed and temporary regulations extending the ability to make a Taxable Exchange Election for one year. T.D. 8863, 2000-1 C.B. 488.

[46] 2000 Final Regulations, 65 Fed. Reg. 3589, 3593 (Jan. 24, 2000). Treasury and the IRS rejected comments to the 1991 Proposed Regulations requesting an election that would permit a domestic acquiring corporation to elect to include small shareholders' All E&P Amounts. Apart from these changes, another less substantial change was the revision to the notice requirement under the 1991 Proposed Regulations: the 2000 Final Regulations narrowed its scope and required a notice only with respect to persons and transactions that may be subject to an inclusion under the 2000 Final Regulation.

[47] *Id.* at 3590. The 2000 Final Regulations did amend the definition to exclude amounts attributable to the holding period of non-U.S. persons, responding to the following concern:

> Section 1.367(b)-2 (d) of the 1991 proposed regulations generally defined "all earnings and profits amount" as the allocable share of net positive earnings and profits accrued by a foreign corporation during a shareholder's holding period. The 1991 proposed regulations provided that the all earnings and profits amount is determined according to the attribution principles of section 1248. Because the section 1248 attribution rules incorporate the section 1223 holding period rules, commentators were concerned that the definition of all earnings and profits amount inappropriately included earnings and profits attributable to the holding period of non-U.S. persons by virtue of the rules of section 1223(2).

Id. at 3591.

exchanging U.S. Shareholders[48] (subject to a new de minimis exception applicable to small shareholders),[49] include in their gross income such amount in Inbound Transactions. In the preamble, Treasury acknowledged the commentators' criticism of the scope of the All E&P Amount,[50] but defended its decision to retain the broad definition, arguing a definition tied to a shareholder's section 1248 Amount "too narrowly construes the role of section 367(b) by focusing on potential shareholder-level consequences without adequately considering the section 367(b) policy of determining the appropriate carryover of corporate-level attributes in inbound nonrecognition transactions."[51]

As with its predecessors with respect to Inbound Transactions, the 2000 Final Regulations were principally concerned with the carryover of E&P and basis of assets from foreign to domestic corporations, which Treasury and the IRS saw as having interrelated shareholder-level and corporate-level components. The preamble to the regulations articulates this concern as follows:

> The section 367(b) regulations have historically focused on the carryover of earnings and profits and bases of assets, simultaneously addressing the shareholder and corporate level concerns by accounting for any necessary adjustments through an income inclusion by the U.S. shareholders of the foreign acquired corporation (and without limiting the extent to which the domestic acquiring corporation succeeds to the attributes). The 1991 proposed regulations required a U.S. shareholder of the foreign acquired corporation (or, in certain cases, a foreign subsidiary of the U.S. shareholder) to currently include in income the allocable portion of the foreign acquired corporation's earnings and profits accumulated during the U.S. shareholder's holding period (all earnings and profits amount). The requirement to include in income the all earnings and profits amount results in the taxation of previously unrepatriated earnings accumulated during a U.S. shareholder's (direct or indirect) holding period. This income inclusion prevents the conversion of a deferral of tax into a forgiveness of tax and generally ensures that the section 381 carryover basis reflects an after-tax amount. However, the all earnings and profits amount inclusion does not consider tax attributes that accrue during a non-U.S. person's holding period.[52]

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[48] However, "in order to provide greater consistency among its various ownership thresholds," the 2000 Final Regulations did revise the regulations "so that § 1.367(b)-3(b) applies to a foreign corporation with respect to which there is, in general, a 10 percent U.S. shareholder." *Id*. at 3592.
[49] Treas. Reg. § 1.367(b)-3(c)(4) (2000).
[50] Commentators argued that the All E&P Amount should be limited to the amount that a shareholder would include in income as a deemed dividend under section 1248. 2000 Final Regulations, 65 Fed. Reg. 3589, 3590 (Jan. 24, 2000).
[51] *Id*.
[52] *Id*.

Regulations finalized in 2006 further modified the rules relating to the carryover of E&P and foreign tax credits in Inbound Transactions, but the framework has largely stayed the same.[53]

