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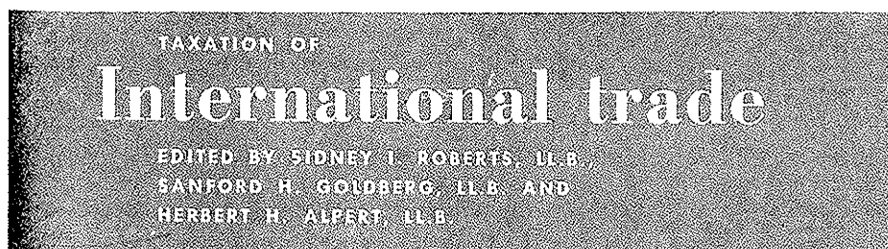

Tax Reform Act toughens foreign transfer provisions of 1491 and liberalizes 367

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Among the most significant changes made by the 1976 Tax Reform Act are the increased excise tax on the transfer of property to foreign persons to avoid Federal income tax (Section 1491) and the enactment of new procedural rules regarding the transfer of property to foreign corporations (Section 367). The authors examine the affect of the 1976 Act on these sectors of international taxation.

PRIOR TO THE TAX REFORM ACT *of* 1976 (the "Act"), one could sense a growing concern among practitioners that the tax law, because its complexities and uncertainties, was nearing the breaking point.[1] The Act, with its own complexities and uncertainties may have brought us closer to that point. In some instancse new concepts have been introduced; in other instances, much of the old jargon has been retained—only the meanings have been changed. Perhaps Congress has recognized the problem by including in Act, Section 507 a direction to the Joint Committee on Taxation to make an "investigation with respect to simplification . . . of the tax laws" and to submit a report to Congress by July 1, 1977.[2]

While public attention has focused primarily on the provisions of the Act dealing with tax shelters, many significant changes have been made in the taxation of international transactions particularly transfers to and from foreign persons which have the potential for tax avoidance.

Transfers to avoid taxes

Sections 1491-1494 have generally been viewed as complementary to Section 367, much in the same manner as a "use tax" under local taxation complements the "sales tax." Section 367 is intended to deal with certain transfers involving foreign corporations on which gain is realized but not recognized and where the purpose of the transaction may be tax avoidance. Similarly, Sections 1491-1494 are intended to deal with situations involving transfers to foreign persons for tax avoidance purposes. However, the types of transfers with which Congress has been primarily concerned are those in which the transferor does not receive property in exchange. These transfers do not neatly fit within traditional concepts of realization.[3] Accordingly, Section 1491 imposes a flat rate "excise" tax on the transfer (rather than "income" tax); however, the amount subject to tax is measured by the excess of the value of the transferred property over the transferor's adjusted basis therefor, *i.e.,* the untaxed gain inherent in the property.

As originally was the case of Section 367, the 1491 tax can be avoided (pursuant to Section 1492(2)), if *prior to* the transfer, the taxpayer can satisfy the IRS that the transfer is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. However, unlike Section 367 (prior to the amendment by the 1976 Act) the taxpayer also has a remedy of sorts after the transfer. While the tax must be paid immediately upon making a transfer without a ruling,[4] under Section 1494 (b), the tax can be abated or refunded if, after the transfer, the Service is satisfied that the transfer was not pursuant to a plan having as one of its principal purposes the avoidance of Federal income tax.

While the changes made by the Act[5] are relatively few in number, the Act has increased the scope of Section 1491, and it may be useful to quickly summarize the operation of this Code provision.[6]

The class of persons that can be subject to the 1491 tax continues to be limited to transferors who are either U. S. citizens or residents, domestic corporations or domestic partnerships or trusts which are not foreign trusts. Section 1491 has no application to a transfer by any person not in the class as described above.[7] Thus, it would not be applicable in the case of a transfer by an estate, apparently regardless of whether such an estate would be taxable as a resident for income tax purposes. Significantly, the omission of domestic estates from the class of transferors subject to the 1491 tax was only of marginal importance under prior law: except insofar as the stock of a "foreign personal holding company" was concerned (see Section 1014(b)(5)), appreciated assets transferred by death generally obtained a step-up in basis (Section 1014 (a)). However, for decedents dying after 1976, the significance of the omission gains considerable importance by virtue of the new carryover basis provisions contained in Section 1023.

As under prior law, the class of transferees covered by Section 1491 remains limited only to foreign corporations,[8] foreign trusts and foreign partnerships; while the class of transferors and transferees described in Section 1491 remains unchanged, considerable changes have been made to the scope of Section 1491, to the rate of the tax imposed by Section 1491, and to the method of its computation. In addition, a new election has been provided under which a transferor may elect to recognize in full the potential gain on the transferred assets in lieu of payment of the tax imposed by Section 1491.

Perhaps the most significant change from prior law is that Section 1491 now covers transfers of all types of property. Under prior law, only transfers of stocks or securities were covered.

Section 1491, both before and after the Act, applies to transfers to corporations "as paid-in surplus or as a contribution to capital,"[9] and simply to "transfers" in other cases. Under prior law, confusion existed as to whether Section 1491 was applicable where the transferee was other than a corporation and there was no donative intent, *i.e.,* where there was a sale. The negative side of this argument drew some support from the treatment of transfers to corporations, as well as the amendment enacted in 1970 which added an exception for

transfers covered by Section 367(d) (added to the Code at the same time). The latter provided that certain contributions to the capital of a foreign corporation were to be treated for purposes of Chapter 1 (Section 1491 is not part of Chapter 1) as an exchange of property for stock of the corporation equal in value to the property transferred.[10] The obvious intention of the exception added to Section 1491 was to avoid having Section 1491 apply to transfers already subject to the income tax provisions.

