U.S. Outbound Transfers – Section 367(a) – Recent Developments
AGENDA

- Proposed GRA Regulations
- Notice 2012-15
- Section 367(a)(5)
Proposed GRA Regulations
Proposed GRA Regulations (1/30/2013)

What is the problem?

- Current regulations require both basis and fair market value to be provided as part of the GRA.
- Because of the difficulty in valuing the stock of a non-publicly traded subsidiary, taxpayers routinely did not provide the basis and fair market value of the transferred stock but rather “available upon request.”
- IRS auditors made determinations that such GRAs did not satisfy the regulations and the gain was triggered as if the GRA had not been filed.
- Harsh result if taxpayer could not demonstrate reasonable cause.
- LB&I Directive permits a taxpayer to provide the basis and fair market value if the GRA was timely filed and avoid gain recognition.
- However, the Directive is effective only until “further notice.”
- The issuance of final GRA regulations likely will be “further notice.”
- Taxpayers that have not provided basis and fair market value information should do so as soon as possible to avoid a “willful failure” under the new regulations.
2013 Proposed Regulations

- The IRS issued proposed GRA regulations on January 30, 2013 (the “Proposed Regulations”) which address or amend the current rules and practice primarily by:
  - Clarifying what constitutes a properly filed GRA and the relief available to a taxpayer that fails to comply with the GRA requirements;
  - Providing coordination between the GRA rules under section 367(a) and the filing requirements under section 6038B;
  - Modifying the reporting requirements under section 367(e)(2) for liquidations so that they are consistent with the reporting requirements under sections 367(a) and 6038B; and
  - Including similar rules with respect to other filing requirements under section 367(a).
Relief under the Proposed Regulations

- Recognizing that the existing reasonable cause standard “may not be satisfied by U.S. transferors in many common situations even though the failure was not intentional and not due to willful neglect,” the Proposed Regulations adopt a “willfulness” standard for obtaining relief for a failure to comply with the GRA requirements.

- Willfulness in this context would be determined consistently with other civil penalties (e.g., cases of gross negligence, reckless disregard, or willful neglect).

- The U.S. transferor must file an amended return with the required information and demonstrate that the failure was not willful.

- Under the current GRA regulations, a request for relief is deemed to satisfy the reasonable cause standard if the IRS does not respond to the request within 120 days. The Proposed Regulations eliminate the 120-day period for the IRS to respond to requests for relief.
Available Upon Request” is a Willful Failure

- A GRA that provides that information is “available upon request” is not considered to be complete in all material respects under the Proposed Regulations and is considered to be a “willful failure” that is not eligible for relief.
  - The Directive discussed above is effective only until “further notice,” and the Directive may be withdrawn after the Proposed Regulations are finalized.
  - Taxpayers that have filed GRAs that state that basis and fair market value information is “available on request” should consider availing themselves of the Directive as soon as possible in order to avoid having to recognize any deferred gain covered by such GRAs.
Coordinating Section 367(a) and Section 6038B

The Proposed Regulations would require taxpayers that otherwise file GRAs with respect to outbound transfers of stock or securities to file Forms 926 (Return by a U.S. Transferor of Property to a Foreign Corporation) with respect to those transfers. Under the current rules, a taxpayer that makes an outbound transfer of stock or securities and properly files a GRA is not required to file a Form 926 for that transfer. Under the Proposed Regulations, however, only Parts I and II of Form 926 are required to be completed if a GRA is filed with respect to the transfer.

The Proposed Regulations also clarify that, when a taxpayer fails to file a proper GRA or an annual certification, or when a taxpayer fails to comply with the GRA rules in any material respect, the taxpayer not only may be required to recognize gain under section 367(a), but also may be subject to penalties under section 6038B.

While the consequences for failing to comply under section 367(a) are conditioned on willfulness, the penalties under section 6038B for failing to comply are based on a reasonable cause standard.
Reporting Under Section 367(e)(2)

- As a general matter, section 367(e)(2) conditions nonrecognition treatment for complete liquidations of subsidiaries into foreign corporations on compliance with certain reporting requirements described in the regulations promulgated under that provision.

- The current section 367(e)(2) regulations do not provide explicit guidance regarding the treatment of taxpayers who fail to comply with these reporting requirements.

- Consistent with the changes made by the Proposed Regulations with respect to transfers subject to section 367(a), the Proposed Regulations apply the same standards and procedures for relief to the filings required under section 367(e)(2).

