

FALL 2019
NEW YORK UNIVERSITY
SCHOOL OF LAW

“Has Helen’s Ship Sailed?: A Re-Examination of the “Helen of
Troy” Regulations.”

Deborah Paul

Wachtell, Lipton, Rosen, and Katz

November 26, 2019

Vanderbilt Hall – 202

Time: 4:00 – 5:50 p.m.

Week 13

SCHEDULE FOR FALL 2019 NYU TAX POLICY COLLOQUIUM
(All sessions meet from 4:00-5:50 pm in Vanderbilt 202, NYU Law School)

1. Tuesday, September 3 – Lily Batchelder, NYU Law School.
2. Tuesday, September 10 – Eric Zwick, University of Chicago Booth School of Business.
3. Tuesday, September 17 – Diane Schanzenbach, Northwestern University School of Education and Social Policy.
4. Tuesday, September 24 – Li Liu, International Monetary Fund.
5. Tuesday, October 1 – Daniel Shaviro, NYU Law School.
6. Tuesday, October 8 – Katherine Pratt, Loyola Law School Los Angeles.
7. Tuesday, October 15 – Zachary Liscow, Yale Law School.
8. Tuesday, October 22 – Diane Ring, Boston College Law School.
9. Tuesday, October 29 – John Friedman, Brown University Economics Department.
10. Tuesday, November 5 – Marc Fleurbaey, Princeton University, Woodrow Wilson School.
11. Tuesday, November 12 – Stacie LaPlante, University of Wisconsin-Madison, Wisconsin School of Business.
12. Tuesday, November 19 – Joseph Bankman, Stanford Law School.
13. Tuesday, November 26 – Deborah Paul, Wachtell, Lipton, Rosen, and Katz.
14. Tuesday, December 3 – Joshua Blank, University of California at Irvine Law School, and Ari Glogower, The Ohio State University, Moritz College of Law.

**HAS HELEN’S SHIP SAILED?:
A RE-EXAMINATION OF THE “HELEN OF TROY” REGULATIONS**

Deborah L. Paul

November 12, 2019

Contents

| | | |
|------|--|----|
| I. | Introduction..... | 1 |
| II. | Technical Challenges Applying the Helen Regulations | 5 |
| A. | Summary of the Helen Regulations | 6 |
| B. | Substantiality Test..... | 7 |
| C. | Domestic Shareholder Presumption..... | 16 |
| D. | Section 367(a) Gain and Spin-offs before or after the Acquisition | 18 |
| III. | Shareholder Tax Avoidance as a—or the only—Policy of Section 367(a) | 25 |
| A. | 1932 Enactment of Section 112(k) | 26 |
| B. | Revenue Procedure 68-23 | 28 |
| C. | 1976 Amendment to Section 367..... | 30 |
| D. | The <i>Kaiser Case</i> | 31 |
| E. | 1984 Amendment to Section 367..... | 32 |
| F. | Notice 87-85..... | 34 |
| G. | Notice 94-46 and the 1995 Regulations..... | 36 |
| IV. | Protections against Corporate Base Erosion after the Helen Regulations | 38 |
| A. | 2004: Section 7874 | 38 |
| B. | 2004: Section 4985 | 41 |
| C. | 2016: Section 385 Regulations | 44 |
| D. | 2017: Tax Cuts and Jobs Act | 44 |
| V. | What to Do with the Helen Regulations | 48 |

Has Helen’s Ship Sailed?:
A Re-Examination of the “Helen of Troy” Regulations

By Deborah L. Paul*

I. INTRODUCTION

On January 5, 1994, Helen of Troy Corporation announced a special meeting of shareholders to vote upon an exchange agreement pursuant to which Helen of Troy Corporation would be acquired by Helen of Troy Limited. Helen of Troy Corporation was incorporated in Texas, while Helen of Troy Limited was organized in Bermuda. The Bermuda company was, in the words of the proxy, “formed to facilitate the change of domicile” of the Texas company.¹ Three months later, on April 18, 1994, the Internal Revenue Service released Notice 94-46² causing shareholder gain to be recognized under Section 367(a) in outbound stock-for-stock transactions along the lines that Helen of Troy contemplated. The Internal Revenue Service (“IRS”) perceived a threat to the corporate tax base, stating that it had become “concerned that

* Partner, Wachtell, Lipton, Rosen & Katz. The author gratefully acknowledges the assistance of David B. Sturgeon, Associate, Wachtell, Lipton, Rosen & Katz. The views expressed in this article are solely those of the author and do not, and are not intended to, represent those of Wachtell, Lipton, Rosen & Katz or any other person. This Article was originally presented at the Tax Forum in New York City on December 3, 2018.

¹ Helen of Troy Ltd., Prospectus/Proxy Statement, at 1 (January 5, 1994).

² 1994-1 C.B. 356.

widely-held U.S. companies with foreign subsidiaries recently have undertaken restructurings for tax-motivated purposes.”³

The release of Notice 94-46 was a pivotal moment. Prior to that time, Section 367(a) had not expressly been used to protect against erosion of the domestic corporate tax base. By the same token, since that time, a host of protections against erosion of the domestic corporate tax base via corporate expatriations have been enacted or promulgated. The time is ripe to re-examine the role of Section 367(a) in protecting against corporate base erosion.

From a practitioner’s perspective, a starting point is the difficulty of applying Treasury Regulation Section 1.367(a)-3(c), the so-called “Helen of Troy” regulations (the “Helen Regulations”) that stemmed from Notice 94-46. As will be discussed, they are vague, rigid and overbroad. They include an IRS ruling process that could, in theory, function as a safety valve but does not, in fact, compensate sufficiently for the anomalies in the Helen Regulations. The Helen Regulations should be modernized.

The question then arises as to what tax policies such a modernization should advance. Section 367(a)(1) by its terms taxes shareholders and is thus a natural tool for treating transactions that resemble sales of domestic target stock by shareholders as sales. Less obvious is the use of Section 367(a)(1) to address concerns about the taxation of domestic target corporations themselves. To put the point: do we need the Helen Regulations to protect against erosion of the domestic corporate tax base?⁴

³ Notice 94-46, 1994-1 C.B. 356.

⁴ This is not the first time that the Helen Regulations have been questioned in light of post-1994 developments. See Peter M. Daub, *Section 367 Adrift: Old Statute, New Applications*, TAX NOTES, May 30, 2016, at 1207 (arguing that IRS guidance since 1994 deviates from Section 367 policy); N.Y. ST. BA. ASS’N, TAX SEC., *Report with Respect to Regs. §1.367(a)-3(c)*, Report No. 1086, at 2-3 (April 26, 2005) (questioning the continued usefulness of the Helen Regulations and, if so, encouraging conformity to Section 7874).

(Continued)

As is well known, the United States federal income tax is a “classical” system. It imposes tax on corporate-level income and separately imposes tax on shareholder-level income. Corporate-level taxes do not offset or reduce shareholder-level taxes or vice versa.⁵ Protection of the shareholder-level tax base and protection of the corporate-level tax base are separate policies of the federal income tax system. Consistent with our classical system, the implementation of these policies is typically reflected in separate provisions of the Internal Revenue Code. The Helen Regulations contain elements of each, however, delineating transactions eligible for an exception to the general gain recognition rule of Section 367(a)(1).⁶

Section 367(a)(1) was originally intended to prevent taxpayers from engaging in transactions that resemble sales for cash without recognizing gain. Over time, the most blatant types of disguised sales by shareholders have been countered by other rules. But, Section

Moreover, reconsideration of the Helen Regulations is timely in light of IRS regulatory priorities. In April 2017, the President directed the Secretary of the Treasury to review all significant tax regulations issued by the Department of the Treasury on or after January 1, 2016 and identify such regulations that impose an “undue financial burden on United States taxpayers”, “add undue complexity” to the tax law or “exceed the statutory authority” of the IRS. Exec. Order No. 13789, 82 FED. REG. 19317 (April 21, 2017). The IRS has identified another aspect of the Section 367 regulations—relating to outbound transfers of foreign goodwill and going concern value—as regulations to consider substantially revising. U.S. Department of the Treasury, Exec. Order No. 13789—*Second Report to the President on Identifying and Reducing Tax Regulatory Burdens*, 82 FED. REG. 48013, paragraph 6 (October 2, 2017) (the “Second Report”). See also U.S. Department of the Treasury, *Statement of Regulatory Priorities*, October 17, 2018, Section VI (available at https://www.reginfo.gov/public/jsp/eAgenda/StaticContent/201810/Statement_1500.html). The Second Report also stated that the IRS could reconsider regulations under Section 385, discussed in Part IV.C. below, relating to intercompany distributions of debt instruments after enactment of tax legislation addressing base erosion and earnings stripping. See Section 5 of the Second Report. Review of those regulations appears to be on the most recent IRS Statement of Regulatory Priorities. U.S. Department of the Treasury, *Statement of Regulatory Priorities*, Section VI. Meanwhile, the IRS recently issued proposed regulations withdrawing the Section 385 minimum documentation requirements for intercompany debt. REG-130244-17.

⁵ Corporate-level taxes do reduce corporate earnings and profits, which may reduce the amount of a distribution characterized as a dividend under Section 301(c)(1).

⁶ Section 367(a)(1) provides that “If, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.”

367(a)(1) has continued to protect against appreciated assets leaving U.S. taxing jurisdiction on a tax-deferred basis in circumstances where the appreciated asset is, or seems likely eventually to be, sold by the foreign acquiror.

The question whether the Helen Regulations have an additional role -- protecting against domestic corporate base erosion -- raises questions of Congressional intent, practical deterrence and alignment of rule with policy. As will be seen, while Congressional intent seems to support gain recognition in certain circumstances to protect against corporate base erosion, it does not support the breadth of the Helen Regulations. The deterrent effect of the Helen Regulations with respect to corporate expatriations seems debatable, especially in light of the numerous other rules that have been enacted or promulgated since adoption of the Helen Regulations. And, the misalignment of the Helen Regulations with a policy to deter corporate base erosion seems clear, as the Helen Regulations impose tax on shareholders, not the domestic target.

Thus, as discussed below, the Helen Regulations could be redirected in at least three alternative ways. One approach would treat the foreign acquiror as domestic (that is, not provide any special rule for foreign acquirors) on the view that the shareholder- and corporate-level concerns at play have been addressed in other more targeted and efficient ways. A second would be to conform the Helen Regulations to the Section 367(a) regulations that address transfers of foreign stock and securities on the view that Section 367(a) continues to play a role in addressing concerns about shareholder-level gain. Finally, the Helen Regulations could be conformed to Section 7874 in the sense that the threshold for shareholder-level gain recognition would be the 60 percent threshold of Section 7874, generally calculated consistent with Section 7874, on the view that Section 367(a) may continue to play a role in monitoring both shareholder- and corporate-level policies.

Part II of this article discusses technical challenges in applying the Helen Regulations, especially the “substantiality test” of Treasury Regulation Section 1.367(a)-3(c)(3)(iii) (the “Substantiality Test”). Part III argues that shareholder tax avoidance was the principal concern of Section 367 (and its predecessors) from the time of enactment in 1932 until the IRS issued Notice 94-46 seeking to combat corporate base erosion using Section 367(a). Part IV summarizes key protections against base erosion since 1994 and analyzes the extent to which Congress has expressed a view through these changes about the role of Section 367(a) in relation to corporate expatriations. Finally, Part V discusses three approaches to modernizing the Helen Regulations.

II. TECHNICAL CHALLENGES APPLYING THE HELEN REGULATIONS

The Helen Regulations are anachronistic and vague making them difficult to apply.⁷ This article does not seek to catalogue all the challenges and anomalies contained in the Helen Regulations but rather identifies certain areas where modernization and updating would be important if the Helen Regulations are meant to be retained in anything like their current form. Further, the discussion below identifies specific areas where the Section 7874 regulations contain modern versions of concepts in the Helen Regulations where conformity could be desirable.