Congress recognized the confusion under existing law, and was particularly disturbed about the prospect of "private" annuity transactions with, and installment sales to, foreign trusts escaping Section 1491. Congress, therefore, sought to clarify the law by indicating in the Committee Reports that the absence of donative intent was relevant only for purposes of obtaining a non-tax avoidance ruling under Section 1492.[11] In addition, Congress changed the method for computing the tax (as discussed later) in a manner which implies that Section 1491 is not restricted to transfers with donative intent. It is curious, however, that Congress was not particularly disturbed about such transactions being concluded with non-resident alien individuals; where individuals are the transferees of the property, the Section is still inapplicable.

Under prior law, the amount subject to tax under Section 1491 was the excess of the fair market value of the property transferred over its adjusted basis in the hands of the transferor. The Act has modified this by providing a reduction for the amount of gain recognized to the transferor "at the time of the transfer." The effect of the last clause is to preclude any reduction for gain which will not be taxable until a later date by reason of a nonrecognition provision, an installment election or other accounting method or otherwise, for example, where the purchase price is contingent upon an event which has not occurred at the time of the transfer. It is not clear what the "time of the transfer" will be in the case of a sale of several related properties which are delivered on different dates, with the purchase price paid upon the last delivery. At least where all the transfers take place in a single taxable year, one would hope that Regulations would provide that the time of the transfer, for this purpose, would not be until the end of the year. The case of property sold by a cash-basis taxpayer on short-term notes presents a more difficult problem on the language of the statute. This might even include the case where a check is received by the seller at the time of the transfer, but after banking hours. It is hoped that the Regulations will provide some rule of thumb by which gain recognized in the same taxable year in which the transfer takes place will be deemed to meet the statutory requirement. This, of course, would necessitate the granting of an extension to file the return and pay the tax (which otherwise shall "without assessment or notice and demand, be due and payable by the transferor at the time of the transfer") (Section 1494(a)). A similar extension may also be needed in view of the Section 1057 election, discussed below.

Despite the fact that there is obviously some relationship between the application of Section 1491 and the operation of the income tax provisions, it is clear that they are not identical. In *Rev. Rul.* 71-433, 1971-2 CB 325, it has been ruled that where both appreciated assets as well as depreciated assets have been transferred, a "netting" is not permitted. Thus, Section 1491 takes on at least some aspect of a penalty provision. In the same vein, the starting point in the computation of the tax is the "fair market value" of the property, which is not necessarily the same as the "amount realized," even where there has been a sale at arm's length. It is conceivable that even where the taxpayer has made a sale, the Service may argue that the seller did not bargain hard enough and that the "amount realized" was less than the fair market value.

The tax imposed by Section 1491 is at the flat rate of 35% (under prior law, it was 27½%). This is the maximum rate applicable to individuals' capital gains, and presumably represents "rough justice." In some cases, the capital gains tax which would have applied to the gain from a sale might be lower; in other cases, the property transferred may be "ordinary income" property which could have resulted in a greater rate being applicable if the property were sold.

Although every kind of transfer of property is now covered, Congress anticipates that a favorable ruling[12] would be issued in the case of ordinary business sales or exchanges involving, for example, an unrelated foreign trust or foreign partnership.[13] It is not clear why it was thought necessary that such a transfer be made subject to tax in the first place. Indeed, including ordinary commercial transactions within the sweep of Section 1491 will make it just that much more difficult for U. S. persons to conduct business with foreign persons who choose to operate as a foreign partnership at least where there is any question as to whether the U. S. person realized the full fair market value of the asset sold, and recognized the full amount of the gain at the time of the transfer. Moreover, under Reg. 1.1494-1(a), even if no tax is due, a return will have to be filed on the date the transfer is made.

New Section 1492(4), has provided an

[1] Roberts, Friedman, Ginsburg, Louthan, Lubick, Young and Zeitlin, "A Report on Complexity and the Income Tax," 27 *Tax L.R.* 325 (1972); See Eustice, "Tax Complexity and the Tax Practitioner," *Calif. CPA Quarterly* (September 1976).

[2] It appears that Congress may have overlooked Section 8022(2) (substantially unchanged since 1926) which provides that the Joint Committee is to: "investigate measures and methods for the simplification of . . . the income tax"; "publish from time to time, for public examination and analysis, proposed measures and methods for the simplification of such taxes"; and "'report, from time to time, to [Congress], the results of its investigations, together with such recommendations as it may deem advisable."

[3] The transferor in such cases "participated in no transaction in which gain could be attributed to him under existing law." H. Rep't. No. 708, 72d Cong. 1st Sess. (1932).

[4] Regs. 1.1494-1(a) and 1.1494-1(c). The statutory procedures generally applicable in the case of income taxes, including the requirement of "notice and demand" (Section 6303) prior to levy (Section 6331) and the restrictions on assessments and access to the Tax Court provided by Section 6213(a), are not available in the case of the excise tax imposed by Section 1491. See *Rev. Rul.* 72-29, 1972-1 CB 283. It is understood that in practice the Service will sometimes hold off an assessment under Section 1491 during the pendency of discussions relating to the merits of an abatement under Section 1494(b).