III. RE-EXAMINING THE SCOPE OF THE INBOUND ASSET REORGANIZATION REGULATIONS: WERE THEY TOO BROAD?

One way to fully understand the underlying principles that informed the section 367(b) regulations, beyond reading the preambles cited above, is to go back to Charles Kingson's writings about them, given that Kingson served as deputy international tax counsel in the U.S. Treasury Department during the Carter administration and wrote the initial regulations under section 367.[54] Perhaps the most accessible of Kingson's writings are his 1979 Tax Law Review article,[55] after the original 1977 Temporary Regulations were issued, and an article he published in Tax Notes in 2004,[56] after the current 2000 Final Regulations were issued. In both articles, Kingson begins by acknowledging that the statutory standard for applying section 367(b) is "tax avoidance," defining avoidance, for this purpose, as being able to do indirectly what cannot be done directly.[57] Kingson stated that, with respect to Inbound Asset Reorganizations, section 367(b) deals with *both shareholder* and *corporate level* tax avoidance. He believed shareholder level avoidance had to do with preserving or triggering the section 1248 Amount and emphasized that shareholder level avoidance is wholly separate from corporate level avoidance. To deal with corporate level avoidance, he stated that the section 367(b) regulations should result in a broader income inclusion than that required to prevent shareholder level avoidance because, as cited above, "a United States person obtains tax basis only for amounts which have been included in income."[58] He cited Professor Andrews' renowned article on E&P for that principle[59] and posited that because an Inbound Asset Reorganization results in basis to a U.S. corporation, the amount of income giving rise to that basis should be taxed. After all, had the income been earned directly by the U.S. person, it would have been subject to U.S. tax. Kingson then explained, however, that not all such earnings should be taxed: "[t]he inclusion is limited to the earnings accumulated while the shareholder held stock in the transferor foreign corporation since … earnings accumulated prior to its participation economically represent capital."[60] In other

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53 71 Fed. Reg. 44887 (Aug. 8, 2006).

54 *In memoriam: Charles Kingson (1938-2019)*, NYU LAW NEWS (Mar. 18, 2019) https://www.law.nyu.edu/news/Charles-Kingson-in-memoriam-Graduate-Tax-Program-international [https://perma.cc/8SWJ-EWRR].

55 Kingson, *supra* note 15.

56 *See* Charles I. Kingson, *Seven Lessons on Section 367*, 105 TAX NOTES FED. (TA) 1015 (Sept. 13, 2004).

57 Kingson, *supra* note 15, at 28-33. He analogized the standard as the negative use of the affirmative "tax avoidance" standard in section 269 as applied in the *Cromwell* case. *See also Cromwell Corp. v. Comm'r*, 43 T.C. 313, 322 (1964).

58 Kingson, *supra* note 15, at 27.

59 *See* William D. Andrews, *"Out of Its Earnings and Profits": Some Reflections on the Taxation of Dividends*, 69 HARV. L. REV. 1403, 1408 (1956).

60 Kingson, *supra* note 15, at 28.

words, since capital as well as earnings gives rise to basis in assets, only earnings tied to current shareholders need be taxed. He went on to say that, in the context of section 367(b) and foreign corporations, the existence of avoidance at the corporate level is "cloud[ed]" by the fact that in an inbound section 361 transaction, section 367(b) can only apply at the shareholder level and not at the corporate level,[61] and that in a section 332 Inbound Liquidation the foreign corporation disappears.

This last point was not emphasized in his writing but is of crucial importance to understanding the regulations. The expansion of shareholder taxation in Inbound Asset Reorganizations, beyond dealing with shareholder section 1248 Amounts—to tax the All E&P Amount rather than the section 1248 Amount of section 1248 Shareholders and to tax other U.S. taxpayers who are not U.S. Shareholders—serves as a proxy for the tax that should have been imposed at the corporate level but could not be because of the statutory limitations on the scope of section 367(b). At various times the regulation writers considered other proxies for imposing corporate level tax, including a downward adjustment to the basis of the assets inbounded in an Inbound Asset Reorganization to the extent All E&P was not taxed at the shareholder level. Ultimately, as described above, that "fix" was rejected, not because it was inappropriate in theory, but because as a practical matter it would unfairly affect corporate level results with respect to all shareholders rather than just historical U.S. Shareholders.

The above thinking has led to a regime that imposes tax at the shareholder level to deal with perceived corporate level avoidance. To many observers, over time the historical rationale for taxing shareholders became obscured. But the end result is that relatively small shareholders in a foreign corporation are taxed in an otherwise tax-free Inbound Asset Reorganization because the foreign corporate earnings that are transferred to a U.S. corporate entity and give rise to basis were not subject to U.S. corporate tax as earned and could not be subjected to U.S. corporate tax at the time of the inbound transaction. It all results from the core premise, for which Kingson cites Professor Andrews' article, that when earnings and assets come into U.S. corporate tax solution, basis should be given only to the extent the earnings have been subject to tax.

That premise should be challenged. Indeed, based on a reading of Professor Andrews' article dealing with the intersection of corporate level and shareholder level taxation, we suspect he might have led the challenge.