⁷ Since their promulgation, commentators have identified numerous technical difficulties with the Helen Regulations. See, e.g., Jason Francl, *LTR 200440009 Underscores Need for Guidance under Substantiality Test*, 4 J. TAX’N GLOBAL TRANSACTIONS 73 (2005) (discussing the need for guidance regarding convertible securities, acquisitions of foreign subsidiaries that are not qualified foreign subsidiaries and cash proceeds of debt offerings); Paul W. Oosterhuis, *Taxing Cross-Border Combinations: Nationalistic Rules in a Global Economy*, 75 TAXES 858 (1997) (discussing the “unintended problems” of the Substantiality Test); Robert J. Staffaroni, *Size Matters: Section 367(a) and Acquisitions of U.S. Corporations by Foreign Corporations*, 52 TAX LAWYER 523, at 547-557 (1999) (discussing numerous problems with the Substantiality Test); David R. Tillinghast, *Practical Problems in Applying the Section 367 Regulations to Outbound Transfers of a Publicly Traded Domestic Corporation’s Stock*, 25 INT’L TAX J. 38 (1999) (discussing, among other things, challenges a domestic public company has in identifying its foreign shareholders) (hereinafter “Tillinghast (1999)”).

A. Summary of the Helen Regulations

The Helen Regulations provide that a transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation that would otherwise be subject to Section 367(a)(1) is not so subject if, in addition to the domestic target complying with certain reporting requirements, (i) 50 percent or less of both the total voting power and the total value of the stock of the foreign acquiror is received in the transaction in the aggregate by U.S. persons that transfer stock or securities of the domestic target in exchange for stock of the foreign acquiror in the exchange (the “50 Percent Receipt Test”), (ii) 50 percent or less of each of the vote and value of the stock of the foreign acquiror is owned in the aggregate immediately after the transfer by U.S. persons that are officers or directors of the domestic target or five percent shareholders prior to the exchange of the domestic target (the “Control Group Test”), (iii) either the U.S. person is not a five percent shareholder in the foreign acquiror immediately after the exchange or the U.S. person is such a five percent shareholder and enters into a five-year gain recognition agreement in the form provided in Treasury Regulation Section 1.367(a)-8 and (iv) the active trade or business test of Treasury Regulation Section 1.367(a)-3(c)(3) (the “Active Trade or Business Test”) is satisfied.⁸ For purposes of the above, persons who exchange stock or securities of the domestic target for foreign acquiror stock are presumed to be U.S. persons (the “Domestic Shareholder Ownership Presumption”).⁹

The Active Trade or Business Test, in turn, has several components. The test is satisfied if (A) the foreign acquiror or any “qualified subsidiary” or “qualified partnership” is engaged in an active trade or business outside the United States for the entire 36 month period prior to the

⁸ Treas. Reg. Section 1.367(a)-3(c)(1).

⁹ Treas. Reg. Section 1.367(a)-3(c)(2).

exchange, (B) at the time of the exchange, neither the transferors nor the foreign acquiror has an intention to substantially dispose of or discontinue such trade or business and (C) the Substantiality Test is satisfied.¹⁰

The Helen Regulations contemplate a private letter ruling procedure. The IRS may “in limited circumstances” issue a ruling to permit an exception to the gain recognition rule of Section 367(a)(1) if a taxpayer cannot satisfy all the requirements of the Active Trade or Business Test, satisfies all the other requirements of the Helen Regulations and is “substantially in compliance” with the Active Trade or Business Test (the “Substantial Compliance Ruling Procedure”).¹¹

B. Substantiality Test

A primary example of the anachronism and vagueness of the Helen Regulations is the Substantiality Test.¹² The Substantiality Test states that the foreign acquiror “will be deemed” to satisfy the test if, “at the time of the transfer,” the “fair market value” of the foreign acquiror is at least equal to the “fair market value” of the domestic target.¹³

The regulation does not identify what fair market value is meant to be measured.¹⁴ In practice, the received wisdom is that the equity of the foreign acquiror and domestic target are

¹⁰ Treas. Reg. Section 1.367(a)-3(c)(3).

¹¹ Treas. Reg. Section 1.367(a)-3(c)(9)(i). The Helen Regulations also contemplate a private letter ruling procedure if the Helen Regulations cannot be satisfied as a result of the application of Section 318, as modified by Section 958(b), pursuant to Treas. Reg. Section 1.367(a)-3(c)(4)(iv).

¹² See Oosterhuis, *supra* note 7 at 864-5 (1997) (discussing technical issues with the Substantiality Test and the need for private rulings in public company transactions).

¹³ Treas. Reg. Section 1.367(a)-3(c)(3)(iii)(A).

¹⁴ See Staffaroni, *supra* note 7 at 547 (1999) (observing that regulations give no guidance as to how to determine fair market value for this purpose and that advisors have assumed that stock and other equity interests are meant to be valued).

meant to be compared. It is unclear what the significance is, if any, of the “will be deemed” language. This could be read as suggesting that the foreign acquiror could satisfy the Substantiality Test in another way, which could be a reference to the Substantial Compliance Ruling Procedure, but the regulations do not make clear whether this is the connection or whether there is another way for the foreign acquiror to satisfy the Substantiality Test.

Another received wisdom is that the value of options outstanding at the domestic target and foreign acquiror are disregarded for purposes of the Substantiality Test.¹⁵ The Helen Regulations support this, but could be clearer. First, the Helen Regulations state that “[e]xcept as otherwise provided in this section,” Section 318, as modified by Section 958(b), applies for purposes of determining the ownership or receipt of stock, securities or other property. Section 318 contains an option attribution rule. But, the Substantiality Test is not directly a determination of the ownership or receipt of stock, securities or other property. Thus, the Section 318 option attribution rule would not seem to apply for purposes of the Substantiality Test.

The Helen Regulations also state that for purposes of “paragraph (c)”, which is the entire Helen Regulation, including the Substantiality Test, an option is treated as exercised “and thus will be counted as stock for purposes of determining whether the 50 percent threshold is exceeded or whether a control group exists” if a principal purpose of the issuance or acquisition of the option was to avoid Section 367(a)(1). The 50 percent threshold would appear to be a reference to the 50 Percent Receipt Test. The “control group” reference is a reference to the Control Group Test. If the rule that options are only attributed in the case of a bad principal purpose is meant to apply to the Substantiality Test, the rule could be clearer.

¹⁵ See *id.* at 548 (discussing the treatment of options and convertible securities).

The Regulations under Section 7874 contain a modern version of the treatment of options that is worth comparing to the treatment of options in the Helen Regulations. For purposes of Section 7874, an option is treated as stock with a value equal to the holder's claim on the equity of the corporation.¹⁶ The excess of the value of the underlying share over the strike price of the option is treated as part of the value of the relevant corporation. But, an option is not treated as exercised for purposes of measuring voting power unless a principal purpose of the issuance or transfer of the option is to avoid Section 7874.¹⁷ Moreover, an option is disregarded for purposes of measuring value if a principal purpose of the issuance or acquisition of the option is to avoid Section 7874 or the probability of the option being exercised is remote.¹⁸ The Section 7874 regulations' approach to taking options into account for purposes of measuring value seems closer to economic reality than the apparent approach of the Substantiality Test that generally disregards options.¹⁹

Although the Substantiality Test specifies that the relevant values are meant to be measured "at the time of the transfer", they do not say whether such value may be determined by reference to a trailing average or historical values.²⁰ Again, conventional wisdom is that only the

¹⁶ Treas. Reg. Section 1.7874-2(h)(1).

¹⁷ Treas. Reg. Section 1.7874-2(h)(2).

¹⁸ Treas. Reg. Section 1.7874-2(h)(4).

¹⁹ By comparison, in 2018, the IRS conformed a separate aspect of the Helen Regulations to the Section 7874 Regulations by incorporating rules relating to non-ordinary course dividends into the Helen Regulations. *See* T.D. 9834, I.R.B. 2018-31.

²⁰ Commentators have noted the difficulty of predicting at the time a transaction agreement is signed the fair market value of the foreign acquiror and domestic target at closing. *See, e.g.,* Philip Tretiak, *Section 367(a) Stock Transfers in 1998: All You Need to Know!*, TAX NOTES, July 13, p. 239 (1998).

values on the closing date are relevant. But, IRS rulings have taken a different approach, taking into account historic values and disregarding deal premium.²¹

Taking then the Substantiality Test to compare the fair market value of the equity of the domestic target and the foreign acquiror on the closing date, the passive asset deduction rule of Treasury Regulation Section 1.367(a)-3(c)(3)(iii)(B)(1)(i) (the “Passive Asset Deduction Rule”) contains anomalies. That rule is meant as an anti-stuffing rule. That is, the IRS does not want parties bolstering the value of the foreign acquiror in order to satisfy the Substantiality Test. The paradigm is of assets contributed to the foreign acquiror in exchange for foreign acquiror stock contemporaneously with the foreign acquiror’s acquisition of the domestic target. Such additional value is not meant to be included in the value of the foreign acquiror for purposes of the Substantiality Test.

Before discussing the staggering number of anomalies inherent in the Passive Asset Deduction Rule, it is worth observing that Section 7874 again contains a modern-day version of an anti-stuffing rule that could potentially be used in place of the Passive Asset Deduction Rule. Section 7874(c)(2)(B) disregards foreign acquiror stock sold in a public offering related to the acquisition. Treasury Regulation Section 1.7874-4 interprets the statute broadly, disregarding, among other stock, stock in the foreign acquiror that is transferred in exchange for cash, foreign acquiror obligations or certain other types of passive assets in an exchange that is related to the

²¹ Priv. Ltr. Rul. 200122026 (Feb, 27, 2001) (relying on values over a “significant amount of time” prior to announcement); Priv. Ltr. Rul. 199903048 (Oct. 21, 1998) (relying on historic values over a 100 day period ending in close proximity to the closing date); Priv. Ltr. Rul. 199929039 (Apr. 12, 1999) (relying on historic values over a six month period prior to announcement rather than values influenced by agreement to pay a premium). See Staffaroni, *supra* note 7 at 549 (discussing whether a premium paid to target shareholders should be taken into account).

acquisition of the domestic target.²² That Regulation goes out of its way to reinforce its anti-stuffing nature, stating that foreign acquiror stock is disregarded “only to the extent that the transfer of the stock in the exchange increases the fair market value of the assets” of the foreign acquiror.²³ No such rationality exists in the Passive Asset Deduction Rule.

The Passive Asset Deduction Rule sweeps well beyond the paradigm of assets stuffed into the foreign acquiror on the brink of an acquisition such that the Passive Asset Deduction Rule is not a stuffing rule at all.²⁴ The rule provides that the value of the foreign acquiror includes assets acquired outside the ordinary course of business within the 36-month period preceding the acquisition only if either (i) (A) the assets (or the proceeds thereof) do not produce and are not held for the production of passive income as defined in Section 1297(b) and (B) the assets were not acquired for the principal purpose of satisfying the Substantiality Test (clause (i), the Not Passive and Not Bad Purpose Rule) or (ii) the assets consist of the stock of a qualified subsidiary or an interest in a qualified partnership (clause (ii), the “Per Se OK Rule”).

First among the anomalies, the Passive Asset Deduction Rule deducts assets acquired without regard to whether they were acquired in exchange for foreign acquiror equity.²⁵ If, as surmised, the Substantiality Test compares the fair market value of the equity of the foreign acquiror with the equity of the domestic target, it is not apparent why assets acquired for other

²² See Treas. Reg. Section 1.7874-4(a), -4(c), -4(i)(2). N.Y. ST. BA. ASS’N, TAX SEC., *Report on Temporary Regulations under Section 7874*, Report No. 1308 (September 5, 2014) (recommending that changes to the Section 7874 regulations be made to provide for more consistent treatment among economically similar transactions).

²³ Treas. Reg. Section 1.7874-4(c)(2).