[5] The changes are effective to transfers occurring after October 2, 1975. Act, Section 1015(d).

[6] For an excellent detailed discussion of Sections 1491-1494 before the Act, most of which is still relevant, see Tillinghast, "Sections 1491-4: Much Ado About a Non-problem—Or is It? *Tax Forum No.* 330 (May 6, 1974). As it would be difficult to improve on Tillinghast's discussion, the discussion herein largely follows the outline of his paper.

[7] *Cf, Abegg*, 50 TC 145 (1968), *aff'd.* 429 F.2d 1209, (CA-2, 1970), *cert. den.*

[8] And only to transfers to a foreign corporation as paid in surplus or a contribution to capital.

[9] The Act now expressly exempts from Section 1491's coverage all transfers to which Section 367 applies. Section 1492(3).

[10] Section 367(d), renumbered by the Act in slightly modified form as Section 367(c)(2).

[11] H. Rep't. No. 94-658, 94th Cong., 1st Sess. 213-214 (1975). S. Rep't. No. 94-938, 94th Cong., 2d Sess. 223 (1975).

[12] Either under Section 1492(2) before the transfer or by an abatement under Section 1494(b).

[13] See S. Rep't. No. 94-938, *supra* note 11 at 223.

[14] S. Rep't No. 94-938, *supra* note 11 at 223 states that "normal rules will apply to increase the basis to the transferee by the amount of gain recognized." Section 1016 does not provide for any relevant adjustment so that the only "normal" rule applicable would appear to be Section 1012.

exception to 1491. The tax does not apply to a transfer for which an election has been made under Section 1057, which was also added by the Act. Under this Section, the taxpayer may elect for purposes of subtitle A to treat a transfer described in Section 1491 as a sale or exchange of property. In such case, the taxpayer will be required to recognize as gain the excess of the fair market value of the property over the taxpayer's adjusted basis therefor. While the statute literally does not require the gain to be recognized "at the time of the transfer," this can be implied from the context.

If an election is made, the basis of the property in the hands of the transferee is the fair market value. This would appear to follow from the fact that the transferor's election applies for purposes of the subtitle. Accordingly, the transferee apparently is treated as having purchased the property for purposes of Section 1012.[14] Similarly, where the transferee is a foreign trust, the Section 1057 election would appear to make the new grantor trust rules inapplicable to the transferred property (Section 679 (a)(2)(B)).

New Section 367

One of the areas of mystique which has received a good deal of attention over the last several years is Section 367. Prior to the Act, the statutory language which had been in the tax laws for over 40 years, remained relatively short and simple, at least by current standards. Basically, it involved the application, or rather non-application, of Sections 332, 351, 354, 355, 356 and 361 (relating to tax-free corporate organizations, reorganizations, and liquidations in which a foreign corporation was involved). In determining the extent to which gain was to be recognized on an exchange,[15] a foreign corporation was not to be considered a "'corporation" for purposes of applying these sections, unless it was established to the "satisfaction" of the Commissioner that the exchange was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. Moreover, with one relatively minor exception,[16] the Commissioner had to confirm his "satisfaction" *prior to* the exchange taking place. If the Commissioner refused to be "satisfied," the taxpayer did not have any effective remedy.

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Each of the sections enumerated above depends for its application on the existence of a "corporation"; the result of failure to obtain a 367 ruling, therefore was to make those sections inapplicable. Under the terms of the statute, this applied only in determining gain; it did not affect losses realized on an exchange, such losses being non-recognized whether or not the Commissioner issued a favorable ruling. However, in the absence of a favorable ruling, there was less certainty concerning other aspects of the transactions, *e.g.*, the basis of the stock or property received in the exchange by the respective parties, the application of Section 381 to various potential "carryover" items, and the application of Section 337 to certain sales.[17] The Service's position appears to have been that Section 367 could not be used as a shield by the taxpayer, *i.e.*, the Commissioner in his discretion could treat the various nonrecognition provisions as applying or not, presumably depending upon which produced the greatest revenue.[18] However, at least in those situations where the realization of gain could not create any U. S. tax liability, either directly by a party to the exchange, or indirectly as a result of the application of Subpart F,[19] the Commissioner ruled that Section 367 had no application.[20]

Like Section 367 itself, the Regulations under Section 367 have been relatively miniscule, merely outlining for the taxpayer how he may apply for a ruling. However, over the years, the Service developed its own criteria of when it would grant a favorable ruling. These criteria were published as "guidelines" in *Rev. Proc.* 68-23, 1968-1 CB 821, which has been supplemented on several occasions.[21] Under the guidelines, the issue of the taxpayer's tax avoidance motives still depends on all the circumstances, at least theoretically, but specific criteria are set forth under which the Service ordinarily will rule favorably but only under certain conditions. This has resulted in the term "toll charge" being added to tax jargon, the "toll charge" referring to the income which the taxpayer is required to include in his return in order to induce the Service to permit the transaction to be consummated as a tax-free exchange. This is not as absurd as it may seem at first blush. The Service would otherwise be placed in the impossible position of having to determine, in complex situations and on an all-or-none basis, whether a taxpayer is motivated by tax avoidance possibilities. By use of "toll charges" in those situations in which it is almost certain that substantial U. S. taxes will be avoided or at least deferred, the Service has been able to allow other potential taxable income (generally appreciation in capital and Section 1231 assets which likely will not be disposed of in the near future) to be deferred under the nonrecognition provisions otherwise applicable. Ignoring the fact that all practitioners have gripes with the Service some of the time, and some have gripes all of the time, the concept of the "guidelines," including the "toll charges," seems to have been well-accepted among the tax bar as a practical way to deal with a difficult problem.