IV. PROFESSOR ANDREWS' PERSPECTIVE ON THE INTERSECTION OF CORPORATE AND SHAREHOLDER LEVEL TAXATION

Professor Andrews' statement cited above on the synchronization of basis and E&P was made in the purely domestic context. It was focused on the situation where a corporation distributes property under section 311. He made the entirely logical point that corporate asset basis as an accounting matter equals the sum of

[61] Kingson believed that section 367(b) could not apply at the corporate level because its authority is to treat a foreign corporation as a corporation as opposed to a collection of assets; in an Inbound Asset Reorganization such treatment is not necessary for the transaction to be tax-free to the acquiring corporation—under section 1032 it is not taxable on the acquisition of assets generally, whether or not in corporate solution. *Id*. at 28-29.

contributed capital and retained earnings (assuming no leverage) so that if appreciated assets are distributed by a corporation, and (as the Code then provided) no gain is recognized at the corporate level, earnings and profits should be reduced only by asset basis.[62] The gain should not be recognized for E&P purposes if it is not subject to tax. The need to keep E&P and asset basis in synch compelled such results.

Professor Andrews' point was, of course, correct in the domestic context: wherever possible, asset basis should reflect contributed capital and retained earnings, which presumably have been subject to tax unless specifically exempted. But that point was just a piece of his much broader analysis of the role of E&P in our corporate tax as it had developed by the mid-1950s. Professor Andrews began that analysis by positing that the taxation of shareholders on corporate earnings, as reflected in part in E&P, is best understood by comparing two polar paradigms of the intersection of corporate and shareholder level taxation. The first paradigm is that shareholder taxation of distributions should be based on the amount of corporate retained earnings that are attributable to that shareholder's share ownership. The second paradigm is that shareholder taxation should be seen as unrelated to any corporate earnings and based solely on distributions received that are not in the nature of capital gains. He then tested the current law (as of 1955), including caselaw, to see which paradigm most closely fits. He pointed to a number of court cases where the taxation of a distribution to a shareholder was tied to the earnings of the corporation during the shareholder's ownership period—cases relating to pre-1913 earnings distributed after 1913, distributions of post-1913 earnings by corporations with pre-1913 losses, and distributions of prior year corporate earnings in a year (like 1917) when tax rates on dividends received by individuals were increased. He concluded that "the idea that earnings realized at the corporate level are the real subject of income tax on shareholders has had more than just a passing vogue and may serve to explain, if it does not justify, some of the applications of the earnings and profits requirement."[63]

He then pointed out the "number of ways in which our present taxation of shareholders does not simulate a delayed tax on corporate earnings."[64] He discussed cases involving the distribution of current earnings after years of prior deficits, pointing out that shareholders do not benefit from the losses by treating the distribution as a return of invested capital even though at the corporate level the losses are effectively so treated. He described that the proceeds from corporate liquidations are treated as capital gain rather than as a dividend to the extent of retained earnings. And he pointed out that shareholders selling their stock receive capital gain treatment even though the gain may reflect increases in retained earnings. He concluded that the taxation "of distribution[s], both in operation and in reason, is a good deal more than a mere postponement of tax on corporate earnings."[65] Based on that conclusion, Professor Andrews suggested that the concept of E&P, while useful in the context of exempting post-1913 distributions of pre-1914 corporate earnings, has outlived its usefulness and should be eliminated

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[62] Andrews, *supra* note 60, at 1408.
[63] *Id.* at 1417.
[64] *Id.* at 1418.
[65] *Id.* at 1425.

or substantially limited: the tax on shareholders mostly is, and should be, a separate tax on realized distributions and not a delayed tax on corporate earnings.

Professor Andrews did not discuss foreign corporations in his article. But there is no basis, in his analysis at least, for distinguishing the tax on realized distributions of foreign corporations from those of domestic corporations. And, while Professor Andrews never used the word, his discussion of a policy that treats the tax on dividends as a delayed tax on corporate earnings could have been described as a policy of "deferral." To him, a true delayed tax on corporate earnings would look a lot like what later became section 1248 as applied to foreign corporations that are or were CFCs. We suspect he would describe section 1248 as converting what otherwise is a separate tax on distributions by foreign companies into a delayed tax on the earnings of such companies at the shareholder level.

