TAXATION OF MAQUILADORA EXCHANGES: THE TAMING OF THE SHREW

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I. INTRODUCTION 203
II. TAXABILITY OF THE SUBSIDIARY 207
A. *In General* 207
B. *Currency* 207
C. *Purchasing Goods and Services* 209
D. *Exchange with No Material Difference* 210
E. *Contribution to Capital* 211
F. *Reorganization Exchanges* 212
G. *Blocked Income* 213
H. *Reappraisal* 213
III. NO MATERIAL DIFFERENCE 214
A. *Introduction* 214
B. *Early Authorities* 215
1. Regulations 215
2. Reorganization Rulings 216
3. Exchange Regulations 217
4. Reorganization Decisions 217
C. *Congressional Action* 218
1. Business Interests 218
2. Official Opinions 219
3. Exchanges of Securities 220
D. *Material Difference Standard* 221
1. Exchange Regulations 221
2. Interest in the Same Property 221
3. Interests in Different Properties 222
4. Securities Transactions 223
E. *Debt Modification Regulations* 224
F. *Reappraisal* 226
IV. CONTRIBUTIONS TO CAPITAL 227
A. *Introduction* 227
B. *Early Authorities* 228

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1. Shareholder Contributions 228
2. Nonshareholder Contributions 229

C. Shareholder Contributions 230

D. Nonshareholder Contributions 230

1. Intent 231
2. Bargaining 232
3. Working Capital 233
4. Benefit 233
5. Employment 234
6. Balancing the Factors 234
7. A Critique of the Factors 235

E. Applying the Factors 235

F. Reappraisal 241

V. TAXABILITY OF THE PARENT 242

A. In General 242

B. Actual Transfer by the Parent 243

C. Deemed Transfer by the Parent 245

1. Imputed Sales 245
2. Assignment of Income 246
3. Reallocation of Income 247
4. Controlled Foreign Corporation 248
5. Foreign Personal Holding Company 252
6. Passive Foreign Investment Company 253

D. Reappraisal 255

VI. BLOCKED INCOME 257

A. Introduction 257

B. Cash Method 257

C. Accrual Method 259

D. Deferrable Foreign Income Method 261

E. Controlled Foreign Corporations 263

F. Reallocation of Income 266

G. Burden of Proof 269

H. Reappraisal 270

VII. PLANNING 273

A. Introduction 273

B. Direct Involvement of the Parent 273

C. Indirect Involvement of the Parent 277

D. Lack of Receipt by the Subsidiary 279

F. Reappraisal 281

VIII. CONCLUSION 282

I. INTRODUCTION

The ability of less developed countries to borrow almost any quantity of dollars produced a debt crises.[1] The announcement of Mexico that it could no longer service its debt[2] convinced many lenders that full repayment was unlikely, and they wrote off fifty percent or more of the face value of the debts.[3] Since Mexico wished to avoid default, it decided to repurchase dollar obligations[4] at a much smaller discount[5] with pesos which could only be used to establish or expand approved business operations in Mexico.[6]

The repayment plan made everyone at least reasonably happy. Creditors holding dollar obligations found a new market for the suspect debts. Mexico avoided default without using expensive hard currency, and increased business activity would improve the economy. Businesses were able to finance new or enhanced operations at a fraction of the usual cost.[7]

The typical arrangement is for a United States corporation to finance a new enterprise to be run by a new Mexican subsidiary.[8] Income

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1. *See* Alberto Santos, *Beyond Baker and Brady: Deeper Debt Reduction for Latin American Sovereign Debtors*, 66 N.Y.U. L. REV. 66, 71 (1991). Another crises may be just around the corner. *See* Rory MacMillan, *The Next Sovereign Debt Crises*, 31 STAN. J. INT'L L. 305, 306 (1995).

2. *See* Lawrence Rout & Julie Salamon, *Mexico Seeks to Stop Paying Debt Principal*, WALL ST. J., Aug. 20, 1982, at 2. *See generally* DANIEL YERGIN, THE PRIZE 667, 730-32 (1992).

3. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 61 (1994), *on reconsideration*, 106 T.C. 257 (1996).

4. Mexico and other countries borrowed dollars, and promised to repay in dollars. *See* M.L. Dionne, *Revenue Ruling on Debt/Equity Swaps Leaves Unanswered Questions—to the Delight of the Tax Bar*, 39 TAX NOTES 166, 173, tbl. 2 (1988); *G.M. Trading*, 103 T.C. at 61.

5. One corporation purchased a dollar obligation for 50% of face value, which was redeemed for pesos worth 87% of face value as part of a Maquiladora exchange. *See G.M. Trading*, 103 T.C. at 63-64.

6. *See* Mexico, *Operating Manual for Debt Capitalization and Public Debt Substitution by Investment* (1986); Mark Baker, *Debt/Equity Swaps and Mexican Law: The Interplay Between Law and Regulation*, 9 NW. J. INT'L L. & BUS. 333, 347 (1988); J. Hayden Kepner, *Mexico's New Foreign Investment Regulations*, 18 SYRACUSE J. INT'L L. & COM. 41, 46 (1992). *See generally* Lee Buchheit, *Alternative Techniques in Sovereign Debt Restructuring*, 1988 U. ILL. L. REV. 371; Lee Buchheit, *The Capitalization of Sovereign Debt*, 1988 U. ILL. L. REV. 401; Michael Chamberlain et al., *Sovereign Debt Exchanges*, 1988 U. ILL. L. REV. 415; Derek Asiedu-Akrofi, *Sustaining Lender Commitment to Sovereign Debtors*, 30 COLUM. J. TRANSNAT'L L. 1, 21 (1992); Enrique Carrasco & Randall Thomas, *Encouraging Relational Investment and Controlling Portfolio Investment in Developing Countries in the Aftermath of the Mexican Financial Crises*, 34 COLUM. J. TRANSNAT'L L. 539, 550 (1996); Rory Macmillan, *Towards a Sovereign Debt Work-out System*, 16 NW. J. INT'L L. & BUS. 57 (1996).

7. *See G.M. Trading*, 103 T.C. at 61.

8. The business must be operated by a Mexican corporation, which can be a new or existing subsidiary. *See G.M. Trading*, 103 T.C. at 60.

from a Maquiladora transaction will not be taxed to the subsidiary because there is no tax on the foreign income of a foreign corporation.[9] Since the parent is a United States corporation, it will be taxed on its worldwide income regardless of the source.[10]

Maquiladora exchanges can be accomplished in several ways. One approach is for the parent to purchase a dollar obligation and transfer it to Mexico. Mexico conveys permission to do business in Mexico and a restricted peso account to a new corporation, and delivers all of the stock to the parent.[11] Another method is for the parent to purchase the dollar obligation, and transfer it to an existing subsidiary. The subsidiary transfers the obligations to the government in exchange for the permission and the account. Neither of those approaches is recommended because the direct involvement of the parent in the exchange transaction presents opportunities for the Internal Revenue Service (IRS) to tax the parent.[12]

The treatment of income received by the subsidiary is important. Although it is not taxable to the subsidiary, it may be taxable to the parent. A parent usually does not realize income from a subsidiary until it receives an actual distribution.[13] Undistributed income may be taxed to the parent under anti-tax avoidance rules which include[14] the imputed sales[15] and assignment of income[16] doctrines, and the reallocation of income,[17] controlled foreign corporation[18] foreign personal holding company,[19] and passive foreign investment company[20] statutes.

There are several ways for the subsidiary to accomplish an exchange. Suppose the parent forms a new Mexican subsidiary with enough cash to purchase a dollar obligation and pay the other expenses of an exchange with the government.

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9. *See* 3 BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS ¶ 66.1, at 66-3 (2d ed. 1991).

10. *See* Cook v. Tait, 265 U.S. 47, 51 (1924); Barclay & Co. v. Edwards, 267 U.S. 442, 448 (1924); 3 BITTKER & LOKKEN, *supra* note 9, ¶ 65.1, at 65-2 to -4.

11. *See G.M. Trading*, 103 T.C. at 64.

12. *See id.* at 68-69.

13. *See* Eisner v. Macomber, 252 U.S. 189, 217 (1920).

14. The other antiavoidance rules have no effect on a Maquiladora exchange. *See generally* 3 BITTKER & LOKKEN, *supra* note 9, chs. 66-71.

15. *See* Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

16. *See* Lucas v. Earl, 281 U.S. 111, 115 (1930).

17. *See* I.R.C. § 482.

18. *See id.* § 951(a).

19. *See id.* § 551(a).

20. *See id.* §§ 1293(a)(1); 1291(a)(1).

There is no tax on purchasing a dollar obligation for less than face value,[21] and the basis for the obligation is the purchase price.[22] The subsidiary exchanges the obligation for permission and an account worth more than the basis. The gain is not realized if there is no material difference[23] between the properties. The material difference rule is not a workable planning tool because the test is subjective, and there is little favorable precedent.

The properties received may be a contribution to capital to the extent they exceed the value of the obligation. Nonshareholder contributions to capital by a government are not taxable[24] if several criterion are satisfied.[25] While this theory seems to apply, success is uncertain because the Tax Court has concluded that a Maquiladora exchange did not include a contribution to capital.[26]

The reorganization rules are a possibility. Mexico forms a corporation and transfers permission and an account to the corporation. The subsidiary exchanges a dollar obligation for all of the stock of the corporation. Since the obligations are apparently not qualified consideration,[27] reorganization treatment probably is not available.

Exchanging dollars for pesos has a better chance of success. The subsidiary purchases pesos for dollars, and Mexico uses the dollars to purchase dollar obligations. There is no tax on purchasing pesos for cash,[28] and the subsidiary will argue that there is no tax on using the pesos to purchase business assets such as plant and equipment.[29]

Another alternative is using dollars to acquire business assets. The subsidiary agrees to pay in advance for mutually agreeable plant and equipment to be delivered by Mexico, and Mexico uses the cash to

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21. *See* Commissioner v. LoBue, 351 U.S. 243, 248 (1956); Hunley v. Commissioner, 25 T.C.M. (P-H) 355, 355 (1966). *See generally* 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78.

22. *See id.* Rev. Rul. 87-124, 1987-2 C.B. 205; G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 59 (1994), *on reconsideration*, 106 T.C. 257 (1996).

23. *See* Treas. Reg. § 1.1001-1(a) (1994).

24. *See* I.R.C. § 118.

25. *See* United States v. Chicago, B. & Q. R.R., 412 U.S. 401, 407-16 (1973).

26. *See G.M. Trading*, 106 T.C. at 257.

27. *See* Emery v. Commissioner, 166 F.2d 27, 30 (2d Cir. 1948); *see also* Girard Tr. Co. v. United States, 166 F.2d 773, 775 (3d Cir. 1948).

28. *See* Commissioner v. LoBue, 351 U.S. 243, 248 (1956); Hunley v. Commissioner, 25 T.C.M. (P-H) 355, 355 (1966). *See generally* 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78.

29. *See* I.R.C. § 985(a), (b)(1)(B); S. REP. NO. 99-313, at 450 (1986), *reprinted in* 1986-3 (vol. 3) C.B. 450; STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1086 (Comm. Print 1987), *reprinted in* 61 TAX REFORM 1986, at 1086 (Reams & McDermott eds., 1987).

purchase dollar obligations. The IRS will argue that the subsidiary realizes interest income[30] and gain on purchasing goods and services[31] because the advance is a loan.[32]

The transaction which is most likely to succeed is a simultaneous exchange of dollars for business assets. The parties agree that Mexico will construct and furnish a building in exchange for progress payments. Mexico pays for the building and furnishings with pesos, and uses dollars to purchase dollar obligations. The subsidiary would not receive income since the transaction clearly is a cash purchase of goods and services.[33]

The extent of the discount on the dollar obligations varies with the desirability of the proposal,[34] and the form of the transaction is another matter for negotiation with Mexico. Negotiators should be prepared to discuss the value of a discount depending on whether the exchange may be subject to United States tax. They should point out that it will cost Mexico nothing to provide freedom from tax.

The parent will have to assess its chances for success with the most desirable type of exchange that is acceptable to Mexico. The ultimate decision will be based on the probability that the proposed business venture will be sufficiently profitable to justify the definite costs and other risks.

Many countries other than Mexico have borrowed heavily,[35] and some of them have Maquiladora programs.[36] Although the discussion focuses on exchanges with Mexico, it is equally applicable to transactions with other countries.

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30. *See* I.R.C. § 7872(a-b).

31. *See* Treas. Reg. § 1.1001-1(a) (1994); Rev. Rul. 55-757, 1955-2 C.B. 557; Rev. Rul. 60-210, 1960-1 C.B. 38; Rev. Rul. 70-41, 1970-1 C.B. 77.

32. The contract should make it clear that the transaction is not a loan. Since the declaration is only one of the factors to be considered, whether a transaction will be treated as a loan usually is unclear. *See, e.g.*, Zohoury v. Commissioner, 52 T.C.M. (P-H) 2423 , 2426-28 (1983).

33. *See LoBue*, 351 U.S. at 248; *see also Hunley*, 25 T.C.M. at 355. *See generally* 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78.

34. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 61 (1994), *on reconsideration*, 106 T.C. 257 (1996); Christopher Gottscho, *Debt-Equity Swap Financing of Third World Investments*, 8 VA. TAX REV. 143, 158-60 (1988).

35. *See* Dionne, *supra* note 4, at 173, tbls. 1, 2.

36. *See* Bruce Cohen, *Tax Implications of Debt-for-Equity Swaps*, 12 HASTINGS INT'L & COMP. L. REV. 575, 576 (1989); Thomas Reiter, *The Feasability of Debt-Equity Swaps in Russia*, 15 MICH. J. INT'L L. 909, 943-50 (1994). *See generally* Jon H. Sylvester, *Impractibility, Mutual Mistake and Related Contractual Bases for Equitably Adjusting the External Debt of Sub-Saharan Africa*, 13 NW. J. INT'L L. & BUS. 258 (1992).

This Article addresses approaches to reducing the United States tax burden on the American parent. Discussion begins with ways in which the foreign subsidiary may avoid receipt of income, continues with exchanges where there is no material difference, contributions to capital, ways in which the American parent may postpone receipt of income, the effect of blocked income, and ends with application of the rules to alternative approaches to the transaction. The conclusion argues that the IRS has been improperly restrictive in applying the rules.

II. TAXABILITY OF THE SUBSIDIARY

A. In General

The subsidiary is not liable for United States tax on income from a Maquiladora exchange because foreign corporations are not taxed on foreign income.[37] The nature of the transaction between the subsidiary and Mexico is important because it affects the amount and timing of the liability of the parent for United States tax.

The parent may be liable for tax under several anti-tax avoidance rules.[38] Since inclusion in the gross income of the subsidiary usually is required,[39] anything that can be done to reduce or postpone inclusion may be helpful to the parent. Results are largely dependent of the form of the Maquiladora exchange.

B. Currency

The amount and timing of the subsidiary's gain from the Maquiladora exchange may depend on its functional currency.[40] The

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37. 3 BITTKER & LOKKEN, *supra* note 9, ¶¶ 66.1 - 66.2, 66.3.5. Returns and other information may have to be filed by foreign corporations which are not subject to tax. *See generally* Ralph Kelley & John Schrier, *Increased Reporting Requirements Imposed on Foreign Corporations*, 72 J. TAX. 366 (1990); John Pridjian, *Using a Shotgun When a Pistol Would Do*, 11 VA. TAX REV. 427 (1991); Joel Williamson et al., *Reporting and Record Keeping Requirements for Foreign and Foreign-Owned Corporations*, 44 S. CAL. TAX INST. ch. 22 (1992).

38. *See infra* Part V.

39. Inclusion is not required in a few situations. *See* Treas. Reg. § 1.482-1(f)(1)(iii) (1994); *see, e.g.*, Michael Loening, *Section 482 Allocations Resulting in the Creation of Income*, 30 N.Y.U. TAX INST. 1247, 1248-65 (1972); Francis Allegra, *Section 482: Mapping the Contours of the Abuse of Discretion Standard of Judicial Review*, 13 VA. TAX REV. 423, 450 n.84 (1994).

40. *See generally* Robert Hudson & Greg Lemein, *U.S. Tax Planning for U.S. Companies Doing Business in Latin America*, 27 U. MIAMI INTER-AM. L. REV. 233, 276-85 (1996); BORIS BITTKER & LAWRENCE LOKKEN, FEDERAL TAXATION OF INCOME, ESTATES AND GIFTS, 1996 Cumulative Supp. No. 4, S71-1 to -89 (1997) [hereinafter Supp. No. 4]; DONALD RAVENSCROFT, TAXATION AND FOREIGN CURRENCY: THE INCOME TAX CONSEQUENCES OF FOREIGN EXCHANGE TRANSACTIONS AND EXCHANGE RATE FLUCTUATIONS (1973).

dollar is the functional currency[41] of the subsidiary unless it elects[42] to use the peso.[43] If the election was not made, pesos are treated as property for tax purposes, and gain is recognized if pesos are exchanged for something worth more than the basis.[44] If the election was made, legislative history in effect concludes pesos are money if they are used to pay ordinary and necessary expenses, and no gain is recognized if the expense is greater than the basis.[45] Since there is no apparent reason to treat capital facilities differently, gain presumably is not recognized if pesos are used to purchase plant and equipment to be used directly in the operation of the business.[46]

Where pesos are the functional currency, dollars might be classified as property.[47] If that argument is successful, gain may be realized when dollars are used to make purchases.[48] That result could affect the timing and amount of the subsidiary's income.

The questions disappear if the election is not made. Hence the election is not a desirable choice when the only consideration is the treatment of a Maquiladora transaction. Where the election is desirable for other reasons, a decision will have to be based on a comparison of the other reasons with the probable Maquiladora results.

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41. *See* I.R.C. § 985(b)(1)(A).

42. The subsidiary is a qualified business unit. *See* Treas. Reg. § 1.989(a)-1(e), exs. 4-5, 9 (1991). The subsidiary may elect to use any currency in which a significant part of its activities are conducted by keeping its books and records in that currency. *See* I.R.C. § 985(b)(1)(B).

43. Currency means metal or paper money used as a circulating medium of exchange. *See* Rev. Rul. 74-218, 1974-1 C.B. 202. Mexican bullion gold pesos are not currency because they are not a circulating medium of exchange. *See* Rev. Rul. 76-214, 1976-1 C.B. 218; California Fed. Co. v. Commissioner, 76 T.C. 107, 113 (1981), *aff'd*, 680 F.2d 85, 87 (9th Cir. 1982).

44. *See, e.g.*, Rev. Rul. 74-7, 1974-1 C.B. 198. *See generally* Supp. No. 4, *supra* note 40, at S71-38 to -39.

45. *See* S. REP. NO. 99-313 at 450 (1986), *reprinted in* 1986-3 C.B. 450; STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1086 (Comm. Print 1987), *reprinted in* 61 TAX REFORM 1986, at 1086 (Reams & McDermott eds., 1987).

46. A tax service reports that some IRS officials feel that a functional currency election never affects the timing or amount of income. *See* 10 FED. TAX COORDINATOR 2d (RIA) 24, 964.

47. A dollar is not always a dollar. Cases involving statutes which differentiate between money and other property conclude that money is other property whenever the value is greater than the face amount. *See California Fed.*, 76 T.C. at 109-12; Cordner v. United States, 671 F.2d 367, 368 (9th Cir. 1982); Joslin v. United States, 666 F.2d 1306, 1307 (10th Cir. 1981). *See generally* Robert Henry, *The Emerging Concept of Amount Realized: Results in Search of Reasons*, 51 BROOKLYN L. REV. 41, 88-93 (1984).

48. *See* Rev. Rul. 79-143, 1979-1 C.B. 264; *California Fed.*, 76 T.C. at 109-12.

C. Purchasing Goods and Services

There is no gross income from a cash purchase of goods and services.[49] The IRS presumably will not question the result if dollars and the plant and equipment are exchanged almost simultaneously. The result is uncertain if there is a substantial delay between payment of the dollars and delivery of the assets.

Some cases conclude that the nature of the transaction does not change even where there is a substantial delay. One taxpayer agreed to transfer land, and was given the right to select the replacement land to be delivered to him at a later time. The transaction was a like-kind exchange even though the taxpayer selected the replacement land, and eighteen months elapsed before he received the replacement land. The result has been approved by the IRS and by Congress.[50]

The IRS probably will be successful with the argument that an advance payment of dollars is a loan. The difficulty in determining whether there was a debtor-creditor relationship[51] is illustrated by the subjective nature of debt-equity litigation,[52] and the fact that the IRS and the Treasury were unable to formulate satisfactory debt-equity regulations.[53] The problem is compounded by the fact that the taxpayer has the burden of proving that an advance was not a loan.

There are two consequences of loan classification. The subsidiary will be treated as having received interest income to the extent that the

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49. *See* Commissioner v. LoBue, 351 U.S. 243, 248 (1956); *see also* Hunley v. Commissioner, 25 T.C.M. (P-H) 355, 358 (1966). *See generally* 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78.

50. *See* Starker v. United States, 602 F.2d 1341, 1342-44, 1351-56 (9th Cir. 1979), *cited with approval by* Garcia v. Commissioner, 80 T.C. 491, 498-500 (1983), *acq.* 1984-2 C.B. 1. The result was confirmed, and the delay period was limited by the 1984 Act. *See* H.R. CONF. REP. NO. 98-861, at 866 (1984), *reprinted in* 1984-3 (vol. 2) C.B. 120.

51. The contract should make it clear that the transaction is not a loan. Since the declaration is only one of the factors to be considered, whether a transaction will be treated as a loan usually is unclear. Zohoury v. Commissioner, 52 T.C.M. (P-H) 2423, 2426-28 (1983); Dorzback v. Collison, 195 F.2d 69, 71 (3d Cir. 1952). *See generally* William Plumb, *The Federal Income Tax Significance of Corporate Debt*, 26 TAX L. REV. 369 (1971); David Hariton, *The Taxation of Complex Financial Instruments*, 43 TAX L. REV. 731 (1988); William Rands, *The Closely Held Corporation: Its Capital Structure and the Federal Tax Law*, 90 W. VA. L. REV. 1009 (1988).

52. *See* BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 4.02[7], at 4-16, 4.03[2][a], at 4-20 to -22 (6th ed. 1994).

53. Two authorities describe the problem as a "hot potato." Regulations proposed in 1979 covered 110 pages of single spaced material. After several law review articles, hearings, and modifications, the proposal was withdrawn in 1983 because the government was unable to find a combination of rules that could never be used against it. An absence of rules allows the IRS to argue whatever position it finds suitable under the circumstances. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 4.02[8][a], at 4-17 n.56; 3 BITTKER & LOKKEN, *supra* note 9, ¶ 91.10.4, at 91-45 to -46.

interest stated in the contract is inadequate.[54] Repayments of principal are treated as received in exchange for the debt, and gain is realized if the amount of the repayment exceeds the subsidiary's basis for the debt.[55]

D. Exchange with No Material Difference

Gain is not realized if there is no material difference in kind or extent between the property given up and the property received.[56] The material difference standard is too general to be useful in attempting to compare properties, and legislative and administrative materials[57] offer little or no assistance for most properties. A 1996 regulation[58] does provide relatively concrete rules for determining whether a modification of a debt instrument is material.[59]

The 1996 regulation gives the IRS additional grounds for argument in most cases. One requirement is that the old and new properties are classified as debt for federal income tax purposes.[60] Exchanging dollar obligations for pesos is a material modification because pesos are not a debt. Another rule limits the amount of change in interest rates. Surrendering a dollar obligation for a restricted peso account[61] is a material modification[62] if the rates differ by more than 1/4th of a percent.[63]

A modification is material if the ability of the debtor to pay is changed from primarily speculative to adequate, and the alteration is substantial.[64] Since changing from payments in dollars to payments in

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54. *See* I.R.C. § 7872(a-b).

55. *See, e.g.*, Treas. Reg. § 1.1001-1(a) (1994); Rev. Rul. 55-757, 1955-2 C.B. 557; Rev. Rul. 60-210, 1960-1 C.B. 38; Rev. Rul. 70-41, 1970-1 C.B. 77.

56. *See* Treas. Reg. §§ 1.1001-1(a) (1994), 1.1001-3(a) (1996).

57. *See* Craig Friedrich, *The Treasury's Debt Modification Regulations:* Cottage Savings *Proves a Perilous Beacon*, 20 J. CORP. TAX'N 151, 152 (1993).

58. Treas. Reg. § 1.1001-3(a), (e) (1996).

59. *See generally* Friedrich, *supra* note 57, at 151; A.B.A. Tax Section Task Force, *Report on Prop. Regs. § 1.1001-3: Modifications of Debt Instruments*, 47 Tax Law. 987, 1008 (1994).

60. *See* Treas. Reg. § 1.1001-3(e)(5)(i) (1996).

61. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 63-4 (1994), *on reconsideration*, 106 T.C. 257 (1996).

62. The IRS could also argue that the deposit contract is not a debt for federal income tax purposes.

63. The five percent rule does not apply to exchanging one debt for another. *See* Treas. Reg. § 1.1001-3(e)(2)(ii) (1996). In one case, the interest rate on the dollar obligation was not stated. The restricted peso account bore a variable interest rate, and the rates actually paid varied between 40.28% and 152.88%. *See G.M. Trading*, 103 T.C. at 64.

64. *See* Treas. Reg. § 1.1001-3(e)(4)(vi)(A)(1) (1996).

pesos was designed to enhance the ability of Mexico to pay,[65] the change may be material.

Whether all or parts of the regulation should be upheld is uncertain. Since it attempts to change the judicial gloss on an existing statute,[66] it may be an invalid attempt to legislate by regulation.[67]

E. Contribution to Capital

A contribution to capital by a nonshareholder generally is excluded from the gross income of the recipient.[68] Since the statute was enacted to give approval to results reached by the courts,[69] judicial authorities are the principal guide for determining whether a transaction qualifies for an exclusion.

The primary test is the intent of the person who made the payment. If he only expected indirect benefits, then four additional tests are concerned with the intent and actions of the recipient. If the tests are satisfied, the payment is a excludable as a contribution to capital.[70]

Several cases conclude that part of a payment was for services, and the balance was a contribution to capital.[71] One decision treats Maquiladora transactions differently. Even though Mexico received indirect consideration, the Tax Court concluded there was no contribution to capital because Mexico intended to obtain relief from its dollar obligation.[72]

People may be able to avoid the refusal to allocate by dividing the transaction into two parts. Although the IRS will argue the step transaction doctrine,[73] it should not apply since the corporation is not

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65. *See G.M. Trading*, 103 T.C. at 59.

66. *See* Cottage Savings Assoc. v. Commissioner, 499 U.S. 554, 560-62 (1992); Richard M. Lipton, *IRS Issues Proposed Regulations on Debt Modifications*, 71 TAXES 67, 70 n.24 (1993).

67. *See* United States v. Empey, 406 F.2d 157, 170 (10th Cir. 1969).

68. *See* I.R.C. § 118(a).

69. *See* S. REP. NO. 83-1622 (1954), *reprinted in* 2 U.S. REVENUE ACTS 1954, at 1, 18-19 (Bernard D. Reams ed., 1982).

70. *See* United States v. Chicago, B. & Q. R.R., 412 U.S. 401, 413 (1973).

71. *See* Bear Valley Mutual Water Co. v. Riddell, 283 F. Supp. 949, 960 (Cal. 1968), *aff'd per curiam*, 427 F.2d 713 (9th Cir. 1970); Lake Forrest, Inc. v. Commissioner, 32 T.C.M. (P-H) 176, 184-85 (1963); Concord Village, Inc. v. Commissioner, 65 T.C. 142, 155-60 (1975); Board of Trade of the City of Chicago v. Commissioner, 106 T.C. 369, 382-92 (1996).

72. *See* G.M. Trading Corp. v. Commissioner, 106 T.C. 257, 266 (1996). *See generally* I.R.S., Maquiladora Industry: Debt/Equity Swaps, 1995 WL 391419 [hereinafter Maquiladora Industry]; William R. Leighton & T. Richard Sealy III, *Federal Income Tax Issues in the Organization, Financing and Operation of Maquiladoras*, 23 ST. MARY'S L. J. 721, 727-33 (1982).