Notwithstanding the long-established use of "toll charges" by the Service in issuing 367 rulings, it had not been entirely clear that they were authorized by the Code or otherwise received Congressional sanction.[22] This is no longer the case. Section 367 has been amended by the Act[22a] with the existing guidelines obviously forming the basis for the new provision. The general purpose of the changes is to provide for a formalization of these guidelines and thereby avoid the necessity for obtaining advance rulings except "in those types of transactions where the amount of tax, if any, which must be paid to protect against tax avoidance can only be determined by judging the specific facts of the case."[23] Thus, the concept of "toll charges" has been given Congressional blessing. Moreover, the new provisions seek to place some limit on the delay a taxpayer must suffer in those situations where a ruling is still required, and to afford the taxpayer some degree of judicial review of the Service's determination.[24]

Classes of transactions. The new provision, like the old one, is concerned only with exchanges described in Sections 332, 351, 354, 355, 356, 361. However,

these exchanges are now divided into two classes: (1) "outbound transfers"[25] ("where the statutory aim is to prevent the removal of appreciated assets or inventory from U. S. tax jurisdiction prior to their sale"), and (2) "other transfers" ("primarily" those transactions "where the statutory purpose in most cases is to preserve the taxation of accumulated profits of controlled foreign corporations").

An "outbound transfer" is one in which, "in connection with" an exchange described in one of the above enumerated sections, "there is a transfer of property . . . by a United States person to a foreign corporation."[26] This clearly would cover the liquidation of a U. S. subsidiary into a foreign parent; the transfer of assets by a U. S. person to a foreign corporation in a Section 351 exchange; an A, C or D reorganization where the acquired corporation is domestic and the acquiring corporation is foreign (even where the stock received pursuant to the reorganization is that of the foreign corporation's domestic parent corporation); and a B reorganization where the stock of a domestic corporation is acquired by a foreign corporation (again, even where the stock received in exchange is that of the acquiring corporation's domestic parent). The Committee Reports indicate that a transfer of assets from one domestic corporation to another domestic corporation in a C reorganization would be classified as an "outbound transfer" if the acquiring corporation is controlled by foreign persons who were not in control of the acquired corporation before the transaction.[26a] The basis for this conclusion is not readily apparent. It is difficult to see how the transaction described falls within the statutory language requiring a transfer of property to a foreign person. Moreover, except where the stock received in the exchange is that of a foreign parent of the acquiring corporation, whether the shareholders of the acquiring corporation are "corporations" does not appear to be relevant under the operative sections.[26b]

It would also appear that E and F reorganizations of a foreign corporation would *not* be included in "outbound transfers." The shareholders in such reorganizations would merely be transferring stock or securities of a party to the reorganization which is specifically excepted; the possible asset transfer in an F reorganization of a foreign corporation would not involve a transfer by a U. S. person.

"Other transfers" include any transfers made in connection with any of the enumerated exchanges and which are not "outbound transfers." These include a liquidation of a foreign subsidiary into its domestic or foreign parent; a transfer of assets from a foreign person to a foreign corporation in a Section 351 exchange; a C or D reorganization in which the assets of a foreign corporation are acquired by a domestic corporation or another foreign corporation; a B reorganization in which the stock in a foreign corporation is acquired by a domestic or a foreign corporation; an E reorganization, and presumably an F reorganization, of a foreign corporation.

Treatment of "other transfers." Commencing with 1978, the ruling procedure will be totally abandoned insofar as "other transfers" are concerned. Instead, this area is to be dealt with entirely by Regulation. The Treasury is given broad regulatory power which apparently is intended to upgrade the various existing "guidelines" insofar as they relate to "other transfers," into rules of law.[27]

In the case of any of the enumerated exchanges which does not involve an "outbound transfer," a foreign corporation will be considered a "corporation" except to the extent otherwise provided in the Regulations to be prescribed. These Regulations dealing with "other transfers" will obviously contain many of the rules presently embodied in the guidelines, including the "toll charges." However, it is clear that they will go even further. Congress in Section 367(b)(2) has specifically directed the Treasury to provide rules "dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person." These rules are to provide (1) the circumstances under which gain or dividends are to be taken into account currently and when they are to be deferred and taken into account at a later date by the shareholder or his successor; and (2) the extent to which adjustments are to be made to earnings and profits, basis of stock and securities, and basis of assets. It would appear that this authorization is broad enough for the Treasury to not only include the various conditions for which closing agreements have been used in the past,[28] but possibly even to rewrite Subchapter C as applied to a transaction in which a foreign person is involved. The statutory standard[29] is only that they be "necessary or appropriate to prevent the avoidance of Federal income taxes." According to the Committee Reports, the Regulations will not require any immediate tax liability to a U. S. person, either directly or under Subpart F, in the case of exchanges involving solely foreign corporations; but the Regulations will have to maintain the potential liability of the U. S. shareholder of a "controlled foreign corporation."[30] For example, the Committees apparently were concerned

[15] A 'distribution" described in Section 355 was, and still is, treated as an "exchange" for purposes of Section 367. Section 367(c)(1), formerly Section 367(c). Similarly, since 1970, the Code has provided that certain contributions to the capital of an 80% foreign corporation shall be treated for purposes of Chapter 1 (which includes Section 367) as an exchange of the contributed property for stock having an equal value. Section 367(c)(2), with slight modification, formerly Section 367(d).