How does all this relate to section 367(b) and corporate level tax avoidance in an Inbound Asset Reorganization? Returning to first principles, the United States does not tax a foreign corporation on its earnings that are not FDAP or effectively connected to a U.S. trade or business. That is a sensible jurisdictional rule, at least assuming the corporation is not managed and controlled in the United States. Non-effectively connected and non-U.S.-source amounts are excluded from gross income; section 11(d) says section 11 applies "only as provided by section 882." Section 882(b) provides that gross income "includes only" amounts that are effectively connected with a U.S. trade or business or are otherwise derived from U.S. sources. That treatment is parallel to the treatment of tax-exempt bond interest under section 103, which provides that "gross income does not include" such interest. We often say we are "deferring" the tax on a foreign corporation's income until it is distributed, but jurisdictionally that is a misnomer. Even before the 2017 TCJA, the United States never taxed non-U.S. source, non-effectively connected foreign corporation income as such. Apart from Subpart F (and now GILTI), we only taxed dividends as they were received, which is consistent with a separate tax on shareholders rather than a delayed tax on corporate earnings, just as it is in the domestic corporate context. We did provide an appropriate foreign tax credit to corporate U.S. Shareholders but arguably that was justifiable as our way of managing cross-border double taxation of corporate earnings, as an alternative to a dividends-received deduction, not an indication of a system of deferred tax on corporate earnings. That is why, for example, we provided the credit for pre-acquisition earnings that are distributed to acquiring shareholders of a foreign corporation. Nonetheless, the notion that the U.S. tax on the income of a foreign corporation generally should ultimately be imposed but is "deferred" has influenced our international tax policy for over 60 years.

Given the paradigm of separate shareholder taxation posed by Professor Andrews as a general matter, we would argue we only really adopted the paradigm that the tax on a shareholder of a foreign corporation is a deferred tax on corporate earnings with the enactment of Subpart F and section 1248 (and its expansion with GILTI), and the application of that paradigm is limited to section 1248 Shareholders and U.S. Shareholders. If a foreign company liquidates under section 331, we treat the income as capital gain to the shareholder apart from section 1248. If a U.S. company acquires a foreign corporation in a taxable transaction and subsequently liquidates it, we do not tax the foreign corporation's pre-acquisition earnings. Even if the U.S. corporation acquires the to-be-liquidated foreign corporation in a tax-free reorganization transaction, we do not tax the pre-acquisition earnings where the corporation was acquired from shareholders who are not subject to U.S. tax. In these liquidation cases, we appropriately exempt the foreign corporation's earnings from U.S. tax because, other than under sections 881 and 882, as a jurisdictional matter, we do not treat pre-acquisition income of a foreign corporation as ours to tax. The corporate tax for a non-CFC foreign corporation is properly viewed as separate from the shareholder tax, just as Professor Andrews viewed it for a domestic corporation.

If the tax on dividends is separate from the tax on corporate earnings where section 1248 Shareholders and U.S. Shareholders of CFCs are not involved, why should migrating a foreign corporation's retained earnings—when they are not previously taxed E&P ("PTEP") or section 1248 Amounts—to its U.S. acquiror in an Inbound Asset Reorganization be viewed as tax avoidance? Kingson's explanation was that it is corporate level avoidance to grant an inbounding company asset basis when its earnings have not been taxed. But we suspect even he would have granted that basis derived from tax exempt income should be recognized. While we could not find a discussion in Kingson's writings, Professor Andrews was clear that exempt income at the corporate level creates corporate earnings and asset basis. Moreover, in his 1979 article, Kingson acknowledged that the migration of the E&P of a Puerto Rican company liquidating into a U.S. company would not give rise to section 367(b) tax avoidance because had it conducted itself as a U.S. corporation its earnings would have been exempt.[66] The granting of inbound asset basis is only "tax avoidance" if the earnings that gave rise to that basis *should have been subject to U.S. tax in the first place*. If they are properly exempt from U.S. tax, no tax avoidance results from the resulting basis. Kingson's deferral paradigm makes sense in a world of CFCs and section 1248 Shareholders; we would argue it does not make sense beyond that world.[67]

The preambles to the 1977 Temporary Regulations and the 1991 Proposed Regulations both posited that the regulations attempted to balance the desire for taxing repatriations that would otherwise result in avoidance with the need to minimize distortions.[68] But both adopted Kingson's framework that there was corporate level avoidance (dealt with in the § 7.367(b)-3 regulation) separate from any shareholder level avoidance (dealt with in the § 7.367(b)-7 regulation) and that, since there is no authority to tax the inbounded earnings under section 367(b) directly, the earnings should be taxed to its shareholders or, if feasible, asset basis should be reduced. But if the premise that non-CFC foreign corporate earnings should be subject to U.S. tax before assets can have basis is wrong because the pre-transaction earnings are exempt because they are not ours to tax, we need not worry about the magnitude of asset basis when non-CFC corporations move inbound—

[66] *See* Kingson, *supra* note 15, at 31.

[67] In a post-*Loper Bright* world, we wonder whether taxpayers could challenge the regulations as exceeding the authority granted by Congress in situations where there arguably is no "avoidance of Federal income taxes." *See Loper Bright Enters. v. Raimondo*, 603 U.S. 369 (2024) (overruling *Chevron*).

[68] *See supra* Part II.B. (overviewing the "Repatriation Principle" and "Distortion Principle").

any more than we worry about the basis of assets of individuals when they become U.S. resident taxpayers.