²⁴ See Staffaroni, *supra* note 7 at 553 (observing that the Passive Asset Deduction Rule excludes certain assets “notwithstanding the absence of any purpose whatsoever to ‘stuff’”).

²⁵ See *id.* at 555 (stating that it is “difficult to understand why passive assets acquired other than through an increase in the transferee’s equity are relevant”).

corporate assets, such as cash (whether cash on the balance sheet or cash that is borrowed), should be deducted from the value of the foreign acquiror. Of course, a tracing rule might be overly wooden. Thus, a sensible rule relating to stuffing would consider whether stock is issued or has been issued over a relevant period of time,²⁶ but the Passive Asset Deduction Rule has no such reference to stock issued. Accordingly, by its terms, it deducts from the value of the foreign acquiror the value of assets that were not stuffed into the foreign acquiror in any sense.

The Passive Asset Deduction Rule is also anomalous in that it deducts a gross value from a net value.²⁷ The value of the equity of the foreign acquiror is a net number. Generally, equity equals the value of the gross assets of a corporation less its liabilities. But, the value that is deducted under the Passive Asset Deduction Rule is a gross number, namely, the value of the assets covered by the rule. This can lead to counter-intuitive results. If a corporation has 1000 gross value of assets, 600 of liabilities and an asset covered by the rule worth 400, then the foreign acquiror's value for purposes of the Substantiality Test is zero, a result that does not seem warranted.

As noted, under the Per Se OK Rule, acquisitions of stock of a qualified subsidiary or an interest in a qualified partnership are not deducted from the value of the foreign acquiror under the Passive Asset Deduction Rule even if acquired within the prior 36 months outside the ordinary course.²⁸ The Per Se OK Rule draws a sharp distinction between acquired corporations

²⁶ Cf. Treas. Reg. Section 1.7874-4.

²⁷ See N.Y. ST. BA. ASS'N, TAX SEC., *Report with Respect to Regs. §1.367(a)-3(c)*, *supra* note 4.

²⁸ A qualified subsidiary is a foreign corporation whose stock is at least 80 percent owned by vote and value by the foreign acquiror (but not if acquired for the principal purpose of satisfying the Active Trade or Business Test). Treas. Reg. Section 1.367(a)-3(c)(5)(vii). A qualified partnership is a domestic or foreign partnership in which the foreign acquiror either has active and substantial management functions as a partner or owns at least 25 percent of the capital and profits (but not if acquired for the principal purpose of satisfying the Active Trade or Business Test). Treas. Reg. Section 1.367(a)-3(c)(5)(viii).

and acquired partnerships. In order to be covered by the Per Se OK Rule, a corporation must be foreign, while a partnership may be domestic or foreign. Moreover, the ownership threshold is 80 percent for corporations but only 25 percent for partnerships. Furthermore, partnerships can qualify for the Per Se OK Rule under an active management test while corporations cannot. All these distinctions were drawn prior to the promulgation of the check-the-box entity classification regulations in 1997 and thus do not reflect modern concepts of entity classification. In many cases, the foreign acquiror would not have made, or considered making, a classification election for U.S. federal income tax purposes, but potentially could have. While entity classification certainly matters in many areas of federal income tax law,²⁹ it is unclear why much should ride on the classification of an acquired entity for purposes of the Substantiality Test, as the Substantiality Test seeks to determine aggregate value of the target and the acquiror and the Passive Asset Deduction Rule seeks to identify assets stuffed into the foreign acquiror.

Another difficulty with the Passive Asset Deduction Rule is the definition of passive assets. The regulation defines passive by reference to Section 1297(b). Section 1297(b) defines passive income to be income of a kind which would be foreign personal holding company income under Section 954(c) but provides an exception for, among other things, dividends from a related person within the meaning of Section 954(d)(3) to the extent the dividend is allocable to non-passive income of the related person. Section 954(c) defines foreign personal holding company income to include, among other things, dividends, and gain from the sale of property

²⁹ See, e.g., Section 355(b)(3) (treating corporate members of a separate affiliated group as one corporation for purposes of Section 355 active trade or business test); Treas. Reg. Section 1.368-1(d)(4) (distinguishing between partnerships and corporations for purposes of the continuity of business enterprise test for reorganizations); Rev. Rul. 2007-42, 2007-2 C.B. 44 (analyzing the extent to which a corporation is treated as engaged in a partnership trade or business for purposes of the Section 355 active trade or business test); Rev. Rul. 2002-49, 2002-2 C.B. 288 (same).

that gives rise to dividends, but excludes dividends received from a related person organized, or having a substantial part of its assets used in a trade or business located in, the same foreign country as the recipient and excludes dividends from a related controlled foreign corporation to the extent attributable to active income of the dividend payor. Relatedness under Section 954(d)(3) is a more-than-50 percent control test. From all this, the received wisdom tends to be that stock in domestic or foreign corporations acquired by the foreign acquiror within the 36 month period is not passive if the foreign acquiror owns more than 50 percent of such acquired corporation and if the acquired domestic or foreign corporation, as would typically be the case, earns primarily active income. But, again, the rule could be clearer. For example, some argue that ownership of 25 percent of the corporation should be sufficient on the basis of the 25 percent look-through rule for passive foreign investment company purposes in Section 1297(c). Further, it is unclear what the purpose of the Per Se OK Rule is in respect of foreign corporations if qualified subsidiaries are considered non-passive in any event on account of the Section 1297 and 954 rules mentioned above.

As noted, passive assets are deducted from the value of the foreign acquiror even if acquired with a good purpose. If the Passive Asset Deduction Rule covered stuffing transactions with a degree of precision, then it might be understandable to cover passive assets regardless of whether they were acquired with a bad purpose, as the IRS could appropriately prefer an objective rule, rather than a purpose based rule. But, given the overbroad scope of the Passive Asset Deduction Rule and the fact that a good purpose does not turn the rule off, a ruling is required in many cases in order to achieve certainty. In the ruling context, the IRS has limited

the Passive Asset Deduction Rule to passive assets acquired with a bad principal purpose.³⁰ The Passive Asset Deduction Rule is in need of rationalization.

The Substantial Compliance Ruling Procedure cannot replace the need for modernization of the Substantiality Test. The IRS's resources are limited. Nothing close to all transactions can be ruled upon. Even when rulings are potentially availing, they generally cannot be obtained on a time frame prior to signing a transaction.

Indeed, the historical reliance of Section 367 on rulings has declined over time, because it has always presented practical problems. When enacted in 1932, Section 112(k), the predecessor to Section 367, required taxpayers to obtain an advance ruling in all cases in order to avoid gain recognition. In 1971, the statute was amended to permit post-transaction rulings in limited circumstances.³¹ The advance ruling requirement for most transactions continued, however, to present problems, including “undue delay for taxpayers attempting to consummate perfectly proper business transactions” and the inability of a taxpayer to challenge the Commissioner’s determination regarding tax avoidance purpose because the statute required the “satisfaction of the Commissioner”.³² Thus, in 1976, the statute was again amended, providing, in the case of Section 367(a) transactions, that rulings need not be sought to the extent provided in regulations and that, in cases where rulings were required, the request had to be filed no later than the close

³⁰ Priv. Ltr. Rul. 200709054 (Nov. 28, 2006); Priv. Ltr. Rul. 200440009 (Jun. 14, 2004); Priv. Ltr. Rul. 199903048 (Oct. 21, 1998); Priv. Ltr. Rul. 200203015 (Nov. 26, 2001); Priv. Ltr. Rul. 200122026 (Feb. 27, 2001) .

³¹ Pub. L. No. 91-681, Sec. 1, 84 Stat. 2065 (permitting rulings after the exchange in the case of a “mere change in form”).

³² S. Rep. No. 94-938, 94th Cong., 2d Sess., at 263 (1976).

of the 183rd day following the beginning of the transfer.³³ A 1984 amendment to Section 367 eliminated ruling requirements altogether.³⁴

The Substantial Compliance Ruling Procedure seems to be a vestige of this historical tendency to rely on rulings in the Section 367 context. That approach should be reconsidered. Section 7874 does not rely on a ruling procedure as a backstop. It is not apparent why Section 367(a) could not likewise accommodate objective rules capable of being complied with by taxpayers without a ruling.

C. Domestic Shareholder Presumption

As noted, the Helen Regulations presume that the former shareholders of the domestic target are U.S. persons.³⁵ The Domestic Shareholder Ownership Presumption may be rebutted, however, if the domestic target obtains statements (“Non-U.S. Ownership Statements”) from its shareholders that are not U.S. persons sufficient to demonstrate that the 50% Receipt Test is satisfied.³⁶ As well, the domestic target must include a special statement in its return compiling information relating to the 50% Receipt Test.³⁷

Even prior to the 2017 enactment of Public Law 115-97, known as the Tax Cuts and Jobs Act (the “TCJA”), obtaining Non-U.S. Ownership Statements would have been difficult, if not impossible, for a public company domestic target. To begin with, prior to signing a merger agreement involving a public company, confidentiality is paramount. Thus, contacting non-U.S. shareholders in advance of signing is not practical. After signing, such a contact may be

³³ Tax Reform Act of 1976, Pub. L. No. 94-455, Sec. 1042, 90 Stat. 1520.

³⁴ Deficit Reduction Act of 1984, Pub. L. No. 98-369, Sec. 131, 98 Stat. 495.

³⁵ Treas. Reg. Section 1.367(a)-3(c)(2).

³⁶ Treas. Reg. Section 1.367(a)-3(c)(7).

³⁷ *Id.*

practical but a non-U.S. shareholder may be disinclined to provide such a statement. The shareholder would not wish to be bound to retain the shares of the domestic target until closing. Shareholders prefer flexibility to sell at appropriate times. This problem can be avoided if the Non-U.S. Ownership Statement is provided after closing, but uncertainty around whether such a statement would be forthcoming prevents predictability of tax consequences in advance and thus prevents clear disclosure in the domestic target's proxy statement on the basis of which domestic target shareholders vote on the transaction.

Furthermore, the Non-U.S. Ownership Statement may be difficult or impossible for the shareholder to give even apart from questions about whether the owner will own shares at closing. To provide the statement, the owner must either (a) own less than one percent of the vote and value of the domestic target the stock of which is subject to Schedule 13D filing requirements (generally stock registered with the Securities and Exchange Commission)³⁸ or (b) not be related to any U.S. person to whom the stock or securities owned by the person making the statement are attributable under Section 958(b) (and, in either case, the owner cannot have acquired the stock with a principal purpose to enable the U.S. shareholders or security holders of the domestic target to satisfy the 50% Receipt Test). The Non-U.S. Ownership Statement from a one percent or greater shareholder thus requires the non-U.S. owner to analyze Section 958(b). Such an owner may be disinclined to hire an advisor to figure this out as the non-U.S. owner has no stake in whether the transaction qualifies for an exception to Section 367(a)(1). Indeed, a non-U.S. owner could perceive only a risk of liability and no advantage in providing a Non-U.S. Ownership Statement. Furthermore, now that Section 958(b)(4) has been repealed, the statement might well not be true of many non-U.S. persons owning shares in the domestic target as there

³⁸ Rules 13d-1(d) and -1(i) of Regulation 13D, 17 C.F.R. § 240.13d-1.

no longer is a prohibition on downstream attribution from a non-U.S. person to a U.S. person under Section 958(b). Thus, as a practical matter, by their terms, the Regulations provide little opportunity to rebut the Domestic Shareholder Ownership Presumption. The IRS should be open to alternative forms of proving non-U.S. ownership if non-U.S. ownership remains relevant.

D. Section 367(a) Gain and Spin-offs before or after the Acquisition

The Helen Regulations also impede spin-offs that are intended to qualify for tax-free treatment under Section 355, because a taxable sale of stock under the Helen Regulations can have implications under the “device” and “active trade or business” rules of Section 355.