[16] Sections 367(a)(2) and (b) (in effect prior to the enactment of the Act), relating to a mere change in form of a foreign corporation.

[17] In general, Section 337 is inapplicable to a liquidation to which Section 332 "applies." If the parent corporation realized a gain on liquidation and a 367 ruling was not obtained, would Section 332 "apply" to the liquidation? *Cf. Rev. Rul.* 76-90, IRB 1976-11, 9.

[18] *Rev. Rul.* 64-177, 1964-1 (Part 1) CB 141.

[19] Gain from an exchange of stock or securities is included in the definition of "Subpart F income." Sections 954(c)(1) and 553(a)(2).

[20] *Rev. Rul.* 64-158, 1964-1 (Part 1) CB 140.

[21] *Rev. Proc.* 75-29, 1975-1 CB 754; *Rev. Proc.* 73-5, 1973-1 CB 751; *Rev. Proc.* 74-36, 1974-2 CB 491; *Rev. Proc.* 69-19, 1969-2 CB 301.

[22] At least a number of the Judges of the Tax Court do not appear to be impressed by longstanding rules consciously adopted by Treasury to provide certainty in an area peculiarly crying for it. See the various opinions in *Larson*, 66 TC 159 (1976).

[22a] The changes effected by the Act are, with one transitional exception discussed *infra*, effective for transfers beginning after 10/9/75. Act, Section 1042(e).

[23] H. Rep't. No. 94-658, *supra* note 11 at 241; S. Rep't. No. 94-938, *supra* note 11 at 263.

[24] H. Rep't. No. 94-658, *supra* note 11 at 240-41; S. Rep't. No. 94-938, *supra* note 11 at 262-63.

[25] The term "outbound transfer" is not used in Section 367 itself, but rather in the Committee Reports. See H. Rep't. No. 94-658, *supra* note 11 at 242; S. Rep't. No. 94-938, *supra* note 11 at 265.

[26] "Property" for this purpose does not include "stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization." The term "party to the exchange" is defined in the Committee Reports only: "The term 'party to the exchange' as used in this provision includes a party to the reorganization (as defined in Section 368(b)) and the transferor and transferee in an exchange other than a reorganization." H. Rep't. No. 94-658, *supra* note 11 at 242; S. Rep't. No. 94-038, *supra* note 11 at 265.

[26a] H. Rep't. No. 94-658, *supra* note 11 at 243; S. Rep't. No. 94-938, *supra* note 11 at 265. The inclusion of this footnote seems unfortunate in light of both Committees' observation that U. S. taxpayers "should be able to determine the tax effects of the transaction from the statue and accompanying regulations . . ." H. Rep't. No. 94-658, *supra* note 11 at 241; S. Rep't. No. 94-938, *supra* note 11 at 263.

about a particular case involving the exchange of stock in a second tier foreign subsidiary for the stock in a "similar" foreign corporation. It is the intent that the usual "toll charge" measured by the accumulated earnings and profits would be "deferred." The suggested method for deferral would be to designate the stock received as "stock with a deferred tax potential." Upon a subsequent disposition of such stock, there would be dividend income, but only to the extent of the gain realized on the subsequent disposition unless the disposition were by way of liquidation into the first tier foreign subsidiary, in which case there would be further deferral until the disposition of the stock in the first tier subsidiary.[31]

The application of the Regulations to a particular case cannot be the subject of the declaratory judgment procedure (discussed below in connection with "outbound transfers"); judicial review is limited to normal procedures initiated after a deficiency notice has been issued. However the Committee Reports apparently contemplate a broader scope of review by the courts than would normally be the case. Thus, Congress intends that the courts may determine "that the Regulations, as applied in the taxpayer's case, are not necessary or appropriate to prevent the avoidance of Federal income taxes." In such case, the court is to apply the balance of the Regulations "to the extent appropriate."

One issue that is not directly dealt with is what happens if the taxpayer prefers that the foreign corporation not be treated as a "corporation" for purposes of the enumerated sections. For example, a U. S. parent corporation would prefer to have a capital gain on liquidation of a foreign subsidiary, or would like a step-up in basis of the subsidiary's assets in its hands. Could this be achieved simply by not requesting a ruling? In the case of an "other transfer," *i.e.*, a liquidation of a foreign subsidiary into a domestic parent, the answer would be no. Section 367 has no effect on "other transfers" except to the extent the Regulations provide to the contrary, and it is highly unlikely that the Regulations would provide to the contrary.[32]

As noted above, unless and until such time as Regulations providing to the contrary are made final, Section 367 would have no affect on "other transfers." Such a rule obviously could not be put into effect immediately; hence, another "transition rule." Treasury has been given until 1978 to issue final Regulations. Until that date, the rules described below applicable to "outbound transfers" will also apply to "other transfers" (Section 367 (d)).