73. *See generally* Maquiladora Industry, *supra* note 72.

trying to avoid a legitimate tax liability.[74] If the step transaction doctrine is applied, the taxpayer has the burden of proving the value of the direct and indirect benefits received by Mexico.[75]

F. Reorganization Exchanges

Nonrecognition is available[76] if the transaction satisfies a definition and meets the other requirements for a reorganization. It is doubtful that an exchange of dollar obligations for stock or a restricted peso account could qualify for nonrecognition.

A reshuffling of the capital structure of a corporation is a recapitalization[77] if there is no change in the right to corporate assets.[78] An exchange of a dollar obligation for a restricted peso account probably does not qualify because of the differences in the rights. The right to receive dollars presumably is materially different from the right to receive pesos.[79]

Even if an exchange is a recapitalization or satisfies another definition,[80] the transaction probably is not a reorganization. Several decisions conclude the statute does not apply to an exchange of municipal bonds because Congress did not intend that result.[81] Since the decisions were based on the differences between governmental and private business activity,[82] they seem equally applicable to any exchange which includes dollar obligations of a foreign government.

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74. *See* Gregory v. Helvering, 293 U.S. 465, 469-70 (1935); *G.M. Trading*, 106 T.C. at 267.

75. *See, e.g.*, *Bear Valley Mutual Water*, 283 F. Supp. at 960; *Concord Village*, 65 T.C. at 155-60; *see also Board of Trade of the City of Chicago*, 106 T.C. at 382-92.

76. *See* I.R.C. §§ 354(a)(1), 361(a).

77. *See* Helvering v. Southwest Consolidated Corp., 315 U.S. 194, 202 (1942).

78. *See* Bazley v. Commissioner, 331 U.S. 737, 740 (1947).

79. *See* Treas. Reg. § 1.1001-3(c)(1) (1996). *See generally* Rev. Rul. 87-124, 1987-2 C.B. 205; *G.M. Trading*, 103 T.C. at 67.

80. *See* I.R.C. § 368(a); *see also* BITTKER & EUSTICE, *supra* note 52, ¶¶ 12.20-.30[5][f], at 12-23 to -151; JOEL KUNTZ AND ROBERT PERONI, 2 U.S. INTERNATIONAL TAXATION B5-1 to -111 (1996).

81. *See, e.g.*, Emery v. Commissioner, 8 T.C. 979, 984 (1947), *aff'd*, 166 F.2d 27, 30 (2d Cir. 1948).

82. *See e.g.*, Speedway Water Co. v. United States, 100 F.2d 636, 637-38 (7th Cir. 1938); Emery v. Commissioner, 8 T.C. 979, 984 (1947), *aff'd*, 166 F.2d 27, 30 (2d Cir. 1948). Several judges found there was no reason to distinguish between bondholders of public and private corporations. *See id.* at 985-87 (LeMire & Opper, JJ., dissenting), *aff'd*, 166 F.2d at 31-32 (Chase, J., dissenting).

Nonrecognition is available if the transaction is a reorganization and the consideration received is stock or securities.[83] While stock in a new corporation satisfies the definition of stock, a restricted peso account is not a security if the subsidiary can withdraw the pesos within five years after the Maquiladora exchange.[84]

Where there is substantial doubt about nonrecognition, many taxpayers insist on a favorable advance ruling.[85] A favorable ruling is unlikely because of the rules mentioned above, and the general hostility of the IRS towards Maquiladora exchanges.[86]

G. *Blocked Income*

Income received in a foreign country is not currently taxable by the United States if it is blocked. Income which cannot be spent in a foreign country[87] or the United States[88] is blocked because the taxpayer is unable to benefit from the income. The exact requirements for blockage vary depending on the circumstances. If an item is blocked when it is received, it continues to be blocked until the restriction is removed.

H. *Reappraisal*

Some of the topics do not seem worthy of further consideration. Since the consequences of an election to treat pesos as the functional currency are very uncertain, it is assumed that no one would make the election until it could not alter the results of a Maquiladora transaction. Whether a transaction is a loan will not be discussed because precedent is

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83. *See* I.R.C. §§ 354(a)(1), 361(a). *See generally* David J. Rachofsky, *The Reorganization that Fails: Tax Consequences of an Involuntarily Taxable Reorganization*, 32 N.Y.U. TAX INST. 639 (1974); Robert r. Tufts, *The Taxable Merger*, 7 J. CORP. TAX'N 342 (1981).

84. *See, e.g.*, Pinellas Ice & Cold Storage Co. v. Commissioner, 287 U.S. 462, 468 (1933); *cf. G.M. Trading*, 103 T.C. at 63-65 (large majority of pesos withdrawn within seven months), *with* Neville Coke & Chemical Co. v. Commissioner, 148 F.2d 599, 602 (3d Cir. 1945) (five-year notices were short term), *cert. denied*, 326 U.S. 726 (1945). *See generally* BITTKER & EUSTICE, *supra* note 52, ¶ 12.41[2], at 12-154 to -167.

85. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 12.41[2], at 12-154 to -167.

86. *See generally* Maquiladora Industry, *supra* note 72; *see also* Leighton and Sealy, *supra* note 72, at 727-33.

87. *See* International Mortgage and Inv. Corp. v. Commissioner, 36 B.T.A. 187, 190 (1937), *acq.* 1937-2 C.B. 15.

88. *See* United Artists Corp. of Japan v. Commissioner, 13 T.C.M. (P-H) 679, 683 (1944).

of little value in making determinations.[89] Reorganizations will not be discussed since that approach is unlikely to be successful.[90]

Other topics deserve extensive investigation. Even though it is clear that no material difference arguments will not be successful, they will be discussed[91] because people are still relying on that theory,[92] and the new debt modification regulations[93] strengthen the position of the government. Contribution to capital should provide an exclusion for part of the gain[94] from exchanging dollar obligations for property such as stock or a restricted peso account.[95] Blocked income is another fertile ground for favorable results.[96]

III. NO MATERIAL DIFFERENCE

A. Introduction

There is no taxable gain from an exchange if the property received does not differ materially from the property given up.[97] Planning is difficult because the material difference standard is too general to be a useful guide.

Administrative materials and court decisions provide some assistance. The taxpayer has a good chance of winning if he merely retains a modified interest in the same property. Where a common ownership is partitioned so the taxpayer becomes the sole owner of a portion of the property, there is no material difference.[98]

The taxpayer's prospects are poor where he gives up one asset and receives another. The IRS and the courts agree that different properties rarely satisfy the material difference standard. Even if mortgage pools are economically identical,[99] there is a material difference

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89. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 4.02[7], at 4-16.

90. *See, e.g.*, Emery v. Commissioner, 8 T.C. 979, 984 (1947), *aff'd*, 166 F.2d 27, 30 (2d Cir. 1948).

91. *See infra* Part III.

92. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 69-71 (1994), *on reconsideration*, 106 T.C. 257 (1996).

93. *See infra* Part III.

94. *But see G.M. Trading*, 103 T.C. at 69, *on reconsideration*, 106 T.C. at 265-67.

95. *See infra* Part IV.

96. *See infra* Part VI.

97. *See* Treas. Reg. § 1.1001-1(a) (1994).

98. *See* Rev. Rul. 55-77, 1955-1 C.B. 339; Rev. Rul. 56-437, 1956-2 C.B. 507; Collins v. Commissioner, 412 F.2d 211, 212 (10th Cir. 1969).

99. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 6.10[4][b], at 6-60 n.270.

because the individual mortgages provide different rights and liabilities.[100]

A 1996 regulation attempts to introduce a greater degree of certainty into application of the material difference standard if the transaction is a debt modification.[101] It applies if a dollar obligation is exchanged for a restricted peso account or another type of indebtedness.[102] Since it attempts to change the judicial gloss on an existing statute,[103] there is substantial doubt about whether the regulation is enforceable.[104]

B. Early Authorities

1. Regulations

The meaning of the phrase gross income was established at an early date. The 1909 regulations concluded that it included income from operation of a corporation, and income it derived from any other source.[105] Supreme Court decisions emphasized the fact that gross income included income from all sources.[106]

Exchanges were covered by another portion of the same regulation. One clause required reporting of gain from sales of capital assets,[107] and another concluded that receipts could be in cash or property.[108] Hence, where properties were exchanged, the gain to be reported was the fair market value of the property received less the cost of the property given up.

The 1909 Act only applied to corporations,[109] and there were no reported decisions involving exchanges of debts, or of securities. The

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100. *See* Cottage Savings Assoc. v. Commissioner, 499 U.S. 554, 559-67 (1991). Another decision involved corporations which were incorporated in different states. Since the state laws provided different rights and powers to the corporations, their stocks were materially different. *See* Marr v. United States, 268 U.S. 536, 541 (1924).

101. *See* Treas. Reg. § 1.1001-3 (1996).

102. *See id.* § 1.1001-3(a)(1).

103. *See Cottage Savings*, 499 U.S. at 560-62; Lipton, *supra* note 66, at 70.

104. *See* United States v. Empey, 406 F.2d 157, 170 (10th Cir. 1969).

105. *See* Treas. Reg. 31, art. 2, ¶ 5 (1909), *reprinted in* 12 TREAS. DEC. INT. REV. 137 (1909).

106. *See, e.g.*, Flint v. Stone Tracy Co., 220 U.S. 107, 144-47 (1911); Stratton's Independence v. Howbert, 231 U.S. 399, 417 (1913).

107. *See* Treas. Reg. 31, art. 2, ¶ 5 (1909), *reprinted in* 12 TREAS. DEC. INT. REV. 137 (1909); *see also* Hays v. Gauley Mountain Coal Co., 247 U.S. 189, 193-94 (1918); Merchant's Loan and Tr. Co., 255 U.S. 509, 518-21 (1921).

108. *See* Treas. Reg. 31, art. 2, ¶ 5 (1909), *reprinted in* 12 TREAS. DEC. INT. REV. 137 (1909).

109. *See* Tariff Act of 1909, ch. 6, § 38, 36 Stat. 11, 112-13 (1909).

1913 Act continued the same gross income rules[110] for corporations, and extended them to individuals.[111] The IRS generally insisted that all exchanges were taxable.[112]

2. Reorganization Rulings

People assumed that gains from reorganization exchanges were taxable, and started looking for ways to avoid that result. A 1914 ruling found that a loss could not be deducted until the transaction was complete, which did not occur until the investment had irredeemably disappeared from the assets of the owner.[113] The 1914 ruling was used as the basis for a reorganization ruling request, and a 1915 letter found the transaction was not complete and concluded that the exchange was tax-free.[114]

Several letters in the next few years established standards for proposed transactions.[115] Business interests found that the conservative IRS approach to reorganizations[116] and other business adjustments[117] were not helpful, and many proposed transactions were abandoned because people were unwilling to pay substantial tax on modifications of their business holdings.[118]

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110. *See* Treas. Reg. 33, art. 4 (1914), *reprinted in* 132 U.S. REVENUE ACTS 1909-1950, at 30 (Bernard D. Reams ed., 1979).

111. *See* Tariff Act of 1913, ch. 16, §§ IIA(1), IIB, IIG(a), 38 Stat. 114, 166-67, 172 (1913).

112. *See Revenue Revision: Hearings before the Comm. on Ways and Means*, 66th Cong. 139 (1921) (statement of Frederick R. Kellogg, Esq.), *reprinted in* 1 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 30; *see also* 57 Cong. Rec. 829 (1918) (statement of Sen. LaFollette).

113. *See* Mim. Letter to Collectors (Aug. 14, 1914), *reprinted in* 1916 Income Tax Service (Corp. Tr. Co.) ¶ 181; Decision No. 110, Office of Internal Revenue, Decisions 60 (1871).

114. *See* Priv. Ltr. Rul. (Apr. 1, 1915), *reprinted in* 1918 Income Tax Service (Corp. Tr. Co.) ¶¶ 398, 1302.

115. For example, assets of corporation 1 were transferred to corporation 2, and shareholders of corporation 1 exchanged their stocks for those of corporation 2. Since the stocks were supported by the same assets, the shareholders did not realize income. *See* Priv. Ltr. Rul. (Mar. 9, 1917), *reprinted in* 1918 Income Tax Service (Corp. Tr. Co.) ¶¶ 1302-04. In another letter, corporation *A* would exchange its assets for stock of corporation *B*, and *A* would distribute the *B* stock in exchange for *A* stock. Both exchanges were taxable. *See* Priv. Ltr. Rul. (Sept. 9, 1916), *reprinted in* 1918 Income Tax Service (Corp. Tr. Co.) ¶¶ 1297-1301.

116. *See* O.D. 480, 2 C.B. 39 (1920); A.R.R. 156, 2 C.B. 39 (1920); A.R.M. 67, 3 C.B. 54 (1920); A.R.R. 289, 3 C.B. 57 (1920); O.D. 783, 4 C.B. 45 (1921); O.D. 1008, 5 C.B. 56 (1921).

117. *See* Notes on the Revenue Act of 1918, § 7-8 (1919), *reprinted in* 94 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 124.

118. *See Revenue Revision: Hearings before the Comm. on Ways and Means*, 66th Cong. 128 (1921) (statement of Frederick R. Kellogg, Esq.), *reprinted in* 1 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 129.

3. Exchange Regulations

The volume of requests for rulings on proposed business transactions led to inclusion of exchange material in the regulations under the 1918 Act. The preliminary edition concluded that gain or loss was realized if the property received was essentially different from the property given up. An essential difference existed if there was a change in substance, and not merely in form.[119] If gain or loss was not realized, the property received was considered a substitute for the property given up, and the basis carried over from the old property to the replacement property.[120]

Examples offered guidance for applying the essential difference test to securities transactions. Exchanging listed stock for a voting trust certificate was a mere change in form. There was a change in substance if listed stock was exchanged for stock in a small, closely held corporation, or stock for a liberty bond, or a bond was converted to stock.[121]

There was no change in the next two versions of the regulations. The final edition of the 1918 regulations reversed the last example by concluding that conversion of a bond into stock was a mere change in form.[122] That result is still in force.[123]

4. Reorganization Decisions

The essential difference standard was applied in a series of Supreme Court opinions. Since all of the decisions are solely concerned with the treatment of shareholders who exchange their securities, the IRS does not seem to have asserted tax at the corporate level.[124]

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119. *See* Treas. Reg. 45 (prel. ed.), art. 1563 (1919), *reprinted in* 134 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 147. The IRS had a difficult time deciding whether a difference was substantive. *See Internal Revenue: Hearings before the Senate Finance Comm.*, 67th Cong. 199 (1921) (statement of Dr. T. S. Adams, Tax Advisor, Treas. Dept.), *reprinted in* 95A U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 30.

120. *See* Treas. Reg. 45 (prel. ed.), art. 1564 (1919), *reprinted in* 134 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 148.

121. *See id.* art. 1563.

122. *See id.* However, there is an essential difference if an exchange of bonds for stock in the same corporation is not pursuant to a conversion privilege. *See* S.R. 2316, III-2 C.B. 26 (1925). There is no essential difference between par and no par stock in the same corporation. *See* O.D. 1080, 5 C.B. 56 (1921).

123. *See* Rev. Rul. 72-265, 1972-1 C.B. 222.

124. On the other hand, a letter ruling concluded that a corporate-level exchange was taxable. *See* Priv. Ltr. Rul. (Sept. 9, 1916), *reprinted in* 1918 Income Tax Service (Corp. Tr. Co.) ¶¶ 1297-1301.

There were two inquiries in dealing with the treatment of shareholder exchanges. One was whether there was an essential difference in the corporations. Where the new was formed in the same state with presumably the same powers as the old, and continued to operate the same business under the old management, there was no essential difference.[125] There would have been an essential difference if they had been formed under the laws of different states since the corporations would have different rights and liabilities.[126]

If there is no essential difference in the corporations, the second issue is whether there is a essential difference in the stocks. If each shareholder winds up with the same rights he previously held, there is no essential difference.[127] There is an essential difference if his rights are modified. Hence tax would be imposed if seven percent voting preferred was exchanged for six percent nonvoting preferred.[128]

C. Congressional Action

1. Business Interests

Many businesses had substantially modified their operations to meet the production requirements of the First World War. At the same time, there was a dramatic increase in tax rates to finance the war. The need to adjust to the post-war economy created many tax problems.

Frederick Kellogg testified that he had killed millions of dollars in proposed transactions because the owners could not afford to expand operations if they had to pay taxes exceeding forty percent on exchanges.[129] The problem was that IRS insisted on a tax whenever

125. *See* Weiss v. Stern, 265 U.S. 242, 247 (1924); Marr v. United States, 268 U.S. 536, 541 (1924).

126. *See, e.g.*, United States v. Phellis, 257 U.S. 156, 170 (1921) (du Pont of New Jersey became du Pont of Delaware); Marr v. United States, 268 U.S. 536, 541 (1924) (General Motors of New Jersey became General Motors of Delaware).

127. *See* Weiss v. Stern, 265 U.S. 242, 252 (1924).

128. *See Marr*, 268 U.S. at 541. *See generally* Roswell Magill, *Realization of Income*, 36 COL. L. REV. 519, 542-54 (1936); ROSWELL MAGILL, TAXABLE INCOME 65-82 (rev. ed. 1945) [hereinafter MAGILL, TAXABLE INCOME].

129. *See Revenue Revision: Hearings before the Comm. on Ways and Means*, 66th Cong. 128 (1921) (statement of Frederick R. Kellogg, Esq.), *reprinted in* 1 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 129. *See generally Internal Revenue: Hearings before the Senate Finance Comm.*, 67th Cong. 29 (1921) (statement of Dr. T.S. Adams, Tax Advisor, Treas. Dept.), *reprinted in* 95A U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 381.

there was an exchange of properties even if the property received could not be immediately disposed of for its cash value.[130]

2. Official Opinions

The Secretary of the Treasury thought post-war business should be encouraged. Prosperity could not be maintained unless business could tell in advance how a transaction would be taxed.[131] The Treasury proposed that the approach to exchanges should be modified with mechanical exclusions for reorganizations, transfers to controlled corporations, and like kind exchanges,[132] and a new valuation rule for other exchanges.[133]

Reorganizations and transfers to controlled corporations did not result in a sufficient difference in the ownership of the property to justify taxing gain or deducting loss.[134] Although there was a complete change of ownership of like kind properties, gain or loss should not be taxed since investment was continued in the same general sort of property.[135]

An exchange that did not qualify for a mechanical exclusion was taxable only if the property received was readily marketable. Hence, property was treated as cash only if it could be easily sold for its fair market value.[136]

Congress agreed with the Treasury. The Ways and Means and Finance Committees found that the presumption in favor of taxation hampered business and led to much uncertainty and litigation. They concluded that changes were needed to facilitate the return to a peacetime

130. If a house is exchanged for marketable stock, there is no reason to postpone tax because the stock can be immediately resold. But if a house is exchanged for another house, the taxpayer may not be able to sell the replacement house for immediate cash. It would be unfair to tax a profit not actually received. *Revenue Revision: Hearings before the Comm. on Ways and Means*, 66th Cong. 139 (1921) (statement of Frederick R. Kellogg, Esq.), *reprinted in* 1 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 129; T.D. 2971, 2 C.B. 38 (1920).

131. Letter from Secretary McAdoo to Finance Committee Chairman Simmons (Nov. 14, 1918), *reproduced in* S. REP. NO. 65-617, at 6 (1918), *reprinted in* 1939-1 (pt. 2) C.B. 119.

132. *See, e.g.*, *Internal Revenue: Hearings before the Senate Finance Comm.*, 67th Cong., 28-30 (1921) (statement of Dr. T. S. Adams, Tax Advisor, Treas. Dept.), *reprinted in* 95A U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 381.

133. *See id.* at 199.

134. *See id.* at 30.

135. *See id*. at 28.

136. *See id.* at 199-200; Warren Jones Co. v. Commissioner, 524 F.2d 788, 791 (9th Cir. 1975); Biscane Tr. Co. v. Commissioner, 18 B.T.A. 1015, 1021 (1930), *acq*. IX-2 C.B. 6 (1930); *see also* 61 Cong. Rec. 6549 (1921) (statements of Sen. McCumber).

economy, and to enhance business.[137] The Treasury proposals were enacted in 1921.[138]

3. Exchanges of Securities

Exchanges of securities could qualify for nonrecognition under the reorganization[139] and controlled corporation[140] provisions of the 1921 Act, and that result is still available.[141] The original like-kind statute did not mention securities,[142] and the regulations approved exchanges of stocks, or of bonds. The conclusion that stocks and bonds were not like-kind[143] was rejected by the courts.[144] The ability to use the like kind statute for securities lasted less than two years. The Treasury complained that people were avoiding tax on large amounts of gains in modifying their personal portfolios,[145] and Congress responded by excluding stocks and bonds from the definition of like kind property.[146] Congress felt nonrecognition for exchanges of securities should be limited to the business situations covered by the reorganization and controlled corporation statutes.[147]

Exchanges of securities which did not qualify for nonrecognition were taxed under the 1921 Act if the securities received were readily marketable. Although this rule was supposed to reduce controversies, it merely changed the issue to whether the property received could be easily sold for its fair market value.[148] In 1924, the Treasury stated there had been no change in quantity of disputes,[149] and Congress agreed to a return to the fair market value rule.[150]

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137. *See* H.R. REP. NO. 67-350, at 10 (1921), *reprinted in* 1939-1 (pt. 2) C.B. 175; S. REP. NO. 67-275, at 11 (1921), *reprinted in* 1939-1 (pt. 2) C.B. 188.

138. *See* Revenue Act of 1921, § 202(c), 42 Stat. 227, at 30 (1921).

139. *See id*. § 202(c)(2), 42 Stat. 227, at 30 (1921).

140. *See id*. § 202(c)(3), 42 Stat. 227, at 30.

141. *See* I.R.C. §§ 351; 354 (1997).

142. *See* Revenue Act of 1921, § 202(c)(2), 42 Stat. 227, at 30 (1921).

143. *See* Treas. Reg. 62, art. 1566(a) (1921), *reprinted in* 136 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 38.

144. *See* Green v. Commissioner, 15 B.T.A. 401 (1928), *nonacq.* VIII-1 C.B. 54 (1929), *aff'd*, 42 F.2d 852 (2d Cir. 1930); Edison v. Lucas, 40 F.2d 398, 405 (8th Cir. 1930).

145. *See* Letter from Secretary of the Treasury A.W. Mellon to Acting Ways and Means Chairman William R. Green, Jan. 13, 1923, *reproduced in* S. REP. NO. 67-1113, at 1 (1923), *reprinted in* 1939-1 (pt. 2) C.B. 845-6.

146. *See* Act of March 4, 1923, § 1, 42 Stat. 1560 (1923).

147. *See* S. REP. NO. 67-1113, at 3 (1923), *reprinted in* 1939-1 (pt. 2) C.B. 846.

148. *See* S. REP. NO. 179, at 13-14 (1924), *reprinted in* 1939-1 (pt. 2) C.B. 275.

149. *See id*.

150. *See* Revenue Act of 1924, § 202(c), 43 Stat. 253, at 6 (1924).

The fair market value rule has been the general standard since 1924. Hence, an exchange was taxable if the securities received had a fair market value,[151] and there was an essential difference in the securities.[152]

D. *Material Difference Standard*

1. Exchange Regulations

The essential difference standard was continued by regulations[153] and rulings[154] covering the period from 1921 through 1933. The 1934 regulations changed from essential difference to material difference, and required that there be no material difference either in kind or extent.[155] The courts concluded that the same criterion applies under both standards,[156] and the 1934 approach is still in force.[157]

2. Interest in the Same Property

The standards differ depending on whether the taxpayer receives different property, or merely retains an interest in his original property. A series of rulings on land and various sorts of personal property conclude there is no material difference where there is a change in the form of ownership. No tax is imposed if a the title is changed from joint tenancy with the right to survivorship to tenancy in common.[158]

The same reasoning applies where a common ownership is partitioned.[159] Hence, there is no material difference if a joint tenancy with the right to survivorship in an entire property becomes fee simple absolute in a portion of the property.[160]

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151. *See id.*

152. *See, e.g.*, O.D. 308, 1 C.B. 43 (1919); O.D. 98, 1 C.B. 43 (1919); O.D. 1080, 5 C.B. 56 (1921).

153. *See* Treas. Reg. 62, art. 1564(a) (1922), *reprinted in* 136 U.S. Revenue Acts 1909-1950, *supra* note 110, at 38.

154. *See, e.g.*, G.C.M. 18436, 1937-1 C.B. 101.

155. *See* Treas. Reg. 86, § 111-1 (1935), *reprinted in* 140 U.S. Revenue Acts 1909-1950, *supra* note 110, at 25.

156. One opinion used the words “materially” and “essentially” interchangeably, and rejected an IRS attempt to interject new criterion. *See* Cottage Savings Assoc. v. Commissioner, 499 U.S. 554, 562, 565 (1991).

157. *See* Treas. Reg. § 1.1001-1(a) (1994).

158. *See* Rev. Rul. 56-437, 1956-2 C.B. 507; G.C.M. 22056, 1940-2 C.B. 189.

159. *See* Rev. Rul. 55-77, 1955-1 C.B. 339.

160. *See* Collins v. Commissioner, 412 F.2d 211, 212 (10th Cir. 1969).

The partition rule was applied in divorce property settlement cases[161] where each spouse had a vested ownership interest.[162] Application of the material difference standard went further than any other type of case since decisions routinely approved receipts of different assets.[163] One husband received stock in the corporation which owned the family business, and his wife received the family house.[164]

Even receipts of cash could qualify as property which was part of a nontaxable exchange. Several decisions involve exchanges of marital property where a cash payment was necessary to equalize the values. If the cash was marital property the courts concluded that a receipt of cash was not taxable because the cash was part of a nontaxable exchange, and the IRS has published agreement.[165]

3. Interests in Different Properties

Results usually are different where the taxpayer gives up one asset and receives another asset. Hence, exchanges of properties such as parcels of land[166] or trucks[167] are taxable. The same results generally are reached in exchanges of things like stocks in different corporations,[168] and stock for a bond of another company.[169]

A financial institution seeking to spread its risks exchanged contractual interests in mortgage pools. The taxpayer argued that a loss was recognized because there was a material difference in the contracts or

161. After the 1984 Act, gain realized on divorce property settlements was not taxed. *See* I.R.C. § 1041(a) (1984).

162. If the spouses did not have vested ownership interests, divorce partitions were taxable. *Compare* United States v. Davis, 370 U.S. 65, 74 (1962) (transfer by the husband to his former wife of appreciated stock pursuant to a property settlement agreement was taxable), *with* McIntosh v. Commissioner, 85 T.C. 31, 44-45 (1985), *acq*. 1986-2 C.B. 1 (where petitioner transferred appreciated ranch to his former wife pursuant to a property settlement agreement, the transfer was in the nature of a division of property and was not a taxable transfer).

163. *See*, *e.g.*, Rev. Rul. 76-83, 1976-1 C.B. 213.

164. *See* Carriers v. Commissioner, 64 T.C. 959, 960 (1975), *acq*. 1976-2 C.B. 1, *aff'd*, 552 F.2d 1350 (9th Cir. 1977).

165. *See id*.; *see also* Goldstein v. Commissioner, 56 T.C.M. (P-H) 224, 227-28 (1987).

166. *See* California Delta Farms, Inc. v. Commissioner, 6 B.T.A. 1301, 1314-15 (1927), *acq*. VII-1 C.B. 5 (1928).

167. *See* Cooper-Brannan-Naval Stores Co. v. Commissioner, 9 B.T.A. 105, 109 (1927), *acq*. VII-1 C.B. 7 (1928).

168. *See* Applegate v. Commissioner, 10 B.T.A. 705, 708-09 (1928), *acq*. VII-2 C.B. 2 (1928).