If this is correct, then the focus of section 367(b) with respect to corporate level avoidance in Inbound Asset Reorganizations should be preserving or collecting the section 1248 Amount.[69] Requiring shareholders to include the All E&P Amount instead of the section 1248 Amount for the acquired foreign corporation and requiring gain recognition by non-section 1248 Shareholders in lieu of that inclusion becomes a distortion rather than a way of preventing avoidance.

Indeed, as a policy matter, one could go further and say that our current rules create an even greater distortion in an Inbound Asset Reorganization because, while section 362 steps down the basis of any net loss assets of the foreign corporation, nothing steps up the basis of assets with net built-in gains.[70] Arguably, unrealized asset gains that are attributable to periods before the foreign corporation is acquired should also be seen as not ours to tax. Many foreign jurisdictions take that view and provide inbound assets with a fair market value basis.[71] Moreover, our rules can result in double taxation because most jurisdictions (including the United States) generally trigger an exit tax on appreciated assets when a resident company liquidates, merges, or migrates to another jurisdiction.[72]

V. IMPACT OF 2017 TCJA ON INBOUND ASSET REORGANIZATION CORPORATE LEVEL TAX AVOIDANCE UNDER REG. § 1.367(b)-3

This review of past history spotlights an arguably fundamental error in assuming the paradigm of "deferral" with respect to the taxation of shareholders on foreign corporation earnings but not with respect to domestic corporation earnings. The 2017 TCJA largely eliminated the deferral paradigm with the enactment of section 245A. That provision, of course, effectively exempts dividends received by corporate U.S. Shareholders in a foreign corporation to the extent of the foreign corporation's "undistributed foreign earnings" unless the dividend is a "hybrid dividend" or unless the shareholder holds its foreign corporation stock for less than one year. Assuming no "hybrid dividend" and a one-year holding period, any

[69] The focus of section 367(b) with respect to shareholder level avoidance in Inbound Asset Reorganizations will be discussed later. *See infra* Part VI.

[70] Note, however, that where section 362(e)(1) applies and inbounded property has an aggregate built-in-loss, the inbounding corporation steps down the basis of the built-in-loss assets and steps up the basis of its built-in-gain assets. *See* I.R.C. § 362(e)(1).

[71] The U.S. does allow foreign individuals coming into the U.S. tax net to engage in self-help transactions that step up asset basis prior to domestication through a check-the-box election. For instance, pursuant to Treas. Reg. § 301.7701-3(g)(1)(iv), such foreign individual would be treated as contributing all of the assets and liabilities of a disregarded entity to a corporation in exchange for stock of the corporation. If the election is effective on the day of the domestication, under Reg. § 301.7701-3(g)(3), the deemed contribution would be treated as occurring immediately before the close of the day before the individual comes into the U.S. tax net, and so, the individual would have a fair market value basis in such inbounded assets. *See* I.R.S. Chief Counsel Memorandum, AM 2021-002 (April 2, 2021).

[72] As a practical matter, the prevalence of these foreign exit taxes means that foreign companies consider an Inbound Asset Reorganization only if they are (or can be restructured to be) holding companies resident in jurisdictions that exempt gain on the sale of subsidiary stock.

distribution of a foreign corporation out of its earnings and profits is not taxed to a corporate U.S. Shareholder as long as the E&P did not originate from U.S. effectively connected income or from a dividend paid by an 80%-owned U.S. corporation ("U.S.-sourced undistributed earnings"). This fundamental shift in tax policy requires us to rethink our notions of both corporate level avoidance and shareholder level avoidance; it provides an opportunity to correct the arguable mistakes of the past.

We do not think that even Kingson would have argued that an Inbound Asset Reorganization should trigger U.S. tax on the undistributed foreign-source earnings of a foreign corporation after the enactment of section 245A notwithstanding his avoidance principle (i.e., avoidance is doing indirectly what could not be done directly).[73] Thus, even if the arguments above about the mistakes of our prior deferral policy are not accepted, it is clear there can be no corporate level avoidance in an Inbound Asset Reorganization where all of the earnings of the foreign corporation are undistributed foreign earnings under section 245A, no hybrid dividend issue exists and the one-year holding period is met. In that circumstance the concern of the section 367(b) regulations should be entirely focused on shareholder level avoidance.

