Office of Chief Counsel
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Memorandum

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subject: Active trade or business requirement under Treas. Reg. § 1.367(a)-3(c)(3)(i)(A)

This memorandum should not be used or cited as precedent.

FACTS

Assumed Facts

The following facts are assumed for purposes of the two scenarios described below.

- USCo, a domestic corporation, files a U.S. income tax return on a calendar basis. USCo is wholly owned by USSH, a U.S. citizen.
- FA, a foreign corporation, conducts research and product development. It has a single class of stock outstanding at all times.
- FA will acquire all the USCo stock from USSH in exchange for newly issued FA stock pursuant to a reorganization described in section 368(a)(1)(B).
- The requirements provided in Treas. Reg. § 1.367(a)-3(c), other than that described in Treas. Reg. § 1.367(a)-3(c)(3)(i)(A), have been satisfied.

Scenario 1:

FA has conducted research and product development for the entire 36-month period immediately before the acquisition of the USCo stock. During this time, FA employed more than 100 employees. FA has received offers to buy or license its products, but it has not generated income. FA has decided not to license or sell its products because it believes they will generate more consumer interest with further development. Thus, FA is a "pre-revenue corporation." FA would need to obtain approval from U.S. and foreign regulatory agencies to license or sell its products. FA's products are novel; however, it is likely that FA's products will obtain the requisite approvals though it is uncertain whether approval would be granted within the next 12 months.

Scenario 2:

For a period of time since the beginning of the 36-month period immediately before the acquisition of the USCo stock, FA had been selling product 1 and developing product 2. During this time, FA employed more than 150 employees. FA generated significant income in year 1 from selling product 1 to its customers. However, despite FA having exercised reasonable precautions, a regulatory agency discovered a product defect related to product 1, and FA was required to discontinue sales of product 1. During year 2, FA did not generate any income from product 1 or product 2. FA also reduced the number of its employees, but it continued to develop product 2 and continued to attempt to remedy the defect in product 1. FA received governmental approval from the relevant regulatory agencies to sell product 2 to customers, and generated income in year 3 from sales of product 2.

ISSUE

Whether a transferee foreign corporation, or any qualified subsidiary or any qualified partnership, that has not generated income during the entire 36-month period described in the active trade or business ("ATB") requirement[1] of the ATB test can satisfy that requirement in light of its standard that there be activities which "must ordinarily include the collection of income."

LAW

Subject to certain exceptions, section 367(a)(1) provides that if a U.S. person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361, the foreign corporation will not be considered a corporation for purposes of determining the extent to which the U.S. person recognizes gain on such transfer.

[1] *See* Treas. Reg. § 1.367(a)-3(c)(3)(i)(A); *see also* Treas. Reg. § 1.367(a)-3(c)(5)(vi), (vii), and (viii).

In 1987, the Department of the Treasury (the "Treasury Department") and the Internal Revenue Service ("IRS") issued Notice 87-85, which announced rules that would substantially alter temporary regulations under section 367(a). Those rules set forth certain exceptions to the general gain recognition rule of section 367(a)(1) for transfers of stock or securities of a domestic or foreign corporation by a U.S. person to a foreign corporation.[2] Specifically, Notice 87-85 announced that regulations under section 367(a) would provide an exception to the general rule of gain recognition for certain transfers, including transfers where a U.S. person transfers stock or securities to a foreign corporation if the U.S. person owned less than 5 percent of both the total voting power and the total value of the stock of the transferee corporation immediately after the exchange. As such, there were instances, particularly in the context of widely-held domestic corporations, where U.S. shareholders transferring domestic stock to a foreign corporation were able to avoid the application of section 367(a)(1) based on their stock ownership percentage in the transferee foreign corporation after the exchange.

