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REPORT
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TAX TREATMENT OF CERTAIN TRANSFERS OF PROPERTY TO FOREIGN CORPORATIONS

December 30 (legislative day, December 28, 1970).—Ordered to be printed

Mr. Long, from the Committee on Finance, submitted the following

REPORT

[To accompany H.R. 19686]

The Committee on Finance, to which was referred the bill (H.R. 19686) to amend section 367 of the Internal Revenue Code of 1954, having considered the same, reports favorably thereon with amendments and recommends that the bill as amended do pass.

I. SUMMARY

Present law provides that, where a foreign corporation is involved in an exchange which otherwise would be a tax-free transaction, tax-free treatment is not available unless prior to the transaction the Internal Revenue Service has made a determination to the effect that the transaction is not being made to avoid Federal income taxes. Under current practice, the determination is made by the issuance of a ruling. H.R. 19686 modifies this provision in to provide that the required determination may be obtained after (as well as before) the transaction in the case of a transaction which involves only a change in the form of organization of a second (or lower) tier foreign subsidiary.

The House bill also provided that a contribution of property to the capital of a foreign corporation by one or more of the controlling shareholders of the corporation was to be treated as a taxable exchange unless the required determination was obtained from the Revenue Service prior to the transaction. In view of the fact that public hearings on this provision have not been held, the committee deleted this latter provision, without any expression of view on it, because those persons affected by the provision have not yet had an opportunity to present their views to Congress.

The Treasury Department has indicated that it does not oppose the enactment of this bill.

II. REASONS FOR BILL

Under present law (sec. 367), an exchange involving a foreign corporation which would otherwise be treated as a tax-free transaction under the corporate organization, reorganization, or liquidation provisions (secs. 332, 351, 354, 355, 356 or 361) does not qualify for tax-free treatment, unless prior clearance is obtained from the Internal Revenue Service. In other words, the taxpayer must obtain a ruling from the Internal Revenue Service prior to the transaction to the effect that the transaction is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

This provision is applicable whether the exchange involves both a domestic and a foreign corporation or whether it involves only foreign corporations. An example of the latter situation is the liquidation of a second tier foreign subsidiary into a first tier foreign subsidiary or the merger of two second tier foreign subsidiaries. A transaction involving second tier foreign subsidiaries can have immediate tax consequences to the U.S. shareholders of the first tier foreign subsidiary (under subpart F of the Code) if the transaction is treated as a taxable transaction. This is because the transaction in this case can result in taxable income to the first tier foreign subsidiary which would be currently taxable to the U.S. shareholder as a constructive dividend (under subpart F). Even if the U.S. shareholder is not currently taxable on the income because of the application of one of the exceptions (to subpart F treatment) the classification of the transaction as a taxable transaction might have an eventual effect on the taxation of the U.S. shareholder since it may result in an increase in the earnings and profits of the first tier foreign subsidiary. The earnings and profits of the subsidiary are relevant in determining whether a subsequent distribution to a U.S. shareholder constitutes a dividend. Moreover, in this case this would represent income on which the subsidiary is not likely to have paid any foreign taxes and, therefore, a foreign tax credit may not be available with respect to it.

It has been suggested in the past that a number of the transactions with respect to which an advance ruling is presently required (under sec. 367) are unlikely to involve avoidance of Federal income taxes and, accordingly, the taxpayer should be allowed to obtain the required ruling after the transaction has occurred as well as prior to its occurrence. In this regard, it has been suggested that the time required to obtain an advance ruling often is unduly lengthy in comparison to the time otherwise required to effect a business transaction. It also has been suggested that it is not infrequent for the U.S. parent company to be unaware of formal changes at the second tier foreign subsidiary level.

Although the committee is not prepared at this time to recommend a general revision of the advance ruling requirement (sec. 367), the committee agrees with the House that in the type of situation discussed below it is appropriate at this time to allow the required ruling to be obtained after the transaction occurs as well as before it occurs. The type of situation referred to involves a U.S. parent company which owns a first tier foreign subsidiary which in turn owns a second tier foreign subsidiary. The second tier foreign subsidiary

changed its form of organization from one corporate form under the applicable local foreign law to another corporate form. Under U.S. tax law, this transaction is treated as an exchange by the first tier foreign subsidiary of stock in the second tier foreign subsidiary for stock in a new second tier foreign subsidiary. This type of transaction is one which would be treated as a tax-free exchange under our tax law (secs. 354 and 368(a)(1)(F)).