That leaves questions about whether and how the exclusions from section 245A should affect the treatment of Inbound Asset Reorganizations. First, should corporate level avoidance be an issue if the foreign corporation does have U.S.-source undistributed earnings? We would argue it should not to the extent the foreign corporation is not a CFC. These undistributed earnings by definition have already been subject to U.S. tax. In most cases they will be dividends from U.S. subsidiaries of the foreign corporation, which in addition to being subject to U.S. corporate tax could well have been subject to a U.S. withholding tax. Similarly, effectively connected earnings have been subject to U.S. tax and, potentially, branch profits tax.[74] Section 245A excludes them presumably to avoid an advantage to a U.S. corporation owning less than 80% of the stock of another U.S. corporation by holding those shares through a foreign corporation in circumstances where the dividend was not subject to Subpart F inclusion. But it would be an unusual case indeed if the foreign corporation utilized to hold the stock were not a CFC, making the abuse to which the section 245A limitation applied essentially irrelevant where non-CFC foreign companies are involved. And the practical difficulties of determining the historic E&P of a foreign multinational and tracking which portion is attributable to earnings other than undistributed foreign earnings would seem to accomplish little of value other than yet more accounting firm revenues. Including the section 1248 Amount at the shareholder level in an Inbound Asset Reorganization (which would trigger the section 245A deduction to the extent applicable) would thus seem to be a sufficient deterrent to any real concerns regarding U.S.-source undistributed earnings.[75]

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[73] Admittedly, taking the argument to its logical conclusion, even after the enactment of section 245A, Kingson may have argued that if the foreign corporation had always been a U.S. corporation, it would have been subject to U.S. tax.

[74] I.R.C. § 884.

[75] Admittedly, this provides a benefit to Inbound Asset Reorganizations when compared to Inbound Stock Reorganizations, but given the practical difficulty of tracking historical domestic source

Hybrid dividends, though rare in today's post-BEPS world, do need to be dealt with, but also are only relevant in the context of foreign corporations that are CFCs. If a foreign corporation that is acquired in an Inbound Asset Reorganization is a CFC and has a U.S. Shareholder with a hybrid dividend account with respect to its stock, that account should be triggered to that shareholder. If the account relates to a lower-tier CFC, the account need not be triggered because the Inbound Asset Reorganization should not affect subsequent Subpart F or direct income inclusions if the lower-tier CFC pays a dividend in the future.

That leaves the section 246 one-year holding period to be dealt with. The assumed rationale for this limitation is to prevent dividend stripping transactions and other midco-type planning opportunities that could arise from temporary ownership of foreign corporation stock. An easy path to prevent such planning in the Inbound Asset Reorganization context would be to require that a substantial portion of the assets acquired in the transaction be held for one year or more in order to avoid current taxation of the foreign corporation's E&P.[76]

In sum, any corporate level avoidance in an Inbound Asset Reorganization can be more than adequately dealt with through regulations that trigger an inclusion to a section 1248 Shareholder of the section 1248 Amount and to a U.S. Shareholder of a CFC of the hybrid dividend account for the inbounding CFC with respect to such U.S. Shareholder's stock. Otherwise, there is no reason why corporate level tax avoidance should be seen as an issue and the foreign corporation's E&P (other than any PTEP) should migrate to the U.S. corporation, subject to the normal rules under section 381. There is no reason to expunge the E&P of the foreign company; given that our corporate tax is best viewed as a separate tax, its distributions out of earnings should be dividends whether or not the distributed amounts were earned before or after the transaction.[77]

VI. SHAREHOLDER LEVEL TAX AVOIDANCE ON INBOUND ASSET AND STOCK REORGANIZATIONS

The above analysis leads to the conclusion that, to prevent corporate level tax avoidance in an Inbound Asset Reorganization, the section 1248 Shareholders should generally be taxed on their section 1248 Amounts and U.S. Shareholders on any amount in their hybrid dividend accounts. But what about shareholder level avoidance? Under the current Reg. § 1.367(b)-3, the required inclusion of the All

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earnings of foreign corporations that are not CFCs, it is difficult to see this benefit as avoidance. Moreover, it seems that, when adopted, regulations under section 245A (which give the Secretary very broad authority) should provide a generally applicable practical limit on the need to track the historical U.S. source E&P in the case of a section 245A distribution by a foreign corporation that has never been a CFC. Without such a limit, the statute is arguably unadministrable for U.S. corporations acquiring interests in such foreign corporations.

[76] If necessary, taxpayers could be required to sign an agreement to file an amended return reflecting taxation of that E&P where a substantial portion of the foreign corporation assets are not retained for the twelve-month period.

[77] In conformity with the section 362 imported loss rule, the regulations could limit any imported net operating loss ("NOL"). Technically, however, the only NOL that could be imported would be one arising from effectively connected gross income, so there is a strong argument for letting section 381 apply as it would in a transaction between two domestic corporations.

E&P Amount and the triggering of gain eliminate any need to consider further any shareholder avoidance, so the regulations are silent. In that context, it is helpful to review the history of the regulations' treatment of section 1248 Shareholders and other shareholders in Inbound Stock Reorganizations (i.e., reorganizations under section 368(a)(1)(B) or (a)(2)(E)) where shareholder level avoidance does need to be separately considered.