In 1994, the Treasury Department and the IRS issued Notice 94-46, which announced that the regulations under section 367(a) would be modified because the Treasury Department and the IRS were "concerned that widely-held U.S. companies with foreign subsidiaries [had] undertaken certain restructurings [i.e., inversions] for tax-motivated purposes."[3] The notice further provided that "[t]he Internal Revenue Service and Treasury Department are concerned that these transactions, or related transactions undertaken pursuant to the restructurings, present opportunities for avoidance of U.S. tax."[4]

In 1995, temporary and proposed regulations were issued to address inversions and implement Notice 94-46 with certain modifications. The preamble to the temporary regulations described one such modification as follows:

> [T]hese regulations contain a new active trade or business requirement not contained in Notice 94-46, which taxpayers must meet in order to qualify for an exception to the general rule of taxation under section 367(a). The IRS and the Treasury Department added the active trade or business requirement to address abuse potential, in particular, in a case in which a U.S. target company is smaller than a foreign acquirer that was formed and capitalized with a view to enabling the smaller U.S. company to move offshore. The IRS and the Treasury Department believe that this type of transaction presents an inappropriate

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[2] *See* Notice 87-85, 1987-2 C.B. 395; *see also* Treas. Reg. § 1.367(a)-3T (1995).

[3] Notice 94-46, 1994-1 C.B. 356 (announcing that the regulations under section 367(a) will be modified to provide that the transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation is taxable under section 367(a)(1) if all U.S. transferors own in the aggregate 50 percent or more of either the total voting power or the total value of the stock of the transferee corporation immediately after the exchange).

[4] *Id*.

> opportunity for avoiding the anti-deferral regime without payment of the tax envisioned by Notice 94-46. The IRS and the Treasury Department believe that an exception to taxation is proper only in cases where a combination of two active businesses is contemplated and that the opportunity for tax avoidance is ameliorated when such businesses have been conducted for a period of at least 36 months prior to the exchange. Under the requirement contained in the regulations, no exception to taxation is available unless either the transferee foreign corporation or an affiliate of that corporation was engaged in the active conduct of a trade or business for the entire 36-month period prior to the exchange, and unless such business is substantial in relation to the business conducted by the U.S. target company.[5]

Under the final regulations, Treas. Reg. § 1.367(a)-3(c) provides an exception to the general rule of section 367(a)(1) for certain transfers by a U.S. person of stock or securities of a domestic corporation to a foreign corporation. This exception only applies, however, if the U.S. target company complies with the reporting requirements in Treas. Reg. § 1.367(a)-3(c)(6) and if the four conditions set forth in Treas. Reg. § 1.367(a)-3(c)(1)(i) through (iv) are satisfied. The condition set forth in Treas. Reg. § 1.367(a)-3(c)(1)(iv) requires that the ATB test, as described in Treas. Reg. § 1.367(a)-3(c)(3), be satisfied.

The ATB test is met if three requirements are satisfied. First, under the ATB requirement set forth in Treas. Reg. § 1.367(a)-3(c)(3)(i)(A), the transferee foreign corporation (or any qualified subsidiary or qualified partnership) must have been engaged in the active conduct of a trade or business outside the United States for the entire 36-month period immediately preceding the transfer. For this purpose, the terms “trade or business,” “active conduct,” and “outside of the United States” are defined in Treas. Reg. § 1.367(a)-2(d)(2), (3), and (4), respectively.[6] When defining a trade or business, Treas. Reg. § 1.367(a)-2(d)(2) states:

> Whether the activities of the foreign corporation constitute a trade or business is determined based on all the facts and circumstances. In general, a trade or business is a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit …. The group of activities must *ordinarily* include the collection of income and the payment of expenses. If the activities of the foreign corporation do not constitute a trade or business, then the exception provided by this section does not apply, regardless of the level of activities carried on by the corporation.[7]

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[5] T.D. 8638, Preamble, 60 FR 66739.

[6] Treas. Reg. § 1.367(a)-3(c)(3)(i)(A).

[7] Treas. Reg. § 1.367(a)-2(d)(2) (emphasis added).