Treatment of outbound transfers. Congress has opted for what appears to be a hybrid method for the treatment of "outbound transfers"—they are to be handled in part through Regulations, and in part through a modified rulings process.

Section 367(a)(2) authorizes the issuance of Regulations which will designate what types of outbound transfers may take place, or what types of property may be transferred, without obtaining any clearance from the Service. The statutory language authorizing these Regulations is not as sweeping as those authorizing the Regulations applicable to "other transfers." However, the legislative history contemplates that the Regulations in effect will be a formalization of some of the existing guidelines, particularly including the concept of "toll charges." To the extent designated by the Regulations a ruling will not be required, but the taxpayer automatically will be subject to the "toll charges" prescribed therein if he carries out the exchange. How helpful these Regulations will be remains to be seen. The Committee Reports are not particularly encouraging. They give as an example the case of a Section 351 exchange involving only the transfer of cash and inventory, and state that the Regulations "may" designate the transaction as one not requiring a ruling, "although the regulations would require the inventory to be taken into income."[33] It is hoped that the Committees were merely being overly cautious in giving this example. In any case, even this example has some limited value in providing certainty. Even where 100% of the gain would be recognized through "toll charges," the exchange presumably would still be one to which Section 351 applied, with all its attendant consequences.[34]

With respect to all outbound transfers not provided for in the Regulations described above, or at least aspects thereof, a new ruling procedure is provided by Section 367(a)(1) which differs from prior law in two major respects. First, a ruling need not be obtained *prior* to the transaction. Second, a special declaratory judgment procedure is available in the Tax Court to review an adverse determination.

The relationship between the Regulations discussed above and the availability of the ruling process is not entirely clear. Undoubtedly there will be taxpayers whose transactions appear to be covered by the Regulations, but who nevertheless desire an advance ruling because of a seeming ambiguity in the Regulations or because they want certainty. It would appear that rulings issued under these circumstances do not come under Section 367(a)(1), a matter which takes on significance in connection with the availability of the declaratory judgment procedure (discussed below). This procedure is available only to review a determination made in respect to an exchange "described" in Section 367(a)(1). Section 367(a)(2) provides that Section 367(a)(1) "shall not apply to any exchange (otherwise within paragraph (1), or to any type of property," designated in the Regulations. It is at least arguable that a transaction to which Section 367 (a) (1) does not "apply" is nevertheless still one "described" in that provision. The Congressional intent in this matter is not entirely clear. The Committee Reports contemplate that any taxpayer disagreeing with the application of the Regulations may challenge them under the normal procedure following a deficiency, but this appears to refer only to the Regulations dealing with "other transfers."

The result is even less clear with respect to conditions, such as "toll charges," which may be provided for in the Regulations. Does a taxpayer still have a right to request a ruling that a "toll charge" be waived under the particular facts of his case? And if the Service refuses to do so, would such determination be subject to review by the Tax Court? As noted below, under certain circumstances the Tax Court has the power to determine the terms and conditions to be imposed. Does this extend to the waiver of "toll charges" which may be specifically required in all cases by the Regulations dealing with "outbound transfers"? Note that the standards for review of "toll charges" under the Regulations dealing with "other transfers" possibly may be as broad as the standards under the declaratory judgment procedure.

Section 367(a)(1) provides that a request for ruling may be filed not later than the close of the 183rd day after "the beginning" of the transfer. When a transfer "begins" is not entirely clear. It does not begin with a board of direc-

tors or similar decision, nor is it necessary that title to assets be irrevocably transferred, at least where the contingency which the assets will be returned relates to obtaining favorable approval from the Service.[35] However, whether the transfer "begins" when the parties become obligated to proceed or not until title or possession to an asset of material value is actually transferred, or any gradations between the two, are questions which hopefully will be answered by Regulations. It would seem consistent with the policy underlying the new provision that the transfer would not be deemed to begin before there has been some taxable event to which the relevant statutory provision would apply.

If, after a timely request has been filed, the Service determines that the exchange will be considered to be in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes, or if the Service determines that it will so consider the exchange except if the taxpayer agrees to "toll charges" or other conditions unacceptable to the taxpayer, or if the Service has not issued any determination within 270 days after the request was filed, the taxpayer may petition the Tax Court for declaratory judgment (Sections 7477(a)(1) and (b)(2)), provided that he has first exhausted the administrative remedies available to him within the Service.[36] The meaning of this is not entirely clear.[37] At one point, the Committee Reports indicate that the taxpayer must "appeal" any adverse decision within the Service. However, the Committee Reports later state that the Service's notice of determination is to be treated as determinative that the taxpayer has exhausted his administrative remedies.[38] Possibly the latter assumed that an appeal had already been made within the Service.

Where the Service has made a determination and has sent notice thereof to the taxpayer by certified or registered mail, the petition to the Tax Court must be filed before the 91st day after the date of mailing (Section 7477(b)(4)).