In the case of a purported Section 355 distribution followed by an acquisition of the distributing corporation or the controlled corporation by a foreign acquiror, the Helen Regulations can cast doubt on whether the distribution satisfies the device test under Section 355 if the Helen Regulations require shareholder gain recognition upon the acquisition by the foreign acquiror. Under the device test of Section 355(a)(1)(B), Section 355 does not apply to a transaction that facilitates “the avoidance of the dividend provisions of the Code through the subsequent sale or exchange of stock of one corporation and the retention of the stock of another corporation.”³⁹ One could argue that a post-spin-off acquisition resulting in Section 367(a) gain recognition implicates the device test, because a shareholder recognizes gain at capital gains rates and obtains a corresponding basis step up in the stock of the foreign acquiror. Likewise, a taxable acquisition of stock of a distributing or controlled corporation for stock of a domestic acquiror arguably implicates the device test. But, for the reasons mentioned below, neither of them should implicate the device test.

³⁹ Treas. Reg. Section 1.355-2(d)(1).

The question of device in a publicly traded context where dividends are taxed at the same rate as long term capital gains and stock may readily be sold for cash is debatable. One could argue that no such spin-offs (or all of them) should be considered a device. But, the rules have never gone in that direction. Instead, a sale or exchange negotiated or agreed upon before the distribution is substantial evidence of device (the “Pre-Negotiated Sale Device Factor”).⁴⁰ But, a disposition of the stock of one of the corporations pursuant to a plan of reorganization does not contravene the device test if no gain or loss or only an insubstantial amount of gain is recognized (the “Reorganization Exception”).⁴¹ In a case where Section 367(a) imposes gain recognition, the transaction would not appear to fit within the Reorganization Exception, because gain is recognized.⁴²

But, the rationale for the Reorganization Exception supports the notion that a taxable acquisition in which the acquiror pays only with its own stock is not a device. That is, the corollary of the Reorganization Exception is that neither a taxable acquisition by a domestic acquiror for domestic acquiror stock nor an acquisition by a foreign acquiror in which shareholders recognize gain under Section 367(a) should be a device. In these cases, the acquiror makes no outlay of cash, or indeed of any property, owned by the acquiror, only of the acquiror’s own shares.

⁴⁰ Treas. Reg. Section 1.355-2(d)(2)(iii)(B).

⁴¹ Treas. Reg. Section 1.355-2(d)(2)(iii)(E).

⁴² A transaction could result in Section 367(a) gain recognition without falling afoul of Section 355(e). Section 355(e) imposes corporate-level gain recognition if one or more persons acquire a 50 percent or greater interest in the distributing or controlled corporation as part of the plan with the distribution. An acquisition by a foreign acquiror does not in and of itself trigger Section 355(e). Section 355(e)(3)(A)(iv). Rather, Section 355(e) requires an evaluation of the ownership of the foreign acquiror after the acquisition. Thus, in general, if the shareholders of the domestic target (distributing or controlled) own more than 50 percent of the combined company after the acquisition, Section 355(e) generally would not apply, but Section 367(a) could well require gain recognition.

The device test relates to avoidance of the dividend provisions of the Code, a bailout of earnings of the corporation at capital gains rates. Thus, the device test seeks to identify transactions in which cash (or other property) reflecting earnings of the corporation finds its way into the hands of shareholders. A taxable sale of stock is evidence of a device on the thought that the acquiror may well need to cause the acquired corporation to pay a distribution to the acquiror to replenish the funds used by the acquiror to buy the acquired corporation's stock. Just as cash should not move directly from a corporation to its shareholders without Section 301 applying, nor should cash move indirectly from the corporation, through the acquiror, to the corporation's historic shareholders. The acquiror and the acquired corporation are a unit, and just as cash from the acquired corporation would have implicated device, so does cash from the acquiror.

In the case of an acquisition giving rise to Section 367(a) gain recognition, those concerns regarding an indirect bailout are not at play. Likewise in the case of a domestic acquiror that pays all stock. The acquisition is not a means to move cash, or any other property of the distributing corporation, to its shareholders, as the shareholders receive only acquiror stock in the acquisition. This is indeed the rationale for the Reorganization Exception and should apply equally to taxable transactions involving consideration all in the form of stock of the acquiror. The only difference between a transaction that results in Section 367(a) gain recognition and one that does not is that the acquiror is foreign rather than domestic, and thus it is difficult to see how the former involves a bailout and the second does not. By the same token, where acquiror stock is the consideration for the acquisition, the shareholder remains invested in the acquired corporation through the shareholder's ownership of the acquiror stock and thus the shareholder should not be viewed as having made a "subsequent sale or exchange," as contemplated by Treasury Regulation 1.355-2(d)(1) in the case of a device. Indeed, in

articulating the Reorganization Exception, Treasury Regulation Section 1.355-2(d)(2)(iii)(E) treats “the stock received in the exchange . . . as the stock surrendered in the exchange.” In the case of a dividend, by contrast, the shareholder disinvests of a portion of the shareholder’s stock ownership by receiving cash or other property. The IRS agreed in PLR 201232014 that Section 367 gain recognition did not implicate the device test.⁴³

Another scenario in which the Helen Regulations impede tax-free treatment under Section 355 is where a domestic target is acquired by a foreign acquiror in a transaction giving rise to Section 367(a) gain recognition and then, within five years, the domestic target is meant to distribute stock of a controlled corporation to the foreign acquiror (an “internal distribution”) and the foreign acquiror is meant to further distribute either the distributing or controlled corporation to the foreign acquiror’s shareholders (an “external distribution”) in a series of tax-free distributions under Section 355.

The “active trade or business test” of Section 355(b) would appear to be violated both in the case of the internal distribution and the external distribution. But, the policies of Section 355(b) are not violated by reason of a distribution following an acquisition in which Section 367(a) gain is recognized, because the acquisition does not involve a payment of anything other than foreign acquiror stock and because Section 367(a) gain does not correspond to basis in the hands of the foreign acquiror in the stock of the domestic target. Section 355(b)(2)(C) and (D) are the relevant limitations to the tax-free treatment of the internal and external distributions, but

⁴³ Priv. Ltr. Rul. 201232014 (Feb. 16, 2012). In the ruling, the IRS relied on a representation of the taxpayer to the effect that the distribution was not being used principally as a device for the distribution of earnings and profits, taking into account the Section 367(a) gain. *Id.* (representation 1). As well, the IRS caveated that no opinion was expressed regarding the device test. *Id.* See also Priv. Ltr. Rul. 201817001 (Apr. 27, 2018) (relying on same representation and caveating that no opinion was expressed regarding impact of Section 367(a) gain on device test).

the transaction does not violate their purposes, as described in the proposed active trade or business regulations:

The common purpose of section 355(b)(2)(C) and (D) is to prevent the direct or indirect acquisition of the trade or business to be relied on by a corporation in exchange for assets in anticipation of a distribution to which section 355 would otherwise apply. An additional purpose of section 355(b)(2)(D) is to prevent a distributee corporation from acquiring control of distributing in anticipation of a distribution to which section 355 would otherwise apply, enabling the disposition of controlled stock without recognizing the appropriate amount of gain.⁴⁴

Starting with the internal distribution, Section 355(b)(2)(D) was intended to preclude perceived end-runs around repeal of *General Utilities*,⁴⁵ specifically, where a parent corporation acquires a target corporation in a transaction that provides the parent corporation with fair market value basis in the stock of the target, then causes the target to distribute a controlled corporation to the parent under Section 355 resulting in the parent's high outside stock basis being allocated between the parent's stock in the distributing and controlled corporations and then sells the distributing or controlled corporation in a taxable transaction.⁴⁶ In such case, if all went according to the parent corporation's plan, the parent corporation would have indirectly sold a portion of the target's business with gain or loss determined based on the taxpayer's outside basis in the target stock, a perceived violation of *General Utilities* repeal.

⁴⁴ Prop. Reg. Section 1.355-3(b)(4)(iii).

⁴⁵ *General Utilities & Operating Co. v. Helvering*, 56 S. Ct. 185 (1935).

⁴⁶ Prop. Reg. Section 1.355-3(b)(4)(iii). See also, e.g., Thomas F. Wessel, Joseph M. Pari, Stephen G. Charbonnet, M. Todd Prewett and Richard D'Avino, Practising Law Institute, *The Corporate Tax Practice Series: Strategies for Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings, Reorganizations & Restructurings*, Vol. 15, *Corporate Distributions Under Section 355*, at 537 (2017). Section 355(b)(2)(D) states that the active trade or business test is failed if control of a corporation (the domestic target, in the case of the internal distribution) is acquired by a distributee corporation (the foreign acquiror, in the case of the internal distribution) within the five years preceding the distribution in a transaction in which gain or loss was recognized.

The policy is not implicated in the case at hand, however.⁴⁷ To begin with, the transaction targeted by Section 355(b)(2)(D) involves a taxable disposition of distributing or controlled by the distributee parent corporation. Here, the foreign acquiror intends to dispose by means of a tax-free external Section 355 distribution.

Second, even if the distributee parent corporation's disposition of distributing or controlled were to be taxable in some sense, the parent corporation is the foreign acquiror, not a U.S. taxpayer. Thus, the link between the target shareholders' gain on the acquisition for U.S. federal income tax purposes and the foreign acquiror's tax basis for U.S. federal income tax purposes does not exist, since the foreign acquiror's jurisdiction's rules would govern the foreign acquiror's tax treatment.

Finally, even if one were to believe there is relevance to the foreign acquiror's tax basis under U.S. federal income tax rules, again, there is no link between the Section 367(a) gain recognized by the domestic target shareholders and the foreign acquiror, because the foreign acquiror's tax basis is generally net asset basis,⁴⁸ a calculation that does not reflect the target shareholders' gain. Indeed, the proposed "active trade or business" regulations confirm that Section 355(b)(2)(D) is not violated if the distributee corporation's basis in the stock of distributing is "determined in whole by reference to the transferor's basis".⁴⁹ Under the net asset basis construct, the distributee corporation's basis is determined by reference to the target's basis in its assets (less liabilities). The target should be viewed as the transferor, satisfying the

⁴⁷ See Wessel et al., *supra* note 46 at 537-547 (arguing that gain recognized upon certain acquisitions should not defeat satisfaction of the Section 355 active trade or business test).

⁴⁸ Treas. Reg. Section 1.358-6 (providing for net asset basis if the acquisition qualifies under Section 368(a)(2)(D) or (E) or a choice of net asset basis or transferred basis if the acquisition qualifies both under Section 368(a)(2)(E) and either Section 368(a)(1)(B) or Section 351).

⁴⁹ Prop. Reg. Sections 1.355-3(b)(4)(iii)(C) and -3(d)(2), example 40.

proposed regulation. In Private Letter Ruling 201551005, the IRS held consistently that boot in a Section 368(a)(1)(A) reorganization did not cause Section 355(b)(2)(D) to be violated in the case of a subsequent distribution by an acquired subsidiary of a controlled corporation to the acquiror, because the distributee corporation's basis was not increased on account of the target shareholders' gain recognition arising from the boot. In the ruling, the taxpayer represented that the acquiror's basis in the stock of the acquired subsidiary was equal to, and determined in whole by reference to, the target's basis in such stock.