Second, at the time of the transfer, neither the transferors nor the transferee foreign corporation (and, if applicable, the qualified subsidiary or qualified partnership engaged in the active trade or business) has an intention to substantially dispose of or discontinue such trade or business.[8]

Finally, the substantiality test of Treas. Reg. § 1.367(a)-3(c)(3)(iii) must be satisfied.[9]

Language describing the ATB requirement in Treas. Reg. § 1.367(a)-3(c)(3)(i)(A) is substantially similar to language in Treas. Reg. § 1.355-3(b)(2)(ii) regarding the active business requirement under section 355(b).[10] The language in the section 355 regulation preceded and was the backdrop for the section 367(a) regulation's ATB requirement. When describing a trade or business, both provisions state that the relevant corporation's activities must "ordinarily" include the collection of income and the payment of expenses.

The word "ordinarily" has not been interpreted in published guidance for purposes of the ATB requirement in Treas. Reg. § 1.367(a)-3(c)(3)(i)(A). However, in 1982, before the issuance of Notice 94-46 and Treas. Reg. § 1.367(a)-3(c), a section 355 revenue ruling[11] provided the following interpretation of the word "ordinarily":

> The use of the word "ordinarily" in section 1.355-1(c)[12] of the regulations indicates that there are exceptional situations where, based upon all the facts and circumstances, there is no concurrent receipt of income and payment of expenses which, nevertheless, will constitute an [ATB] within the meaning of section 355(b) of the Code.

In that ruling, the IRS ruled that a corporation, Y, was engaged in the active conduct of a trade or business within the meaning of section 355(b), even though it failed to collect any income for one year during the relevant period.[13] Y's only

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[8] *See* Treas. Reg. § 1.367(a)-3(c)(3)(i)(B).

[9] *See* Treas. Reg. § 1.367(a)-3(c)(3)(i)(C).

[10] *See* Treas. Reg. § 1.355-3(b)(2)(ii).

[11] *See* Rev. Rul. 82-219, 1982-2 C.B. 82. Before 1982, the IRS issued revenue rulings that could be interpreted as requiring income to qualify as an ATB. *See* Rev. Rul. 57-464, 1957-2 C.B. 244, and Rev. Rul. 57-492, 1957-2 C.B. 247. As discussed further below, these revenue rulings were suspended in 2019 by Rev. Rul. 2019-09, 2019-14 I.R.B. 925.

[12] This language is currently located in Treas. Reg. § 1.355-3(b)(2)(ii).

[13] *See* Rev. Rul. 82-219, 1982-2 C.B. 82 ("Y's failure to receive manufacturing receipts during 1980 was unforeseen and caused by events outside of its control [(i.e.,Y's only customer, Z, went bankrupt and unilaterally cancelled further orders from Y)]. Y took all reasonable steps to secure manufacturing receipts by redesigning its limited use product and actively seeking new customers for such product, and shortly

customer, Z, unexpectedly went bankrupt; and Z's plant shut down. Although Y reduced its workforce during this period, it retained some employees to manage its equipment, modify its product, and seek new customers. The IRS determined that the failure of Y to generate revenue was unforeseen and caused by "extraordinary facts" beyond its control.

On September 25, 2018, the IRS issued a statement announcing a study regarding the ATB rule under section 355(b).[14] The statement explained that the IRS and the Treasury Department are considering guidance to address, for purposes of section 355, "whether a business can qualify as an ATB if entrepreneurial activities, as opposed to investment or other non-business activities, take place with the purpose of earning income in the future, but no income has yet been collected."[15] The statement also announced that the IRS would entertain private letter ruling requests on the issue.[16]

On March 21, 2019, the IRS issued Revenue Ruling 2019-09, which, pending completion of the study of the ATB test under section 355 announced in 2018, suspended two section 355 revenue rulings[17] that focused on the lack of income generated by the activities under consideration and, accordingly, "could be interpreted as requiring income" to qualify as an ATB.