The 1977 Temporary Regulations recognized a potential for shareholder level tax avoidance when a U.S. Shareholder of a CFC exchanges stock in the CFC for stock in a domestic corporation. Thus, the regulation (Reg. § 7.367(b)-7) required an inclusion of the section 1248 Amount by the exchanging section 1248 Shareholder, in a manner similar to the inclusion had the shares been exchanged for stock in a foreign corporation that was not a CFC or with respect to which the exchanging section 1248 Shareholder was not a section 1248 Shareholder. That provision thus triggered the section 1248(c)(2) amount of lower-tier foreign corporations for a section 1248 Shareholder. The 1991 Proposed Regulations and the 2000 Final Regulations took a different approach, concluding that the provision, as applied to an exchange for domestic corporation stock, was unnecessary because, though not explicitly stated, the acquiring corporation would inherit the section 1248 Amount of the exchanging section 1248 Shareholder. Even then, it is not clear this change in direction was justified, for two reasons. First, the treatment to individual section 1248 Shareholders exchanging stock in a foreign corporation differed substantially from the treatment of foreign corporate distributions to acquiring domestic corporations eligible for the foreign tax credit. Second, for corporate shareholders exchanging stock in a foreign corporation, a section 1248 inclusion can often be advantageous due to the accompanying foreign tax credit and basis step-up—benefits that, absent a recognition event, pass on to the acquiring corporation.[78] In today's world, the 2000 Final Regulations are perhaps even more questionable given the section 245A deduction and basis step up for corporate shareholders. Nonetheless, the regulation writers were apparently of the view that preserving the section 1248 Amount was sufficient to satisfy the avoidance standard of section 367(b) even though that result advantaged some shareholders and disadvantaged others.

Of note is that, even from the perspective of the 1977 Temporary Regulations, the regulations drafters did not see other taxpayer favorable results from the transaction as a distortion that constituted avoidance. For example, the fact that after the exchange a corporate holder of stock was eligible for a dividends-received deduction on any dividend paid by the acquiring domestic corporation was not viewed as an avoidance. Subsequent to the temporary and ultimately the 2000 Final Regulations, Congress in 2002 enacted section 1(h)(11), providing a favorable tax rate on dividends from domestic corporations and certain foreign corporations. No one suggested then, or to our knowledge since then, that an exchange of stock in a foreign corporation not eligible for the favorable rate for stock of a domestic corporation creates an avoidance that should be addressed. Indeed, both provisions are evidence that Congress views the shareholder tax on

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[78] The section 1248 inclusion allows corporate U.S. Shareholders an indirect foreign tax credit for a proportionate amount of the CFC's creditable foreign taxes deemed paid. *See* I.R.C. § 960; *see also* I.R.C. § 902 prior to its repeal in the TCJA.

dividends as a separate tax, not a delayed tax on corporate earnings; in both cases shareholders are eligible for favorable treatment for all eligible dividends received in a year, independent of when the amounts were earned and when the relevant shareholder acquired the corporate stock.

Given this history of what constitutes shareholder level avoidance in Inbound Stock Reorganizations, triggering the section 1248 Amount for section 1248 Shareholders in Inbound Asset Reorganizations should be sufficient to deal with any section 367(b) shareholder level avoidance concern. But it does lead to the question of whether the treatment of Inbound Stock Reorganizations should be changed if the shareholder rules are changed as described above for Inbound Asset Reorganizations. The historical view on Inbound Stock Reorganizations was no doubt influenced by the fact that after a stock acquisition of a foreign corporation the pre-acquisition E&P of the acquired corporation would be subject to U.S. tax if distributed to the acquiring U.S. corporation and the U.S. corporation would inherit the exchanging section 1248 Shareholder's section 1248 Amount. But, after the enactment of section 245A, both distributed earnings and section 1248 Amounts will likely be substantially exempt. Thus, avoidance arguably can occur with respect to the section 1248 Amounts of exchanging individual section 1248 Shareholders. Whether that is a concern or not, we leave to others to ponder; suffice it to say here that if the regulations are changed to pick up the section 1248 Amount of section 1248 Shareholders in an Inbound Asset Reorganization, it is worth considering the same result in Inbound Stock Reorganizations.

In any case, that consideration should not extend beyond the treatment of section 1248 Shareholders and U.S. Shareholders holding hybrid dividend accounts in a CFC. The treatment of distributions to other shareholders in CFCs and to any shareholder in a non-CFC differs after both an Inbound Asset Reorganization and an Inbound Stock Reorganization in ways that can be favorable or unfavorable, including corporate eligibility for the dividends-received deduction and the favorable dividend tax rate for individuals. In the end, these detriments and benefits should just be seen as attributes of the separate shareholder tax that differ based on whether the distributing corporation is foreign or domestic.