If the required advance ruling were not obtained prior to the transaction, however, any gain on the transaction would be treated as ordinary income. Moreover, because in certain cases income of controlled foreign corporations is attributed on a current basis to the U.S. parent shareholders (under subpart F) any "gain" arising on the exchange may not only be considered ordinary income to the first tier foreign subsidiary but also in turn treated as currently taxable to the U.S. parent company.

The committee agrees with the House that this result is unduly harsh and that the U.S. parent company should be allowed to demonstrate to the Internal Revenue Service after the exchange that it did not have as one of its principal purposes the avoidance of Federal income taxes. This allows the exchange to be treated as a tax-free exchange and thus prevents the tax consequences described above from occurring. In this regard it should be noted that under the Internal Revenue Service's ruling policy the required advance ruling would normally be granted as a matter of course in this type of transaction.

The bill as passed by the House also provided that a contribution of property to the capital of a foreign corporation by one or more of the controlling shareholders of the corporation was to be treated as a taxable exchange, unless the required determination (under sec. 367) was obtained from the Internal Revenue Service prior to the transaction. No public hearings have been held on this provision and, accordingly, those persons who would be adversely affected by it have not had an opportunity to present their views to Congress. In deleting this provision, however, the committee is not expressing any view on the merits of the provision.

III. EXPLANATION OF BILL

For the reasons discussed above, the bill in general modifies the advance ruling requirement which applies in the case of exchanges involving foreign corporations (sec. 367) to allow the required ruling under that provision to be obtained subsequent to the exchange in the case of a transaction involving merely a change in the form of organization of a second or lower tier foreign subsidiary. In other words, the bill provides that the required ruling may be obtained after a transaction involving the exchange by a foreign corporation of its stock in a second foreign corporation (the old form) for stock in a third foreign corporation (the new form) if three requirements are met. First, the transaction must be merely a change in form (of the type which would qualify as a "change of form F reorganization"). Second, the second and third corporations may differ only in their form of organization. Third, the ownership of the second and third foreign corporations must be identical.

The amendments made by the bill are to apply with respect to transfers made after (including exchanges occurring after) December 31, 1967.

IV. CHANGES IN EXISTING LAW

In compliance with subsection (4) of rule XXIX of the Standing Rules of the Senate, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, existing law in which no change is proposed is shown in roman):

SECTION 367 OF THE INTERNAL REVENUE CODE OF 1954

SEC. 367. FOREIGN CORPORATIONS.

[In determining the extent to which gain shall be recognized in the case of any of the exchanges described in section 332, 351, 354, 355, 356, or 361, a foreign corporation shall not be considered as a corporation unless, before such exchange, it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes. For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.]

(a) GENERAL RULE.—In determining the extent to which gain shall be recognized in the case of any of the exchanges described in section 332, 351, 354, 355, 356, or 361, a foreign corporation shall not be considered as a corporation unless—

(1) before such exchange, or

(2) in the case of an exchange described in subsection (b), either before or after such exchange,

it has been established to the satisfaction of the Secretary or his delegate that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

(b) APPLICATION OF SUBSECTION (a)(2).—Subsection (a)(2) shall apply in the case of a mere change in form in which there is an exchange by a foreign corporation of—

(1) stock in one foreign corporation for,

(2) stock in another foreign corporation,

if the corporation referred to in paragraphs (1) and (2) differ only in their form of organization, and if the ownership of the corporation referred to in paragraph (1) immediately before such exchange is identical to the ownership of the corporation referred to in paragraph (2) immediately after such exchange.

(c) SECTION 355 DISTRIBUTIONS TREATED AS EXCHANGES.—For purposes of this section, any distribution described in section 355 (or so much of section 356 as relates to section 355) shall be treated as an exchange whether or not it is an exchange.

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