On May 6, 2019, the IRS issued a statement, explaining that the study regarding the ATB test under section 355 announced in 2018 was ongoing and requesting information regarding certain ventures to facilitate the study.[18] The statement notes that the study contemplates a deviation from the historic approach under section

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thereafter began to again receive manufacturing receipts from its business. These extraordinary facts, when coupled with Y's activities before January, 1980, and after January, 1981, indicate that Y was engaged in the active conduct of a trade or business within the meaning of section 355(b)").

[14] *See IRS statement regarding the active trade or business requirement for section 355 distributions*, https://www.irs.gov/newsroom/irs-statement-regarding-the-active-trade-or-businessrequirement-for-section-355-distributions (Sept. 25, 2018).

[15] *Id*.

[16] Since the statement, the IRS has issued private letter rulings that address situations that previously may not have satisfied the ATB test under section 355 because income was not collected during the relevant period under the section 355 regulations.

[17] Rev. Rul. 57-464, 1957-2 C.B. 244, and Rev. Rul. 57-492, 1957-2 C.B. 247. The suspension of these revenue rulings is pending the completion of a study regarding the ATB requirement under sections 355(a)(1)(C) and (b). The study is ongoing.

[18] *See IRS request for information regarding the active trade or business requirement for section 355 separations of entrepreneurial ventures*, https://www.irs.gov/newsroom/irs-request-for-information-regarding-theactive-trade-or-business-requirement-for-section-355-separations-of-entrepreneurial-ventures (May 6, 2019).

355. Under that approach, the IRS generally has required a qualifying ATB to have collected income continuously for the period set forth in the section 355 regulations "in the absence of exceptional circumstances beyond the business's control (such as drought, fire, financial distress, or seasonal downtime)."[19]

ANALYSIS AND CONCLUSIONS

Because the section 355 and 367 regulations use similar language when defining an ATB, taxpayers might contend that the phrase "ordinarily include the collection of income" should be interpreted to have the same meaning under both sets of regulations and, accordingly, might assert that Revenue Ruling 2019-09 and the IRS statements in 2018 and 2019 are relevant for the ATB requirement under section 367(a).

The interpretation of "ordinarily," as described in Revenue Ruling 82-219, which was in effect before Notice 94-46 and Treas. Reg. § 1.367(a)-3(c) were issued, should apply for purposes of interpreting the ATB requirement of Treas. Reg. § 1.367(a)-3(c)(3)(i)(A). This interpretation, which allows for an ATB absent the collection of income only in exceptional circumstances, is consistent with the policy underlying the ATB test under section 367(a).

As indicated in Notice 94-46, certain transfers of stock of domestic corporations to foreign corporations were undertaken for tax-motivated purposes and presented opportunities for tax avoidance. Similarly, the preamble to the 1995 temporary and proposed regulations under section 367(a) explains that the ATB test was added to prevent the potential for abuse, including the avoidance of the anti-deferral regimes described in Notice 94-46. Thus, the ATB requirement under section 367(a) should be interpreted in a manner that would not unduly weaken the anti-avoidance and anti-inversion policies of Treas. Reg. § 1.367(a)-3(c).

Moreover, this conclusion is unaffected by the IRS statements, in 2018 and 2019, and Revenue Ruling 2019-09. By their terms, the 2018 and 2019 statements and Revenue Ruling 2019-09 apply only with respect to the ATB rule under section 355.

Furthermore, the policies that motivated the study of this issue under section 355 are distinguishable from the anti-avoidance and anti-inversion policies underlying the ATB requirement under Treas. Reg. § 1.367(a)-3(c)(3)(i)(A). For example, the policy concern, under section 355, regarding separating business assets from inactive assets[20] to avoid dividend treatment are distinguishable from anti-inversion

[19] *Id*.

