Hershey Foods Corp. v. Commissioner, 76 T. C. 312 (1981)

Foreign incorporation of a historically unprofitable branch does not automatically constitute tax avoidance under section 367 when future profits are not yet earned and the transaction serves legitimate business purposes.

Summary

Hershey Foods Corporation sought to transfer its unprofitable Canadian branch to a Canadian subsidiary, triggering a dispute with the IRS over whether the move constituted tax avoidance under section 367. The IRS argued that the transfer would prevent future Canadian profits from being taxed in the U. S. , thereby justifying a tax recapture of past losses. The Tax Court rejected this argument, ruling that the IRS's determination was unreasonable. The court emphasized that Hershey's income had been clearly reflected annually, and no tax benefit rule or statutory recapture provision applied. The decision clarified that future, unearned foreign income is not a valid basis for tax avoidance under section 367, and that Congress's comprehensive approach to foreign losses in section 904(f) precluded the IRS's position.

Facts

Hershey Foods Corporation operated a Canadian branch that incurred losses from 1970 to 1978, except for a small profit in 1976. In 1977, Hershey acquired Y & S Candies, Inc. , which had a profitable Canadian branch. Hershey proposed transferring both branches to a new Canadian subsidiary, Hershey Canada, Ltd. (HC), to consolidate operations and reduce exchange rate risks. The IRS determined that the transfer had a principal purpose of tax avoidance under section 367, requiring Hershey to include the Canadian branch's net cumulative losses as income to receive a favorable ruling.

Procedural History

Hershey requested a ruling from the IRS under section 367, which was denied unless Hershey agreed to recognize past losses as income. Hershey then sought a declaratory judgment from the U. S. Tax Court under section 7477, challenging the reasonableness of the IRS's determination.

Issue(s)

1. Whether the IRS's determination that Hershey's proposed transaction had a principal purpose of tax avoidance under section 367 was reasonable.
2. If the determination was unreasonable, what terms and conditions, if any, were necessary for the transaction to comply with section 367.

Holding

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1. No, because the IRS's determination was not supported by substantial evidence and was inconsistent with the annual nature of U. S. income taxation and Congress's comprehensive treatment of foreign losses in section 904(f).
2. No additional terms or conditions were necessary beyond those Hershey had already agreed to in its ruling request.

Court's Reasoning

The court found that the IRS's position was an unreasonable extension of section 367's application. It rejected the notion that Hershey's income was not clearly reflected, emphasizing that U. S. taxation is computed annually, not transactionally. The court also noted that no tax benefit rule or statutory recapture provision applied to Hershey's situation. It highlighted that the IRS's argument would lead to double counting of foreign losses, contrary to the foreign tax credit system's purpose of preventing double taxation. The court concluded that Congress's comprehensive approach to foreign losses in section 904(f) preempted the IRS's attempt to use section 367 to recapture past losses upon foreign incorporation. The court quoted from the legislative history of section 936, which distinguished between foreign incorporation and other transactions that trigger loss recapture, further supporting its conclusion.

Practical Implications

This decision clarifies that future, unearned foreign income cannot be used as a basis for tax avoidance under section 367. It also emphasizes that Congress's comprehensive treatment of foreign losses in section 904(f) limits the IRS's ability to use section 367 to recapture past losses upon foreign incorporation. Practically, this means that companies with historically unprofitable foreign branches can incorporate them without fear of automatic tax recapture, as long as the transaction serves legitimate business purposes and does not involve the transfer of assets subject to statutory recapture provisions. This ruling may encourage multinational corporations to restructure their foreign operations more freely, potentially leading to increased foreign investment and efficiency. Subsequent cases, such as *Theo. H. Davies & Co. v. Commissioner*, have cited this decision in analyzing the tax treatment of foreign losses and incorporations.

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