169. *See* Duff v. Commissioner, 23 B.T.A. 1343, 1348-51 (1931), *acq. on this issue*, XI-1 C.B. 3 (1932).

the properties. Even though the pools were economically identical,[170] there was a material difference since rights created by the individual mortgages were not identical.[171]

4. Securities Transactions

Obligations of a debtor are considered the same security where the maturity date is modified.[172] Cases where there are additional changes illustrate the inability of the courts to agree on how far differences can go without being material. The Tax Court and the Second and Third Circuits found a material difference where the replacement obligations had different interest rates and maturity dates, and a higher value.[173] On the other hand, the Fifth Circuit found there was no material difference where the replacement obligations had different interest and maturity dates, and provision for a sinking fund.[174] The Eighth Circuit reached the same conclusion where a right to renewal commissions was exchanged for a fixed income payable over fifteen years.[175]

Unless the exchange results from the exercise of a conversion privilege,[176] the IRS thinks bonds are always materially different from stock.[177] The position is reasonable in cases where the rights under the bond are materially different from those provided by the stock.[178] An

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170. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 6.10[4][b], at 6-60 n.270.

171. *See, e.g.*, Cottage Savings Assoc. v. Commissioner, 499 U.S. 554, 562 (1991); First Nat'l Mtg. Assoc. v. Commissioner, 90 T.C. 405, 411 (1988), *aff'd*, 896 F.2d 580 (D.C. Cir. 1990), *cert. denied*, 499 U.S. 974 (1991).

172. *See, e.g.*, Motor Products Corp. v. Commissioner, 47 B.T.A. 983, 994-98 (1942), *nonacq. on this issue*, 1943 C.B. 37, *nonacq. withdrawn*, 1946-1 C.B. 3, *aff'd per curiam*, 146 F.2d 449 (6th Cir. 1944); Western Missouri Power Co. v. Commissioner, 18 T.C. 105, 109 (1952), *acq.* 1952-2 C.B. 3; Shafer v. United States, 204 F. Supp. 473, 476 (S.D. Ohio 1962), *aff'd*, 312 F.2d 747 (6th Cir.), *cert. denied*, 373 U.S. 933 (1963).

173. *See* Watson v. Commissioner, 8 T.C. 569, 580-82 (1947), *acq. on another issue*, 1947-2 C.B. 5; *see also* Emery v. Commissioner, 166 F.2d 27, 30 (2d Cir. 1948); Girard Tr. Co. v. United States, 166 F.2d 773, 774 (3d Cir. 1948).

174. *See* Mutual Loan & Savings Co. v. Commissioner, 184 F.2d 161, 165 (5th Cir. 1950).

175. *See* Commissioner v. Olmsted Inc. L.I. Agency, 304 F.2d 16, 22 (8th Cir. 1962).

176. *See* Treas. Reg. 45 (1920 ed.), art. 1563 (1921), *reprinted in* 134 U.S. Revenue Acts 1909-1950, *supra* note 110, at 39; Rev. Rul. 72-265, 1972-1 C.B. 222. *See generally* Robert A. Rizzi, *The Treatment of Miscellaneous Convertible Debt*, 16 J. CORP. TAX'N 365 (1990).

177. *See* Treas. Reg. § 1.1001-3(e)(1) (1996). That result should be compared with the application of the similar or related in service or use language of section 1033. Common stock held for investment can be replaced by preferred stock or mutual fund shares if the replacement securities are held for investment. *See* Rev. Rul. 66-355, 1966-2 C.B. 302; Priv. Ltr. Rul. 86-01-012 (July 18, 1988). Another letter approves replacing lithographs with various other types of art works. *See* Priv. Ltr. Rul. 81-27-089 (April 10, 1981).

178. *Compare* Marr v. United States, 268 U.S. 536, 541 (1924), *and* Cottage Savings Assoc. v. Commissioner, 499 U.S. 554, 557 (1991), *with* Green v. Commissioner, 15 B.T.A. 401, 407

exchange of stock for any type of government obligation is taxable, regardless of whether the obligation was issued by the federal,[179] or a state,[180] local,[181] or foreign government.[182]

There is no material difference in the stocks of corporations if the corporations provide the same rights and liabilities, operate the same businesses with the same assets and managements, and the stocks are identical.[183] People have been unsuccessful in most other situations. For example, there is a material difference in the rights and liabilities of corporations if they are formed under the laws of different states.[184] Similarly, there is a material difference in mortgage pools since the individual mortgages provide different rights and liabilities.[185]

E. Debt Modification Regulations

Uncertainty about application of the material difference standard in the mortgage pool decision[186] led Treasury to issue debt modification regulations.[187] Where it applies, the regulation changes the approach from a subjective comparison of rights and liabilities[188] to application of

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(1928), *nonacq.* VIII-1 C.B. 54 (1929), *aff'd*, 42 F.2d 852 (2d Cir. 1930). *See generally* 3 BITTKER & LOKKEN, *supra* note 9, ¶ 91.10.4, at 91-46.

179. *See*, *e.g.*, Treas. Reg. 45 (1920 ed.), art. 1563 (1921), *reprinted in* 134 U.S. Revenue Acts 1909-1950, *supra* note 110, at 39.

180. *See* Landon v. Commissioner, 59 F.2d 989, 990 (2d Cir. 1932).

181. *See* Emery v. Commissioner, 8 T.C. 979, 30 (1947), *aff'd*, 166 F.2d 27 (2d Cir. 1947); Girard Tr. Co. v. United States, 166 F.2d 773, 774 (3d Cir. 1948).

182. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 61 (1994), *on reconsideration*, 106 T.C. 257 (1996); Rev. Rul. 87-124, 1987-1 C.B. 205. *See generally* New York State Bar Assoc., Report on Developing Country Debt-Equity Swaps (Dec. 1, 1988).

183. *See* Weiss v. Stern, 265 U.S. 242, 252 (1924); *Marr*, 268 U.S. at 541.

184. *See*, *e.g.*, United States v. Phellis, 257 U.S. 156, 173-74 (1921) (du Pont of New Jersey became du Pont of Delaware); *Marr*, 268 U.S. at 541 (General Motors of New Jersey became General Motors of Delaware).

185. *See* Cottage Savings Assoc. v. Commission, 499 U.S. 554, 562, 565 (1991); First Nat'l Mtg. Assoc. v. Commissioner, 90 T.C. 405, 422-23 (1988), *aff'd*, 896 F.2d 580 (D.C. Cir. 1990), *cert. denied*, 499 U.S. 974 (1991). *See generally* Harold L. Adrion and Ronald W. Blasi, *Renegotiated Debt: The Search for Standards*, 44 TAX LAW. 967 (1991).

186. *See Cottage Savings*, 499 U.S. at 561-65.

187. *See* Treas. Reg. 1.1001-3 (1996). *See generally* Supp. No. 4, *supra* note 40, S40-3 to -14.

188. *See generally* Philip S. Winterer, *"Reissuance" and Deemed Exchanges Generally*, 37 TAX LAW. 509 (1984); Emanuel S. Burstein, *Federal Income Taxation of Debt Swaps and Modifications*, 17 J. CORP. TAX'N 3 (1990); Richard H. Nichols, *Cottage Savings: More S & L Problems?*, 45 TAX LAW. 727 (1992).

several pages[189] of mechanical rules. Many of the rules have nothing to do with Maquiladora exchanges.[190]

The regulation gives the IRS additional grounds for argument in most cases. One requirement is that the old and new properties are classified as debt for federal income tax purposes.[191] Exchanging dollar obligations for pesos is a material modification because pesos are not a debt. Another rule limits the amount of change in interest rates. Surrendering a dollar obligation for a restricted peso account[192] is a material modification[193] if the rates differ by more than 1/4th of a percent.[194]

Improving the ability of the debtor to pay is another consideration. A modification is material if the ability changes from primarily speculative to adequate, and the alteration is substantial.[195] Since changing from payments in dollars to payments in pesos was designed to enhance the ability of Mexico to pay,[196] the change may be material under the regulation.

Whether the regulation should be upheld is uncertain. The material difference standard is the established interpretation of the statute,[197] and the debt modification regulation can be attacked for attempting to change that interpretation.[198] Regulations generally are presumed to be correct, especially where they construe a new statute or are based on specific legislation. The courts have regularly refused to follow regulations which are contrary to the judicial gloss on an

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189. The official explanation is over three pages, and the text exceeds six pages. Treasury Modifications of Debt Instrument Regulations, 61 Fed. Reg. 32,926-36 (1996).

190. *Compare* G.M. Trading Corp. v. Commission, 103 T.C. 59, 61 (1994), *on reconsideration*, 106 T.C. 257 (1996), *with* Treas. Reg. § 1.1001-3(a)(1) (1996), *and* Friedrich, *supra* note 57, at 152, *and* A.B.A. Tax Section Task Force, Report on Prop. Regs. § 1.1001-3: *Modifications of Debt Instruments*, 47 TAX LAW. 987 (1994).

191. *See* Treas. Reg. § 1.1001-3(e)(5)(i) (1996).

192. *See G.M. Trading*, 103 T.C. at 63-64.

193. The IRS could also argue that the deposit contract is not a debt for federal income tax purposes.

194. The five percent rule does not apply to exchanging one debt for another. *See* Treas. Reg. § 1.1001-3(e)(2)(ii) (1996). In one case, the interest rate on the dollar obligation was not stated. The restricted peso account bore a variable interest rate, and the rates actually paid varied between 40.28% and 152.88%. *See G.M. Trading*, 103 T.C. at 64.

195. *See* Treas. Reg. § 1.1001-3(e)(4)(vi)(A)(1) (1996).

196. *See G.M. Trading*, 103 T.C. at 59.

197. *See* Cottage Savings Assoc. v. Commissioner, 499 U.S. 554 at 560-62.

198. *See generally* A.B.A. Tax Section Task Force, Report on Prop. Regs. § 1.1001-3: *Modifications of Debt Instruments*, 47 TAX LAW. 987 (1994); Lipton, *supra* note 66.

ambiguous statute.[199] One decision described an administrative attempt to modify a substantive law as an invalid "attempt to legislate by regulation."[200]

While mechanical rules have legitimate purposes, a regulation cannot alter a statute which requires a value judgment.[201] One ruling concluded that a person could never be considered temporarily away from home if his stay lasted more than two years.[202] The Tax Court refused to follow the mechanical approach, and observed that it was a "rule of thumb" that may have been useful to the IRS for its own purposes.[203] Although the debt modification regulation may be a valid administrative guideline, it is not a substitute for the value judgment required by the statute.[204]

F. Reappraisal

Strict construction of the circumstances required to avoid realization of gain can be justified by the general policy for gross income. Since Congress intended exert the full measure of its taxing power, anything that is received is gross income[205] unless the taxpayer can prove that he is entitled to an exemption.[206]

Analysis of the authorities supports application of that approach to exchanges of securities. In most situations, the courts have determined that what would appear to be very minor changes in ownership interests constitute material differences. One case involved corporations which were incorporated in different states. Since the state laws provided

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199. *See*, *e.g.*, Kurzner v. United States, 413 F.2d 97, 112 (5th Cir. 1969); O'Neill v. United States, 410 F.2d 888, 895 (6th Cir. 1969).

200. *See* United States v. Empey, 406 F.2d 157, 170 (10th Cir. 1969).

201. The court sarcastically observed that the "approach may make a little more work for the commissioner and the courts, but their job is to decide cases despite the inconvenience of doing so." Jones v. Commissioner, 743 F.2d 1429, 1433 (9th Cir. 1984); *see also* Commissioner v. Duberstein, 363 U.S. 278, 284-90 (1960).

202. *See* Rev. Rul. 83-82, 1983-1 C.B. 45, 46.

203. *See* Libbey v. Commissioner, 57 T.C.M. (P-H) 1301, 1305 (1988).

204. *See* Jones v. Commissioner, 743 F.2d 1429, 1433 (9th Cir. 1984); Commissioner v. Duberstein, 363 U.S. 278, 284-90 (1960).

205. *See* I.R.C. § 61(a); *see also* Commissioner v. Glenshaw Glass Co., 348 U.S. 426, 429 (1955).

206. *See* Treas. Reg. § 1.61-1(a) (1957); Commissioner v. LoBue, 351 U.S. 243, 246 (1956). The current statute supports that conclusion for exchanges of properties. Gains are taxable unless nonrecognition is available, and gains from dealings in property are part of gross income. *See* I.R.C. § 1001(c), 61(a)(3).

different rights and powers to the corporations, their stocks were essentially different.[207]

The general material difference rule has no utility in planning Maquiladora transactions because the standard is subjective and most of the decisions are unfavorable. The probable effect of the debt modification regulation is to bolster the position of the IRS. Since application of most of the rules is mechanical and usually results in imposition of tax, the principal issue is whether the regulation is enforceable. A battle over the validity of the regulation would be expensive, and the outcome is not certain.

Advance plans should avoid reliance on the material modification rule. If a case has reached the litigation stage and the rule is the only ground for avoiding tax on an exchange, counsel has a duty to advise the client to strongly consider settlement.[208]

IV. CONTRIBUTIONS TO CAPITAL

A. *Introduction*

Corporations are not taxed on contributions to capital.[209] Contributions usually occur if the transferor of cash or property intends that the payment will become part of the capital of the corporation.[210] The result is easy to accept if the payment is made by a person who has an existing ownership interest. An owner who places additional resources at the risk of the business[211] presumably intends that it will become a permanent part of the working capital structure of the business.[212]

Since persons who do not have an ownership interest are less likely to make a contribution to capital, their motives are subjected to a

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207. *See* Marr v. United States, 268 U.S. 536, 541 (1924) (General Motors of New Jersey became General Motors of Delaware).

208. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 67 (1994), *on reconsideration*, 106 T.C. 257 (1996).

209. *See* I.R.C. § 118(a).

210. *See*, *e.g.*, Treas. Reg. § 1.118-1 (1956); United States v. Chicago, B. & Q. R.R., 412 U.S. 401, 411, 413 (1973). *See generally* Note, United States v. Chicago, B. & Q. R.R.: *A New Test for Nonshareholder Contributions to Capital*, 27 TAX LAW. 503, 507-10 (1974); Note, *Tax Consequences of Non-Shareholder Contributions to Corporate Capital*, 66 YALE L. J. 1085 (1957).

211. Parent's payment of subsidiary salary expense was a contribution to capital. *See* Rev. Rul. 84-68, 1984-1 C.B. 31.

212. *See* Treas. Reg. § 1.118-1 (1956). For example, a nonprorata payment by a shareholder to protect his interest in the corporation is a contribution to capital. *See* Commissioner v. Fink, 483 U.S. 89, 94, 100 (1987). *See generally* Calvin H. Johnson, *Tax Models for Nonprorata Shareholder Contributions*, 3 VA. TAX REV. 81 (1983).

more rigorous analysis. Five factors are used to distinguish between contributions and other payments from persons without an ownership interest.[213]

B. Early Authorities

1. Shareholder Contributions

The meaning of the phrase gross income was established at an early date. The 1909 regulations concluded that it included income from operation of a corporation, gain from sales of capital assets,[214] and income derived from any other source.[215] Supreme Court decisions emphasized the fact that gross income included income from all sources.[216]

Payments received by a corporation from issuance of its own stock have never been considered gross income.[217] Rulings under the 1909 Act treated those transactions as capital,[218] and a 1914 ruling added that a corporation did not receive income even if the stock was issued at a premium.[219] Perhaps that result is justified because the benefit is offset by the obligation to return all remaining capital to the shareholders upon liquidation.[220]

The issuance of stock rule was applied to shareholder contributions by the 1918 regulations. If the corporation needed money

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213. *See Chicago, B. & Q. R.R.*, 412 U.S. at 413; Rev. Rul. 93-16, 1993-1 C.B. 26.

214. *See*, *e.g.*, Treas. Reg. 31, art. 2, ¶ 5 (1909), *reprinted in* 12 Treas. Dec. Int. Rev. 137 (1909); Hayes v. Gauley Mountain Coal Co., 247 U.S. 189, 194 (1918); Merchant's Loan and Tr. Co., 255 U.S. 509, 519 (1921).

215. *See* Treas. Reg. 31, art. 2, ¶ 5 (1909), *reprinted in* 12 Treas. Dec. Int. Rev. 137 (1909).

216. *See*, *e.g*., Flint v. Stone Tracy Co., 220 U.S. 107, 144-47 (1911); Stratton's Independence v. Howbert, 231 U.S. 399, 417 (1913).

217. Cases distinguishing treasury stock were rejected when section 1032 was enacted. *See* BITTKER & EUSTICE, *supra* note 52, ¶¶ 3.17, at 3-60 to -61.

218. *See*, *e.g*., T.D. 1606 ¶¶ 14, 16 (1910), *reprinted in* 13 Treas. Dec. Int. Rev. 41 (1910). *See* Treas. Reg. 33, art. 95 (1914), *reprinted in* 132 U.S. Revenue Acts 1909-1950, *supra* note 110, at 59; T.D. 2090, Part II (1914), *reprinted in* 16 Treas. Dec. Int. Rev. 281 (1914).

219. *See* T.D. 2090, Part II (1914), *reprinted in* 16 Treas. Dec. Int. Rev. 277 (1914). The rule was added to the regulations in 1918. *See* Treas. Reg. 33 (rev.), art. 97 (1918), *reprinted in* 132 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 59.

220. The duty to return capital to the shareholders is analogous to a debtor's obligation to repay the principal of a loan. *See* United States v. Oregon-Washington R.R. & Nav., 251 F. 211, 213 (2d Cir. 1918); Matarese v. Commissioner, 44 T.C.M. (P-H) 775, 778 (1975). A borrower does not have gross income when the loan is initiated because the benefit is offset by his consensually recognized duty to repay. *See, e.g*., United States v. Rochelle, 384 F.2d 748, 751 (5th Cir. 1967), *cert. denied*, 390 U.S. 946 (1968); Spartian Petroleum v. United States, 437 F. Supp. 733, 736 (D.S.C. 1977).

and obtained it by voluntary payments from shareholders, the corporation was treated as having received an additional payment for stock.[221]

2. Nonshareholder Contributions

Since they cannot be treated as if they are making an additional payment for their stock, an exclusion for contributions from nonshareholders must rest on a different footing.[222] Suggestions that they were not taxable because they were gifts,[223] reimbursement for capital expenses or did not flow from operation of the business[224] were difficult to accept.[225]

Lack of a rational basis for the result led to 1954 legislation which excluded all contributions to the capital of a corporation from its gross income.[226] Congress explained that nonshareholder contributions were not gifts since the payments are made by persons who expected an indirect benefit. Exclusion was granted where the anticipated benefit was sufficiently intangible so that the contribution should not be treated as payment for future services.[227]

221. *See* Treas. Reg. 33 (rev.), arts. 96, 99 (1918), *reprinted in* 132 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 82.

222. One article suggests that the nonshareholder and the corporation are engaged in a joint venture, and the contribution represents a share of the cost of the venture. *See* Note, *Taxation of Nonshareholder Contributions to Corporate Capital*, 82 HARV. L. REV. 619, 623 (1969). *See generally id*. at 629-38; Joseph T. Sneed, *The Criteria of Federal Income Tax Policy*, 17 STAN. L. REV. 567, 604-13 (1965); Lloyd Fletcher, Jr., *Taxability of the Government Subsidy*, 12 GEO. WASH. L. REV. 245 (1944).

223. *See* Texas & Pacific Ry. v. United States, 286 U.S. 285, 289 (1932).

224. *See* Edwards v. Cuba R.R., 268 U.S. 628, 632-33 (1925).

225. *See*, *e.g*., MAGILL, TAXABLE INCOME, *supra* note 128, at 386-89; J. Malcolm Harris, Comment, *Federal Income Tax Exclusion of Non-Shareholder Contributions to Capital*, 39 TEXAS L. REV. 623, 625 (1961); Fletcher, *supra* note 222, at 252-85. *Compare* Henry Rottschaefer, *The Concept of Income in Federal Income Taxation*, 13 MINN. L. REV. 637, 669-73 (1929) (The logic of the position that the acquisition of additional assets with no increase in liabilities due thereto produces income leads to the conclusion that gifts, bequests and devises are income to the recipient, however much they may from the general social point of view represent mere redistributions of capital.), *with* Paul Harvey, *Some Indicia of Capital Transfers under the Federal Income Tax Laws*, 37 MICH. L. REV. 745, 746-51 (1939) (Considering the company as an economic unit, there can be no distinction between capital and income transactions in a situation like this.).

226. *See* I.R.C. § 118 (1954).

227. *See* S. REP. NO. 83-1622, at 18-19 (1954), *reprinted in* 2 U.S. REVENUE ACTS 1954, *supra* note 69, at 18. *See generally* Note, *supra* note 222; Thomas L. Evans, *The Taxation of Nonshareholder Contributions to Capital: An Economic Analysis*, 45 VAND. L. REV. 1457 (1992).

C. Shareholder Contributions

The purpose for any payment by an owner to his corporation is a question of fact. Suppose a corporation obtains needed funds by voluntary contributions from its shareholders, and the amounts received are credited to the surplus account. Where a shareholder does not receive goods or services for a voluntary payment, it is easy to infer that he intended to pay an additional price for his stock.[228]

An intent to pay an additional price may be inferred from marginal circumstances. One case involved a mutual water company which did not charge for water supplied to its shareholders. The directors intended that revenue from annual assessments would be used first to offset the operating deficit, and the remainder would be available for capital expenditures. The revenue was not segregated for accounting purposes. The court concluded that the shareholders intended to contribute to the extent of the capital expenditures.[229]

D. Nonshareholder Contributions

There are two principal types of transactions. Governments and civic groups frequently pay money or property to induce businesses to locate or expand operations in their locality. When the motivation is to benefit the community at large and the contributor does not expect any direct benefit, the payment is a contribution to capital.[230]

The other sort is payments which are part of the cost of purchasing goods or services. An individual living in a rural area who desires to purchase electricity from a utility usually will be required to pay the cost of extending a power line to his house. Since his motive is to obtain electric service, the connection cost is a taxable payment for services.[231]

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228. Treas. Reg. § 1.118-1 (1956). The Tax Court has identified three objective factors for use in deciding whether a shareholder has made a contribution to capital. *See* Board of Trade of the City of Chicago v. Commissioner, 106 T.C. 369, 386-92 (1996).

229. *See* Lake Forrest, Inc. v. Commissioner, 32 T.C.M. (P-H) 176, 184-85 (1963); Bear Valley Mutual Water Co. v. Riddell, 283 F. Supp. 949, 960 (C.D. Cal. 1968), *aff'd per curiam*, 427 F.2d 713 (9th Cir. 1970); Concord Village, Inc. v. Commissioner, 65 T.C. 142, 155-60 (1975); Board of Trade of the City of Chicago v. Commissioner, 106 T.C. 369, 381-92 (1996).

230. *See* Brown Shoe Co. v. Commissioner, 339 U.S. 583, 589 (1950); *see also* Evans, *supra* note 227, at 1459-60.

231. *See*, *e.g.*, Detroit Edison Co. v. Commissioner, 319 U.S. 98, 102 (1943); State Farm Road Corp. v. Commissioner, 65 T.C. 217, 219 (1975); Evans, *supra* note 227, at 61. Payments for connections received by regulated public utilities were excludable from 1976 until 1986. *See* S.

Because the circumstances may make it difficult to identify the motive for a payment,[232] five factors are used to determine whether a payment is an excludable contribution.[233] The first factor focuses on the intent of the person making the payment, and the remaining four are addressed to the economic effect of the payment on the corporation.[234]

1. Intent

There are three possible classifications for payments received by corporations.[235] Payments which proceed from detached and disinterested generosity are gifts,[236] and the opposite extreme is payments for goods or services.[237] One case involved an agreement by the federal government to pay for the training of unemployed individuals. Since they were compensation for services rendered by the corporation, the payments were not contributions to capital.[238]

REP. NO. 94-938, 434-36 (1976), *reprinted in* 1976-3 (vol. 3) C.B. 472-74; H.R. REP. NO. 94-658, 643-45 (1985), *reprinted in* 1986-3 (vol. 2) C.B. 643-45.

232. *See generally* Fletcher, *supra* note 222; Lawrence A. Frolik, *Section 118 and the Tax Treatment of Nonshareholder Contributions to Capital*, 38 OHIO ST. L.J. 499, 512-18 (1977).

233. *See* United States v. Chicago, B. & Q. R.R., 412 U.S. 401, 413 (1973); Rev. Rul. 93-16, 1993-1 C.B. 26, 7.

234. *See Chicago, B. & Q. R.R.*, 412 U.S. at 410-13. Several commentators suggest that the decision created confusion by its failure to clearly define the standards. *See, e.g.*, A. Jan Behrisin, *What Constitutes a Contribution to Capital is Still Unclear*, 44 J. OF TAX. 270, 274 (1976); Evans, *supra* note 227, at 1463-66; Frolik, *supra* note 232, at 507-23.

235. *See Chicago, B. & Q. R.R.*, 412 U.S. at 412-13; *see also* Frolik, *supra* note 232, at 509-10.

236. *See* Commissioner v. Duberstein, 363 U.S. 278, 285 (1960). *Compare* Collins v. Commissioner, 1 T.C. 605, 608 (1943), *nonacq*. 1943 C.B. 29 ("[O]ne of the essentials of a taxable gift is a donative intent."), *with* Estate of Hitchon v. Commissioner, 45 T.C. 96, 99-104 (1965), *acq*. 1966-2 C.B. 5 (father made a gift of his stock to the issuing corporation), *and* Estate of Higgins v. Commissioner, 60 T.C.M. (RIA) 174, 180-82 (1991) (transfer of property to a corporation for less than adequate and full consideration was a taxable gift). *See generally* Behrisin, *supra* note 234, at 273-74.

237. *See, e.g.*, Detroit Edison Co. v. Commissioner, 319 U.S. 98, 102 (1943); Texas & Pac. Ry. v. United States, 286 U.S. 285, 294 (1932); Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 294 (1932). One indicator of whether a payment is for goods and services is whether the amount is directly related to the price of the things provided. *See* Board of Trade of the City of Chicago v. Commissioner, 106 T.C. 369, 380-81 (1996); Edwards v. Cuba R.R., 268 U.S. 628, 632 (1925).

238. *Compare* Deason v. Commissioner, 45 T.C.M. (P-H) 965, 971-72 (1976), *aff'd*, 590 F.2d 1377 (5th Cir. 1979) (since the payments were compensation for services, they were not contributions to capital), *with* Rev. Rul. 93-16, 1993-1 C.B. 26-27 (gross income does not include any contribution to the capital of a corporation).

The intermediate class is for contributions to capital,[239] which occur when the transferor has an ambiguous motive. A payment is not a gift if the transferor expects something in return,[240] and it is not for goods or services if the anticipated benefit is indirect.[241] Direct benefits are the result of enjoyment of goods or services purchased by the payment, while indirect benefits flow from intangibles like the establishment of a location in the community, or an increase in economic activity.[242]

A developer believed that a proposed shopping center would benefit from additional customers, better tenants, and greater rental income if the center included a full-line department store. Since the developer expected only the indirect benefits of additional business in the center, the cash and land paid to obtain a commitment to open and operate the store was a contribution to capital.[243]

A payment which has more than one primary purpose is divided, and each part is classified according to its purpose.[244] Several cases conclude that part of a payment was the price paid for services, and the balance was a contribution to capital.[245]

2. Bargaining

The money or other property must have been sought by the transferee.[246] The bargaining test was not satisfied where the corporation

239. A payment may be a contribution to capital even if it is not made voluntarily. *See City of Chicago*, 106 T.C. at 378.

240. *See* S. REP. NO. 1622, at 18-19 (1954), *reprinted in* 2 U.S. REVENUE ACTS, *supra* note 69, at 18-19.

241. *See id*.

242. *See* Brown Shoe Co. v. Commissioner, 339 U.S. 583, 591 (1950); Rev. Rul. 93-16, 1993-1 C.B. 26.