[20] *See* REG-134016-15, Preamble, 81 Fed. Reg. 46004 (July 15, 2016) ("It is generally understood that Congress intended section 355 to be used to separate businesses, not to separate inactive assets from a business"); *see also* S. Rep. No. 83-1622, at 50-51 (noting that section 355 "contemplates that a tax-free separation shall involve only the separation of assets attributable to the carrying on of an active business"

policy. The anti-inversion policy is, in general, to discourage acquisitions of domestic corporations by foreign corporations that can allow the avoidance of U.S. tax on foreign operations, and permit earnings-stripping techniques to avoid U.S. tax on U.S. operations, by imposing gain on U.S. persons that are shareholders of the target domestic corporation. The base erosion concerns underlying Treas. Reg. § 1.367(a)-3(c)(3)(i)(A) differ from policies promoting market-efficient allocation of capital and resources underlying section 355.

The safeguards in place to protect section 355 and Treas. Reg. § 1.367(a)-3(c) policies also differ. Under section 355, there are statutory and regulatory protections in place, such as requirements related to device,[21] continuity of shareholder interest,[22] and the section 355(e) provisions,[23] that are distinguishable and, arguably, more robust than those present under Treas. Reg. § 1.367(a)-3(c). In addition, section 355's ATB test is more stringent from a temporal standpoint given that it requires a 60-month period of active conduct preceding the distribution, whereas Treas. Reg. § 1.367(a)-3(c)(3)(i)(A) only requires a 36-month period of activity prior to the acquisition.[24]

Accordingly, to ensure that the policy of Treas. Reg. § 1.367(a)-3(c) is furthered, the word "ordinarily" described in Treas. Reg. § 1.367(a)-3(c)(3)(i)(A) (by cross reference to Treas. Reg. § 1.367(a)-2(d)) should be interpreted to mean that only in exceptional (i.e., *extra*ordinary) situations should the foreign corporation be treated as satisfying the ATB requirement even though it does not generate income during the entire 36-month period immediately before the transfer. As a general rule, an entity cannot satisfy the ATB requirement if its activities are solely research and product development, and it does not generate income for the entire 36-month period.[25] A pre-revenue corporation's lack of income while a product is being developed does not constitute an exceptional circumstance for this purpose.

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and does not permit "the tax free separation of an existing corporation into active and inactive entities").

[21] *See* IRC 355(a)(1)(B).

[22] *See* Treas. Reg. § 1.355-2(c).

[23] *See* IRC 355(e).

[24] *See* Treas. Reg. §§ 1.355-3(b)(3) and 1.367(a)-3(c)(3)(i)(A).

[25] As noted above, this is a general rule, and the ATB requirement determination will be based on the unique facts and circumstances presented. The scenarios provided are for illustrative purposes.

Scenario 1

FA is a pre-revenue corporation. It has received offers to purchase or license its products, and its products will likely obtain the requisite approvals. It also has many employees. However, FA's having not yet generated income is not related to an unforeseen circumstance outside of its control. Accordingly, FA's lack of income during the product development phase does not constitute an exceptional situation. Therefore, FA has not demonstrated that its activities "ordinarily" include the collection of income, and the ATB requirement of Treas. Reg. § 1.367(a)-3(c)(3)(i)(A) has not been satisfied.

Scenario 2

FA has generated income for two of the three years immediately preceding the acquisition of the USCo stock. FA's failure to earn income during the entire three-year period immediately before the acquisition of the USCo stock is based on circumstances not reasonably anticipated by FA. In addition, FA continued to develop a product during year 2 and generated income in year 3 related to sales of product 2. In this case, the temporary cessation of generating income is not dispositive of whether FA can meet the requirements of Treas. Reg. § 1.367(a)-3(c)(3). Further, the unexpected discovery of a product defect, and FA's resulting loss of income, constitute an exceptional situation. Thus, FA has demonstrated that its activities "ordinarily" include the collection of income, and its activities constitute a "trade or business" for purposes of satisfying the ATB requirement of Treas. Reg. § 1.367(a)-3(c)(3)(i)(A).[26]

Please call L. Ulysses Chatman at (202) 317-3800 if you have any questions.

[26] The conclusions in this memorandum have no bearing on the meaning of "ordinarily" for purposes of the section 355 ATB requirement, and no inference is intended for any other purpose.