By the same token, the external distribution could be viewed as running afoul of Section 355(b)(2)(C) on account of the Section 367(a) gain recognized on foreign acquiror's acquisition of domestic target, but, as above, the Section 367(a) gain does not violate the policies of Section 355(b)(2)(C). Section 355(b)(2)(C) was intended to backstop the device test.⁵⁰ While the device test monitors against distributions of assets, especially liquid assets, to shareholders in transactions that resemble dividends, Section 355(b)(2)(C) prevents those assets from being used by the distributing corporation to acquire an active trade or business that is then spun off in a purported Section 355 distribution. Just as a distribution of assets, such as cash, to shareholders followed by the shareholders' exchange of those assets for an active trade or business is not meant to be covered by Section 355, neither is the corporation's exchange of cash for an active trade or business followed by a distribution of the active trade or business meant to be covered. But, these principles do not apply in the case of an acquisition by a foreign acquiror of a domestic target giving rise to Section 367(a) gain. In the case of the external distribution, Section 355(b)(2)(C) could be seen to be violated by its terms on the grounds that the foreign

⁵⁰ Section 355(b)(2)(C) states that the active trade or business test is failed if the trade or business being relied upon (a trade or business of the domestic target, in the case of the external distribution) is acquired within such five year period in a transaction in which gain or loss was recognized in whole or in part.

acquiror acquired the active trade or business in the acquisition of the domestic target and Section 367(a) gain was recognized. But, this gain does not arise from an outflow of liquid assets, or indeed any assets, from the foreign acquiror. Thus, Section 367(a) gain recognition does not seem pertinent to the policies underlying the active trade or business test. The only difference between a transaction giving rise to Section 367(a) gain recognition and one that does not is that the acquiror is foreign, rather than domestic.

Amending the Helen Regulations in a manner that generally does away with shareholder-level gain recognition would help with the above types of transactions. But, doing so might not be sufficient in all cases. If the Helen Regulations continue to apply in the case of certain shareholders required to file a gain recognition agreement, taxpayers may continue to be concerned that gain recognition on account of a shareholder failing to enter into a gain recognition agreement, or a gain recognition agreement being triggered, could implicate the device or active trade or business tests in the situations described above. Thus, clarification from the IRS would be desirable to the effect that, specifically, Section 367(a) gain recognition does not implicate Section 355.

III. SHAREHOLDER TAX AVOIDANCE AS A—OR THE ONLY—POLICY OF SECTION 367(A)

The above discussion has shown that the Helen Regulations are in need of modernization. But, any update should occur in light of policy goals. A consistent theme in the legislative history of Section 367(a) is the policy against shareholder tax avoidance, as discussed below.⁵¹ It is certainly arguable that this is and should be the only policy of Section 367(a) and that

⁵¹ See Tretiak, *supra* note 20 (arguing that Section 367(a) is intended to prevent deferral in tax avoidance cases, an evolution of its original purpose of preventing appreciated property from leaving U.S. tax jurisdiction).

Section 367(a) should not also be used to protect against corporate base erosion. This argument is strong, although perhaps not as clear cut as one might have thought at first blush.

A. 1932 Enactment of Section 112(k)

The predecessor to Section 367 was enacted as Section 112(k) in 1932. It provided for a broad override of non-recognition treatment unless an advance ruling was obtained. Under Section 112(k), in determining the extent to which gain would be recognized in the case of various exchanges that otherwise would have qualified for non-recognition:

a foreign corporation shall not be considered as a corporation, unless, prior to such exchange or distribution, it has been established to the satisfaction of the Commissioner that such exchange or distribution is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.⁵²

The Report of the Ways and Means Committee graphically describes Congress's concern. Congress did not want to afford non-recognition treatment to a transaction that resembled a sale by a shareholder owning appreciated stock. The transaction described by the Ways and Means Committee involves a purported reorganization in which a newly formed foreign corporation acquires the stock of a domestic corporation from a U.S. citizen for foreign acquiror stock in a purported non-recognition transaction, sells the stock of the domestic corporation for cash, drops the cash proceeds into a domestic controlled corporation and distributes the stock of the domestic controlled corporation in another purported non-recognition transaction to the U.S. citizen who is the former shareholder of the domestic corporation that was sold:

⁵² Revenue Act of 1934, PUB. L. 72-154, Sec. 112(k), 48 STAT. 620, *reproduced in* J.S. Seidman, SEIDMAN'S LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 1938-1861, at 452 (1938).

Property may be transferred to foreign corporations without recognition of gain under the exchange and reorganization sections of the existing law. This constitutes a serious loophole for avoidance of taxes. Taxpayers having large unrealized profits in securities may transfer such securities to corporations organized in countries imposing no tax upon the sale of capital assets. Then, by subsequent sale of these assets in the foreign country, the entire tax upon the capital gain is avoided. For example, A, an American citizen, owns 100,000 shares of stock in corporation X, a domestic corporation, which originally cost him \$1,000,000 but now has a market value of \$10,000,000. Instead of selling the stock outright A organizes a corporation under the laws of Canada to which he transfers the 100,000 shares of stock in exchange for the entire capital stock of the Canadian company. This transaction is a nontaxable exchange. The Canadian corporation sells the stock of corporation X for \$10,000,000 in cash. The latter transaction is exempt from tax under the Canadian law and is not taxable as United States income under the present law. The Canadian corporation organizes corporation Y under the laws of the United States and transfers the \$10,000,000 cash received upon the sale of corporation X's stock in exchange for the entire capital stock of Y. The Canadian corporation then distributes the stock of Y to A in connection with a reorganization. By this series of transactions, A has had the stock of X converted into cash and now has it in complete control.⁵³

The specific transaction that the 1932 Ways and Means Committee worried about would not pass muster under current law for numerous reasons.⁵⁴ Indeed, even at the time, the Committee believed that the transaction might not succeed in avoiding gain recognition but nonetheless enacted Section 112(k) to eliminate opportunities for abuse along the lines of the transaction described above:

While it is probable that the courts will not hold all transactions of this nature to be tax-free exchanges, the committee is convinced that the existing law may afford opportunity for substantial tax avoidance. To prevent this avoidance the proposed amendment withdraws the transaction from the operation of the nonrecognition sections where a foreign corporation is a party to the transaction, unless prior to the exchange the

⁵³ H. Rep. No. 708, 72nd Cong., 1st Sess., *reproduced in* Seidman, *supra* note 52 at 452.

⁵⁴ *E.g.*, Section 7874, Section 368 (continuity of business enterprise test, business purpose test), Section 355 (active trade or business test, business purpose test).

commissioner is satisfied that the transaction does not have as one of its principal purposes the avoidance of taxes. It will be noted that under this provision a taxpayer acting in good faith can ascertain prior to the transaction, by submitting his plan to the commissioner, that it will not be taxable if carried out in accordance with the plan. Of course, if the reorganization or the transfer is not carried out in accordance with the plan the commissioner's approval will not render the transaction tax free.⁵⁵

Thus, in 1932, Congress was plain that their concern was shareholder tax avoidance via purported non-recognition transactions that facilitate sales for cash. The statute swept more broadly, but the ruling process allowed a taxpayer to prove the absence of a bad principal purpose.

B. Revenue Procedure 68-23

In 1968, the IRS issued procedures articulating when the IRS would be so inclined to rule.⁵⁶ Revenue Procedure 68-23 demonstrates a keen interest in defending the akin-to-a-sale policy staked out by the 1932 Ways and Means Committee, but also a perception that other policy concerns were also implicated in the context of non-recognition transactions involving foreign corporations. In addition to addressing scenarios that were akin to sales by a U.S. person transferring property, including stock, to a foreign corporation, the Revenue Procedure addresses, for example, inbound and outbound Section 332 liquidations,⁵⁷ inbound and outbound asset reorganizations⁵⁸ and foreign to foreign asset and stock reorganizations.⁵⁹ The Revenue Procedure, in fact, forms the basis of many Section 367 rules we have today.

⁵⁵ H. Rep. No. 708, reproduced in Seidman, *supra* note 52.

⁵⁶ Rev. Proc. 68-23, 1968-1 C.B. 821.

⁵⁷ *Id.*, Section 3.01.

⁵⁸ *Id.*, Section 3.03

Revenue Procedure 68-23 defended the akin-to-a-sale policy particularly in the context of potential Section 351 transactions. It provided that a Section 351 transfer to a foreign corporation would ordinarily receive favorable consideration under Section 367 where the property would be “devoted . . . to the active conduct, in any foreign country, of a trade or business.”⁶⁰ However, a list of tainted assets would generally not be so treated. The tainted assets included inventory, accounts receivable, stock or securities and property transferred “under circumstances which make it reasonable to believe that its sale or other disposition by the transferee foreign corporation is one of the principal purposes of its transfer.”⁶¹

Revenue Procedure 68-23 does not appear to be concerned with any policy relating to domestic corporate base erosion in its rules relating to Section 351 transactions or reorganizations. In significant part, it applies the same rule to reorganizations involving a domestic target as it applies to reorganizations involving a foreign target. By definition, a reorganization involving a foreign target does not raise the corporate base erosion concerns relating to an outbound acquisition of a domestic target.

Specifically, Revenue Procedure 68-23 provided that a potential reorganization involving the acquisition of a domestic target by a foreign acquiror would ordinarily receive favorable consideration under Section 367 if immediately after the exchange the former shareholders of the domestic target “do not own directly or indirectly . . . more than 50 percent” of the voting power

⁵⁹ *Id.* See Daub, *supra* note 4 at 1211-2 (stating that Revenue Procedure 68-23 sought to protect Section 1248 and avoid distortions on inbound reorganizations and liquidations)

⁶⁰ Rev. Proc. 68-23, *supra* note 56, Section 3.02(1). The favorable approach toward property used in a trade or business in a foreign country was codified in 1984, as discussed in Part III.E., and then repealed in 2017, as discussed in Part IV.D..

⁶¹ *Id.*, Section 3.02(1)(a).

of the foreign acquiror.⁶² On the other hand, the Revenue Procedure also appears to specify that where the former shareholders of the domestic target are in Section 368(c) control (an 80 percent test) of the foreign acquiror after the transaction, then a ruling would not ordinarily be granted.⁶³ The rules for a potential reorganization involving an acquisition of a foreign target by a foreign acquiror are basically the same, except that if the foreign acquiror were not a controlled foreign corporation then shareholders had to pick up a deemed dividend to the extent that Section 1248 would have so required in a taxable sale.⁶⁴ Since the rules for domestic and foreign targets were generally the same, it seems that defending against corporate base erosion was not a policy of Revenue Procedure 68-23.

C. 1976 Amendment to Section 367

In 1976, Congress amended Section 367, teasing apart Section 367(a) and 367(b)⁶⁵ and affirming the concern of Section 367(a) with akin-to-a-sale transactions as well as other policy concerns addressed by Revenue Procedure 68-23. The 1976 legislative history does not identify base erosion of an acquired domestic target as a Congressional concern. In discussing the IRS's ruling practice under the Revenue Procedure, the Senate Finance Committee explained the concerns involving inbound and outbound transactions as follows:

[T]he statutory standard for determining that a transaction does not have as one of its principal purposes tax avoidance has evolved through administrative interpretation into a requirement generally that tax-free treatment be permitted only if the U.S. tax on accumulated earnings and

⁶² *Id.*, Section 3.03(1)(d).

⁶³ *Id.*

⁶⁴ *Id.*, Section 3.03(1)(g).

⁶⁵ With respect to Section 367(b), Congress sought to “preserve the taxation of accumulated profits of controlled foreign corporations”. S. Rep. No. 94-938, *supra* note 32.

profits (in the case of transfers into the United States by a foreign corporation) or if the U.S. tax on the potential earnings from liquid or passive investment assets (in the case of transfers of property outside the United States) is paid or is preserved for future payment.⁶⁶

The Senate Finance Committee further explained the distinction drawn by the 1976 amendment between outbound transfers, on the one hand, and inbound or entirely foreign transfers, on the other hand:

Transactions in the first group generally include those transactions where the statutory aim is to prevent the removal of appreciated assets or inventory from U.S. tax jurisdiction prior to their sale, while transfers in the second group primarily include those where the statutory purpose in most cases is to preserve the taxation of accumulated profits of controlled foreign corporations.⁶⁷

D. The *Kaiser* Case

In 1977, the IRS issued an adverse ruling to Kaiser Aluminum & Chemical Corp. under Revenue Procedure 68-23 to the effect that a purported Section 351 transaction involving a contribution of four percent of the stock of an Australian alumina processing corporation to another Australian corporation in the aluminum business was in pursuance of a plan having a principal purpose of tax avoidance.⁶⁸ In 1981, the Tax Court overruled that decision on the basis that the IRS had not taken into account that the foreign acquiror had no intention to sell the acquired stock.⁶⁹

According to the Tax Court, the IRS had applied its Revenue Procedure overly rigidly. While it was true that the property transferred in the purported Section 351 transaction was stock,

⁶⁶ *Id.* at 262.