If this is correct, then the regulatory solution of triggering the section 1248 Amount for section 1248 Shareholders and any hybrid dividend account for U.S. Shareholders in a CFC should be sufficient to prevent tax avoidance at both the corporate and shareholder levels. Eligible corporate section 1248 Shareholders will receive the section 245A deduction for the foreign-sourced portion of that inclusion subject to triggering any hybrid dividend account. Individual section 1248 Shareholders will be fully taxed but at dividend rates reflecting the status of the acquired foreign corporation. All such shareholders will receive a basis step-up in the stock of the acquiring U.S. corporation. And the acquiring U.S. corporation will inherit the foreign corporation's E&P under the normal rules of section 381.

An important benefit of this proposal is its intersection with section 1059. The current regulations' inclusion of the All E&P Amount can lead to situations where a tax-favored inclusion given the section 245A deduction can generate a basis step up that results in a built-in capital loss in the stock of the acquiring U.S. corporation received in the exchange. That creates potential avoidance that arguably should be dealt with in the section 367(b) regulations. But by including only the section 1248 Amount, which is limited to any built-in gain, the proposal presented here will not create a built-in capital loss to the section 1248 Shareholder. A range of concerns and complexities can be avoided.

One caveat to the above proposal: the section 1248 Amount includes the E&P of lower-tier CFCs as well as the foreign acquired corporation. That makes sense where an exchanging U.S. Shareholder receives stock in a U.S. corporation it only partially owns. But where that exchanging shareholder is, for example, part of the same U.S. consolidated group as the acquiring U.S. corporation, the need to trigger the section 1248 Amount with respect to lower-tier CFCs is absent. In that circumstance the inclusion triggered by the Inbound Asset Reorganization could exclude the section 1248 Amount of the lower-tier CFCs otherwise included under section 1248(c)(2). There may be other circumstances worth considering where that lower-tier E&P amount can be sufficiently preserved to allow a more limited inclusion.

VII. TREATMENT OF INBOUND LIQUIDATIONS

If accepted, the above framework provides clear guidance for the treatment of Inbound Liquidations. The section 1248 Shareholder in the section 332 Inbound Liquidation should pick up its section 1248 Amount attributable to the liquidating foreign corporation, but not any amount under section 1248(c)(2) attributable to lower-tier foreign corporations as long as its interest in such lower-tier corporations preserves that section 1248 Amount. That shareholder should be eligible for the section 245A deduction without regard to its holding period of the foreign corporation as long as after the liquidation it holds a substantial portion of the foreign corporation's assets for one year or more. Like in Inbound Asset Reorganizations, the pre-liquidation E&P of the liquidating foreign corporation should migrate to the shareholder domestic corporation.

VIII. CONCLUSION

This article lays out what arguably is a fundamental rethinking of the relationship between U.S. persons and the foreign corporations in which they own stock. It takes the position that the earnings of a foreign corporation should be treated as exempt income because they are not ours to tax except with respect to section 1248 Shareholders and U.S. shareholders of CFCs and then only to the extent of the Subpart F, GILTI and section 1248 Amounts attributable to their stock and their hybrid dividend account. This position is based on the premise that our income tax on corporate earnings is best viewed as a separate tax from the shareholder income tax on distributions from corporations, and that, beyond sections 881 and 882, we do not and should not assert taxing jurisdiction over the corporate level earnings of a foreign corporation that is not a CFC. We do, of course, assert jurisdiction over distributions to U.S. taxpayers' foreign corporations that are not CFCs, and our methods of taxing them vary from that of distributions from domestic corporations for both individual and corporate shareholders. But, as applied to shareholders other than section 1248 Shareholders and U.S. Shareholders in CFCs, those methods are best viewed as variations in the separate tax on distributions, not as any kind of proxy for taxing underlying foreign corporate earnings. The consequence of this view is that the section 367(b) regulations should focus on triggering or maintaining the section 1248 and hybrid dividend amounts with regard to specific section 1248 Shareholders and U.S. Shareholders, not on taxing other U.S. persons on any foreign corporate earnings that might be attributed to them in a "delayed tax" or "deferral" paradigm.

Fortunately, the enactment of section 245A as it applies to corporate shareholders and the equalization for individual shareholders of tax rates on dividends and capital gains have potentially made embracing the recommendations of this article possible even without agreement on its premise. The "tax avoidance" stakes in any inbound reorganization are now minimal. As a result, revising the regulations dealing with inbound transactions in a manner that ends the acceleration of U.S. tax on U.S. persons holding foreign corporation stock, beyond the section 1248 Amount and any hybrid dividend amounts of relevant shareholders, would seem to be a proposal most policymakers can support. In the end, understanding that the fundamental premises of the existing regulations may well have been a mistake should just make it easier to achieve that support.