243. *Compare* Federated Dep't Stores, Inc. v. Commissioner, 51 T.C. 500, 516-20 (1968), *nonacq*. 1971-2 C.B. 4, *aff'd*, 426 F.2d 417 (6th Cir. 1970) (receipt of land and cash for a promise to locate a store in a developer's shopping center was a contribution to capital), *and* May Dep't Stores Co. v. Commissioner, 43 T.C.M. (P-H) 1050, 1051-52 (1974), *aff'd per curiam*, 519 F.2d 1154 (8th Cir. 1975) (since the benefits sought by the grantors were indirect and intangible, the value of the land conveyed to the taxpayer was a capital contribution), *with* John B. White, Inc. v. Commissioner, 55 T.C. 729, 736-37 (1971), *aff'd per curiam*, 458 F.2d 989 (3d Cir. 1971), *cert. denied*, 409 U.S. 876 (1972) (payment to relocate car dealership was not a contribution since the manufacturer expected the direct benefit of increased sales of its cars).

244. *See*, *e.g.*, Guest v. Commissioner, 77 T.C. 9, 11-15 (1981) (part sale, part gift to charity), *acq*. 1982-2 C.B. 1.

245. *See*, *e.g.*, Lake Forrest, Inc. v. Commissioner, 32 T.C.M. (P-H) 176, 184-85 (1963); Bear Valley Mutual Water Co. v. Riddell, 283 F. Supp. 949, 960 (C.D. Cal. 1968), *aff'd per curiam*, 427 F.2d 713 (9th Cir. 1970); Concord Village, Inc. v. Commissioner, 65 T.C. 142, 155-60 (1975); *see* Board of Trade of the City of Chicago v. Commissioner, 106 T.C. at 282-92.

246. *See generally* Behrisin, *supra* note 234, at 283-84; Frolik, *supra* note 232, at 510.

did not seek to acquire the facilities received.[247] On the other hand, the test was satisfied where the corporation expressly negotiated to acquire the payment, or to increase the amount of the payment.[248]

3. Working Capital

The transferor must intend to contribute to the capital of the corporation.[249] Accounting for the payment as an addition to working capital is evidence of the purpose for the payment,[250] and the actual use of the payment is another way to demonstrate that it was to become a part of working capital.[251]

The payment must become a permanent part of the working capital[252] of the corporation.[253] Some decisions conclude that the use of cash payments must be expressly restricted to acquisition of capital assets,[254] while others hold or suggest that actual use of the payment is adequate evidence that it has become a permanent part of working capital.[255]

4. Benefit

The transferee must foresee a benefit in an amount commensurate with value of the payment.[256] The Supreme Court found it was not

247. *See* United States v. Chicago, B. & Q. R.R., 412 U.S. 401, 413-14 (1973).

248. *See* Rev. Rul. 83-73, 1983-1 C.B. 84; *see also Federated Dep't Stores*, 51 T.C. at 516-20; *May Dep't Stores Co.*, 43 T.C.M. at 1051-52. Bargaining should include consideration of the need of the corporation for capital funds. *Chicago, B. & Q. R.R.*, 412 U.S. at 414. A payment may be a contribution to capital where it is not needed by the corporation for the conduct of its business. *City of Chicago*, 106 T.C. at 379.

249. *See* Louisville & Nashville R.R., 66 T.C. 962, 992 (1976), *modified on other issues*, 641 F.2d 435 (6th Cir. 1981); *see Chicago, B. & Q. R.R.*, 412 U.S. at 414.

250. *See* Treas. Reg. § 1.118-1 (1956); *Concord Village*, 65 T.C. at 155-60; Rev. Rul. 74-563, 1974-2 C.B. 38; Commissioner v. Fink, 483 U.S. 89, 97 (1987).

251. *See* Lake Forrest, Inc. v. Commissioner, 32 T.C.M. (P-H) 176, 184-85 (1963); Bear Valley Mutual Water Co. v. Riddell, 283 F. Supp. 949, 960 (C.D. Cal. 1968), *aff'd per curiam*, 427 F.2d 713 (9th Cir. 1970); *see* Edwards v. Cuba R.R., 268 U.S. 628, 632 (1925).

252. Working capital means assets used by the corporation in the operation of its business. *See* Brown Shoe Co. v. Commissioner, 339 U.S. 583, 589-90 (1950); *Concord Village*, 65 T.C. at 155-60; *Edwards*, 268 U.S. at 632. *See generally* Behrisin, *supra* note 234, at 273.

253. *See, e.g.*, *Chicago, B. & Q. R.R.*, 412 U.S. at 413. *See generally* Frolik, *supra* note 232, at 510.

254. *See, e.g.*, Springfield Street Ry. v. United States, 577 F.2d 700, 703 (Ct. Cl. 1978); Rev. Rul. 74-563, 1974-2 C.B. 38; *Edwards*, 268 U.S. at 632-33; General Am. Investors Co. v. Commissioner, 348 U.S. 434, 436 (1955).

255. *See Lake Forrest*, 32 T.C.M. at 184-85; *Bear Valley Mutual Water Co.*, 283 F. Supp. at 960; Commissioner v. Fink, 483 U.S. 89, 96-97 (1987); *Edwards*, 268 U.S. at 273.

256. *See generally* Behrisin, *supra* note 234, at 273; Frolik, *supra* note 232, at 510.

satisfied where a railroad received various facilities to improve safety at highway crossings because the motoring public was the primary beneficiary. Although the railroad benefited from things like lower accident rates and higher train speeds, the benefits were insubstantial when compared to the value of the assets.[257]

Application of the test is not consistent. Where an airport received facilities analogous to those received by the railroad, the IRS found the test was satisfied because they had a definite economic value to the airport.[258] Since it made no attempt to compare the value to the airport with the value of the payment, the IRS apparently feels the benefit test is satisfied by any definite economic value to the corporation.[259]

5. Employment

The asset usually must be used in production of additional income.[260] The Supreme Court found it was not satisfied where a railroad received various facilities to improve safety at highway crossings because they did not materially contribute to the production of income.[261] The IRS concluded the test was satisfied where payments were used to move existing electric power poles to accommodate expanded streets and highways.[262] The results are consistent if facilitating development of the area would materially contribute to the production of income.[263]

6. Balancing the Factors

The factors do not have equal weight.[264] If it is for goods and services provided to the transferor, the payment is not a contribution.[265]

257. *See Chicago, B. & Q. R.R.*, 412 U.S. at 403, 414.

258. *See* Rev. Rul. 93-16, 1993-1 C.B. 26, 27.

259. *See id.* at 26; Priv. Ltr. Rul. 96-22-029 (Feb. 29, 1996). *See generally*, Behrisin, *supra* note 234, at 273; Note, *Contributions to the Capital of a Corporation*, 44 U. CIN. L. REV. 549, 564-65 (1975).

260. *See* Frolik, *supra* note 232, at 510, 511.

261. *Chicago, B. & Q. R.R.*, 412 U.S. at 403, 414.

262. *See* Priv. Ltr. Rul. 96-22-029 (Feb. 29, 1996).

263. *Compare Chicago, B. & Q. R.R.*, 412 U.S. at 403, 414 (assets received were not contributions to capital because they were not bargained for by CB&Q), *with* Rev. Rul. 93-16, 1993-1 C.B. 26 (receipt of planning and development facilities by airport qualified since they would generate additional income through increased public use of facilities and services).

264. *See generally* Behrisin, *supra* note 234, at 274.

265. *See Chicago, B. & Q. R.R.*, 412 U.S. at 413.

Payments which are not for goods and services are tested under the remaining criterion.[266]

The remaining criterion do not have equal weight. While the bargaining, working capital, and benefit factors must be satisfied, the employment criteria is optional.[267] Subsequent decisions have not provided substantial assistance in applying the factors.

7. A Critique of the Factors

Everyone agrees that determining whether a payment is for goods and services is a necessary consideration when judging nonshareholder contributions. There is substantial doubt about whether the economic effect on the corporation is a relevant concern. One commentator concludes that the use of a payment has no bearing on whether it is income,[268] and several others suggest the other factors exist solely because the Supreme Court wanted a ground to reach the desired result.[269]

The factors facilitate ad hoc decisions. After the Supreme Court found replacement of existing facilities, and additional facilities to enhance highway safety at railroad crossings were not contributions, the IRS concluded that funds for analogous airport facilities were contributions.[270] Perhaps the results can be justified on the ground that the additional facilities will materially add to the income of the airport. Skeptical people may suspect that the IRS approved the airport transaction because all of the funds were provided under a federal program.

E. Applying the Factors

Suppose the subsidiary exchanges a dollar obligation for a restricted peso account.[271] The pesos were worth substantially more than

266. *See id.*

267. The language in the descriptions creates uncertainty. While the payment "certainly must" become a part of working capital, it "must" be bargained for, "must" foreseeably provide an adequate benefit, and will "ordinarily, if not always" be employed to produce income. *See id.*

268. *See* MAGILL, *supra* note 128, at 387.

269. *See* Frolik, *supra* note 232, at 509; Note, *Contributions to the Capital of a Corporation*, *supra* note 259, at 60; Behrisin, *supra* note 234, at 273-74.

270. *See Chicago, B. & Q. R.R.*, 412 U.S. at 414; Rev. Rul. 93-16, 1993-1 C.B. 26.

271. *Compare* Jerome B. Libin & G. Garner Prillaman, *More on G.M. Trading: ISP Paper Ignores Key Factors in Section 118 Analysis*, 69 TAX NOTES 99 n.1 (1995), *with* Maquiladora Industry, *supra* note 72, at 1.

the dollar obligations, and can only be used to purchase goods and services which will be used to establish or expand a Mexican business operation. Since the subsidiary should be able to structure the transaction so that it will satisfy the bargaining, working capital, benefit and employment factors, the question is proper application of the intent factor.

Whether a payment is qualified depends on the intent of the Mexican government, which is to be determined by the nature of the benefit it received. The benefit must be sufficiently intangible as to not warrant treating the contribution as a payment for future services.[272] Factors bearing on the nature of the benefit include whether it was direct or indirect, specific or general, certain or speculative.[273]

One principal purpose of the Mexican government was retirement of its dollar obligation.[274] Since Mexico was relieved of its duty to pay the dollar obligation, the benefit was direct, specific and certain,[275] and the payment was not a contribution to capital to the extent it was for retirement.

The other principal purpose was obtaining new investment.[276] Because enhancement of the community by an increase in business activity was an indirect, general and speculative benefit, the payment was a contribution to capital[277] to the extent it was for obtaining new investment.

Where a payment has exempt and other purposes, an allocation is necessary to determine what portion is a contribution. Several cases have

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272. *See* S. REP. NO. 1622, at 18-19 (1954), *reprinted in* 132 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 30.

273. *See Chicago, B. & Q. R.R.*, 412 U.S. at 411.

274. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 61 (1994), *on reconsideration*, 106 T.C. 257 (1996). The overall purpose can be subdivided to include things like a desire to conserve dollars, and to reduce inflation and currency devaluation. *See id*. at 59-61; Libin & Prillaman, *supra* note 271, at 107.

275. *See G.M. Trading*, 103 T.C. at 65-67. One article suggests that a payment was a contribution because the corporation was not in the business of assisting in the retirement of debt obligations. Although there is language in one opinion which suggests a business condition, the argument is not convincing since the criterion is whether the transferor received a direct, specific and certain benefit. *Compare* Libin & Prillaman, *supra* note 271, at 100-01, *with Chicago B. & Q. R.R.*, 412 U.S. at 413.

276. *See G.M. Trading*, 103 T.C. at 61. The overall purpose can be subdivided to include things like enhancing the economy by increasing business activity, employment, exports and tax revenues. *See id*. at 59-61, 106 T.C. at 259; Libin & Prillaman, *supra* note 271, at 101. *See generally* Gottscho, *supra* note 34, at 152-53, 158-60.

277. *See* Brown Shoe Co. v. Commissioner, 339 U.S. 583, 589-90, 592 (1950).

concluded that part of a payment was the price paid for services, and the balance was a contribution to capital.[278]

One corporation exchanged a dollar obligation for a restricted peso account.[279] The corporation received a quantity of pesos determined with a favorable exchange rate and permission to construct a plant, and Mexico received relief from its dollar obligation, a commitment that the pesos would stay in Mexico, and new investment.[280] The Tax Court held there was no contribution because Mexico received the direct benefit of debt relief.[281]

The decision is suspect because it was based on decisions where only one type of benefit was received.[282] Where both were received, the Tax Court and other courts have concluded that the portion of the payment that was not for a direct benefit was a contribution to capital.[283] Hence, the exclusion should be available to the extent that Mexico is paying for indirect benefits.[284]

One can only speculate about why the Tax Court refused to allocate. Perhaps it was because some of the benefits received by Mexico

278. The fact that the contributions were made by shareholders is irrelevant because the question was the extent to which the shareholder intended to pay for services. Hence, allocation also should be available for nonshareholder contributions where the facts reflect more than one motive. *See* Lake Forest, Inc. v. Commissioner, 32 T.C.M. (P-H) 176, 184-85 (1963); Bear Valley Mutual Water Co. v. Riddell, 283 F. Supp. 949, 960 (C.D. Cal. 1968), *aff'd per curiam*, 427 F.2d 713 (9th Cir. 1970); Concord Village, Inc. v. Commissioner, 65 T.C. 142, 158 (1975); Board of Trade of the City of Chicago v. Commissioner, 106 T.C. 369, 382-92 (1996).

279. The corporation paid $634,000 for a dollar obligation with a face amount of $1,200,000. The dollar obligation was immediately exchanged for a restricted peso account which contained pesos worth $1,044,000. *See G.M. Trading*, 103 T.C. at 68.

280. *See id.* at 61.

281. *See id.* at 69. The decision has been defended by the IRS, and criticized by attorneys representing clients interested in the decision. *Compare* Libin & Prillaman, *supra* note 271, at 101, *with* Maquiladora Industry, *supra* note 72, at 1.

282. *See G.M. Trading*, 103 T.C. at 69 (citing United States v. Chicago, B. & Q. R.R., 412 U.S. 401, 411, 413 (1973); Deason v. Commissioner, 590 F.2d 1377, 1378 (5th Cir. 1979); Helvering v. Claiborne-Annapolis Ferry Co., 93 F.2d 875, 876 (4th Cir. 1938); John B. White, Inc. v. Commissioner, 458 F.2d 989, 990 (3d Cir.), *cert. denied*, 409 U.S. 876 (1972); Federated Dep't Stores, Inc. v. Commissioner, 426 F.2d 417, 418 (6th Cir. 1970).

283. The fact that the contributions were made by owners is irrelevant because the question was amount that they intended to contribute. *Lake Forrest*, 32 T.C.M. at 184-85; *Bear Valley Mutual*, 283 F. Supp. at 960; *Concord Village*, 65 T.C. at 155-60; *see City of Chicago*, 106 T.C. at 382-92.

284. *See* Philip H. Spector, *Mexican Debt-Equity Swap Lands in Tax Court*, 23 TAX MGMT. INT'L J. 496, 499 (1994); Libin & Prillaman, *supra* note 271, at 100-07.

were incapable of independent evaluation[285] in terms of dollars.[286] An allocation should have been based on the value of the only direct benefit.[287] Since the dollar obligation was worth $600,000,[288] that is the amount the corporation received for a direct benefit. Any remaining value is allocated to the package of indirect benefits, and is an excludable contribution to capital.

The Tax Court found that the value of the restricted pesos was the value of the pesos without any reduction for the effect of the restrictions.[289] Concluding that the values were equal is nonsense.[290] If the restricted pesos were worth $1,000,000, Mexico could have sold them for that amount, bought the debt for $600,000,[291] and pocketed the $400,000 difference.[292]

Any lingering doubt[293] about the value of the restricted pesos should be dispelled by the circumstances. Since Mexico was desperate for hard currency,[294] it undoubtedly would have established a program of selling restricted pesos and buying dollar obligations, which would reduce its hard currency obligations and increase its supply of hard currency. The fact that no program of that sort has been established or suggested

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285. The arguments about the values of the dollar obligation and the indirect benefits sound like a classic case of circular reasoning. *Compare G.M. Trading*, 103 T.C. at 61, *and* Maquiladora Industry, *supra* note 72, at 1, *with* Libin & Prillaman, *supra* note 271, at 101.

286. The Tax Court may have suggested valuation when it concluded that the benefits received by Mexico related primarily to its perilous foreign exchange position. *See G.M. Trading*, 103 T.C. at 66.

287. *See Lake Forrest*, 32 T.C.M. at 184-85; *Bear Valley Mutual*, 283 F. Supp. at 960; *Concord Village*, 65 T.C. at 155-60.

288. The value presumably was established by the fact that the corporation purchased it on the open market for $600,000, and immediately exchanged it with Mexico. *See G.M. Trading*, 103 T.C. at 68.

289. *See id.* at 69-71.

290. The published position of the IRS is that use restrictions "generally" reduce the fair market value below the exchange rate for unrestricted pesos. However, the IRS successfully argued that no reduction occurred in *G.M. Trading*, and it intends to continue arguing for that result in litigation. *Compare* Rev. Rul. 87-124, 1987-2 C.B. 205, 206; Maquiladora Industry, *supra* note 72, at 2; *G.M. Trading*, 103 T.C. at 70, *with* NEW YORK STATE BAR TAX SECTION, REPORT ON DEVELOPING COUNTRY DEBT-EQUITY SWAPS (1988), *reprinted in* Tax Notes Today, Dec. 6, 1988.

291. Mexico apparently was aware of the market value of the dollar obligations during negotiations. *See* Gottscho, *supra* note 34, at 172.

292. *See* Hudson & Lemein, *supra* note 40, at 323.

293. Additional arguments about the value of the restricted pesos were offered by the parties and the court. *Compare* Libin & Prillaman, *supra* note 271, at 102, *with* Maquiladora Industry, *supra* note 72, at 1, *and G.M. Trading*, 103 T.C. at 64-71.

294. *See* Gottscho, *supra* note 34, at 143, 146-49; Leslie A. Sowle, *International Debt for Equity Swaps: Does Revenue Ruling 87-124 Make Sense?*, 83 NW. U. L. REV. 1079, 1079-82 (1988); Dionne, *supra* note 4, at 166-67; *G.M. Trading*, 103 T.C. at 66.

should prove beyond a reasonable doubt that the restricted pesos were not worth more than $600,000.[295]

The restriction was ignored because the taxpayer planned to spend the pesos for plant and equipment.[296] Since personal value is irrelevant in determining fair market value,[297] the Tax Court apparently failed to apply the willing seller-willing buyer criterion.[298] The presence of a restriction should mean the account had no value since there was no market, or that a willing buyer would pay an amount less than face value of the pesos because of the restriction.[299] Even if the value was $1,000,000, that amount should have been allocated between the direct and indirect benefits received by Mexico.

The failure to reasonably apply recognized rules and standards produced joy at the IRS,[300] and negative reactions from everyone else. Chrysler[301] filed an amicus brief during reconsideration,[302] and a tax service suggested that those who were being audited should delay settling until the reconsideration was completed.[303] Professional opinions expressed by attorneys,[304] tax publishers,[305] and bar associations,[306] and

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295. The argument is bolstered by the fact that the Mexican program was one of the least successful in terms of reducing dollar obligations. William Park, *Legal Policy Conflicts in International Banking*, 50 OHIO ST. L.J. 1067, 1092 n.139 (1989). *See generally* Dionne, *supra* note 4, at 68-71.

296. *See G.M. Trading*, 103 T.C. at 70-71.

297. *See* I.R.C. § 1001(b); Treas. Reg. § 1.61-2(d)(1-2) (1989); *see also* Rooney v. Commissioner, 88 T.C. 523, 526-28 (1987); Baker v. Commissioner, 88 T.C. 1282, 1288-92 (1987).

298. *See* Treas. Reg. § 20.2031-1(b) (1965); *Rooney*, 88 T.C. at 526-28.

299. *See* Treas. Reg. § 1.83-5(a), (c) exs. (1-2) (1978). *See generally* Daniel S. Goldberg, *Fair Market Value in the Tax Law*, 60 TEX. L. REV. 833 (1982).

300. The Tax Court accepted the arguments of two IRS attorneys, and the IRS plans to continue the same approach in subsequent audits and litigation. *See* Leighton & Sealy, *supra* note 72, at 727-33. *See generally* Maquiladora Industry, *supra* note 72.

301. One source reports that Chrysler had invested 65 million dollars in the Mexican debt-equity program by 1987. *See* Gottscho, *supra* note 34, at 153 n.35.

302. Another amicus brief was filed by Harold L. Adrion, who is a vice president and counselor with the Equitable Finance Co. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 61 (1994), *on reconsideration*, 106 T.C. 257 (1996).

303. *See* Weekly Alert, Fed. Taxes (RIA) 261 (July 13, 1995).

304. *See* Libin & Prillaman, *supra* note 271, at 100-01 (criticizing *G.M. Trading*); Spector, *supra* note 284, at 498 (criticizing *G.M. Trading*); J. Terry, *Debt-Equity Swaps*, 17 TAX MGMT. INT'L J. 151, 154 (1988) (criticizing Rev. Rul. 87-124).

305. *See*, *e.g.*, Dionne, *supra* note 4, at 173 (criticizing Rev. Rul. 87-124); Jim Fuller, U.S. Tax Review, 12 Tax Notes Int'l 1413, 1415 (1996) (criticizing *G.M. Trading*).

306. *See generally Report on Developing Country Debt-Equity Swaps*, *supra* note 290 (criticizing Rev. Rul. 87-124).

presentations at professional meetings[307] and law review commentaries[308] all criticize the approach of the Tax Court.

Persons who are planning litigation should consider another forum unless the unfavorable Tax Court precedent is reversed. People who are planning to invest in a Maquiladora program should separate the parts of the overall transaction. Hence, the value of the pesos received in exchange for the dollar obligations should not exceed the basis of the dollar obligation,[309] and every effort should be made to establish that those pesos are the sole consideration for the dollar obligation.[310] The contribution of pesos for establishing or increasing business in Mexico should be a separate transaction, and every effort should be made to establish that indirect civic benefits is the only type of benefit that Mexico expects to receive.[311]

Proving that the considerations are independent may be difficult. If the only thing that happens is a payment of pesos to locate a business in Mexico, the pesos clearly should be a contribution to capital.[312] If Mexico insists on relief from its dollar obligation, the best way to establish that the considerations are independent may be closing the business location transaction first, with no obligation of any sort on either party to go ahead with relief from dollar obligations.

Whether this approach will be successful is uncertain. The IRS will argue that the ostensibly separate arrangements must be treated as a single transaction under the step transaction doctrine.[313] Although the

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307. *See, e.g.*, James P. Fuller, *Current Foreign Currency Issues*, *in* 19th ANNUAL INST. ON INT'L TAX 1989, at 171-74 (PLI Tax Law & Est. Planning Course Handbook Series No. 281, 1989) (criticizing Rev. Rul. 87-124); Edward J. Ray, *U.S. Tax Aspects of Debt Rescheduling and Debt Equity Swaps*, presentation at the International Bar Association's 22d Biannual Conference (Sept. 1988) (criticizing Rev. Rul. 87-124).

308. *See, e.g.*, Hudson & Lemein, *supra* note 40, at 291-323 (criticizing *G.M. Trading*); Stuart M. Berkson & Bruce A. Cohen, *Tax Implications of Debt-for-Equity Swaps*, 12 HASTINGS INT'L & COMP. L. REV. 575, 579 (1989) (criticizing Rev. Rul. 87-124).

309. *See* Rev. Rul. 87-124, 1987-2 C.B. 205.

310. Allocation is required for some asset acquisitions. *See* I.R.C. § 1060. Even if it is not required, the fact that an evaluation was prepared at the time of the transaction will have some evidentiary value. *See generally* BITTKER & EUSTICE, *supra* note 52, ¶ 10.40, at 10-73 to -80; Unger, *Gain Recognition and Basis in Acquisitions*, 45 N.Y.U. TAX INST. Ch. 3 (1987); Stuart J. Offer & Rachel Krevans, *Purchase Price Allocation in Taxable Stock and Asset Acquisitions*, 39 S. CAL. TAX INST. 300 (1987).

311. *See* United States v. Chicago, B. & Q. R.R., 412 U.S. 401, 402 (1973) (determining the standard for such transactions).

312. *Compare* Brown Shoe Co. v. Commissioner, 339 U.S. 583, 589, *with Chicago, B. & Q. R.R.*, 412 U.S. at 401, *and* G.M. Trading Corp. v. Commissioner, 106 T.C. 257, 266-67 (1996).

313. *See* Maquiladora Industry, *supra* note 72, at 3.

transactions are in fact related, the purpose is to avoid the consequences of the failure of the Tax Court to allocate. The Tax Court and other courts have expressly agreed that taxpayers are permitted to arrange their affairs to reduce or eliminate taxes by legal means.[314] Since the corporation is not attempting to avoid a legitimate tax obligation,[315] the doctrine should not be applied.

The corporation has the burden of proof on the valuation issue. If the step transaction doctrine is applied, the IRS will argue that all of the value received by Mexico was for direct benefits.[316] Hence, the corporation must demonstrate the proper values for the direct and indirect benefits received by Mexico.

An alternate is negotiating for a better price. Some corporations may not want to pay the tax or enter into a deal with a substantial risk of a controversy with the IRS. There is no risk if the gain is reported, and the corporation may willing to go ahead if Mexico pays enough additional consideration to cover a large part of the tax bill.

If Mexico does not want to pay additional consideration, another possibility is structuring the transaction to avoid the problem. There should be no tax if the subsidiary makes cash progress payments for capital facilities delivered by Mexico.

F. Reappraisal

Strict construction of the circumstances required to avoid realization of gain can be justified by the general policy for gross income. Since Congress intended exert the full measure of its taxing power, anything that is received is gross income[317] unless the taxpayer can prove that he is entitled to an exemption.[318]

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314. *See*, *e.g.*, Commissioner v. First Security Bank of Utah, 405 U.S. 394, 398 n.4 (1972); Salyersville Nat'l Bank v. United States, 613 F.2d 650, 654-55 (6th Cir. 1980); Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 338-39, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992). *See generally* Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968).

315. *See* Gregory v. Helvering, 293 U.S. 465, 469-70 (1935); *G.M. Trading*, 106 T.C. at 267.

316. *See* Maquiladora Industry, *supra* note 72, at 3.

317. *See* I.R.C. § 61(a); *see also* Commissioner v. Glenshaw Glass, 348 U.S. 426, 429-30 (1955).

318. *See* Treas. Reg. § 1.61-1(a) (1957); *see also* Commissioner v. LoBue, 351 U.S. 244, 246 (1956) (citing *Glenshaw Glass*, 348 U.S. at 426, 429-30). The current statute supports that conclusion for exchanges of properties. Gains are taxable unless nonrecognition is available, and gains from dealings in property are part of gross income. *See* I.R.C. §§ 1001(c), 61(a)(3).

Analysis of the authorities supports application of that approach to nonshareholder contributions to capital. Decisions are based primarily on the sort of benefit received by the person who made the payment. When the Supreme Court did not like the result produced by application of the benefit test, it introduced additional criterion based on the economic effect of the payment on the corporation.[319] Several authors have suggested that the additional criterion facilitate ad hoc decisions,[320] and the position of the Tax Court[321] appears to confirm the suspicion.

The contribution to capital rule is not reasonably reliable for planning purposes. If the transaction is divided into separate debt relief and contribution transactions, the IRS may be able to treat it as a single transaction under the step transaction doctrine.[322] If the step transaction doctrine is applied and the court is willing to allocate, the taxpayer has the burden of proving the value of the direct and indirect benefits received by Mexico.[323]

An attorney has the duty to advise his client of the risks. An aggressive client may be willing to risk a controversy with the IRS. If the client is reluctant to take the risk, the alternative is an attempt to negotiate a better price, and compare the costs and potential benefits, with a view to deciding whether to proceed with the transaction.

V. TAXABILITY OF THE PARENT

A. In General

The principal question in analyzing a proposed Maquiladora exchange is whether the gain will be taxed by the United States. The subsidiary is not taxed because a foreign corporation is not taxed on foreign income.[324] Since the parent is an American corporation, it is

319. *See* United States v. Chicago, B. & Q. R.R., 412 U.S. 401, 413 (1973).

320. Frolik, *supra* note 232, at 499, 509; Joan T. Boardman, Note, *Contributions to the Capital of a Corporation*, 44 U. CIN. L. REV. 549, 560 (1975); Behrisin, *supra* note 234, at 270, 273-74.