The petition for a declaratory judgment can be filed only after the exchange has "begun" (Section 7477(b)(3)). Moreover, only a transferor or transferee of stock, securities, or property transferred in the exchange may file the petition.[39] This may well present timing problems for cautious taxpayers. While obtaining a ruling prior to the transaction is no longer required, prudent taxpayers may nevertheless wish to wait until the ruling is issued before proceeding. However, unless they are willing to forfeit their right to a declaratory judgment, they will have only 90 days after receiving an adverse determination to "begin" the transfer. Undoubtedly questions will arise as to how much, either absolutely or relatively, will have to be transferred in order to give the Tax Court jurisdiction to review the adverse determination.

The scope of review ordinarily permitted by the new declaratory judgment appears to be limited in one sense and broad in another. The statute provides that in any case in which the taxpayer is seeking a redetermination of the Service's determination that either (1) the exchange does have as one of its principal purposes the avoidance of taxes, or (2) that the exchange will not be so viewed by the Service only if the taxpayer agrees to a "toll charge" or other conditions, the Tax Court is to review only whether the determination made by the Service is reasonable (Section 7747(a)(2)(A)). If, however, the Tax Court determines either that the Service's determination as to tax avoidance or the conditions imposed in connection therewith are not reasonable, the Tax Court is to determine whether the transaction is one having the proscribed tax avoidance purpose and if so the extent to which conditions imposed would cure the defect. In addition, in a case where the proceeding has been brought because of a failure of the Service to make a determination within the 270-day period allowed (Section 7747(b)(2)), the Tax Court's authority extends to making the determination of the issue of tax avoidance including the conditions, if any, to be imposed in connection therewith.

The precise issue to be reviewed by the Tax Court is whether the transaction has as one of its principal purposes the avoidance of Federal income taxes. Thus, the issue before the court will be one of the "purpose" of the transaction and whether tax avoidance is one of the principal purposes. Where the Service has made a determination as to tax avoidance, the Tax Court will be required to review whether the Service's determination as to purpose was reasonable in light of the facts adduced in the case. Thus, it would appear that in an appropriate case a taxpayer could obtain a determination from the Tax Court in which no "toll" would be charged where it is clear that the transaction was not tax motivated. This should be contrasted with the situation under Section 367(b) where it is likely that the Regulations will prescribe rules which will require inclusion of a "toll charge" based on

[26b] As noted below, the operative adverse effect of Section 367(a) still continues to be that the foreign corporation will not be treated as a "corporation" for purposes of the enumerated provisions.

[27] The broad standard set forth in the statute is that the Regulations be "necessary or appropriate to prevent the avoidance of Federal income taxes." Section 367(b)(1). Moreover, they are to provide the circumstances under which gain or dividend income is to be recognized currently or deferred, and the extent to which adjustments shall be made to earnings and profits, basis of stock or securities, and basis of assets. Section 367(b)(2).

[28] *Rev. Proc.* 75-29, 1975-1 CB 754.

[29] Presumably, the permissible scope of the Regulations is limited to cases involving the enumerated exchanges. Section 367(b)(2), authorizing these rules provides for their inclusion in the Regulation described in Section 367(b)(1). The latter Section clearly appears limited to the enumerated exchanges.

[30] H. Rep't. No. 94-658 *supra* note 11 at 245; S. Rep't. No. 94-938 *supra* note 11 at 268. See *Rev. Rul.* 64-157, 1964-1 (Part 1) CB 139.

[31] H. Rep't. No. 94-658, *supra* note 11 at 246. S. Rep't. No. 94-938, *supra* note 11 at 269. The Reports indicate that the stock should be designated "in a manner similar to Section 1248 without reference to the December 31, 1962 date." The significance of this is not entirely clear; perhaps it indicates that the foreign corporation in the example was not a "controlled foreign corporation."

[32] The same seems true with regard to those "outbound transfers" which will be covered by regulation, *i.e.*, for which no ruling will be required. However, the answer still seems unclear for "outbound transfers" for which a ruling is required, but not requested.

[33] H. Rep't. No. 94-658, *supra* note 11 at 243; S. Rep't. No. 94-938, *supra* note 11 at 265.

[34] *E.g.*, the property in the corporation's hands would have a "tacked on" holding period.

[35] H. Rep't. No. 94-658, *supra* note 11 at 242; *cf. Id.* at 244; S. Rep't. No. 94-938, *supra* note 11 at 265; *cf. Id.* at 266.

[36] This clearly requires that the taxpayer submit the documents and other data required by the Service to make a determination. See H. Rep't. No. 94-658, *supra* note 11 at 244; S. Rep't. No. 94-938, *supra* note 11 at 267.

[37] The Code itself is unclear as to whether a petition for declaratory relief under Section 7477 may be filed prior to the time the administrative remedies have been exhausted even though the Tax Court will not issue a judgment until subsequently.

[38] H. Rep't. No. 94-658, *supra* note 11 at 244, 245 S. Rep't. No. 94-938, *supra* note 11 at 267.

[39] Section 7477(b)(1). Apparently the fact that another transferor in the exchange has already made a transfer will not suffice.

[40] Both the Committee on Ways and Means and the Senate Finance Committee noted their general approval of the standards set forth in *Rev. Proc.* 68-23, 1968-1 CB 821. H. Rep't No. 94-658, *supra* note 11 at 239; S. Rep't. No. 94-938, *supra* note 11 at 261.