⁶⁷ *Id.* at 264.

⁶⁸ *Kaiser Aluminum Chemical Corp. v. Comm'r*, 76 T.C. 325, at 338 (1981), *acq.* 1982-2 C.B. 1.

⁶⁹ *Id.* at 341.

a tainted asset under the Revenue Procedure, the Tax Court observed that the Revenue Procedure itself gave the taxpayer the opportunity to “establish that based on all the facts and circumstances of the taxpayer’s case,” the taxpayer should receive a favorable ruling.⁷⁰ The transaction in the case was intended to provide the Australian transferee corporation with an adequate supply of alumina.⁷¹ The disguised sale concerns of the 1932 Ways and Means Committee Report were nowhere at play. Instead of an intention for the foreign transferee to sell the transferred property, the Australian transferee corporation needed the transferred property to conduct its business. The IRS disregarded these facts and took the position in the case that “when liquid or passive assets (stock or securities) are transferred outside the United States, the transfer is presumed to be in pursuance of a plan having as one of its principal purposes the avoidance of income tax.”⁷² The IRS argued that it did not matter whether the foreign acquiror had an intention to dispose of the transferred stock or securities, because the nature of the assets proved that there was a tax avoidance purpose.⁷³ But, the Tax Court disagreed, viewing the stock that was transferred as a proxy for operating assets and hence the transaction not appropriately viewed as automatically for a tax avoidance principal purpose.⁷⁴

E. 1984 Amendment to Section 367

In 1984, Congress sought to provide greater predictability and administrability than that resulting from the principal purpose ruling procedure that had been in the statute. Thus,

⁷⁰ *Id.* at 343-44.

⁷¹ *Id.* at 329.

⁷² *Id.* at 342-3.

⁷³ *Id.* at 347 (according to the IRS, “the likelihood or unlikelihood of subsequent disposition by the transferee is not relevant”).

⁷⁴ *Id.* at 345.

Congress eliminated the ruling procedure in favor of an “active trade or business” test modelled on Revenue Procedure 68-23. Under the 1984 amendment, the general rule under Section 367(a) was that gain would be recognized on outbound transfers. An exception applied for property transferred for use by the foreign transferee corporation “in the active conduct of a trade or business outside the United States.”⁷⁵

The Ways and Means Committee endorsed *Kaiser* and reinforced the concern of Section 367(a) as relating to transactions that resemble sales. The new statutory active trade or business exception was meant to cover scenarios where the property transferred was not intended to be disposed of by the foreign transferee, for example, where the foreign transferee intends to integrate its operations with the corporation whose stock is transferred:

transfers of stock resembling that in the *Kaiser* case . . . should fall within the exception under the bill.

The regulations implementing the active trade or business exception are also to specify additional circumstances under which outbound transfers of stock may fall within the active trade or business exception. Generally, additional circumstances which might place a transfer of stock within the exception include substantial ownership by the transferee in the corporation whose stock is transferred, and integration of the business activities of that corporation with the business activities of the transferee.⁷⁶

⁷⁵ Sec. 131(a) of the Deficit Reduction Act of 1984, *supra* note 34. *Cf.* Daub, *supra* note 4 at 1214 (stating that, in amending Section 367 in 1984, Congress continued to view a major policy of Section 367 as the deterrence of outbound non-recognition transfers for the purpose of avoiding tax on sale). Also in 1984, Congress enacted Section 1248(i) to protect against corporate base erosion. Sec. 133(a) of the Deficit Reduction Act of 1984, *supra* note 34. *See* David R. Tillinghast, *Recent Developments in International Mergers, Acquisitions and Restructurings*, 72 TAXES 1061, 1064 (1994) (hereinafter “Tillinghast (1994)”).

⁷⁶ H.R. Rep. No. 432, Pt. 2, 98th Cong., 2d Sess., at 431 (1984). *See also* S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess., at 365 (1984) (similar).

By the same token, the Senate Finance Committee articulated a concept of a gain recognition agreement to guard against transactions that did resemble sales:

the IRS should set forth regulations whereby, where appropriate, the IRS would not impose tax on the transfer of such stock, provided the transferor agrees that the stock will not be disposed of by the transferee (or any other person) for a substantial period of time following the year of the transfer.⁷⁷

F. Notice 87-85

In Temporary Regulations in 1986⁷⁸ and then in Notice 87-85,⁷⁹ the IRS took up the invitation of the 1984 Ways and Means Committee and Senate Finance Committee to articulate rules that provided for gain recognition agreements and otherwise to distinguish between transactions where the akin-to-a-sale concern was and was not present.

The 1986 temporary regulations provided that, in the case of an acquisition of domestic or foreign stock, transfers by U.S. persons who own in the aggregate 50 percent or more of the foreign acquiror immediately after the transfer would generally be subject to Section 367(a)(1) gain recognition. In limited circumstances, the regulations provided for an “operating asset” exception for domestic or foreign stock and an “integrated business” or “same country” exception for foreign stock.⁸⁰

The 1987 Notice, however, rejected the *Kaiser Aluminum*-style exceptions in the 1986 temporary regulations.⁸¹ Instead, the Notice relies on concepts that the Helen Regulations also rely on, such as gain recognition agreements for shareholders owning at least five percent in the

⁷⁷ S. Rep. No. 169, *supra* note 76 at 365.

⁷⁸ T.D. 8087, 1986-1 C.B. 175.

⁷⁹ Notice 87-85, 1987-2 C.B. 395.

⁸⁰ *Id.*

⁸¹ *Id.*

foreign acquiror and ownership tests in the foreign acquiror based on a 50 percent threshold and based on ownership by U.S. persons (rather than all persons) previously owning stock in the target. Under Notice 87-85, regulations would provide that, in the case of transfers of domestic or foreign stock or securities to a foreign acquiror, (a) a U.S. transferor owning less than five percent of the vote and less than five percent of the value of the stock of the foreign acquiror immediately after the exchange would not be subject to Section 367(a)(1) and did not need to enter into a gain recognition agreement, and (b) a U.S. transferor owning five percent or more of the vote or value of the foreign acquiror did need to enter into a gain recognition agreement in order to avoid Section 367(a)(1) gain recognition, either a five- or ten-year gain recognition agreement depending on whether the U.S. transferors in the aggregate owned less than fifty percent of the vote and less than fifty percent of the value of the stock of the foreign acquiror immediately after the exchange.⁸² Reflecting Section 367(b) principles, however, the above exceptions would not apply to the transfer of foreign target stock by a U.S. shareholder unless the U.S. shareholder received stock in a controlled foreign corporation in the exchange.⁸³ Moreover, the above exceptions would not apply to a transfer of stock or securities in a domestic target to a foreign acquiror if the U.S. transferor (as distinguished from U.S. transferors in the aggregate) owned more than fifty percent of the vote or value of the stock of the foreign acquiror immediately after the exchange.⁸⁴

⁸² *Id.*

⁸³ *Id.*

⁸⁴ *Id.* The IRS proposed regulations under Section 367(a) in 1991. REG-209035-86.

G. Notice 94-46 and the 1995 Regulations

Notice 94-46 marked a watershed. That Notice was the first instance in which the IRS sought to protect against tax reduction on the part of the domestic target corporation itself using Section 367(a).⁸⁵ In that Notice, as mentioned above, the IRS stated that it was “concerned that widely-held U.S. companies with foreign subsidiaries recently have undertaken restructurings for tax-motivated purposes.”⁸⁶ The Notice makes no mention of subsequent sales by a foreign acquiror of the domestic target. Instead, the:

restructurings typically involve a transfer of the stock of the domestic parent corporation to an existing foreign subsidiary or a newly-formed foreign corporation in exchange for shares of the foreign corporation in a transaction intended to qualify for nonrecognition treatment under the Code. Following the transaction, the former shareholders of the domestic corporation own stock of a foreign corporation that typically is not a controlled foreign corporation (‘CFC’) within the meaning of section 957 of the Code.⁸⁷

The Notice lay the groundwork for the Helen Regulations stating that regulations would be modified to provide that the transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation would be taxable under Section 367(a)(1) if all U.S. transferors

⁸⁵ See Tillinghast (1994), *supra* note 75 at 1067-8 (observing that shareholder level gain recognition bears little or no connection to preserving U.S. tax on existing accumulated earnings of controlled foreign corporations and future earnings of non-U.S. members of the corporate group); Tretiak, *supra* note 20 (arguing that Notice 94-46 stemmed from concern that widely held domestic corporations would undertake inversions in order to cause their CFCs to cease to be CFCs and thereby avoid Subpart F).

⁸⁶ Notice 94-46. See also Hal Hicks, *Overview of Inversion Transactions: Selected Historical, Contemporary, and Transactional Perspectives*, TAX NOTES INT’L at 924 (June 2, 2003) (stating that the Helen Regulations were a means to stop or inhibit inversions); N.Y. ST. BA. ASS’N, TAX SEC., *Report on Notice 94-46 Relating to Certain Outbound Stock Transfers*, Report No. 806 at 3-4 (October 18, 1994) (describing four types of acquisitions of domestic corporations by foreign acquirors at which the Notice was aimed, including a transaction in which CFC assets are transferred to foreign (non-CFC) subsidiaries underneath the foreign acquiror or the migration of new business to such foreign subsidiaries).

⁸⁷ Notice 94-46.

own in the aggregate 50 percent or more of either the total voting power or total value of the stock of the foreign acquiror immediately after the transaction.⁸⁸ Interestingly, this echoes the rule in Revenue Procedure 68-23 in that both turned on whether the 50 percent threshold was met by former shareholders of the domestic target in the aggregate but contrasted with the rule in Notice 87-85 that turned on the 50 percent threshold being met by a single shareholder of the domestic target. At the time it was issued, Notice 94-46 was thought to be a stopgap measure.⁸⁹

Temporary and proposed regulations promulgated in 1995 implemented the Notice.⁹⁰ The preamble to those regulations emphasized that Notice 94-46 was meant to protect against corporate base erosion. According to the preamble, the “purpose of Notice 94-46 was to forestall outbound transfers that are structured to avoid or that lay a foundation for future avoidance of the Internal Revenue Code anti-deferral regimes by imposing a shareholder-level tax on such transfers.”⁹¹ Those regulations required that the foreign acquiror or its affiliate have been “engaged in the active conduct of a trade or business . . . that is substantial in comparison to the trade or business” of the domestic target for the 36 months prior to the transaction, concepts that remain in the Helen Regulations we have today.⁹²

At the same time, the Helen Regulations we have today amply reflect the historic concern of Section 367(a) with shareholder tax avoidance. The 50 Percent Receipt Test measures ownership by U.S. persons, as distinguished from all persons, who were former shareholders of

⁸⁸ *Id.*

⁸⁹ Tillinghast (1994), *supra* note 75 at 1068. *See also* N.Y. ST. BA. ASS’N, TAX SEC., *Report on Notice 94-46 Relating to Certain Outbound Stock Transfers*, *supra* note 86.

⁹⁰ *See* T.D. 8638, 1996 C.B. 43 for the temporary regulations and T.D. 8642, 60 FED. REG. 66771 for the proposed regulations.

⁹¹ T.D. 8638, *supra* note 90.

⁹² Temp. Reg. Section 1.367(a)-3T(c)(iii) (1995).

the domestic target. Likewise, the Control Group Test measures ownership by certain types of U.S. persons only. The gain recognition agreement concept relates plainly to the concern regarding disguised sales by domestic target shareholders. The Helen Regulations' aim at corporate base erosion is imprecise, as the regulations seek to cover both shareholder and corporate-level concerns at once.