321. The decision is suspect since there was no apparent reason to refuse allocation. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 69 (1994), *on reconsideration*, 106 T.C. 257, 265-67 (1996).

322. *See generally* Maquiladora Industry, *supra* note 72.

323. *See, e.g.*, *supra* note 287.

324. *See, e.g.*, 3 BITTKER & LOKKEN, *supra* note 9, ¶ 66.1, at 66-3, ¶ 66.2.1, at 66-5 to -6. Returns and other information may have to be filed by foreign corporations which are not subject to tax. *See generally* Kelley & Schrier, *supra* note 37; Pridjian, *supra* note 37; Williamson et al., *supra* note 37.

taxed on its worldwide income regardless of the source.[325] The parent usually is not taxed on subsidiary income[326] until it receives an ordinary[327] or liquidating[328] dividend.

There are several exceptions to the distribution requirement. They include[329] the imputed sales[330] and assignment of income doctrines,[331] and the reallocation of income,[332] controlled foreign corporation,[333] foreign personal holding company,[334] and passive foreign investment company[335] statutes. If one of the exceptions applies, the parent may be taxed on undistributed subsidiary income in the year when it is realized by the subsidiary.

B. *Actual Transfer by the Parent*

No gain is realized if there is a simultaneous exchange of dollars for plant, equipment and permission to do business in Mexico.[336] If the parent wants a subsidiary to operate the business, another transaction will be necessary.[337] Where the gain is only a small amount, the parent presumably is not concerned about the tax on transferring the property to the subsidiary.

The exclusion for transfers to controlled corporations[338] is available for plant and equipment which will be used in the active conduct of the business.[339] Since the exclusion is not available for intangibles such as a license,[340] gain may be recognized on transfer of the

325. *See* Cook v. Tait, 265 U.S. 47, 51 (1924); Barclay & Co. v. Edwards, 267 U.S. 442, 448 (1924); 3 BITTKER & LOKKEN, *supra* note 9, ¶ 65.1, at 65-2 to -4.

326. *See* Eisner v. Macomber, 252 U.S. 189, 219 (1920).

327. *See* I.R.C. §§ 316(a), 301(c)(1), 61(a)(7).

328. *See id.* §§ 331(a-b), 61(a)(3).

329. The other anti-avoidance rules have no affect on a Maquiladora exchange. *See generally* 3 BITTKER & LOKKEN, *supra* note 9, chs. 66-71.

330. *See* Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

331. *See* Lucas v. Earl, 281 U.S. 111, 115 (1930).

332. *See* I.R.C. § 482.

333. *See id.* § 951(a).

334. *See id.* § 551(a).

335. *See id.* §§ 1291(a), 1293(a).

336. *See* 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78; BITTKER & EUSTICE, *supra* note 52, ¶ 15.80[7][b], at 15-138.

337. *See generally* KUNTZ & PERONI, *supra* note 80, at B2-14 to -54.

338. *See* I.R.C. § 351(a).

339. *See id.* § 367(a)(1), (a)(3)(A). *See generally* 3 BITTKER & LOKKEN, *supra* note 9, ¶ 68.6, at 68-120 to -143.

340. *See* I.R.C. §§ 367(a)(3)(B)(iv), 936(h)(3)(B)(iv).

permission to do business in Mexico.[341] Although all of the gain might be exempt under the reorganization rules, the availability of reorganization treatment is uncertain.[342]

Exchanging a dollar obligation for the stock of a subsidiary[343] is less likely to be successful. Gain is not realized if there is no material difference between the properties.[344] The material difference rule is not satisfied because there are material differences in the rights and liabilities created by stock and obligations.[345]

The controlled corporation exclusion requires that the property received by the subsidiary will used in the active conduct of its trade or business.[346] Since the subsidiary will transfer the obligations to Mexico, the use requirement[347] will not be satisfied.[348]

Contributions to capital[349] are also taxable to the parent. If the parent owns at least eighty percent of the right to control the subsidiary, the transaction is treated as an exchange[350] which is taxable since the transfer does not qualify for the controlled corporation exclusion.[351] Where the parent owns less than eighty percent, it is liable for a thirty-five percent excise tax.[352]

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341. The scope of the license category is unclear. It was enacted in response to tax avoidance by transferring developed patents and similar business properties to possessions corporations. Perhaps permission to do business in Mexico is not covered since it is substantially different from the property to which the statute was addressed. *See generally* H.R. CONF. REP. NO. 97-760, at 504-13 (1982), *reprinted in* 1982-2 C.B. 617-21.

342. Even if the exemption would be available for a domestic transaction, all or part of it may be lost since it is between a domestic and a foreign corporation. *See, e.g.*, I.R.C. § 367(a)(3)(B)(iv). *See generally* BITTKER & EUSTICE, *supra* note 52, ¶¶ 15.84[1] - 15.84[3], at 15-162 to -180; KUNTZ & PERONI, *supra* note 80, at B5-1 to -100.

343. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 61-62 (1994), *on reconsideration*, 106 T.C. 257 (1996).

344. *See* Treas. Reg. § 1.1001-1(a) (1994).

345. *See supra* Part III.

346. *See* I.R.C. § 367(a)(3)(A).

347. *See* Temp. Treas. Reg. § 1.367(a)-2T(b)(2) (1990).

348. *See* I.R.C. § 367(a)(3)(A).

349. Logic suggests that there is no exchange if the transaction is a contribution to capital. *See* H.R. REP. No. 91-1762, at 4 (1971). Although IRS has concluded that no gain is recognized by a shareholder who contributes stock to the issuing corporation, one can only speculate about whether that result would be available if dollar obligations are contributed. *See* Rev. Rul. 70-291, 1970-1 C.B. 168; Commissioner v. Fink, 483 U.S. 89, 94 (1987).

350. *See* I.R.C. § 367(c)(2). The deemed exchange rule was enacted to reduce avoidance. H.R. REP. No. 91-1762, at 4 (1971).

351. *See* I.R.C. § 367(c)(2).

352. The tax is 35% of the fair market value of the property, reduced by the adjusted basis and any gain recognized on the transfer. *See* I.R.C. §§ 1491-1492.

C. *Deemed Transfer by the Parent*

There are several rules which have the effect of treating the parent as the party which made a transfer. In each of the following subdivisions, assume the parent purchases a dollar obligation, and sells it to the subsidiary for no gain. The parent conducts some of the negotiations which lead to realization of gain when the subsidiary exchanges the obligation for a restricted peso account.

1. Imputed Sales

Income from the exchange by the subsidiary will be taxed to the parent if the parent is the real seller. The cases focus on the conduct of the parties to determine the identity of the seller.[353]

One case involved an oral agreement by a corporation to sell land to a purchaser. When the parties met to reduce the agreement to writing, the corporation refused to complete the deal because it would be taxed on a sale. Within a few days, the shareholders received the land as a liquidating distribution,[354] and sold it to the purchaser on substantially identical terms. Even though the oral contract was unenforceable, the corporation was treated as the seller.[355]

Another arrangement began when shareholders offered to sell their stock. The prospective purchaser refused to accept stock, but expressed an interest in buying assets. The offer was rejected because the corporation did not want to pay the tax on a sale. The corporation distributed its assets in liquidation,[356] and the shareholders sold the assets to the prospective purchaser. Since the corporation never planned to make the sale itself, it was not treated as the seller.[357]

Application of the imputed sales doctrine depends on an interpretation of the facts, and several facts and circumstances are relevant.[358] Hence, winning is uncertain and may be very expensive.

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353. *See* Peeler Reality Co., Inc. v. Commissioner, 60 T.C. 705, 714 (1973).

354. At the time, corporations were not taxed on in kind liquidating distributions. *See* Treas. Reg. § 19.22(a)-21, at 42 (1940), *reprinted in* 143 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 42.

355. *See* Commissioner v. Court Holding Co., 324 U.S. 331, 333 (1945).

356. At the time, corporations were not taxed on in kind liquidating distributions. *See* Treas. Reg. § 19.22(a)-21, at 42 (1940), *reprinted in* 143 U.S. REVENUE ACTS 1909-1950, *supra* note 110, at 42.

357. *See* United States v. Cumberland Pub. Serv. Co., 338 U.S. 451, 454-57 (1950).

358. While the imputed sales doctrine arose in liquidation cases, it has grown into a general guide for determining which party is taxable on a sale. *See generally* BORIS I. BITTKER & JAMES

The IRS continued to argue about one transaction until refund litigation was decided adversely by an appeals court, and the IRS had also lost a deficiency proceeding in the Tax Court.[359]

2. Assignment of Income

Income earned by an asset may be taxed to the person who owned it while the income accrued. The existence of an assignment of income depends on the nature of the right to receive income, and the circumstances of the transfer of the right.[360]

Income rights generally are subdivided into two categories. Unrealized appreciation is called potential income because it will not be realized until there is a sale of the property. Since the timing of realization of gain is at the discretion of the owner,[361] a transfer of potential income is not an assignment of income.[362] Hence, there is no assignment of income by the parent to the extent that it makes a bargain sale of the principal to the subsidiary.[363]

Rights to items such as interest are described as earned income, and a transfer of earned income is an assignment of income. Compensation for services is another type of earned income. If the services of the parent in arranging the exchange increases the gain or interest received by the subsidiary, some cases hold the increases are taxable to the parent because they are compensation for services provided by the parent.[364] The fact that the services were rendered after the

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EUSTICE, INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶ 11.63, at 11-64 to -69 (4th ed. 1979) [hereinafter BITTKER & EUSTICE, 4th ed.]; William L. Cary, *The Effect of Taxation on Selling Out a Corporate Business for Cash*, 45 U. ILL. L. REV. 423 (1950); Howard Mintz, *Recent Developments Under the Court Holding Co. and Cumberland Public Service Cases*, 11 N.Y.U. TAX INST. 873 (1953).

359. *See* Peeler Realty Co. v. Commissioner, 60 T.C. 705, 714-16 (1973); *see also* Hines v. United States, 477 F.2d 1063, 1071-72 (5th Cir. 1973).

360. *See generally* Paul A. Teschner, *Anticipation of Income*, 41 IND. L.J. 587 (1966); 3 BITTKER & LOKKEN, *supra* note 9, ¶ 75.1, at 75-1 to -58.

361. *See* SoRelle v. Commissioner, 22 T.C. 459, 478 (1954), *acq*. 1955-2 C.B. 9.

362. *See Peeler*, 60 T.C. at 714; Campbell v. Prothro, 209 F.2d 331, 333-35 (5th Cir. 1954), *acq*. Rev. Rul. 55-138, 1955-1 C.B. 223; Rev. Rul. 57-328, 1957-2 C.B. 229.

363. 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78.

364. *Compare* Hogle v. Commissioner, 132 F.2d 66, 71-72 (10th Cir. 1942) (holding that the income derived from the personal efforts of the grantor of trust should be taxed to grantor and not to the trust), *and* American Savings Bank v. Commissioner, 56 T.C. 828, 838-42 (1971) (management fees received by corporation were taxable to the shareholders because they earned the fees), *with* Haag v. Commissioner, 88 T.C. 604, 611-14 (1987), *aff'd without opinion*, 855 F.2d 855 (8th Cir. 1988) (corporate income not taxed to sole shareholder since it was earned by corporation), *and* Hospital Corp. of America v. Commissioner, 81 T.C. 520, 578-87 (1983), *nonacq*. 1987-2 C.B. 1 (subsidiary income not taxed to parent to the extent it was earned by the subsidiary).

transfer of the dollar obligation to the subsidiary does not affect the result.[365]

If the asset that earned the income and the right to the income are transferred, then the amount of the assigned income is limited to the amount accrued on the date of the transfer.[366] Income which accrues after the date of the assignment is taxable to the assignee.[367]

Income does not accrue if the amount which can be collected is not reasonably certain on the date of the transfer. Whether collection is sufficiently uncertain is a question of fact, and clients should be told that anyone who relies on this theory must be prepared to concede or litigate if the transaction is audited. The discussion should compare the decisions[368] with the present case, and emphasize that the parent has the burden of proof on the collectibility issue.[369]

3. Reallocation of Income

Tax items may be reallocated[370] between related organizations[371] in order to achieve a clear reflection of income.[372] Hence, the dealings of related persons are treated as if they were between unrelated entities dealing at arm's length. Reallocation is improper if the results of dealings between relatives are the same as they would have been if the parties were not related.[373]

The parent purchases a dollar obligation for less that its fair market value, and gain is not recognized when it is transferred to the

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365. *See, e.g.*, Lucas v. Earl, 281 U.S. 111, 114 (1930).

366. *See* Helvering v. Horst, 311 U.S. 112, 115-16 (1940).

367. *See* Rev. Rul. 72-312, 1972-1 C.B. 22; *see also* Blair v. Commissioner, 300 U.S. 5, 14 (1940); Midland-Ross Corp. v. United States, 485 F.2d 110, 116-18 (6th Cir. 1973).

368. *E.g.*, Commissioner v. Timken, 47 B.T.A. 494, 509-13 (1942) (debtor insolvent), *nonacq*. 1942-2 C.B. 32, *aff'd*, 141 F.2d 625 (6th Cir. 1944); Wellhouse v. Tomlinson, 197 F. Supp. 739, 741-42 (S.D. Fla. 1961) (assignee faced with the likelihood of costly litigation). Factors in addition to collectibility may be involved. *Compare* Schulze v. Commissioner, 52 T.C.M. (P-H) 1094, 1097-98 (1983), *and* Jones v. Commissioner, 306 F.2d 292, 297-303 (5th Cir. 1962), *with* Kochansky v. Commissioner, 92 F.3d 957, 959 (9th Cir. 1996).

369. *See* Jones v. United States, 395 F.2d 938, 299-303 (6th Cir. 1968). *See also* 3 BITTKER & LOKKIN, *supra* note 9, ¶ 75.3.3, at 75-43 to -7.

370. *See* Treas. Reg. § 1.482-1(a)(2) (1994).

371. *See* Treas. Reg. § 1.482-1(i)(1, 4-5) (1994). A domestic parent and a foreign subsidiary are related if the parent controls the subsidiary. *See* Treas. Reg. § 1.482-1(i)(1) (1994); Rev. Rul. 77-83, 1977-1 C.B. 139.

372. *See* I.R.C. § 482. *See generally* BITTKER & EUSTICE, *supra* note 52, ¶¶ 13.20 to 13.23[8], at 13-21 to -74; Supp. No. 4, *supra* note 40, at S79-1 to -126; KUNTZ & PERONI, *supra* note 80, at A3-1 to -247.

373. *See* Treas. Reg. § 1.482-1(b)(1), (d)(2), (4)(1)(i) (1994).

subsidiary. The regulations conclude that the gain may be reallocated to the parent even if a nonrecognition statute applies.[374] Since the conclusion is based on a decision which did not evaluate the policy of the nonrecognition statute, it is arguably incorrect because a subsequent decision reached the opposite result based on the policy of the nonrecognition statute.[375]

The subsidiary purchases a dollar obligation for cash, and the parent negotiates an exchange with Mexico. If the services of the parent increased the gain or interest received by the subsidiary, the IRS will conclude that it should be reported by the parent because its efforts earned the income.[376]

It is difficult to win reallocation cases. Since the IRS has express discretion to decide what is necessary to achieve a clear reflection of income, the taxpayer must prove an abuse of discretion to prevail.[377] The problem is complicated by a lack of rules. The clear reflection doctrine has been described as a fuzzy weapon[378] because there are no reasonably definite standards which suggest what may be required.[379] Proving an abuse of discretion where there are no standards is challenging.

4. Controlled Foreign Corporation

People who desired to eliminate or postpone taxes on their affairs frequently transferred them to corporations located in countries with no

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374. *See* Treas. Reg. § 1.482-1(f)(1)(iii) (1994)

375. *See* National Securities Corp. v. Commissioner, 137 F.2d 600, 601-03 (3d Cir.) (sections 351 and 482), *cert. denied*, 320 U.S. 794 (1943); Hempt Bros., Inc. v. United States, 490 F.2d 1172, 1176-78 (3d Cir.) (section 351 and assignment of income), *cert. denied*, 419 U.S. 826 (1974), *cited with approval by* Rev. Rul. 80-198, 1980-2 C.B. 113. *See generally* Miller, *The Application of IRC Section 482 to Transfers Under Section 351; The National Securities Risk*, 1976 ARIZ. ST. L.J. 227. The standards for challenging a regulation have been discussed. *See supra* Part III.E.

376. *See* Perryman v. Commissioner, 57 T.C.M. (P-H) 1863, 1869-72 (1988), *aff'd*, 1990 U.S. App. LEXIS 21999 (9th Cir. 1990); *see also* Asiatic Petroleum Co. v. Commissioner, 79 F.2d 234, 235-36 (2d Cir.), *cert. denied*, 296 U.S. 645 (1935); Hospital Corp. of America v. Commissioner, 81 T.C. 520, 592-602 (1983), *nonacq*. 1987-2 C.B. 1; *see* Treas. Reg. § 1.482-2A(d)(1)(i) (1994).

377. *See* I.R.C. § 482 (1997); *see also* Dolese v. Commissioner, 811 F.2d 543, 546 (10th Cir. 1987); Liberty Loan Corp. v. United States, 498 F.2d 225, 229-32 (8th Cir. 1972), *cert. denied*, 419 U.S. 1089 (1972); Keller v. Commissioner, 77 T.C. 1014, 1016-22 (1981), *aff'd*, 723 F.2d 58 (10th Cir. 1983); Allegra, *supra* note 39, at 450.

378. *See* WALL ST. J., Wed., Nov. 8, 1975, at A1.

379. *See* Cole v. Commissioner, 64 T.C. 1091, 1104 n.5 (1975), *aff'd*, 586 F.2d 747 (9th Cir. 1978). While the arm's length standard provides an overall approach, it is too general to provide substantial guidance for resolving cases. *See* Treas. Reg. § 1.482-1(b)(1)(1994), (d)(1).

income tax.[380] The controlled foreign corporation rules are designed to prevent avoidance of current taxes on businesses operated by foreign corporations.

There is no effort to subject the foreign corporation to United States tax.[381] If the parent is the sole owner, the control requirement[382] is satisfied and the undistributed Subpart F income of the subsidiary is taxed to the parent.[383] Subpart F income is a specially defined category[384] which includes passive income[385] such as interest[386] and gain from disposition of an interest bearing obligation.[387]

The subsidiary pays cash for a dollar obligation. After some interest has accrued, the obligation is exchanged for a restricted peso account and permission to construct a plant in Mexico. Unless there is an excuse, the entire amount of the interest and the gain will be taxed to the parent.[388]

Passive income is not Subpart F income unless it is included in the gross income of the subsidiary.[389] Theories which might result in exclusion are a cash purchase of property,[390] an exchange where there is no material difference,[391] a reorganization,[392] or a contribution to capital by the Mexican government.[393]

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380. *See* Randolph E. Paul, *The Background of the Revenue Act of 1937*, 5 U. CHI. L. REV. 41, 49-56 (1937).

381. *See generally* 3 BITTKER & LOKKEN, *supra* note 9, ¶¶ 68.2.1 to 68.2.14, at 68-25 to -77; BITTKER & EUSTICE, *supra* note 52, ¶¶ 15.60 to 15.65[3], at 15-102 to -125; KUNTZ & PERONI, *supra* note 80, at B3-1 to -159; Hudson & Lemein, *supra* note 40, at 233, 238-60.

382. The control requirement is satisfied for a year if more than half of the vote, or more than half of the value of the stock, is owned by United States persons for 30 consecutive days during the year. *See* I.R.C. §§ 951(a)(1-2), 957(a), 958(b). Ownership includes actual and certain constructive ownership. *See id*. §§ 957(a), 958(b).

383. A pro rata part of undistributed Subpart F income is taxed to United States shareholders on the last day of the year. A person is a U.S. shareholder if he owns 10% of the right to vote. *See* I.R.C. §§ 951(a-b), 7701(a)(3).

384. *See* I.R.C. § 952(a).

385. The passive income is specially defined foreign personal holding company income. *See* I.R.C. § 954(a)(1). *See generally* Laity, *Defining the Passive Income of Controlled Foreign Corporations*, 21 N.C. J. INT'L L. & COM. REG. 293 (1996).

386. *See* I.R.C. § 954(c)(1)(A).

387. *See id.* § 954(c)(1)(B)(i).

388. *See* G.M. Trading Corp. v. Commissioner, 106 T.C. 257, 266 (1996).

389. *See* I.R.C. §§ 952(a)(2), 954(c)(1). The same result should follow even if income from the debt-equity exchange is classified foreign base company income from oil, sales, services, shipping because each definition requires that there be income. The requirement presumably means that income must be realized, and be includable in gross income. *See id*. §§ 954(d-g).

390. *See* 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78.

391. *See* Treas. Reg. § 1.1001-1(a) (1994). No material difference treatment is unlikely for reasons which have been discussed. *See supra* Part III.

The exclusions are mere postponements because of the basis rules. If property is purchased, the basis is the purchase price.[394] If there was no material difference in exchanged properties,[395] or the reorganization rules apply,[396] there is a substituted or carryover basis. While a carryover basis continues with each asset,[397] basis acquired by purchase or as a substitute must be allocated pro rata between the assets received.[398]

Application of the contribution to capital basis rules is uncertain. Since a purchase is not a contribution, the basis of the account is the amount paid.[399] The IRS will argue that there was no contribution,[400] and the cost basis must be allocated between the assets.[401]

The transaction should be treated as a part purchase, part contribution.[402] Although the dollar obligation was a direct benefit, the balance of the consideration received by Mexico was a package of indirect benefits.[403] Hence the entire cost basis would be attributed to the account to the extent of its value,[404] and the basis of the permission would be determined under the contribution to capital basis rules.

Although the goal of the basis statute is to deny basis to the extent of a nonshareholder contribution to capital, results are uncertain because it is not clear whether the pesos are classified as money.[405] If pesos are not

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392. *See* I.R.C. §§ 354, 361. Reorganization treatment is unlikely for reasons which have been discussed; *see also supra* Part II.

393. *See* I.R.C. § 118. The Tax Court has concluded that an exchange of dollar obligations for pesos was not a contribution to capital. *See generally G.M. Trading*, 103 T.C. at 69-70. The contribution to capital rules have been discussed. *See supra* Part IV.

394. *See* I.R.C. § 1012; Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 187-88 (1954).

395. Basis carries over in a no material difference exchange. *See* Treas. Reg. § 1.1002-1(c) (1957); Motor Products Corp. v. Commissioner, 47 B.T.A. 983, 998 (1942), *aff'd per curiam*, 142 F.2d 449 (6th Cir. 1944).

396. I.R.C. §§ 358(a), 362(b). *See generally* BITTKER & EUSTICE, *supra* note 52, ¶ 12.40[1], at 12-152 to -153.

397. *See* I.R.C. § 362(b).

398. The method of pro rata allocation depends on the nature of the transaction. *Compare* Treas. Reg. § 1.61-6(a) (1957), *with* I.R.C. § 358(a)(2), (b)(1), *and* Treas. Reg. § 1.358-2 (1979).

399. *See* I.R.C. § 1012.

400. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 69 (1994), *on reconsideration*, 106 T.C. 257 (1996). *See generally* Maquiladora Industry, *supra* note 72.

401. *See* Treas. Reg. § 1.61.1(a) (1957).

402. *See supra* Part IV.

403. *See G.M. Trading*, 103 T.C. at 66-67; Libin & Prillaman, *supra* note 271, at 99, 100-01.

404. The basis of the account should be equal to the value of the obligation. *See* I.R.C. § 1012; Philadelphia Park Amusement Co. v. United States, 126 F. Supp. 184, 188 (Ct. Cl. 1954).

405. Where a corporation received a peso account, the Tax Court found that the substance of the transaction was receipt of pesos. *See G.M. Trading*, 103 T.C. at 68-69.

money, the contribution basis is zero.[406] If pesos are the functional currency of the subsidiary and they are used to purchase business assets, pesos should be treated as money[407] for basis purposes.[408] Hence, the basis of other property must be reduced by the amount of the contribution.[409]

The remaining consideration is whether gain or loss is recognized when the subsidiary spends the pesos. If the pesos are the functional currency of the subsidiary, there should be no gain or loss on a cash purchase of goods and services.[410] If they are not the functional currency, any gain realized on exchanging the pesos for goods and services[411] is Subpart F income.[412]

There are three ways to reduce or eliminate Subpart F income for a year. The amount is treated as zero if it is de minimis, which means it is less than the smaller of five percent of the gross income of the subsidiary, or $1,000,000.[413] The amount is also treated as zero if the subsidiary is subject to foreign tax exceeding ninety percent of the highest rate of United States tax.[414]

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406. *See* I.R.C. § 362(c)(1).

407. *See id.* § 985(a). When "it is appropriate to measure the results . . . of a foreign operation in a foreign currency . . . [the] taxpayer is not required to recognize exchange gain or loss on currency that is not repatriated but is used to pay ordinary and necessary expenses." S. REP. NO. 99-313, at 450 (1986), *reprinted in* 1986-3 (vol. 3) C.B. 450; STAFF OF THE JOINT COMM. ON TAXATION, 100TH CONG, 1ST SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986, at 1086 (Comm. Print 1987), *reprinted in* 61 TAX REFORM 1986, 1086 (Reams & McDermott ed. 1987). There is no apparent difference between those expenses and the cost of plant and equipment. *See generally* Robert H. Dilworth, Joseph L. Andrus & L. G. Harter, *U.S. Tax Treatment of Financial Transactions Involving Foreign Currency*, 66 TAXES 1019 (1988).

408. One letter issued before enactment of the functional currency statute strongly suggested that foreign currency was money for the purpose of applying the basis statute. *See* Priv. Ltr. Rul. 80-17-095 (Jan. 30, 1980).

409. *See* I.R.C. § 362(c)(2).

410. *See supra* note 407.

411. *See* 3 BITTKER & LOKKEN, *supra* note 9, ¶ 71.4.2, at 71-15; Rev. Rul. 74-7, 1974-1 C.B. 198; *see also* Rev. Rul. 68-634, 1968-2 C.B. 46. *See generally* Leslie B. Samuels, *Federal Income Tax Consequences of Back-to-Back Loans and Currency Exchanges*, 33 TAX LAW 847 (1980).

412. There are two types of property transactions. One is a disposition of property producing passive income, such as interest. Dollar obligations produce interest, as would pesos held in an interest bearing account. The other type is property that does not produce interest, such as pesos or pesos held in a noninterest bearing account. *See* Treas. Reg. § 1.954-2(e)(1)(i)(A-B), (3)(I) (1994). Recognized gain on disposition of both types is Subpart F income. *See* I.R.C. §§ 952(a)(2), 954(a)(1), 954(c)(1)(B).

413. *See* I.R.C. § 954(b)(3)(A).

414. *See id.* § 954(b)(4).

Subpart F income cannot exceed the current earnings and profits[415] of the subsidiary.[416] The definition of earnings and profits for the subsidiary generally is the same as it is for domestic corporations.[417] The earnings and profits exclusion may be a mere postponement since subsequent earnings and profits from other sources will be classified as Subpart F income.[418]

After all of the rules have been applied, the parent will be taxed on Subpart F income in many cases. Even if the tax is postponed and ultimately reduced to a small figure or completely avoided, winning a prolonged controversy with the IRS may be a Pyrrhic victory.

5. Foreign Personal Holding Company

The statute was enacted in response to the practice of transferring investment assets to foreign corporations.[419] Since the principal goal was to postpone income tax while the assets remained in the corporation, the remedy was taxing undistributed income to the shareholders of foreign personal holding companies.[420]

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415. Earnings and profits generally are computed under the rules for domestic corporations. *See* I.R.C. § 964(a). *See generally* 3 BITTKER & LOKKEN, *supra* note 9, ¶ 92.1.3, at 92-7 to -14; BITTKER & EUSTICE, *supra* note 52, ¶ 8.03, at 8-16 to -29; Paul R. McDaniel, *Earnings and Profits*, 32 N.Y.U. TAX INST. 445 (1974).