[41] Section 6511. Moreover, it would appear that the provisions found in Subchapter Q, Part II relating to the mitigation of the effect of the period of limitations would not have any application to the taxpayer's dilemma in the situation posited. See Sections 1311 *et seq.*

[42] Compare the transitional rule contained in Act, Section 1044(b)(2).

the result achieved by the transaction, regardless of motive.

In cases where the Tax Court finds that the Service's determination of tax avoidance is not reasonable or in cases where it must make the determination in the first instance, it will be required to set forth under what conditions, if any, the transaction will not be viewed as having the proscribed purpose. It is not clear what standards the Tax Court will follow in this regard, although it can be presumed that the administrative rules set forth in *Rev. Proc.* 68-23[40] will be taken into account.

Some mention ought also be made of the rules relating to burden of proof. Such rules will, of course, be developed by the Tax Court. The Committee Reports state that they expect the Tax Court to develop rules relating to the declaratory judgment procedure consistent with existing Tax Court rules. Thus, Congress expects that the taxpayer-petitioner will have the burden of proof as to matters set forth in the notice given to him by the Service of a determination (which the taxpayer views to be adverse) and that the Service will have the burden of proof as to matters raised by the Service at the time of the hearing. It would also appear that the Service will have the burden of proof where an action has been commenced because there has been a failure by the Service to make a determination within the 270-day period.

Finally, any declaration made by the Tax Court pursuant to a proceeding initiated under Section 7477, is to have the effect of a final judgment or decree, is to be reviewable as such and is to be binding upon the parties in the case for the year or years involved.

The special transitional rule. A special transitional rule has been included in Act, Section 1042(e)(2) which provides that with respect to any exchange described in Section 367 (as in effect on 12/31/74) which had taken place in any taxable year beginning after 1962 and before 1976 and which did not involve the "transfer of property to or from a United States person," a taxpayer will be permitted to file a ruling request within 183 days after 10/4/76 in order to establish that such transaction did not have as its principal purpose the avoidance of tax.

A taxpayer who now obtains such a ruling retroactively will be deemed to have satisfied the Section 367 requirement. However, this will not help in situations where a refund or credit is barred by the applicable period of limitations.[41] One may speculate as to whether such a practical limitation was intended.[42] ☆

Doing business under new German tax system

EFFECTIVE January 1, 1977, Germany has eliminated the "double tax" on corporate profits for German shareholders, but not for U.S. and other foreign owners. The net result is that the cost of doing business there will be increased by approximately 10%

Under the prior tax system, corporate profits were subject to corporate income tax and trade tax on income. When profits were distributed, the shareholders had to include dividends received as part of their taxable income, thus subjecting such income to double taxation.

The new imputation system eliminates this double taxation. Under this new method, generally, an amount equal to the corporate income tax paid on distributed profits is imputed to the stockholders' dividend income. To compute his personal tax on this grossed-up income, the individual stockholder is entitled to deduct a proportionate part of the corporation's tax as a credit. Under this system however, only stockholders who reside in Germany are entitled to the tax credit. Non-resident shareholders are not.

The effect of the new law will be to limit the advantage currently enjoyed by foreign shareholders over German shareholders of German corporations to dividends that are retained by the parent or reinvested in the distributing corporation. ☆

Antiboycott guidelines and procedures issued

THE SECRETARY OF THE TREASURY has issued, in *Treasury News Release* WS-1156, 11/4/76, guidelines in the form of questions and answers for resolving issues arising under the antiboycott provisions of Section 999, as enacted by the Tax Reform Act of 1976. These guidelines will be followed by the IRS in requiring the filing of reports, in making determinations as to participation in or cooperation with a boycott and in computing the loss of tax benefits of a participating or cooperating person. While the Treasury reserves the right to change or amend the guidelines, changes that are adverse to a taxpayer will apply only to periods beginning after publication of the change.

Section 999 requires that an international boycott report be filed by any person or member of a controlled group as defined in Section 993(a)(3), if a member of such group has operations in or related to (1) a country included on the Treasury's boycott list (or with the government, a company or a national of such country) or (2) a country not on the Treasury's boycott list (or with the government, a company or a national of such country) where such person knows or has reason to know that participation or cooperation with an international boycott is a condition for carrying on its operations in such country. In addition, if the person has participated or cooperated or has been requested to participate or cooperate then a report must be filed. When the person or member of a controlled group is a foreign corporation, then all U. S. shareholders as defined in Section 951(b) must file.

The guidelines further indicate that generally, any U. S. person (within the meaning of Section 7701(a)(30)) or any other person within the meaning of 7701(a)(1)) that either claims the benefit of a foreign tax credit under Section 901, or owns stock of a DISC is required to file a boycott report when their operations have one of the boycott connections listed above.

A taxpayer required to file an international boycott report fulfills his obligation by filing form 5713 (which will be available early in 1977) and all applicable supporting schedules and forms contained in the taxpayer's income returns. These include Form 1118 relating to the foreign tax credit, Form 1120-DISC relating to DISC income and Form 3646 relating to Subpart F income.

In a related news release, the Service announced in IR-1697, 11/16/76, the general interim procedures it will follow in issuing determinations under Section 999(d) as to whether a particular operation of a person, or a member of a controlled group that includes such person, constitutes participation or cooperation with an international boycott. The Treasury guidelines indicate that a determination under Section 999(d) will be treated as a written determination within the meaning of Section 6110(b)(1). The determinations will accordingly be open to public inspection. ☆