IV. PROTECTIONS AGAINST CORPORATE BASE EROSION AFTER THE HELEN REGULATIONS

Subsequent statutes and regulations target corporate expatriations with greater focus. Congress evidently concluded that the Helen Regulations did not provide an adequate deterrent to corporate base erosion via expatriations. Commentators have traced the evolution of anti-expatriation provisions in response to transactions that have occurred or been announced.⁹³ In light of this evolution, it is unclear that the Helen Regulations serve much remaining purpose. By the same token, certain legislative developments shed light on Congressional presumptions about shareholder gain recognition in the context of corporate expatriations.

A. 2004: Section 7874

In 2004, Congress sought to stem expatriations by enacting Section 7874. At that time, the U.S. federal income tax system provided at least three advantages to expatriated former U.S. multinationals: reducing tax on historic foreign earnings, reducing tax on future foreign earnings

⁹³ See, e.g., Hicks, *supra* note 86; John M. Petersen and Bruce A. Cohen, Practising Law Institute, The Corporate Tax Practice Series: Strategies for Acquisitions, Dispositions, Spin-Offs, Joint Ventures, Financings & Restructurings, Vol. 20, *Corporate Inversions: Yesterday, Today, and Tomorrow* (2017); Tillinghast (1994), *supra* note 75.

and reducing tax on U.S. source earnings.⁹⁴ As to historic foreign earnings, earnings of foreign subsidiary corporations of U.S. multinationals were generally not taxed until or unless such earnings were repatriated to the United States.⁹⁵ Thus, U.S. multinationals built up significant amounts of cash in foreign subsidiaries. The United States would impose tax, generally under Section 301, upon a distribution from the foreign subsidiary, subject to a foreign tax credit under Section 902. Potentially, if the former U.S. parent were itself owned by a foreign parent, then access to the cash in the foreign subsidiaries of the U.S. parent could be obtained without U.S. federal income tax. By the same token, future foreign earnings might also not become subject to U.S. federal income tax if the former U.S. parent were owned by a foreign parent as such earnings could potentially be earned underneath the new foreign parent, rather than under the former U.S. parent. Finally, with a foreign parent, the former U.S. parent could potentially make deductible payments, such as interest payments, to the new foreign parent or a foreign subsidiary (a sister to the former U.S. parent) of the new foreign parent.⁹⁶

The legislative history is plain that Congress intended Section 7874 to impede expatriations covered by the statute that have these tax results. Moreover, in relation to the

⁹⁴ See H. R. Rep. No. 108-755, 108th Cong. 2d Sess., at 575 (2004) (stating that inversions facilitate the removal of foreign operations from U.S. tax jurisdiction and U.S. earnings stripping); Deborah L. Paul and Michael B. Love, *A Perfect Storm for Corporate Inversions: Causes and Responses*, 43 TAX MANAGEMENT INT'L J. 671, at 672-678 (2014) (discussing structural incentives in the U.S. and abroad for inversions); N.Y. ST. BA. ASS'N, TAX SEC., *Report on Outbound Inversion Transactions*, Report No. 1014 at 8-9, 20-24 (May 24, 2002) (hereinafter "NYSBA Outbound Report") (stating that the tax goals of inversions appear to be to achieve a "territorial" system of taxation for non-U.S. earnings and a reduction in U.S. tax on domestic earnings).

⁹⁵ The TCJA changes this construct. Now, dividend distributions from controlled foreign corporations to a domestic corporate parent are generally exempt. See Section 245A. And, a 10 percent U.S. shareholder of a controlled foreign corporation is subject to tax on certain earnings of the controlled foreign corporation regardless of whether those earnings are distributed to the U.S. shareholder. See Section 951A.

⁹⁶ The TCJA tightened Section 163(j) and enacted Section 59A, the so-called "BEAT" to impede U.S. earnings stripping.

enactment of Section 7874, the Conference Committee alluded to the inefficacy of Section 367(a), and therefore the Helen Regulations, in stemming inversions:

In stock inversions, the U.S. shareholders generally recognize gain (but not loss) under section 367(a), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. To the extent that a corporation's share value has declined, and/or it has many foreign or tax-exempt shareholders, the impact of this section 367(a) "toll charge" is reduced.⁹⁷

Notably, the Senate version of Section 7874 would have applied if former shareholders of the domestic target owned more than 50 percent of the foreign acquiror by reason of holding stock in the domestic target.⁹⁸ The statute instead applies at 60 percent.

Section 7874 provides that if a domestic target corporation⁹⁹ is acquired by a foreign corporation and the former shareholders of the domestic target corporation own at least 80 percent of the foreign acquiror by vote or value by reason of holding stock in the domestic target, then (unless the group satisfies a "substantial business activities" test, which under regulations is very difficult to satisfy) the inversion fails. The foreign acquiror is treated as a domestic corporation for U.S. federal income tax purposes. Moreover, Section 7874 provides that if former shareholders of the domestic target own at least 60 percent, but less than 80 percent, of the foreign acquiror by reason of holding stock in the domestic target, then (unless the substantial business activities test is satisfied) the taxable income of the domestic corporation for a ten-year period following the transaction shall be no less than the "inversion gain" (generally income or gain recognized by reason of a transfer or license of property of the domestic target to a foreign

⁹⁷ H.R. Rep. No. 108-755, *supra* note 94. at 568-569.

⁹⁸ *Id.*, at 571-572.

⁹⁹ Section 7874 also applies to acquired partnerships.

related person) of the domestic target. In such case, net operating losses may not be used to offset gain or income on such related-party transfers or licenses that would move value out of the domestic target to the new foreign parent or a foreign subsidiary of the new foreign parent.

Over time, the IRS has interpreted Section 7874 broadly creating increased regulatory impediments to expatriations.¹⁰⁰

B. 2004: Section 4985

Section 4985, enacted along with Section 7874, was part of a package aimed at corporate base erosion. Although Section 4985 generally receives less attention than Section 7874 both from commentators and in the transaction context, it arguably provides greater clues as to Congress' thinking about the Helen Regulations than does Section 7874.

In enacting Section 4985, Congress sought to harmonize the treatment of senior management holding stock-based compensation with the treatment of shareholders. The House Report contrasted the prior law treatment of holders of stock-based compensation with the treatment of shareholders: "Shareholders are generally required to recognize gain upon stock inversion transactions. An inversion transaction is generally not a taxable event for holders of stock options and other stock-based compensation."¹⁰¹ And, in explaining the reasons for change, the House Report stated:

¹⁰⁰ See, e.g., Notice 2014-52, 2014-42 I.R.B. 721 (announcing regulations regarding "cash boxes", non-ordinary course distributions over a 36 month period and certain post-acquisition transfers of foreign acquiror stock); Notice 2015-79, 2015-49 I.R.B. 775 (announcing regulations regarding tax residency, "third-country" transactions, and certain controlled foreign corporation transactions); T.D. 9761, I.R.B. 2016-20 (addressing an acquisition by a subsequent foreign acquiror of an initial foreign acquiror of a domestic target pursuant to a plan and acquisitions of multiple domestic targets by a single foreign acquiror over a 36 month period).

¹⁰¹ H.R. Rep. No. 108-755, *supra* note 94.

The Committee believes that certain inversion transactions are a means of avoiding U.S. tax and should be curtailed. The Committee is concerned that, while shareholders are generally required to recognize gain upon stock inversion transactions, executives holding stock options and certain stock-based compensation are not taxed upon such transactions. Since such executives are often instrumental in deciding whether to engage in inversion transactions, the Committee believes that, upon certain inversion transactions, it is appropriate to impose an excise tax on certain executives holding stock options and stock-based compensation. Because shareholders are taxed at the capital gains rate upon inversion transactions, the Committee believes that it is appropriate to impose the excise tax at an equivalent rate.¹⁰²

Consistent with the above legislative history, Section 4985 only applies if two requirements are met. There must be an “expatriated corporation” and shareholder gain recognition. That is, for Section 4985 to apply, there must be a domestic target corporation such that former shareholders of the domestic target own at least 60 percent of the foreign acquiror by reason of holding stock in the domestic target. And, under Section 4985(c), for Section 4985 to apply, it must be the case that “gain (if any) on any stock in such corporation is recognized in whole or part by any shareholder” by reason of the acquisition of the domestic target by the foreign acquiror.¹⁰³

One could argue that the above legislative history and the dependence of Section 4985 on shareholder gain recognition reflect an endorsement of the Helen Regulations, as the Helen Regulations result in the recognition of gain referenced in Section 4985(c). Bolstering the argument is the fact that Congress amended Section 4985 in 2017, increasing the rate of the excise tax from 15 percent to the long-term capital gain rate of 20 percent, thus matching the excise tax rate to the rate of tax generally applicable to shareholders recognizing gain under

¹⁰² *Id.*

¹⁰³ Section 4985(c).

Section 367(a)(1). At the same time, Congress did not touch the requirement in Section 4985(c) that shareholders recognize gain in order for Section 4985 to apply.

But, that argument is likely too quick or too broad. Section 367(a)(1) results in gain recognition, and Section 367(a)(5) authorizes the Secretary to provide exceptions under regulations. While Section 4985 suggests that Congress believes gain should be recognized by shareholders in certain expatriations in order to protect against corporate base erosion, it does not mean that Congress agrees with the lines drawn in the Helen Regulations, lines that stemmed from concerns around shareholder tax avoidance and lines that were drawn when the IRS had fewer arrows in the quiver to combat corporate base erosion. By virtue of its reference to an “expatriated corporation,” Section 4985 only applies if the former shareholders of the domestic target own at least 60 percent of the foreign acquiror by reason of the acquisition. The Helen Regulations apply if any of several 50 percent tests are met. Congress cannot be said to have endorsed, via Section 4985, shareholder gain recognition in scenarios where there would be no expatriated corporation.

Indeed, Section 4985 arguably implies that shareholder gain recognition should occur in only a subset of cases involving an expatriated entity, because Section 4985 requires both an expatriated entity and shareholder gain recognition. If those requirements were co-extensive, there would have been no reason to include the shareholder gain requirement.

From the legislative history, it appears that Congress did not want stock-based compensation holders to be better off than shareholders. The upshot of this in terms of where the line should be drawn for shareholder gain in the case of expatriated entities is unclear, however. It does seem clear that Congress did not endorse shareholder gain recognition where there is no

expatriated entity. In simple terms, Section 4985 does not support imposing shareholder gain in the 50 to 60 percent zone, as the Helen Regulations generally provide.

C. 2016: Section 385 Regulations

The IRS sought to deter U.S. earnings stripping directly with regulations under Section 385 proposed in April 2016 and finalized in October 2016.¹⁰⁴ Of those regulations, the most significant were rules overriding the *Kraft* case.¹⁰⁵ *Kraft* had confirmed that debt issued as a dividend by a corporation to its shareholder could be respected as debt.¹⁰⁶ The Section 385 regulations instead generally treat debt issued as a dividend to a related party as stock for U.S. federal income tax purposes.¹⁰⁷ Those rules made earnings stripping in the context of an expatriation more difficult (as well as making it more difficult in other cases involving foreign-parented multinationals), as, prior to the regulations, a debt dividend or similar transaction could potentially result in intercompany debt owing from the domestic target to the foreign acquiror or a foreign subsidiary of the foreign acquiror.

D. 2017: Tax Cuts and Jobs Act

The implications for corporate expatriations of the enactment of the TCJA on December 22, 2017 have yet to be fully understood, but it is clear that the TCJA changed fundamental

¹⁰⁴ T.D. 9790, I.R.B. 2016-45. See Deborah L. Paul, *How to Kraft (or Not Kraft) Debt-Equity Regulations*, TAX NOTES, July 25, 2016, at 530-531 (discussing proposed Section 385 regulations' rejection of debt dividends). Rules relating to "qualified short-term debt" and consolidated groups were issued as temporary regulations and expired on October 13, 2019, three years after issuance. Notice 2019-58, .