416. *See* I.R.C. § 952(c)(1)(A).

417. A controlled foreign corporation may elect to compute its earnings and profits exclusively under the rules for domestic corporations, except for the treatment of illegal payments. *See* Treas. Reg. § 1.964-1(f) (1983). If the election is not made, the computation for domestic corporations is modified in various ways for controlled foreign corporations. For example, current earnings and profits are reduced by certain deficits. *See* I.R.C. § 952(c)(1)(B); Treas. Reg. § 1.964-1 (1983). *See generally* Stanley Weiss, *Application of American Methods to Foreign Operations: Government Objectives in Setting Up Accounting Requirements*, 23 N.Y.U. TAX INST. 981 (1965); John W. Cook, *Problems in Computing Earnings and Profits of a Controlled Foreign Corporation*, 25 J. TAX'N 48 (1966); Murl D. Harmon, *Calculating Earnings and Profits for Foreign Subsidiaries: Background and Some Actual Results Showing Differences Among Countries*, 51 TAXES 407 (1973); Stephen M. Brecher & William J. Hibbitt, *Recent Developments Presage Increasing IRS Attention to E&P of Foreign Corps.*, 52 J. TAX'N 100 (1980); James A. Reidy & Phillip Garlett, *Proposed Section 964 Regulations Take First Step in Simplifying E&P Computations*, 21 TAX MGMT. INT'L J. 560 (1992).

418. The amount to be reclassified is the lesser of the prior exclusion under the earnings and profits limit, or current earnings and profits from non-Subpart F sources. *See* I.R.C. § 952(c)(2).

419. *See* Randolph E. Paul, *The Background of the Revenue Act of 1937*, 5 U. CHI. L. REV. 41, 49-56 (1937-38); Harry J. Rudick, *Section 102 and Personal Holding Company Provisions of the Internal Revenue Code*, 49 YALE L.J. 171, 173-80 (1939).

420. *See* Paul, *supra* note 419, at 172; *see also* Rudick, *supra* note 419, at 53.

A foreign corporation is a foreign personal holding company[421] if over half of the stock[422] is owned by not more than five United States persons,[423] and at least sixty percent of the gross income[424] is foreign personal holding company income.[425] Foreign personal holding company income consists of several types of passive income[426] including interest.[427]

Each United States shareholder of a foreign personal holding company must report his pro rata share of the undistributed foreign personal holding company income.[428] Undistributed foreign personal holding company income is taxable income with modifications[429] which are similar to those required for computing earnings and profits. Hence, the amount to be reported is about the same as the dividend that would have been received if there had been an actual distribution.[430]

6. Passive Foreign Investment Company

Avoiding the foreign personal holding company statute could be accomplished by either making sure that passive income did not reach sixty percent, or dispersing ownership of a majority of the stock to at least six people.[431] The passive foreign investment statute applies to any corporation that satisfies the income or asset test.[432]

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421. *See generally* BITTKER & EUSTICE, *supra* note 52, ¶ 15.24, at 15-86, ¶ 7.20, at 7-38 to -39; 3 BITTKER & LOKKEN, *supra* note 9, ¶ 68.3, at 68-84 to -96; 1 KUNTZ & PERONI, *supra* note 80, ¶ B2.06[1]-[7], at B2-71 to -103; John H. Alexander, *Foreign Personal Holding Companies and Foreign Corporations that are Personal Holding Companies*, 67 YALE L. J. 1173 (1957); J. Blake Lowe, Jr., *Curaco Investment Companies: Some Shoals in a Tax Haven*, 16 TAX L. REV. 177 (1961).

422. The quantity of stock may be measured either by value or voting rights. *See* I.R.C. § 552(a)(2).

423. *See* I.R.C. § 552(a)(2). Ownership includes actual and constructive ownership. *See id.* § 554.

424. Gross income is specially defined for this purpose. I.R.C. § 555(a). After a corporation becomes a foreign personal holding company, 50% tests are used to determine whether that status continues for subsequent years. *See id*. § 552(a)(1).

425. *See id.* § 552.

426. *See id.* § 553. *See generally* Howard S. Engle, *Controlled Foreign Corporations: Proposed Regulation Deal with Subpart F and Foreign Personal Holding Company Income*, 23 J. CORP. TAX'N 187 (1996).

427. *See* I.R.C. § 553(a)(1).

428. *See id.* § 551(a-b).

429. *See id.* §§ 556, 561.

430. Hudson & Lemein, *supra* note 40, at 240.

431. *See*, *e.g.*, *id.* at 241.

432. For example, a controlled foreign company engaged in manufacturing is a passive foreign investment company when 50% or more of its assets are owned directly or indirectly

A foreign corporation is a passive foreign investment company[433] if at least seventy-five percent of its gross income is passive income, or fifty percent of its assets are passive assets.[434] The fifty percent test is based on the values of the assets, except the adjusted earnings and profits basis is substituted if the corporation is a controlled foreign corporation, or elects to use the basis rule.[435] The seventy-five percent test is applied by determining the percentage of income which is personal holding company income,[436] which includes interest income.[437]

A corporation may avoid passive foreign investment company status for the first year it has gross income. The relief is available if there was no predecessor passive foreign investment company, the corporation satisfies the IRS that it will not be a passive foreign investment company for either of the next two years, and it is not a passive foreign investment company for either of the next two years.[438]

Shareholders will lose the deferral privilege in one of two ways.[439] Undistributed earnings are taxed currently[440] if the corporation

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through certain lower-tier corporations. *See* Rev. Rul. 87-90, 1987-2 C.B. 216. The foreign investment company statute has been irrelevant since enactment of the passive foreign investment companies statute. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 15.43, at 15-95.

433. *See generally* BITTKER & EUSTICE, *supra* note 52, ¶ 15.44, at 15-95 to -98; 3 BITTKER & LOKKEN, *supra* note 9, ¶ 68.5, at 68-101 to -119; 1 KUNTZ & PERONI, *supra* note 337, ¶ B2.08, at B2-114 to -166; Stanley I. Rubenfeld & Jesse R. Rubin, *Passive Foreign Investment Companies*, 36 TAX NOTES 199 (1987); H. Stewart Dunn, Jr., *PFIC Rules—Tax Policy Gone Awry*, 39 TAX NOTES 625 (1988); Greer L. Phillips, *Currency Transactions Under PFIC*, 43 TAX NOTES 1141 (1989); James A. Doering, *Planning for Direct Foreign Investment Under the PFIC Rules*, 6 J. INT'L TAX'N 209 (1995); Gregory Slamowitz, *Passive Foreign Investment Companies*, 73 TAXES 251 (1995).

434. An asset is passive if it produces, or is held for production of passive income. *See* I.R.C. § 1296(a).

435. *See id.* The value or basis of an asset is not reduced by liabilities. *See* I.R.S. Notice 88-22, 1988-1 C.B. 489. *See generally* Bruce W. Reynolds et al., *RRA '93 Anti-Deferral Provisions Create Planning Hurdles for CFCs*, 5 J. INT'L TAX'N 52 (1994); George F. Bernardi, *The Stealth Bombing of CFCs By the PFIC Provisions: Tax Strategies After TAMRA*, 67 TAXES 351 (1989).

436. *See* I.R.C. §§ 1296(b)(1), 954(c). Income received by certain banks, insurance companies and securities dealers, and certain income from certain related persons are excluded from personal holding company income. *See id.* § 1296(b)(2-3).

437. *See id.* § 954(c)(1)(A).

438. *See id.* § 1297(b)(2)(B-C). Relief is available for one or more years of an existing company changing businesses, if similar requirements are satisfied. *See id.* § 1297(b)(3).

439. *See generally* Stephen E. Shay, *The Post-TAMRA Treatment of U.S. Shareholders of PFICs: Part I*, 70 J. TAX. 296 (1989); Stephen E. Shay, *The Post-TAMRA Treatment of U.S. Shareholders of PFICs: Part II*, 70 J. TAX. 374 (1989).

440. *See* I.R.C. § 1293(a)(1). Stock basis increases by the amount included in gross income, and decreases on actual distribution of amounts previously taxed. *See id.* § 1293(d). Shareholders may elect to postpone the time for paying the tax on undistributed earnings. *See id.* § 1294(a)(1).

elects that option.[441] If there is no election, interest is charged on the deferral when the shareholder receives a distribution or sells his stock.[442] The extent and complexity of the proposed regulations[443] suggests that enforcement efforts will be very aggressive.

D. Reappraisal

Application of each device which can be used to tax the parent on income of the subsidiary is subject to one or more defenses. Since a trial would be necessary to establish the facts in contested cases, prevailing on any of those theories will be expensive and the outcome is uncertain. The uncertainty and the cost both increase if the devices asserted in the alternative.

The parent probably can avoid imputed sales, assignment of income and reallocation of income arguments with a relatively small amount of effort if the transaction is structured in a different manner. Suppose the parent transfers cash to the subsidiary and the cash is used to purchase the debt. Since the parent never owned the debt, there could be no assignment of interest income.[444]

All negotiations and other activities in connection with the debt should be conducted by the subsidiary. If the subsidiary performs all of the services for itself, it would be difficult to make a rational argument that the parent was the real seller, that there was an assignment of service income, or that the income should be reallocated because it was earned by the parent.

The parent will be currently taxed if most of the income of the subsidiary is passive, such as interest realized[445] on the dollar obligation and the restricted peso account.[446] While the subsidiary may qualify for relief from the passive foreign investment company status for the first

441. *See* I.R.C. § 1295. An election is permanent unless IRS consents to revocation. *See id*. § 1295.

442. *See id.* § 1291(a)(1-2). There is a deemed sale if the stock is used as security for a loan. *See id*. 1297(b)(6).

443. One authority concludes that they are such a "gargantuan corpus of regulatory hyperlexis . . . [that they may] have achieved extraterrestrial orbit." BITTKER & EUSTICE, *supra* note 52, ¶ 15.44, at 15-97.

444. *See* Rev. Rul. 72-312, 1972-1 C.B. 22; Blair v. Commissioner, 300 U.S. 5, 14 (1940); Midland-Ross Corp. v. United States, 485 F.2d 110, 118-19 (6th Cir. 1973).

445. There is no income unless the interest is realized by the subsidiary.

446. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 64 (1994), *on reconsideration*, 106 T.C. 257 (1996).

year it has gross income,[447] there is no comparable method for avoiding liability under the foreign personal holding company provision. The parent's tax may be negligible because the amount of income received under both statutes is based on the taxable income of the subsidiary.[448]

Current liability may be imposed for interest realized[449] and gain recognized on the Maquiladora exchange under the controlled foreign corporation statute. Gain recognized on exchanging dollar obligations for a restricted peso account, or from using the pesos to purchase goods and services, is Subpart F income. If no gain is recognized,[450] it would never be taxed to the parent[451] under the controlled foreign corporation statute.

Liability for Subpart F income can be reduced or postponed with several devices. Subpart F income for a year is deemed zero if the amount is de minimums,[452] or the subsidiary is subject to an adequate foreign income tax.[453] If the Subpart F income is not deemed zero, it cannot exceed the earnings and profits of the subsidiary. If current earnings are inadequate, controlled foreign corporation liability is postponed until a subsequent year when earnings and profits from other sources will be classified as Subpart F income.[454]

The parent will never be taxed on the Maquiladora exchange if the subsidiary simultaneously exchanges dollars for plant and equipment, and permission. Since there is no tax on a bargain purchase,[455] the subsidiary does not realize income. If the subsidiary does not realize income, there is nothing which can be taxed to the parent.

Tax to the parent is postponed if the subsidiary receives blocked income.[456] Income is blocked if it is deemed not received under either the subsidiary's method of accounting, or a special method of accounting

447. *See* I.R.C. § 1297(b)(2).

448. *See id.* §§ 551(a), 556 (foreign personal holding company), 1293(a)(1), (e), 1291(a)(1), (b)(1-2) (passive foreign investment company).

449. There is no income unless the interest is realized by the subsidiary. *See id.* §§ 952(a)(2), 954(c)(1)(A).

450. For example, the value of the pesos received for the dollar obligation is equal to the basis, and the remainder of the pesos are a contribution to capital.

451. *See id.* §§ 952(a)(2), 954(c)(1)(B)(i, iii).

452. *See id.* § 954(b)(3)(A).

453. *See id.* § 954(b)(4).

454. *See id.* § 952(c)(1)(A).

455. 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78.

456. For example, the subsidiary receives an item which would be taxed to the parent under the controlled foreign corporation rules. Since the item is blocked, there is no current tax under the controlled foreign corporation rules.

for foreign income. Realization is postponed until the restriction is removed,[457] which could produce permanent nonrecognition.[458]

VI. BLOCKED INCOME

A. Introduction

If there is a taxable transaction,[459] the remaining question is whether receipt of the income can be postponed. Income generally must be reported in the year when it is received. An item is not income under the cash method until it is actually or constructively received.[460] An item is not income under the accrual method until the right to receive it is fixed and the amount is reasonably ascertainable.[461] Regardless of his overall method of accounting, a taxpayer may elect the deferrable foreign income method of accounting.[462]

Deferral requires proof of an adequate restriction. Hence the taxpayer must be prepared to demonstrate the existence of a restriction, and that it delayed receipt under his method of accounting.[463]

B. Cash Method

Income is actually received in the year when the benefit is sufficiently available.[464] A client delivers cash to a lawyer who complies with his obligation to hold it in trust until his fee is earned. Since use of the money was restricted, the lawyer does not realize income until the fee is earned, and he has the right to withdraw it from the trust.[465] An actual

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457. *See infra* Part VI.

458. *See* Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3275-76 (1993), *aff'd sub nom.*, Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

459. Interest from the dollar obligation or the restricted peso account, or gain from exchanging the dollar obligation for a restricted peso account or from exchanging pesos for goods and services.

460. *See* Treas. Reg. §§ 1.446-1(c)(1)(i), 1.451-1(a) (1993).

461. *See id.*

462. *See* Rev. Rul. 74-351, 1974-2 C.B. 144.

463. *See* North American Oil Consolidated v. Burnet, 286 U.S. 417, 423-24 (1932); Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972); Texaco, Inc. v. Commissioner, 98 F.3d 825, 828 (5th Cir. 1996).

464. *See* Treas. Reg. § 1.451-2 (1979). *See generally* STEPHEN F. GERTZMAN, FEDERAL TAX ACCOUNTING ¶ 3.03, at 3-12 to -28 (2d ed. 1993); 4 BITTKER & LOKKEN, *supra* note 9, ¶ 105.3, at 105-46 to -59.

465. *See* Miele v. Commissioner, 72 T.C. 284, 288-89 (1979). Several cases reach the same result where criminals honored their agreements to share the ill-gotten gain because there was no claim of right to a personal benefit. *See* Liddy v. Commissioner, 54 T.C.M. (P-H) 494, 497-98 (1985), *aff'd*, 808 F.2d 312 (4th Cir. 1986); Ball v. Commissioner, 53 T.C.M. (P-H) 838, 840, 842-

receipt of foreign currency is not income[466] until the earlier of the time it can be spent in a foreign country[467] or the United States.[468]

There is no constructive receipt of currency which cannot be withdrawn from an account.[469] A postponement of the time for receipt is effective if there is a valid business reason for an additional delay. One nonqualified deferred compensation plan called for payments to be made in 1941. Before the end of 1940, the participant and the employer agreed that the payments would be deferred until 1942. Since there was a valid business reason, the Tax Court found there was no constructive receipt in 1941, and the IRS published agreement with the decision.[470] A subsequent agreement deferred the payments until 1943, and the Tax Court found there was no constructive receipt in 1942.[471]

If it can be withdrawn subject to restrictions, income is constructively received when the currency was credited to the account unless the restrictions are substantial.[472] A restriction is substantial where another person has discretion to decide whether a withdrawal will be allowed.[473] Constructive receipt occurs when the situation is modified so the currency could be withdrawn without substantial restriction.[474]

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44 (1984), *aff'd*, 770 F.2d 1066 (3d Cir. 1985); Roloff v. Commissioner, 50 T.C.M. (P-H) 37, 38 (1981); Shaara v. Commissioner, 49 T.C.M. (P-H) 1098, 1101-2 (1980).

466. *See* International Mortgage and Investment Corp. v. Commissioner, 36 B.T.A. 187, 190 (1937), *acq*. 1937-2 C.B. 15; United Artists Corp. of Japan v. Commissioner, 13 T.C.M. (P-H) 679, 683 (1944); Corn Products Refining Co. v. Commissioner, 21 T.C.M. (P-H) 623, 628 (1952), *aff'd*, 215 F.2d 513, 517-18 (2d Cir. 1954), *aff'd on other issues*, 350 U.S. 46 (1955).

467. *See* McKee v. Commissioner, 54 T.C.M. (P-H) 2557, 2560-61 (1985); Berman v. Commissioner, 52 T.C.M. (P-H) 877, 880-81 (1983); Marty v. Commissioner, 41 T.C.M. (P-H) 26, 28 (1972); Cooper v. Commissioner, 15 T.C. 757, 764-65 (1950), *acq. on other issues*, 1951-1 C.B. 2; Freudmann v. Commissioner, 10 T.C. 775, 797 (1948), *acq. on other issues*, 1948-2 C.B. 2; Eder v. Commissioner, 138 F.2d 27, 28 (2d Cir. 1943).

468. *Compare United Artists*, 13 T.C.M. at 683, *with* Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972), *and* Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 339, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

469. *See International Mortgage and Investment*, 36 B.T.A. at 190; *United Artists*, 13 T.C.M. at 683.

470. *See* Veit v. Commissioner, 8 T.C. 809, 816-18 (1947), *acq.* 1947-2 C.B. 4; Martin v. Commissioner, 96 T.C. 814, 822-23 (1991).

471. *See* Veit v. Commissioner, 18 T.C.M. (P-H) 811, 814 (1949); *Martin*, 96 T.C. at 814.

472. *See* Treas. Reg. § 1.451-2 (1979); *Berman*, 52 T.C.M. at 880-81.

473. *See* Rev. Rul. 73-487, 1973-2 C.B. 153; Rev. Proc. 92-65, 1992-2 C.B. 428; Treas. Reg. § 1.457-1(b)(2) Ex. (3) (1982). *Cf.* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 70-71 (1994), *on reconsideration*, 106 T.C. 257, 261-62 (1996).

474. *Berman*, 52 T.C.M. at 880-81.

Economic benefit is an alternative to constructive receipt.[475] Receipt of a contract right is a realization of income it is equivalent to cash.[476] Receipt of the right is not a realization if it is subject to a substantial restriction.[477] Suppose payment will not occur unless the owner continues to work for his employer for a specified period. Since the condition is substantial, no income is received until the beneficiary completes the required period of employment.[478]

An agreement requires that the pesos be held in a restricted account until Mexico confirms that a payment request is for a qualified expenditure.[479] Since the confirmation requirement prevents earlier disbursements and is for a legitimate business purpose,[480] there is no constructive receipt[481] or economic benefit[482] until confirmation. Income is received under both theories at the moment of confirmation.[483]

C. Accrual Method

Income accrues when the right to be paid becomes fixed, and the amount can be determined with reasonable accuracy.[484] There is no right

475. *See generally* Ridgeley A. Scott, *Rabbis and Other Top Hats: The Great Escape*, 43 CATH. U. L. REV. 1, 18-23 (1993).

476. *See* 4 BITTKER & LOKKEN, *supra* note 9, ¶ 105.3.2, at 105-48 to -50. The fact that the time for payment has been postponed for many years does not affect the fact that income is received at the time title was received. *See* Treas. Reg. § 1.446-1(a)(3) (1987); United States v. Basye, 410 U.S. 441, 450 (1973).

477. *See* Miele v. Commissioner, 72 T.C. 284, 289 (1972); North American Oil Consolidated v. Burnet, 286 U.S. 417, 423-24 (1932); Murray v. Commissioner, 28 B.T.A. 624, 629-31 (1933), *acq*. XII-2 C.B. 10 (1933), *cited with approval by* Rev. Rul. 79-91, 1979-1 C.B. 179. *See generally* Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972); Texaco, Inc. v. Commissioner, 98 F.3d 825, 829 (5th Cir. 1996).

478. *See* Treas. Reg. § 1.83-1(c)(4) ex. (1), (c)(3), (c)(2) (1978).

479. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 64 (1994), *on reconsideration*, 106 T.C. 257 (1996).

480. *See* Veit v. Commissioner, 8 T.C. 809, 821 n.1 (1947), *acq.* 1947-2 C.B. 4; Martin v. Commissioner, 96 T.C. 814, 828-29 (1991).

481. *See* Rev. Rul. 73-487, 1973-2 C.B. 153; Rev. Proc. 92-65, 1992-2 C.B. 428; Treas. Reg. § 1.457-1(b)(2) Ex. (3) (1982). *Cf. G.M. Trading*, 103 T.C. at 70-71, *on reconsideration*, 106 T.C. at 261-62.

482. *Burnet*, 286 U.S. at 423-24; *Murray*, 28 B.T.A. 624, 628. *See generally* Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972); Texaco, Inc. v. Commissioner, 98 F.3d 825, 828 (5th Cir. 1996). *Cf. G.M. Trading*, 103 T.C. at 70-71, *on reconsideration*, 106 T.C. at 261-62.

483. *See* Berman v. Commissioner, 52 T.C.M. (P-H) 877, 880-81 (1983).

484. *See* Treas. Reg. § 1.451-1(a) (1993); Continental Tie & Lumber Co. v. United States, 286 U.S. 290, 297 (1932); United States v. Hughes Properties, Inc., 476 U.S. 593, 606 (1986). *See generally* GERTZMAN, *supra* note 463, ¶ 4.03, at 4-10 to -40; 4 BITTKER & LOKKEN, *supra* note 9, ¶¶ 105.5.1 to 105.5.2, at 105-69 to -80.

if payment to[485] or receipt by[486] the taxpayer would be illegal. A right is not fixed where another person has discretion to decide whether the payment will be made,[487] and the amount cannot be determined with reasonable accuracy where another person has discretion to decide how much is to be paid.[488] Failure to satisfy either requirement will prevent accrual of income.[489]

Accrual occurs at the time an advance payment is received.[490] Receipt of a contract right is an advance payment if it is equivalent to cash.[491] An agreement requires that the pesos be held in a restricted account until Mexico confirms that a payment request is for a qualified expenditure.[492] Receipt of the restricted peso account is not an advance payment if it is not the equivalent of cash.[493] Since the confirmation requirement gives Mexico discretion over disbursements, the right is not fixed until confirmation occurs.[494] If the confirmation power gives Mexico the right to modify a payment request, the amount cannot be determined with reasonable accuracy before confirmation.

485. Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 339-40, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992); *First Security Bank of Utah*, 405 U.S. at 403.

486. *First Security Bank of Utah*, 405 U.S. at 403.

487. Mutual Tel. Co. v. United States, 204 F.2d 160, 161 (9th Cir. 1953); Masonite Corp. v. Fly, 7 A.F.T.R.2d (P-H) 1146, 1161 (S.D. Miss. 1961); Doyle, Dane, Bernback, Inc. v. Commissioner, 79 T.C. 101, 106-07 (1982), *nonacq. on this issue*, Rev. Rul. 1988-2 C.B. 1; Yapp Corp. v. Commissioner, 61 T.C.M. (RIA) 1811, 1813 (1992).

488. Patrick McGuirl, Inc. v. Commissioner, 74 F.2d 729, 730 (2d Cir.), *cert. denied*, 295 U.S. 748 (1935); Emery Kinkhead, Inc. v. Commissioner, 35 T.C. 152, 156 (1960), *acq.* 1961-2 C.B. 4.

489. North American Oil Consolidated v. Burnet, 286 U.S. 417, 423-24 (1932); *First Security Bank of Utah*, 405 U.S. at 403; Texaco, Inc. v. Commissioner, 98 F.3d 825, 828-29 (5th Cir. 1996).

490. *See*, *e.g.*, Gillis v. United States, 402 F.2d 501, 506 (5th Cir. 1968); Schlude v. Commissioner, 372 U.S. 128, 137 (1963).

491. *See Schlude*, 372 U.S. at 137-38; 4 BITTKER & LOKKEN, *supra* note 9, ¶ 105.3.2, at 105-48 to -50. The fact that the time for payment has been postponed for many years does not affect the fact that income is received at the time title was received. *See* Treas. Reg. § 1.446-1(a)(3) (1987); United States v. Basye, 410 U.S. 441, 451-52 (1973).

492. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 70-71 (1994), *on reconsideration*, 106 T.C. 257 (1996).

493. *See generally* 4 BITTKER & LOKKEN, *supra* note 9, ¶ 105.3.2, at 105-48 to -50.

494. *Cf. G.M. Trading*, 103 T.C. at 70-71.

D. *Deferrable Foreign Income Method*

Any person may elect[495] to postpone under the deferrable foreign income method. The right to defer foreign income depends on the difficulty of converting it into United States dollars. Conversion may be either by a direct conversion of the foreign currency into dollars, or by use of the foreign currency to purchase other money or property which can converted into dollars. Deferral is permitted if the foreign currency is not readily convertible into dollars because of monetary, exchange or other restrictions imposed by a foreign country.[496]

One ruling concludes that an opinion of foreign legal counsel that sanctions might be imposed for attempting to export licensing fees established that the income was not readily convertible.[497] The Tax Court has suggested that the IRS will be liberal in determining whether income can be deferred.[498]

The IRS will not be liberal in all situations. The IRS feels that receipt cannot be prevented by foreign law[499] even if disobedience could lead to criminal prosecution[500] or other adverse consequences.[501] The IRS position has been uniformly rejected.

The restriction must be mandatory. The IRS frequently contends that restrictions are voluntary because the corporation could reject them in lieu of doing business with the foreign country. A restriction is mandatory if there is an adequate penalty, which includes inability to start conducting business in the country, loss of an established right to do

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495. An election must be made with the timely federal income tax return of the person making the election. The election must include a statement of the details about the income to be deferred. *See* Rev. Rul. 74-351, 1974-2 C.B. 144, *modified*, Rev. Rul. 81-290, 1981-2 C.B. 108. The method is not available unless the taxpayer complies with the deferral procedures prescribed by the IRS. *See* Berman v. Commissioner, 52 T.C.M. (P-H) 877, 881 (1983).

496. *See* Rev. Rul. 74-351, 1974-2 C.B. 144. Income in excess of a 14% limit on exporting profits, and proceeds of a corporate liquidation apparently were deferrable. *See* Priv. Ltr. Rul. 80-35-028 (May 29, 1980); Priv. Ltr. Rul. 87-22-029 (Feb. 26, 1987). Some decisions are inconsistent with the rules. One letter concludes that a prohibition on distributions from a deficit in earnings and profits computed under foreign law is not a restriction. *See* Priv. Ltr. Rul. 81-21-005 (Feb. 5, 1981). For an extensive discussion of how law is established in Saudi Arabia, see Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3260-76 (1993), *aff'd sub nom*. Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

497. *See* Rev. Rul. 74-245, 1974-1 C.B. 124.

498. *See* Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 340, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

499. *See*, *e.g*., Rev. Rul. 76-243, 1976-1 C.B. 134; Rev. Rul. 82-45, 1982-1 C.B. 89.

500. *See* Procter & Gamble, 95 T.C. at 340, *on reconsideration*, 59 T.C. at 3114-15.

501. *See Exxon Corp.*, 64 T.C.M. at 3268, 3273.

business in the country, nationalization,[502] other economic sanctions,[503] or civil or criminal penalties.[504]

One IRS official would not permit deferral if receipt of blocked income put the corporation in a position to spend or export unrestricted currency.[505] The preliminary draft of a ruling is reported to have found that gain from a Maquiladora exchange could be postponed if the income was blocked.[506] Since permission does not appear in the published ruling[507] and the IRS apparently opposes deferral,[508] it is doubtful that an application for postponement would be approved.

Deferred income is not received if it is converted into another blocked asset. Hence, the right to postpone continues if blocked foreign currency is used to purchase blocked investment or business property.[509] The deferral privilege ends in the year when the block is removed. The IRS feels that removal occurs whenever blocked income is actually converted into dollars,[510] becomes readily convertible into dollars,[511] or the taxpayer obtains a benefit by another means such as making a distribution in blocked currency.[512]

Concluding that a block is removed by a mere conversion to dollars is suspect since the general requirement for realization of income

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502. *See id*.