¹⁰⁵ *Kraft Foods Company v. Comm'r*, 232 F.2d 118 (2d Cir. 1956). Commentators have called for these regulations to be withdrawn or issued in a more targeted and streamlined form. See N.Y. ST. BA. ASS'N, TAX SEC., *NYSBA Tax Section Letter Relating to the Section 384 Per Se Stock Rules*, (June 1, 2018).

¹⁰⁶ *Kraft*, *supra* note 105.

¹⁰⁷ Treas. Reg. Section 1.385-3(b)(2)(i). The regulations also cover debt issued in certain transactions economically similar to a debt dividend. Treas. Reg. Section 1.385-3(b)(2)(ii)-(iii).

aspects of the U.S. federal income taxation of cross-border investments and transactions. In certain respects, the TCJA made the United States more palatable to multinationals than it had been. The TCJA reduced the corporate income tax rate from 35 percent to 21 percent, adopted aspects of a territorial regime such as Section 245A generally exempting dividends from a foreign subsidiary to a US parent¹⁰⁸ and provided a deduction for certain exports in Section 250. By the same token, the TCJA made a foreign-parented structure less desirable than it had been by, for example, enacting Section 59A, the so-called “Base Erosion and Anti-Abuse Tax” or “BEAT,” a minimum tax on deductible payments to foreign affiliates. Although Section 59A in form applies to U.S. multinationals as well, it is more likely to affect foreign multinationals, as U.S. multinationals are unlikely to make the types of payments that Section 59A covers, as such payments would generally be subject to Subpart F. The TCJA amendments to Section 163(j), limiting interest deductions generally to 30 percent of adjusted taxable income, are by their terms, like Section 59A, equally applicable to U.S. and foreign multinationals but have additional bite in the case of foreign multinationals, as they pose a limit to earnings stripping that might otherwise have occurred. Thus, the TCJA undercut certain tax advantages of expatriations by reducing the rate on domestic earnings, especially exports, impeding earnings stripping and facilitating repatriations of cash from foreign subsidiaries.

The TCJA was not all good news for U.S. multinationals as it enacted the so-called “Global Intangible Low-Taxed Income” or “GILTI” regime of Sections 951A and 250, an inclusion system for U.S. shareholders of controlled foreign corporations. Section 951A does not generally apply to foreign subsidiaries of a foreign parent corporation. Section 951A means

¹⁰⁸ The TCJA enacted a one-time tax on historic foreign earnings of controlled foreign corporations under Section 965.

that the new system is not fully territorial, as a U.S. parent corporation is taxed on certain income of its controlled foreign corporations regardless of whether such income is repatriated.

The TCJA contained several provisions specifically targeting corporate expatriations. First, if a 10 percent U.S. shareholder expatriates within ten years of enactment of the TCJA, Section 965(l) requires recapture of the Section 965(c) deduction that would otherwise have ameliorated the one-time tax under Section 965 .

Second, Section 1(h)(11)(C)(iii)(II) prevents dividends from a foreign corporation from qualifying as qualified dividend income eligible for a reduced tax rate if the foreign corporation makes an acquisition of a domestic target covered by Section 7874 after the enactment of the TCJA. This change does seem like a potentially powerful deterrent to expatriations in that it applies for all time to dividends from the foreign acquiror and there is no evident way to make shareholders whole for the detriment. Further, it is notable that Congress chose to impose a tax on shareholders in the context of seeking to deter corporate expatriations. This seems to be an example of rough justice. One could argue that, likewise, Congress might not be troubled by the Helen Regulations' imposition of tax on shareholders with an aim to deter corporate level tax avoidance.

Third, Section 59A(d)(4) applies the BEAT to the cost of goods sold (as well as deductible payments) to foreign related parties in the case of an acquisition covered by Section 7874 after November 9, 2017.

Fourth, as discussed, the Section 4985 excise tax on stock compensation of officers, directors and large holders was increased to 20 percent from 15 percent.

Given this changed landscape, the Helen Regulations no longer serve as a primary bulwark against the erosion of the corporate tax base via expatriations.

The TCJA also repealed Section 367(a)(3), which, as discussed above in Part III.E., had provided generally that outbound transfers of property to be used by the foreign transferee corporation in an active trade or business were not subject to the usual gain recognition requirement of Section 367(a)(1). Repeal of Section 367(a)(3) appears to stem from a special policy goal relating to foreign branches of U.S. taxpayers. Specifically, it has long been a concern that a taxpayer would conduct a foreign business in branch form in the early years when deductions are plentiful, the taxpayer would take those deductions to reduce the taxpayer's taxable income and then, when the business turns profitable, the taxpayer would transfer the business to a foreign corporation such that income is earned in the foreign corporation without U.S. tax. Old Section 367(a)(3)(C) addressed that concern by providing that the taxpayer would recognize gain, up to the amount of such deductible losses, on a transfer of the foreign branch to a foreign corporation.¹⁰⁹ Perhaps acknowledging that the policy relating to previously deducted losses of foreign branches differs from the policy discussed in Part III above relating to avoidance of tax on disguised sales through a foreign corporation, Congress repealed Section 367(a)(3) entirely, thus imposing gain recognition on the transferor without regard to intended foreign use of the incorporated assets, and enacted a loss recapture rule in Section 91 that causes the transferor to recapture any deductions in excess of the amount of gain recognized on the transfer. Thus, under current law, losses are recaptured without a limitation based on the gain realized by the transferor.¹¹⁰ These changes are consistent with the overall thrust of Section 367(a) as addressing a concern with disguised sales by shareholders, while at the same time

¹⁰⁹ Section 904(f)(3) also addresses the concern in the context of the overall foreign loss rules.

¹¹⁰ See H.R. Rep. No. 466, 115th Cong., 1st Sess., at 601-6 (2017); N.Y. ST. BA. ASS'N, TAX SEC., *Report on the Branch Loss Recapture Rules of Section 91*, Report No. 1420 at 5-10 (August 29, 2019).

demonstrating that Section 367(a) may be used for other policy goals as well, here a policy regarding previously deducted losses.

V. WHAT TO DO WITH THE HELEN REGULATIONS

As mentioned above, modernization of the Helen Regulations should be informed by considerations of Congressional intent, the Regulations' efficacy in the real world as a deterrent, and the costs of misaligning policy and rule. The Helen Regulations as currently in effect do not score well on these parameters, as demonstrated above.

At least three conceptual redirections of the Helen Regulations present themselves.

One approach would treat a foreign acquiror as if it were domestic for purposes of Section 367(a)(1), that is, to eliminate Section 367(a)(1) gain recognition in the case of a transfer of a domestic target to a foreign acquiror. This approach would be premised on the idea that both the concern about shareholders engaging in transactions that resemble sales and the corporate base erosion concern have been addressed by other rules. In the case of shareholders, Subpart F, the passive foreign investment company regime and, most recently, Section 951A all tamp down on shareholders' abilities to engage in a sale by funneling the appreciated asset through a foreign corporation. And, in the public company context, the concern is particularly attenuated. Moreover, the reorganization and tax-free spin-off rules have been considerably tightened, and Section 7874 has been enacted, since the House Ways and Means Committee outlined the abusive transaction it was concerned about in 1932, all of which impede the ability of shareholders to engage in disguised sales via transfers to foreign corporations, apart from any impact of Section 367(a). As to the corporate base erosion concern, as discussed above in Part IV, numerous legislative and regulatory developments since 1994 have countered corporate expatriations.

A second approach would be to conform the Section 367(a)(1) treatment of transfers of domestic stock to the treatment of transfers of foreign stock. Under Treasury Regulation Section 1.367(a)-3(b), a transfer of foreign stock or securities by a U.S. person to a foreign corporation that would otherwise be subject to Section 367(a)(1) is not subject to Section 367(a)(1) if either the U.S. person owns less than five percent of the foreign acquiror immediately after the transfer or enters into a five-year gain recognition agreement as provided in Treasury Regulation Section 1.367-8. The logic for this approach would be that the shareholder tax avoidance concern continues to need support and that the rule for foreign stock or securities strikes the right balance. Also a premise of this approach would be that the regime now has sufficient protections against corporate base erosion. By definition, transfers of foreign stock or securities generally do not implicate corporate base erosion of the transferred corporation because the transferred corporation is foreign, not a domestic taxpayer.

Interestingly, Section 367 itself treats transfers of foreign stock and securities differently from transfers of domestic stock and securities. Section 367(a)(2) specifically contemplates an exception to Section 367(a)(1) for transfers of foreign target stock and securities, except as provided in regulations. The significance of this statutory language is unclear, though. As to concerns about shareholders engaging in disguised sales, it would seem that appreciated domestic stock and foreign stock are on about the same footing. Thus, it is not clear from that perspective why the statute treats them differently. Another argument could be that the existence of Section 367(a)(2) implies a corporate tax base erosion concern implicit in Section 367(a)(1). Granting that shareholder tax avoidance policies could well be the same in the case of foreign and domestic target stock, arguably the only other policy concern is at the corporate level. But, this probably reads too much into Section 367(a)(2). A variant of Section 367(a)(2) has been in

the Code since at least 1976¹¹¹ at which time it does not appear that Congress had corporate base erosion in mind. It seems likely instead that in 1976 Congress believed that Section 367(b) would cover the key concerns relating to ownership of foreign corporations. Since Congress authorized regulations to define the scope of both Section 367(a)(1) and (2), it does not seem of great significance that the statute discusses transfers of foreign stock separately nor does it seem an impediment to the approach of conforming the treatment of transfers of domestic stock to transfers of foreign stock.

Indeed, this conforming approach has significant merit. The practical effect of the Helen Regulations in deterring expatriations seems weak. Further, the approach would more accurately target transactions that raise concerns about shareholder tax avoidance. When Section 367(a) was the only arrow in the quiver for the IRS, it was understandable that the IRS would implement it to deter expatriations. But, now, the Helen Regulations do not seem to be worth the candle. Imposing shareholder tax under Section 367(a) in order to impede base erosion by the domestic target creates a mismatch. As the law evolves, it should move toward improved alignment between policies and rules.¹¹² Here, that would suggest the approach of focusing the Helen Regulations on the shareholder gain concern.

A third approach would be to conform the Helen Regulations to Section 7874 in the sense that shareholder gain recognition could turn on whether Section 7874 applies. As discussed above, Section 7874 generally turns on a 60 percent ownership threshold. In general, under this approach, the details and mechanics of calculating whether the 60 percent threshold has been met

¹¹¹ See Sec. 1042 of the Tax Reform Act of 1976, *supra* note 33 (amending Section 367 to include an exception to Section 367(a)(1) for transfers of foreign stock or securities).

¹¹² See NYSBA Outbound Report, *supra* note 94 at 13 (noting a “disconnect” inherent in the Helen Regulations).

would be the same for Section 367(a) purposes as under Section 7874. While there would be special rules for five percent shareholders as there are in the Helen Regulations, the general shareholder gain recognition rule would be the same as the test whether Section 7874 applies.¹¹³ This approach is something of a hybrid. It acknowledges shareholder gain policy concerns by keeping in place a gain recognition agreement for five percent shareholders but recognizes that shareholder gain concerns are not significant in the case of smaller shareholders. Meanwhile, it tips its hat to legislative history that appears to presuppose that shareholder gain would be recognized in at least certain cases covered by Section 7874.

Whichever choice is made, the Helen Regulations should be replaced with regulations that taxpayers are able to apply without a ruling and that are more closely targeted to the policies that they are intended to protect, whether shareholder gain, corporate base erosion or both. Insofar as a variation of the Helen Regulations continues to monitor against corporate base erosion, it would likely be desirable to conform the Helen Regulations in relevant part to the Section 7874 regulations.

¹¹³ Possibly, in order to focus on the shareholder gain concern, the 60 percent test would be analyzed for Section 367(a) purposes by reference only to U.S. persons who are former shareholders of the domestic target.