503. *See* Rev. Rul. 74-245, 1974-1 C.B. 124.

504. *See Procter & Gamble*, 95 T.C. at 337-38 (adverse consequences, including "difficult position" with officials, possible blackmail, and possible criminal prosecution), *on reconsideration*, 59 T.C.M. at 3114-15.

505. The official was Mr. Robert Katcher who was Chief of Branch 5 in the Office of Chief Counsel (International). *See* Stuart M. Berkson & Bruce A. Cohen, *Tax Implications of Debt-for-Equity Swaps*, 12 HASTINGS INT'L & COMP. L. REV. 575, 582 n.16 (1989).

506. *See id.*; *see also* Michale Chamberlin et al., *Sovereign Debt Exchanges*, 1988 U. ILL. L. REV. 415, 461-62. There is some doubt about whether the draft was prepared by the IRS. *See This Week's Tax News*, 39 TAX NOTES 311, 311 (Apr. 18, 1988).

507. *See* Rev. Rul. 87-124, 1987-2 C.B. 205.

508. *See* Leighton & Sealy, *supra* note 72, at 721; G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 70-71 (1994), *on reconsideration*, 106 T.C. 257 (1996). *See generally* Maquiladora Industry, *supra* note 72.

509. *See* I.T. 4037, 1950-2 C.B. 31, *superseded by* Rev. Rul. 74-351, 1974-2 C.B. 144, 146; Veit v. Commissioner, 18 T.C.M. (P-H) 811, 816-17 (1949); Martin v. Commissioner, 96 T.C. 814, 822-23 (1991).

510. *See* Rev. Rul. 74-351, 1974-2 C.B. 144; Rev. Rul. 57-379, 1957-2 C.B. 299.

511. *See* Rev. Rul. 74-351, 1974-2 C.B. 144; United States v. Formige, 659 F.2d 206, 207 (D.C. Cir. 1981).

512. *See* Rev. Rul. 74-351, 1974-2 C.B. 144. Charitable contribution is another transaction which will end deferral. *See* Priv. Ltr. Rul. 86-12-036 (Dec. 20, 1985).

is that the taxpayer obtains an economic benefit.[513] The mere fact that income is converted to dollars does not necessarily mean that the dollars could be spent in a foreign country or the United States. The taxpayer does not receive a benefit from dollars that he cannot spend.[514]

The proper treatment of a distribution of blocked currency is uncertain. The IRS feels that the corporation receives a benefit merely because it made an actual distribution to its shareholders. That line of reasoning is difficult to accept if the shareholders cannot spend the blocked currency.[515]

E. Controlled Foreign Corporations

The amount of a deemed distribution cannot exceed the current earnings and profits[516] of a controlled foreign corporation.[517] Blocked income may be excluded from current earnings and profits under two rules. If the corporation uses the accrual method, an income item is not included in earnings and profits until it accrues.[518] For example, if Mexico retains the right to confirm that a payment request is for a

513. *See*, *e.g*., Miele v. Commissioner, 72 T.C. 284, 291 (1972); International Mortgage and Investment Corp. v. Commissioner, 36 B.T.A. 187, 190 (1937), *acq. on another issue*, 1937-2 C.B. 15.

514. *Compare* United Artists Corp. of Japan v. Commissioner, 13 T.C.M. (P-H) 679, 683 (1944), *with* Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972), *and* Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 339, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

515. A distribution in blocked currency is not taxed to the shareholder at the time of receipt. *See* Treas. Reg. § 1.964-2(c)(5) ex. (d) (1983); *United Artists*, 13 T.C.M. at 683; Corn Products Refining Co. v. Commissioner, 215 F.2d 513, 517-18 (2d Cir. 1954), *aff'd on other issues*, 350 U.S. 46 (1955).

516. Earnings and profits generally are computed under the rules for domestic corporations. *See* I.R.C. § 964(a). *See generally* 3 BITTKER & LOKKEN, *supra* note 9, ¶ 92.1.3, at 92-7 to -14; BITTKER & EUSTICE, *supra* note 52, ¶ 8.03, at 8-16 to -29; Paul McDaniel, *Earnings and Profits*, 32 N.Y.U. TAX INST. 445 (1974).

517. A controlled foreign corporation may elect to compute its earnings and profits exclusively under the rules for domestic corporations, except for the treatment of illegal payments. *See* Treas. Reg. § 1.964-1(f) (1983). If the election is not made, the computation for domestic corporation is modified in various ways for controlled foreign corporations. For example, current earnings and profits are reduced by certain deficits. *See* I.R.C. § 952(c)(1)(B); Treas. Reg. § 1.964-1 (1983). *See generally* Walter S. Weiss, *Application of American Methods to Foreign Operation: Government Objective in Setting Up Accounting Requirements*, 23 N.Y.U. TAX INST. 981 (1965); John W. Cook, *Problems in Computing Earnings and Profits of a Controlled Foreign Corporation*, 25 J. TAX. 48 (1966); Murl D. Harmon, *Calculating Earnings and Profits for Foreign Subsidiaries*, 51 TAXES 407 (1973); Brecher & Hibbitt, *Recent Developments Presage Increasing IRS Attention to E&P of Foreign Corps*., 52 J. TAXATION 100 (1980); Reidy & Garlett, *Proposed Section 964 Regulations Take a First Step in Simplifying E&P Computations*, 21 TAX MGMT. INT'L J. 628 (1992).

518. *See* Treas. Reg. § 1.312-6(a) (1960).

qualified expense, the income does not accrue before confirmation since the right is uncertain up to that time.[519]

The second rule applies where there is a restriction on exporting earnings and profits. A United States shareholder may elect[520] to exclude any portion which could not be distributed from current earning and profits[521] if the restriction satisfies several requirements.[522]

The restriction must be imposed by foreign law, which includes statutes, court decisions, rules or regulations of a governmental agency, and other official actions such as determinations by government employees.[523] The restriction must prohibit distributions in currency and property of a type normally owned in the operation of the business, if it could be readily converted into dollars.[524]

Suppose the corporation manufactures products in Mexico for export to Europe,[525] and Mexico requires that the sales proceeds be returned to Mexico. Mexico prohibits the exportation of profits to United States shareholders of the corporation. Even if the sales proceeds are in dollars, they are excluded from earnings and profits since the dollars cannot make their way to United States shareholders[526] until the prohibition has been terminated.

The restriction cannot be voluntary. If foreign law requires the creation of a reserve out of earnings and profits, the restriction is involuntary to the extent of the contributions needed to satisfy the

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519. *Cf.* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 70-71 (1994), *on reconsideration*, 106 T.C. 257 (1996). Receipt of the right presumably is not an advance payment. *See* Schlude v. Commissioner, 372 U.S. 128, 137 (1963).

520. Every United States shareholder relying on the export rule must file a statement of the details about the restriction with his returns for each year the restriction is in force. The shareholder should be ready to prove the existence of the restriction, and the amount of the earnings subject to the restriction. *See* Treas. Reg. § 1.964-2(d) (1983). The proof must include records which describe the types of income received by the corporation. *See id.* §1.964-3, -4.

521. *See* I.R.C. § 964(b). One letter concludes that a prohibition on distributions from a deficit in earnings and profits computed under foreign law is not a restriction under section 964(b). *See* Priv. Let. Rul. 80-21-005 (Feb. 5, 1981).

522. *See* Treas. Reg. § 1.964-2 (1983).

523. *See id.* § 1.964-2(b)(3). For an extensive discussion of how law is established in Saudi Arabia, see Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3260-76 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

524. *See* Treas. Reg. § 1.964-2(b)(3) (1983).

525. G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 60 (1994), *on reconsideration*, 106 T.C. 257 (1996).

526. A special rule applies if there is an adequate ownership chain. *See* Treas. Reg. § 1.964-2(b)(2)(ii) (1983).

requirement.[527] The regulations offer several examples of voluntary restrictions such as additions to an optional reserve.[528]

The procedures for obtaining permission to make distributions must be reasonably utilized. The United States shareholders must prove that either the procedures had been exhausted, or that use of the procedures would be futile. Exhaustion generally occurs if the controlled foreign corporation made a complete application for dollars or foreign currency readily convertible to dollars at the appropriate exchange rate. Denial of an application for one year is not adequate evidence that a request would be denied for a subsequent year.[529]

A corporation sought permission to organize a wholly owned subsidiary in Spain. The government consented on condition that the subsidiary could not make any royalty or technical assistance payments to the parent. The restrictions reflected normal practice, and the subsidiary did not seek removal of the restrictions on advice of Spanish counsel who thought an application might result in penalties or other repercussions. The Tax Court concluded that an application would have been futile.[530]

The restriction must be in force for a total of 150 days. The first ninety days must be the last ninety days of the tax year, and the last sixty days must be the first sixty days of the next year.[531] Each United States shareholder usually must report his share of earnings and profits as gross income for the year when the restriction is removed.[532] The regulations state that removal occurs when there is an illegal conversion of currency or property into dollars,[533] or currency or property becomes readily convertible into dollars,[534] or there is a distribution is of foreign currency which is not readily convertible to dollars. The shareholder may elect to

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527. *See id.* § 1.964-2(b)(5).

528. *See id.* § 1.964-2(b)(4).

529. *See id.* § 1.964-2(b)(6).

530. Since reallocation would have been improper, section 482 did not apply. *See* Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 326, 336-41, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992); Rev. Rul. 74-245, 1974-1 C.B. 124; Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3273-75 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

531. *See* Treas. Reg. § 1.964-2(b)(1) (1983).

532. *See id.* § 1.964-2(c)(1).

533. *See id.* § 1.964-2(c)(2)(ii).

534. *See id.* § 1.964-2(c)(2)(i-ii). A third ground is termination of a reserve requirement. *See id.* §1.964-2(c)(3).

postpone reporting the distribution under the deferrable foreign income method.[535]

F. Reallocation of Income

Blocked income is a ground for defeating current reallocation under two rules. A corporation may elect[536] to postpone under the deferrable foreign income method[537] if the requirements of the regulations have been satisfied.[538]

The regulations authorize deferral if the restriction is imposed by a foreign law which meets several requirements. The restriction must be publicly promulgated, generally applicable to all similarly situated persons, and not imposed as part of a commercial transaction.[539] The restriction must expressly prevent payment of the amount which otherwise would be reallocated.[540] The corporation must have exhausted all remedies for obtaining a waiver of the restriction, or be able to prove that the prospect for success was negligible.[541] The corporation and the related parties must not have attempted to circumvent the restriction in any material manner.[542] Deferral continues until the restriction is removed.[543]

The deferral regulation was adopted as part of an enforcement program.[544] The extensive list of requirements[545] exists primarily to

535. The regulations sanction deferral where the distribution is received in a foreign country. *See id.* § 1.964-2(c)(3), (5)(d). Deferral should be available even if it is received in the United States. *See* Rev. Rul. 74-351, 1974-2 C.B. 144.

536. *See* Treas. Reg. § 1.482-1(h)(2)(iii)(B) (1994). An election for a taxable year must be made on the return, or an amended return filed before the corporation receives notice of an audit. The election must include a statement of the details about the income to be deferred. *See id.*

537. Rev. Rul. 74-351, 1974-2 C.B. 144.

538. *See* Treas. Reg. § 1.482-1(h)(2)(i), (vi) (1994).

539. *See id.* § 1.482-1(h)(2)(ii)(A).

540. *See id.* § 1.482-1(h)(2)(iii)(C). Deferral allowed where payments were generally prohibited. *See id.* § 1.482-1(h)(2)(iii)(C)(v) ex. (1). Deferral was not allowed where law prevented royalty payments but did not prohibit distributions. *See id.* § 1.482-1(h)(2)(iii)(C)(v) ex. (3). Partial deferral allowed where law permitted limited payment. *See id.* § 1.482-1(h)(2)(iii)(C)(v) ex. (4).

541. *See id.* § 1.482-1(h)(2)(iii)(B).

542. *See id.* § 1.482-1(h)(2)(iii)(D). Deferral denied where corporation arranged for unrelated intermediary to make royalty payment. *See id.* § 1.482-1(h)(2)(iii)(D)(v) ex. (2).

543. *See id.* § 1.482-1(h)(2)(iv).

544. IRS, Treasury, Congress, and the Clinton Administration feel that the new regulations have the potential to produce "enormous" amounts of additional revenue. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 13.21[1][c], at 13-24 n.56.

545. The 482 regulations were extensively modified in 1994. T.D. 8552, 1994-2 C.B. 93. One authority concludes the new deferral requirements were designed to limit use of the method to exceptional cases. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 13.20[4][f], at 13-32 n.87.

coerce corporations into obtaining an advance pricing agreement.[546] If the effort to obtain a greater degree of "voluntary" compliance does not produce an adequate level of "cooperation," there is a substantial prospect of additional regulations or legislation.[547]

International oil was targeted as a major source of revenue,[548] and deficiencies of over eight billion dollars were asserted for a few tax years against two taxpayers.[549] Rejection of the argument that blockage by foreign law did not prevent reallocation of income[550] has been described as a huge victory for the taxpayers,[551] and the decision was affirmed on appeal.[552] Since its best legal talent spent a lot of time on the case,[553] the victory underlines the weakness of the position of the government.

The deferral regulation will not be strictly enforced[554] because reallocation is improper if the corporation did not have the legal right to receive the income.[555] A domestic prohibition on receipt will prevent reallocation,[556] and a 1974 ruling reached the same result where the restriction was foreign.[557] Further consideration led to 1976 and 1982

546. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 13.20[4][h], at 13-33.

547. One authority sarcastically refers to "the truly depressing thought that even more regulations and, God help us, legislative activity may be forthcoming." BITTKER & EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS, 1996 Cumulative Supp. No. 3, S13-17 (6th ed., 1994) [hereinafter Supp. No. 3].

548. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 13.20[1][c], at 13-24 n.56.

549. *See* Matthews et al., *Square Off Over Arm's-Length v. Formula Approach*, 50 TAX NOTES 1336, 1337 (Mar. 25, 1991); *see also* Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3228-29 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996)

550. The argument was the ruling position for a number of years. *See, e.g.*, Rev. Rul. 82-45, 1982-1 C.B. 89.

551. *See* Supp. No. 3, *supra* note 547, S13-12 n.86.

552. *Exxon*, 64 T.C.M. at 3257-63.

553. *See generally* Williamson et al., *supra* note 37, at 22-2 to -9.

554. Several authors note that the regulations are an attempt to reverse judicial decisions, and suggest they are at least partially unenforceable. *See generally* Marc M. Levy & James P. Clancy, *IRS Seeks to Reverse Procter & Gamble with Proposed 482 Regulations*, 4 J. OF INT'L TAX 137 (1993); James A. Davlin, *The Uncertainty of Foreign Blocked Income: Trying to Reconcile the 1994 § 482 Regulations with Procter & Gamble*, 5 DUKE J. COMP. & INT'L L. 117 (1994); Peter A. Glicklich, *Compliance Requires Planning Under Section 482*, 52 N.Y.U. TAX INST. 30-32 to -34 (1994); Hudson & Lemein, *supra* note 40, at 233, 316-19; John Nolan, *U.S. Final Transfer Pricing Regulations*, 50 U. MIAMI L. REV. 537, 545-46 (1996).

555. Where reallocation is improper, the reallocation statute and regulations do not apply. *See, e.g.*, Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972); Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 337-41 (1990), *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

556. *See First Security Bank of Utah*, 405 U.S. at 405-06.

557. *See* Rev. Rul. 74-245, 1974-1 C.B. 124, *discussed in Procter & Gamble*, 95 T.C. at 340, *on reconsideration*, 59 T.C.M. at 3114-15.

rulings[558] and a series of letters[559] which concluded that foreign restrictions were always to be disregarded. The attempt to create a distinction has been rejected because domestic and foreign restrictions have the same effect on the legal right to receive income.[560]

The restriction must be imposed by law, which usually means it was established by a mechanism like a statute or regulation. Other means may be adequate. Restrictions identified by official action such as a determination by a government employee may qualify as imposed by law.[561]

Official actions by government employees frequently are evidenced by documents such as contracts[562] and letters. One opinion concluded that a letter from a Minister was law because the evidence established it was authorized by the King of Saudi Arabia.[563] Another corporation sought permission to organize a wholly owned subsidiary in Spain. A government employee consented on condition that the subsidiary could not make any royalty or technical assistance payments to the parent. The court found the restriction reflected normal practice, and concluded that it was imposed by law.[564]

The restriction must be mandatory. The IRS frequently contends that restrictions are voluntary because the corporation could reject them in lieu of doing business with the foreign country. A restriction is mandatory if there is an adequate penalty, which includes inability to start conducting business in the country, loss of an established right to do

558. *See* Rev. Rul. 76-243, 1976-1 C.B. 134; Rev. Rul. 82-45, 1982-1 C.B. 89.

559. *See, e.g.*, Tech. Ad. Mem. 79-23-003 (Feb. 22, 1979); Tech. Ad. Mem. 87-03-003 (Sept. 15, 1986).

560. *See Procter & Gamble*, 95 T.C. at 339-40, *on reconsideration*, 59 T.C.M. at 3114-15; Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3258-63 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825, 829-31 (5th Cir. 1996). *See generally* Levy & Clancy, *supra* note 554, at 203.

561. *See* Treas. Reg. § 1.964-2(b)(3) (1983).

562. *See* Rev. Rul. 76-243, 1976-1 C.B. 134; Gen. Couns. Mem. 35,490 (Sept. 24, 1973), *reprinted in* 1973 IRS GCM LEXIS 106.

563. *See, e.g.*, *Exxon*, 64 T.C.M. at 3232-33, 3263-65. *See generally* Levy & Clancy, *supra* note 554, at 203.

564. *See, e.g.*, *Procter & Gamble*, 95 T.C. at 326, 332-33, 336-37 (rejecting argument that the restriction "was merely an administrative decision"), *on reconsideration*, 59 T.C.M. at 3114-15; *Exxon*, 64 T.C.M. at 3263-64.

business in the country, nationalization,[565] other economic sanctions,[566] or civil or criminal penalties.[567]

If the restriction is mandatory, the corporation must take reasonable steps to avoid it. Hence, the procedure for removing or waiving the restriction generally must be exhausted.[568] Where foreign legal counsel advised the corporation that use of the procedure probably would be futile and might lead to repercussions, failure to use the procedure was excused.[569]

G. *Burden of Proof*

Taxpayers prevail in most civil suits with a mere preponderance of the evidence,[570] which is the usual standard where the issue is application of the cash or accrual method. The burden of proof changes if the IRS argues the cash or accrual method does not clearly reflect income.[571] The clear reflection standard always applies to the deferrable foreign income method,[572] to the computation of earnings and profits of controlled foreign corporations,[573] and to the reallocation of income.[574]

Since the IRS has express discretion to decide what is necessary to achieve a clear reflection of income, the taxpayer must prove an abuse of discretion to prevail.[575] Proving an abuse of discretion is difficult

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565. *See Exxon*, 64 T.C.M. at 3268, 3273.

566. *See* Rev. Rul. 74-245, 1974-1 C.B. 124.

567. *See Procter & Gamble*, 95 T.C. at 337-38 (adverse consequences, including "difficult position" with officials, possible blackmail, and possible criminal prosecution), *on reconsideration*, 59 T.C.M. at 3114-15.

568. *See* Treas. Reg. § 1.482-1(h)(2)(ii)(B) (1994).

569. *See Procter & Gamble*, 95 T.C. at 326, 337, *on reconsideration*, 59 T.C.M. at 3114-15; Rev. Rul. 74-245, 1974-1 C.B. 124.

570. *See, e.g.*, 2A CASEY, FEDERAL TAX PRACTICE § 8.7 (1994 revision).

571. *See* I.R.C. § 446(b); Cole v. Commissioner, 64 T.C. 1091, 1103-04 (1975), *aff'd*, 586 F.2d 747 (9th Cir. 1978).

572. The IRS presumably will always argue the clear reflection doctrine as the reason for denying the right to use the method. *Compare* Rev. Rul. 74-351, 1974-2 C.B. 144, *with* I.R.C. § 446(b), *and Cole*, 64 T.C. at 1103-04.

573. The clear reflection standard applies because express discretion to make an accounting decision is the equivalent of express discretion to decide what is required for a clear reflection of income. *See* I.R.C. § 964(b). *See, e.g.*, E.F. Higgins & Co. v. Commissioner, 74 T.C. 1029, 1043, 1050-52 (1980); Fujinon Optical, Inc. v. Commissioner, 76 T.C. 499, 506-12 (1981).

574. The statute expressly calls for application of the clear reflection standard. *See* I.R.C. § 482; Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 332, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

575. *See, e.g.*, Treas. Reg. § 1.446-1(b)(1) (1993); *Cole*, 64 T.C. at 1103-04; *Procter & Gamble*, 95 T.C. at 332, *on reconsideration*, 59 T.C.M. at 3114-15; Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3257 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825

since there is no general standard for determining whether restrictions are adequate to prevent realization of income. The problem is complicated by a lack of rules for application of the clear reflection doctrine. It has been described as a fuzzy weapon because there are no reasonably definite criterion which suggest what may be required.[576] Proving an abuse of discretion where there are no standards is challenging.

The victory of international oil illustrates that success is available. Arguments based on logic backed by direct precedent[577] and an analogous Supreme Court decision[578] carried the day.[579]

An argument that the taxpayer asked the foreign government to impose the restriction may lead to a heightened scrutiny of the evidence.[580] The procedure is suspect if the collusion results in a political decision in the form of legislation. Many taxpayers hire lobbyists to obtain special federal, state, and local tax legislation in this country. The enforceability of special legislation not affected by the fact that the taxpayer obtained it to reduce his personal tax bill.

H. Reappraisal

Income is not reportable until it is received under the taxpayer's method of accounting. Even where there is an actual receipt under a claim of right to a personal benefit, reporting is not permitted until the taxpayer has the right to spend the income.[581] Determining when the taxpayer obtains the right to spend the income requires an examination of the circumstances.

The subsidiary receives a peso account which prohibits withdrawals until Mexico confirms that a payment request is for a qualified expenditure. Nothing is to be reported at the time the account is received unless the subsidiary received an economic benefit, or is in constructive receipt. Since there is a bona fide purpose for the

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(5th Cir. 1996). *See generally* Thor Power Tool Co. v. Commissioner, 439 U.S. 522, 531-33 (1979); Allegra, *supra* note 39, at 423, 453-513.

576. *See Cole*, 64 T.C. at 1104 n.5.

577. *See Procter & Gamble*, 95 T.C. at 341.

578. *See* Commissioner v. First Security Bank, 405 U.S. 394, 407 (1972).

579. *See Exxon*, 64 T.C.M. at 3257-63.

580. *See, e.g.*, *Procter & Gamble*, 961 F.2d at 1259; *Exxon*, 64 T.C.M. at 3261-62.

581. *See, e.g.*, Miele v. Commissioner, 72 T.C. 284, 291 (1972) (cash); United Artists Corp. of Japan v. Commissioner, 13 T.C.M. (P-H) 679, 683 (1944) (accrual); Rev. Rul. 74-351, 1974-2 C.B. 144 (deferrable foreign income).

restriction,[582] it should prevent constructive receipt of the pesos under any method.[583]

There is an economic benefit if the account provides an adequate property interest. Income is realized under the cash and accrual methods if the interest is the equivalent of cash,[584] and under the deferrable foreign income method if it is readily convertible to dollars.[585] There should be no economic benefit under any method if the agreement provides that the account cannot be transferred.[586]

If there is no income when the account is received, the question is how long can reporting be postponed. If the subsidiary is on the cash or accrual method, income is received at the instant of approval[587] which gives it the right to spend the pesos for plant and equipment. The result does not depend on whether the subsidiary has the right to sell the plant and equipment.[588] There is no income at the time of approval under the deferrable foreign income method if the subsidiary does not have the right to sell the plant and equipment.[589] The deferral continues until the restriction is removed. Although depreciation is not deductible during the deferral period[590] and an election to use it may be a request for an audit,[591] the method is a popular way to avoid current tax.[592]

Once income has been received by the subsidiary, the question is when is the parent required to report it under the anti-tax avoidance rules. Receipt under the deemed sale and assignment of income doctrines, and

582. *See* Veit v. Commissioner, 8 T.C. 809 (1947), *acq.* 1947-2 C.B. 4.

583. If income has otherwise accrued under the all-events test, constructive receipt would be the last step to accrual since it would give the subsidiary the right to spend the income. *See, e.g.*, *United Artists*, 13 T.C.M. at 683. Constructive receipt under the deferrable foreign income method would mean the income is readily convertible to cash. *See* Rev. Rul. 74-351, 1974-2 C.B. 144.

584. *See* 4 BITTKER & LOKKEN, *supra* note 9, ¶ 105.3.2, at 105-48 to -50; Schlude v. Commissioner, 372 U.S. 128, 137 n.10 (1963).

585. *See* Rev. Rul. 74-351, 1974-2 C.B. 144.

586. *See*, *e.g.*, *Miele*, 72 T.C. at 291 (cash); *United Artists*, 13 T.C.M. at 683 (accrual); Rev. Rul. 74-351, 1974-2 C.B. 144 (deferrable foreign income).

587. The blocked income is valued at the free market exchange rate in the United States. *See* McKee v. Commissioner, 54 T.C.M. (P-H) 2557, 2560-61 (1985).

588. *See* Freudmann v. Commissioner, 10 T.C. 775, 797 (1948), *acq. on other issues*, 1948-2 C.B. 2; Eder v. Commissioner, 138 F.2d 27, 28 (2d Cir. 1943); International Mortgage and Investment Corp. v. Commissioner, 36 B.T.A. 187, 190 (1937), *acq.* 1937-2 C.B. 15; Cooper v. Commissioner, 15 T.C. 757, 764-65 (1950), *acq. on other issues*, 1951-1 C.B. 2; Berman v. Commissioner, 52 T.C.M. (P-H) 877, 880-81 (1983); *McKee*, 54 T.C.M. at 2560-61.

589. *See* I.T. 4037, 1950-2 C.B. 31, *superseded by* Rev. Rul. 74-351, 1974-2 C.B. 144.

590. *See* Rev. Rul. 74-351, 1974-2 C.B. 144; *see also* Treas. Reg. § 1.461-1(a)(4) (1994).

591. *See* Berkson & Cohen, *supra* note 503, at 575, 582.

592. *See*, *e.g.*, *Berman*, 52 T.C.M. at 880-81; *McKee*, 54 T.C.M. at 2560-61.

the foreign personal holding company[593] and passive foreign investment company statutes is governed by whether the income is blocked. The parent does not have to report income if payment to or receipt by it is illegal.[594]

Postponement of receipt by the parent of income that is subject to reallocation is governed by the general rules for blockage if the reallocation statute does not apply. It does not apply if foreign law prohibits payment to or receipt by the parent.[595] If the reallocation statute is applicable, the commercial agreement rule[596] is unenforceable because it is an invalid attempt to legislate by regulation,[597] and the regulations provide that the right to postpone is governed by the deferrable foreign income method.[598]

The deferral regulations under the controlled foreign corporation statute are on a sound footing because of an express grant of authority,[599] and the definition of blocked income has remained unchanged since enactment of the statute.[600] The definition should be fairly easy to satisfy with the possible exception of the voluntary restriction clause. Since restrictions of the sort imposed as a condition to doing business are not voluntary,[601] that clause should be satisfied in most cases.

The blocked income rules provide an opportunity for tax planning. Since a foreign government has the power to control United States tax results with its internal laws,[602] it may be willing to create favorable restrictions in exchange for something it wants. Persons

593. *See* Alvord v. Commissioner, 277 F.2d 713, 719-20 (4th Cir. 1960).

594. *See*, *e.g.*, Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972); Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 339-41, *on reconsideration*, 59 T.C.M. (P-H) 3112, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

595. *See*, *e.g.*, *Procter & Gamble*, 59 T.C.M. at 3114-15; Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3257-63 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

596. *See* Treas. Reg. § 1.482-1(h)(2)(iii)(B) (1994).

597. *See* United States v. Empey, 406 F.2d 157, 170 (10th Cir. 1969).

598. *See* Treas. Reg. § 1.482-1(h)(2)(iv) (1994); Rev. Rul. 74-351, 1974-2 C.B. 144.

599. *See* I.R.C. § 964(b).

600. *Compare* Treas. Reg. § 1.964-2(b)(3-4) (1983), *with* T.D. 6892, 1966-2 C.B. 291, *and* T.D. 7545, 1978-1 C.B. 245, 248.

601. *See* Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 341, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

602. *See* Matthews et al., *supra* note 549, at 1337; BITTKER & EUSTICE, *supra* note 52, ¶ 13.20[4][f], at 13-32 n.86; *Procter & Gamble*, 961 F.2d at 1259; Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3261-62 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

planning to do business in a foreign country should be prepared to negotiate for desirable restrictions.

Restrictions are more likely to be upheld if they are imposed on several people. Hence, it should clearly appear that the restriction is authorized by law, and it is applied to others in comparable circumstances.[603]

VII. PLANNING

A. Introduction

There are several ways to structure a Maquiladora exchange. The transaction should be between the subsidiary and Mexico because a foreign corporation is not liable for tax on foreign income.[604] Since the United States parent is liable for tax on its world-wide income,[605] it should remain as far away from the exchange as possible. Every act that makes it look like the parent was involved in the exchange provides the IRS with ammunition which will be used to argue that income from the exchange was received by the parent.

B. Direct Involvement of the Parent

One case illustrates the dangers of direct involvement. A United States corporation purchased a dollar obligation, and transferred it to Mexico. Mexico delivered a restricted peso account and permission to do business in Mexico to a new corporation, and transferred all of the stock to the United States corporation. The Tax Court treated the transaction as if the United States corporation had exchanged the dollar obligation for the pesos.[606]

All of the arguments to reduce or postpone tax were rejected. Gain was realized on the exchange because there was a material difference between the dollar obligation and the pesos.[607] The gain was

603. *See, e.g.*, *Procter & Gamble*, 95 T.C. at 341, *on reconsideration*, 59 T.C.M. at 3114-15; *Exxon*, 64 T.C.M. at 3261-62, 3265-66.

604. 3 BITTKER & LOKKEN, *supra* note 9, ¶ 66.1, at 66-3, ¶ 66.2.1, at 66-5 to -6, ¶ 66.3.5, at 66-51 to -53. Returns and other information may have to be filed by foreign corporations which are not subject to tax. *See* Kelley & Schrier, *supra* note 37, at 366; Pridjian, *supra* note 37, at 427; Williamson et al., *supra* note 37, ch. 22.

605. *See* Cook v. Tait, 265 U.S. 47, 55-56 (1924); Barclay & Co., Inc. v. Edwards, 267 U.S. 442, 442 (1924); 3 BITTKER & LOKKEN, *supra* note 9, ¶ 65.1, at 65-2 to -4.

606. G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 68-69 (1994), *on reconsideration*, 106 T.C. 257, 263-64 (1996).

607. *See id.* at 67.

taxable since there was no contribution to capital,[608] and the withdrawal restrictions[609] did not reduce the value of the pesos.[610] The conclusions were confirmed on reconsideration.[611]

Results might have been favorable if the transaction had been structured differently.[612] Criticism about failure to segregate the portion of the pesos paid for the dollar obligation and the balance paid for other things may be unwarranted because there was no way to know in advance that the Tax Court would refuse to allocate between the taxable and contribution to capital portions of a single transaction.[613]

The refusal to allocate might be avoided. One possibility is separate exchanges where pesos with a value equal to the value of the dollar obligation is one transaction, and the balance of the pesos are separately transferred for the other things received by Mexico.[614] Another possibility is a contractual allocation which expressly identifies the portion of the consideration paid for the dollar obligation, and what is paid for each of the other things received by Mexico.[615] Either approach is risky because the IRS will challenge the valuations of the parties, and argue the step transaction doctrine.[616]

Pesos could only be removed from the account after Mexico confirmed that a payment request was for a qualified expenditure. Since the Tax Court concluded that the restrictions were inadequate to reduce the value of the pesos,[617] it presumably would have found they would not postpone receipt of income. The time when income would be received depends on the adequacy of the restrictions and the accounting method.

608. *See id.* at 69.

609. *See id.* at 60, 64.

610. *See id.* at 69-71.

611. *See id.*

612. Even the Tax Court suggested that a different structure might have produced a favorable result. *See id.* at 266-67.

613. Allocation was routine in cases where direct and indirect consideration were received. *See* Lake Forrest, Inc. v. Commissioner, 32 T.C.M. (P-H) 176, 184-85 (1963); Bear Valley Mutual Water Co. v. Riddell, 283 F. Supp. 949, 960 (C.D. Cal. 1968), *aff'd per curiam*, 427 F.2d 713 (9th Cir. 1970); Concord Village, Inc. v. Commissioner, 65 T.C. 142, 155-60 (1975); Board of Trade of the City of Chicago v. Commissioner, 106 T.C. 369, 381-92 (1996).

614. *See G.M. Trading*, 106 T.C. at 266-67.

615. Allocation is required for some asset acquisitions. *See* I.R.C. § 1060. Even if it is not required, the fact that an evaluation was prepared at the time of the transaction will have some evidentiary value. *See generally* BITTKER & EUSTICE, *supra* note 52, ¶ 10.40, at 10-73 to -80; Unger, *supra* note 310; Offer & Krevans, *supra* note 310.

616. *See G.M. Trading*, 106 T.C. at 266-67.

617. *See id.* at 259-60, 264, 270-71.

The restriction should prevent constructive receipt of the pesos under the cash method.[618] Receipt of the account is not a taxable economic benefit unless the account is the equivalent of cash.[619] An express prohibition on transfer of the account should prevent receipt under the economic benefit theory.[620] If receipt did not occur when the corporation received the account, receipt would occur at the instant a payment request was approved.

Accrual occurs at the earlier of actual receipt of an advance payment, or the time identified by the all events test.[621] The all events test is not satisfied at the time the corporation received the account since Mexico had discretion to determine whether a payment should be made,[622] and the amount to be paid.[623] Receipt of the account is not an advance payment unless it is a cash equivalent.[624] If accrual does not occur when the account is received, it would occur when a payment request was approved.

The restriction should prevent a direct conversion to cash under the deferrable foreign income method. Since a conversion to cash also could occur indirectly by selling the account, transfer of the account should be expressly prohibited. Receipt would occur when the restriction is removed.[625]

Approval of a payment request will cause receipt of income under either the cash or the accrual method. The amount of the income would be measured by the value of the property received which presumably is the plant and equipment. If they cannot be transferred without advance

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618. *See* Veit v. Commissioner, 8 T.C. 809, 818 (1947), *acq.* 1947-2 C.B. 4; Martin v. Commissioner, 96 T.C. 814, 822-23 (1991).

619. *See* 4 BITTKER & LOKKEN, *supra* note 9, ¶ 105.3.2, at 105-48 to -50.

620. *See* Miele v. Commissioner, 72 T.C. 284, 291 (1972); Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972).

621. *See* Gillis v. United States, 402 F.2d 501, 506 (5th Cir. 1968).

622. *See* Mutual Tel. Co. v. United States, 204 F.2d 160, 161 (9th Cir. 1953); Masonite Corp. v. Fly, 7 A.F.T.R.2d (P-H) 1146, 1149-51 (S.D. Miss. 1961); Doyle, Dane, Bernback, Inc. v. Commissioner, 79 T.C. 101, 102-03 (1982), *nonacq.* 1988-2 C.B. 1; Yapp Corp. v. Commissioner, 61 T.C.M. (RIA) 1811, 1811-12 (1992).

623. *See* Patrick McGuirl, Inc. v. Commissioner, 74 F.2d 729, 730 (2d Cir.), *cert. denied*, 295 U.S. 748 (1935); Emery Kinkhead, Inc. v. Commissioner, 35 T.C. 152, 155 (1960), *acq.* 1961-2 C.B. 4.

624. *See* Schlude v. Commissioner, 372 U.S. 128, 137 (1963); 4 BITTKER & LOKKEN, *supra* note 9, ¶ 105.3.2, at 105-48 to -50.

625. *See* Rev. Rul. 74-351, 1974-2 C.B. 144.

approval of Mexico, the restriction should substantially reduce the value of the assets.[626]

Approval of a payment request will not cause receipt of income under the deferrable foreign income method if the plant and equipment are not transferable. Postponement will continue until the plant and equipment can be transferred.[627] While it is a popular way to postpone tax,[628] the method has negative features. Depreciation cannot be deducted until the end of the postponement,[629] and practitioners feel that making the election is a request for an audit.[630]

The attitude of the IRS may be the overriding factor. Success in one decision[631] has encouraged the government to continue an aggressive approach to Maquiladora transactions.[632] Since the IRS has a track record of attacking legitimate payment restrictions,[633] it is clear that it would attack a restriction which appeared to have been created for purpose of postponing tax on a Maquiladora exchange.

The parent should not make a Maquiladora exchange because the only defense with a substantial probability of success is that the parent did not receive blocked income.[634] Although the length and extent of the deferral varies with the circumstances, none of possibilities compare favorably with a complete exemption which can be obtained if the exchange is by the subsidiary.

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626. *See* Turner v. Commissioner, 23 T.C.M. (P-H) 464, 465 (1954); International Mortgage and Investment Corp. v. Commissioner, 36 B.T.A. 187, 189 (1937), *acq.* 1937-2 C.B. 15.

627. *See* I.T. 4037, 1950-2 C.B. 31, *superseded by* Rev. Rul. 74-351, 1974-2 C.B. 144.

628. *See, e.g.*, Berman v. Commissioner, 52 T.C.M. (P-H) 877, 880-81 (1983); McKee v. Commissioner, 54 T.C.M. (P-H) 2557, 2560-61 (1985).

629. *See* I.T. 4037, 1950-2 C.B. 31, *superseded by* Rev. Rul. 74-351, 1974-2 C.B. 144; Treas. Reg. § 1.461-1(a)(4) (1994).

630. *See* Berkson & Cohen, *supra* note 505, at 575, 582.

631. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 69-70 (1994), *on reconsideration*, 106 T.C. 257 (1996).

632. *See* Maquiladora Industry, *supra* note 72, at 2; Leighton & Sealy, *supra* note 72, at 721, 727-33.

633. *See, e.g.*, Procter & Gamble Co. v. Commissioner, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992); Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3268-75, (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

634. *See Exxon*, 64 T.C.M. at 3268-69.

C. Indirect Involvement of the Parent

The parent usually does not receive income under the anti-tax avoidance rules if the subsidiary does not realize income.[635] If income is received by the subsidiary, the remaining question is when it will be taxed to the parent. The parent will be taxed no later than the time it receives an actual distribution from the subsidiary.[636] The principal issue usually is whether the income can be taxed to the parent at an earlier time.

The parent negotiates a deal with Mexico. After the terms have been finalized, a subsidiary is formed and it signs a contract, delivers the dollar obligations and receives the consideration from Mexico. The parent would be taxed because it is the deemed seller,[637] the assignor of income,[638] or the recipient of income reallocated from the subsidiary.[639] The parent would be taxed at the time the income is received by the subsidiary unless the income is blocked.[640]

Other approaches may be equally disastrous. Suppose after the subsidiary is formed with adequate cash to purchase the dollar obligations, the parent conducts the negotiations, or lends negotiating personnel to the subsidiary. The subsidiary signs a contract with Mexico, purchases and delivers the dollar obligations, and receives the consideration from Mexico. The parent may be the deemed seller,[641] the assignor of income,[642] or the recipient of income reallocated from the subsidiary.[643]

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635. Inclusion is not required in a few situations. *See* Treas. Reg. § 1.482-1(f)(1)(iii) (1994); Loening, *supra* note 39, at 1248-65; Allegra, *supra* note 39, at 423, 450 n.84.

636. *See supra* Part V.A.

637. *See, e.g.*, Commissioner v. Court Holding Co., 324 U.S. 331, 334 (1945).

638. *See, e.g.*, Lucas v. Earl, 281 U.S. 111, 114-15 (1930).

639. *See, e.g.*, I.R.C. § 482 (1997).

640. *See* Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 339-41, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

641. *Compare Court Holding*, 324 U.S. at 334, *with* United States v. Cumberland Public Service Co., 338 U.S. 451, 454-55 (1950).

642. *Compare* Hogle v. Commissioner, 132 F.2d 66, 71-72 (10th Cir. 1942), *and* American Savings Bank v. Commissioner, 56 T.C. 828, 838-42 (1971), *acq. on other issues*, 1972-2 C.B. 1, *with* Haag v. Commissioner, 88 T.C. 604, 610-14 (1987), *aff'd without opinion*, 855 F.2d 855 (8th Cir. 1988), *and* Hospital Corp. of America v. Commissioner, 81 T.C. 520, 578-87 (1983), *nonacq.* 1987-2 C.B. 1.

643. *See, e.g.*, Perryman v. Commissioner, 57 T.C.M. (P-H) 1863, 1869-72 (1988), *aff'd*, 1990 U.S. App. LEXIS 21999 (9th Cir. 1990); Asiatic Petroleum Co. v. Commissioner, 79 F.2d 234, 236-37 (2d Cir.), *cert. denied*, 296 U.S. 645 (1935); Hospital Corp. of America v. Commissioner, 81 T.C. 520, 592-602 (1983), *nonacq.* 1987-2 C.B. 1; Treas. Reg. § 1.482-2A(d)(1)(i) (1994).

The involvement of the parent should be reduced to the absolute minimum. The subsidiary is formed with adequate cash to purchase the dollar obligations and to pay the expenses of the transaction. It conducts the negotiations with its own personnel, signs the contract, purchases and delivers the dollar obligations, and receives the consideration from Mexico. Hence, the only involvement of the parent is formation and capitalization of the subsidiary. An attempt to rely on the deemed sale,[644] assignment of income,[645] or reallocation of income theory[646] should be summarily rejected.

Subsidiary income may be taxed to the parent under the controlled foreign corporation rules. Every effort should be made to avoid realization of income by the subsidiary since nothing is taxed to the parent unless the subsidiary realizes income.[647] If the subsidiary realizes income, the lesser of the income or the earnings and profits of the subsidiary usually[648] is taxable to the parent[649] when the income is received by the subsidiary.

Receipt by the parent is postponed where the subsidiary does not have adequate earnings and profits to match the income. The deferred portion is deemed received in any subsequent year to the extent it has earnings and profits which exceed its current Subpart F income.[650] Receipt by the parent is further postponed if the income is blocked.[651]

Subsidiary income may be taxed to the parent under the foreign personal holding company[652] and passive foreign investment company[653] rules. The amount taxed to the parent generally is the same as the

644. *See Court Holding*, 324 U.S. at 333-34; *Cumberland Public Serv.*, 338 U.S. at 453-55.

645. *See* Helvering v. Eubank, 311 U.S. 122, 115-16 (1940); Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3263 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

646. *Compare* Treas. Reg. § 1.482-1(b)(1) (1994), *with* Commissioner v. First Security Bank of Utah, 405 U.S. 394, 398 n.4 (1972), *and* Salyersville Nat'l Bank v. United States, 613 F.2d 650, 654-55 (6th Cir. 1980), *and* Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 338-39, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

647. Each of the definitions of items to be included in Subpart F income uses the word income, and deductions are allowed in computing the amount of Subpart F income. *See* I.R.C. §§ 952(a)(2); 954(a)(2), (d)(1), (b)(5).

648. There is no tax to the parent if the subsidiary qualifies for either the de minimis or foreign tax defense. *See id.* § 954(b)(3-4).

649. *See id.* § 952(c)(1)(A).

650. *See id.* § 952(c)(2).

651. *See Procter & Gamble*, 95 T.C. at 339-41, *on reconsideration*, 59 T.C.M. at 3114-15.

652. *See* I.R.C. § 551(a).

653. *See id.* § 1293(a)(1).

dividend on an actual distribution.[654] The parent usually is liable for the year when income is realized by the subsidiary.[655] The passive foreign investment company rules permit an election to postpone until the year of an actual distribution plus interest on the period the tax was deferred,[656] and receipt under both statutes is deferred if the income is blocked.[657]

D. *Lack of Receipt by the Subsidiary*

The subsidiary purchases a dollar obligation and exchanges it for a restricted peso account and permission to do business in Mexico. Since receipt by the subsidiary depends on the same considerations as receipt by the parent where it made the exchange, the same recommendations apply. Hence, the subsidiary should allocate the dollar obligation between the account and the permission, make sure the permission, account and plant and equipment are subject to ironclad transfer restrictions imposed by Mexican law, and elect the deferrable foreign income method. Deferral will result if the restrictions are adequate to postpone receipt.

A completely different approach will produce more predictable results. Since there is no tax if dollars are used to make a bargain purchase,[658] the subsidiary should transfer cash to Mexico, and it can use the dollars to purchase dollar obligations. Hence, everyone winds up with the same thing except there is no tax if the transaction is structured properly.

If the subsidiary receives a restricted peso account, there may be a tax when the subsidiary purchases capital facilities. The income will be received at the time when the facilities are delivered to the subsidiary[659] unless it uses the deferrable foreign income method and the facilities are not transferable. The postponement is less valuable than it might seem because the building and facilities are not depreciable during the postponement,[660] and the election is a request for an audit.[661]

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654. *See id.* §§ 551(a), 556, 1293(1)(1), 1293(e)(1-2).

655. *See id.* §§ 551(a-b), 1293(a).

656. Tax is deemed deferred from the year the subsidiary received the income until the year when the item was actually distributed. *See id.* § 1291(a)(1).

657. *See, e.g.*, Alvord v. Commissioner, 277 F.2d 713, 720 (4th Cir. 1960); Commissioner v. First Security Bank of Utah, 405 U.S. 394, 403 (1972); Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 339-41, *on reconsideration*, 59 T.C.M. (P-H) 3112, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

658. 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78.

659. *See* Rev. Rul. 74-7, 1974-1 C.B. 202.

660. *See* Rev. Rul. 74-351, 1974-2 C.B. 144.

661. Berkson & Cohen, *supra* note 503, at 575, 582.

The result usually will be the same if the subsidiary receives a promise to deliver capital facilities at a later time. The IRS probably will be successful if it argues that the advance should be treated as a loan. If it is a loan, the subsidiary will receive interest if the amount stated in the contract is inadequate,[662] and gain to the extent the value of the plant and equipment exceeds the basis for the loan.[663] The income will be received at the time when the facilities are delivered to the subsidiary unless it uses the deferrable foreign income method and the facilities are not transferable.

The transaction which will produce the most satisfactory result is a simultaneous exchange of dollars for capital facilities. The parties agree that Mexico will construct and furnish a building to be delivered in exchange for progress payments. Since the transaction clearly is a cash purchase of goods and services, the subsidiary would not realize any income even if the value of the capital facilities is greater than the face amount of the cash.[664] Depreciation would be allowable from the time the property is placed in service, and the subsidiary would not recognize income from the transaction until it sells the property.

If Mexico is interested in a proposal, it presumably will be willing to accept a transaction[665] structured to deal with the United States tax problem. Negotiators should be prepared to explain the tax problem, and show how much less the transaction would be worth if an immediate or deferred United States tax is imposed on the deal. It will cost Mexico nothing to provide tax freedom.

The fact that the transaction was structured to avoid tax should have no affect on the result. The Tax Court and other courts have expressly agreed that taxpayers are permitted to arrange their affairs to reduce or eliminate taxes by legal means.[666] While the IRS may not like it, negotiating a cash purchase is perfectly legal even if the taxpayer might have increased his tax bill if the transaction had been structured differently.

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662. *See* I.R.C. § 7872 (a-b).

663. *See* Treas. Reg. § 1.1001-1(a) (1994); Rev. Rul. 55-757, 1955-2 C.B. 557; Rev. Rul. 60-210, 1960-1 C.B. 38; Rev. Rul. 70-41, 1970-1 C.B. 77.

664. *See* 1 BITTKER & LOKKEN, *supra* note 9, ¶ 5.8.4, at 5-78.

665. *See* Gottscho, *supra* note 34, at 143, 158-60.

666. *See* Commissioner v. First Security Bank of Utah, 405 U.S. 394, 398 n.4 (1972); Salyersville Nat'l Bank v. United States, 613 F.2d 650, 654-55 (6th Cir. 1980); Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 338-39, *on reconsideration*, 59 T.C.M. (P-H) 3112, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992). *See generally* Marvin A. Chirelstein, *Learned Hand's Contribution to the Law of Tax Avoidance*, 77 YALE L.J. 440 (1968).

F. Reappraisal

Regardless of the care and skill utilized in planning and executing a transaction, there always is a substantial potential for problems. Unrealistic IRS positions is one source for worry. For example, after the IRS lost one case, it advanced new issues in a motion for reconsideration.[667] Another response was an attempt to reverse the decision with new regulations.[668]

The quantity and quality of unrealistic IRS positions increases during enforcement programs, especially if the case involves a lot of money. In one situation, the IRS had announced that the possibility of unspecified economic sanctions was an adequate penalty to postpone reallocation of income.[669] When a case involving deficiencies of over eight billion dollars was covered by a reallocation of income enforcement program[670] and an enforcement program targeting international oil,[671] the IRS argued that the possibilities of nationalization and loss of an established right to do business were inadequate penalties. The argument was rejected by the Tax Court, and the decision was affirmed.[672]

Judicial failure to reasonably apply recognized rules and standards is another consideration. In a recent Maquiladora exchange case, the taxpayer argued that consideration received for a dollar obligation should not exceed the market value of the obligation, and the balance of the consideration was a contribution to capital. The arguments were rejected by the Tax Court[673] in a decision which has been criticized by everyone who expressed an opinion, except the IRS.[674] The IRS has announced that it will use the same approach in subsequent audits and litigation.[675]

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667. *See Procter & Gamble*, 95 T.C. at 338-41, *on reconsideration*, 59 T.C.M. at 3114-15.

668. *See* Levy & Clancy, *supra* note 554, at 94; Davlin, *supra* note 554, at 117; Glicklich, *supra* note 554, at 30-32 to -34; Hudson & Lemein, *supra* note 40, at 233, 316-19; Nolan, *supra* note 554, at 537, 545-46.

669. *See* Rev. Rul. 74-245, 1974-1 C.B. 124.

670. *See supra* note 544.

671. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 13.20[1][c], at 13-24 n.56.

672. *See* Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3268, 3273 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

673. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59, 69-72 (1994), *on reconsideration*, 106 T.C. 257 (1996).

674. *See supra* Part IV.E.

675. *See generally* Maquiladora Industry, *supra* note 72; Leighton & Sealy, *supra* note 72.

VIII. CONCLUSION

In an attempt to reduce the current and accumulated budget deficits, the Clinton Administration has identified foreign business operations[676] as a likely source of substantial additional revenue. Efforts to obtain additional revenue include the issuance of suspect reallocation regulations,[677] taking unreasonable positions during audits,[678] and frivolous litigation.[679]

The IRS has been trying to force taxpayers to settle foreign business cases with an aggressive approach to audits. Although the IRS is expected to take questionable positions, there usually is at least some degree of connection between its positions and reality. Since taking positions which have no connection to reality has become normal procedure in foreign business cases,[680] it is clear that audit coercion[681] is the cornerstone of the enforcement campaign.

The main purpose for the suspect reallocation regulations[682] is to provide a weapon which auditors can use to force people to choose between settling and litigation.[683] Many have agreed to settle reallocation issues because litigation is complex and very expensive.[684] If the

676. *See supra* note 544.

677. *See* Treas. Reg. § 1.482 (1994). *See generally* TREASURY DEPT., A STUDY OF INTERCOMPANY PRICING (1988), *reprinted in* 1988-2 C.B. 458. Many of the positions in the study were incorporated in the 1994 regulations. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 13.20[1][d], at 13-25.

678. *See generally* Maquiladora Industry, *supra* note 72; Leighton & Sealy, *supra* note 72.

679. *See, e.g.*, Procter & Gamble Co. v. Commissioner, 95 T.C. 323, 339-40, *on reconsideration*, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992); Exxon Corp. v. Commissioner, 64 T.C.M. (RIA) 3228, 3257-63 (1993), *aff'd sub nom.* Texaco, Inc. v. Commissioner, 98 F.3d 825 (5th Cir. 1996).

680. Even though everyone who has expressed an opinion thinks a Maquiladora decision is wrong, the IRS will continue to argue the decision in auditing other exchanges. *Compare* G.M. Trading Corp. v. Commissioner, 103 T.C. 59 (1994), *on reconsideration*, 106 T.C. 257 (1996), *and* Maquiladora Industry, *supra* note 72, at 1-2, *with supra* Part IV.E. *See generally* William Dantzler, Jr., *Real World Reflections on the Section 482 Regulations*, 62 TAX NOTES 481 (1994).

681. One authority sarcastically describes the practice as a safari where the IRS is hunting for big game. BITTKER & EUSTICE, *supra* note 52, ¶ 13.20[1][c], at 13-24.

682. *See, e.g.*, Treas. Reg. § 1.482-1(h)(2) (1994). Several authors note that the regulation is an attempt to reverse judicial decisions, and suggest it is at least partially unenforceable. *See* Levy & Clancy, *supra* note 554, at 94; Davlin, *supra* note 554, at 117; Glicklich, *supra* note 554, at 30-32 to -34; Hudson & Lemein, *supra* note 40, at 233, 316-19; Nolan, *supra* note 554, at 537, 545-46.

683. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 13.20[4][g], at 13-33.

684. *See generally* Dantzler, *supra* note 680, at 481; Williamson et al., *supra* note 37; Pridjian, *supra* note 37, at 427.

regulations do not force an acceptable level of agreement,[685] there is a substantial prospect of additional regulations or legislation.[686]

Additional pressure to settle is applied by taking unreasonable positions during litigation. One motion for reconsideration raised several issues which were not included in the deficiency notice, and the IRS was also unsuccessful on appeal.[687] Eligible corporations[688] may find an award under the litigation expense statute[689] is preferable to a deduction for attorney's fees and the other costs[690] of dealing with frivolous IRS arguments.[691]

The general approach to foreign business cases is applied to Maquiladora transactions. With the exception of the IRS, everyone who has offered an opinion about a Maquiladora decision[692] feels it was incorrect.[693] The decision has encouraged the IRS to continue taking unreasonable positions during audits and litigation of Maquiladora cases.[694]

Clients who are considering a Maquiladora exchange should be informed of the attitude of the IRS. Although there is a good chance for success if it is structured properly, the fact of a Maquiladora transaction may cause an audit and a prolonged controversy with the IRS.

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685. Every settlement apparently must include an advance pricing agreement. *See* BITTKER & EUSTICE, *supra* note 52, ¶ 13.20[4][g], at 13-33.

686. *See supra* note 547.

687. *See* Procter & Gamble Co. v. Commissioner, 59 T.C.M. (P-H) 3113, 3114-15 (1990), *aff'd*, 961 F.2d 1255 (6th Cir. 1992).

688. A corporation cannot recover if it has a net worth over $7,000,000 and more than 500 employees. *See* I.R.C. § 7430(c)(4)(A)(ii); 28 U.S.C. § 2412(d)(2)(B)(ii) (1994).

689. *See* I.R.C. § 7430.

690. The recovery for an expense deduction must be compared to that permitted for litigation expenses. Suppose attorney's fees are $200 per hour, the litigation expense limit is $110, and the corporation is in the 35% tax bracket. A $200 deduction reduces taxes by $70 which is less desirable than a $110. recovery. *See id.* § 7430(c).

691. *See id.* § 7430; Ridgeley A. Scott, *Suing the IRS and its Employees for Damages: David and Goliath*, 20 S. ILL. U. L.J. 507, 532-37 (1996).

692. *See* G.M. Trading Corp. v. Commissioner, 103 T.C. 59 (1994), *on reconsideration*, 106 T.C. 257 (1996).

693. *See supra* Part IV.E.

694. *See generally* Maquiladora Industry, *supra* note 72; Leighton & Sealy, *supra* note 72.