- In addition, the Proposed Regulations clarify that the information that must be reported for liquidating distributions of property that are subject to section 367(e)(2) includes the fair market value and basis of the distributed property.
Other Filing Requirements

- As a final matter, the Proposed Regulations also address certain other filing requirements under Treas. Reg. § 1.367(a)-3 in connection with certain transfers of stock or securities.
- The Proposed Regulations clarify that a failure to comply with such filing requirements will prevent the relevant exception to section 367(a) from applying.
- In this regard, the Proposed Regulations clarify that the same standards and procedures for relief with respect to GRAs apply to those statements as well.
Section 367(a) Background

- Section 367(a) generally requires gain recognition on the transfer of tangible property by a U.S. transferor to a foreign corporate transferee (or “outbound”)
- Section 367(a) prevents the removal of built-in gain from U.S. tax jurisdiction by means of a U.S. person's transfer of property to a foreign corporation in what otherwise would be a nontaxable exchange under the reorganization provisions.
- Under section 367(a), if a U.S. person transfers property to a foreign corporation in connection with an exchange described in sections 332, 351, 354, 356 or 361, then the foreign corporation generally is not considered to be a corporation for purposes of determining the extent to which gain is recognized on the transfer.
Section 367(a) Background

Exceptions to Section 367(a) Gain Recognition

- To qualify for an exception from gain recognition under section 367(a), a transferor may be required to enter into a gain recognition agreement (GRA)
  - Treas. Reg. § 1.367(a)-3(b) provides rules which govern the outbound transfer of foreign corporation stock or securities.
  - Treas. Reg. § 1.367(a)-3(c) provides rules which govern the outbound transfer of domestic corporation stock or securities.
  - Treas. Reg. § 1.367(a)-3(d) provides rules which govern indirect stock transfers.
  - Treas. Reg. § 1.367(a)-3(e) provides rules which govern transfers by a domestic corporation to a foreign corporation in a section 361 exchange.
Gain Recognition Agreements

Applies to a U.S. transferor that receives 5% or more of the stock of the foreign transferee (5% shareholder)

GRA must include

- An agreement by the 5% shareholder to recognize gain in accordance upon the occurrence of a triggering event within 5 years (usually a disposition of the foreign transferee stock or of the transferred property by the foreign transferee)
- A description of the transferred stock or securities, including the basis and fair market valuation of the transferred stock
- Identifying information of the transferred and transferee corporations.
- An agreement by the U.S. transferor to comply with all of the other conditions and requirements of the GRA regulations, including extending the statute of limitations through the close of the eighth full taxable year after the transfer and filing annual certifications indicating that the GRA was not triggered.
Proposed GRA Regulations

Recognition of Gain under a GRA

- If any of the transferred stock or securities is disposed of by the transferee during the term of the GRA, the transferor must recognize the gain realized on the original transfer, plus interest (measured from the due date of the tax return for the tax year of the original transfer).
  - May be reported on an amended return for the year of the original transfer or, pursuant to a GRA election (made at the time of the initial transfer), on the return for the year of the triggering disposition.
- A partial disposition of the stock or securities of the transferred corporation by the transferee foreign corporation requires that the U.S. transferor recognize only a proportionate amount of the gain that was realized but not recognized on the initial transfer.
- Recognition of gain under the GRA causes retroactive basis increases in the transferor’s transferee stock and the transferee’s target stock.
Other GRA Triggers

- Other GRA “triggers” which may require the recognition of gain include:
  - Disposition of substantially all of the transferred corporation’s assets.
  - Disposition of the stock of the transferee received by the transferor in the original exchange.
  - Consolidation or deconsolidation of the transferor.
  - Failure to comply with the GRA rules (e.g., not filing an annual certification).
- There are specific exceptions to the above triggering events (generally where the subsequent transfers qualify for nonrecognition treatment) which require, among other things, that a new GRA be entered into by an appropriate party.
Failure to Comply

- Failing to comply in any material respect with the requirements of the GRA regulations, including failing to file an annual certification, is a triggering event and will result in immediate recognition of deferred gain.

- If a failure to include information in the gain recognition agreement as filed constitutes a failure to comply in a material respect, the subsequent provision of such information will not prevent triggering the GRA.

- Treas. Reg. § 1.367(a)-8(p) provides that a U.S. transferor that fails to timely file a GRA, annual certification or other required information may be considered to have timely filed such information if a request for relief is filed and the Director determines that the failure was due to reasonable cause and not willful neglect. Likewise a failure to comply in any material respect with the GRA regulations will not constitute a triggering event if the taxpayer obtains such reasonable cause relief.

- A request for reasonable cause relief must be filed as soon as the U.S. transferor becomes aware of the failure, and the U.S. transferor must file an amended return for the taxable year to which the failure relates which includes the required information.
2010 Directive

- On July 26, 2010, the IRS issued a memorandum on timely-filed documents that purport to be GRAs for an initial transfer or new GRAs filed upon the trigger of the original GRA but do not satisfy the requirements of the GRA regulations (the “Directive”).

- The Directive states that examiners generally should treat any failure to correctly or timely file a document subject to the memorandum as satisfying the timeliness requirement as long as the taxpayer meets certain requirements.

- Unlike the procedures provided in the current final regulations, the Directive does not require that taxpayers demonstrate reasonable cause for the failure or to provide an explanation for their failure to timely file or otherwise comply with the GRA regulations.

- Taxpayers are still required to file an amended return which includes the required information.
Notice 2012-15
Section 304

- Section 304(a)(1) provides that if:
  - One or more persons are in control (50% or more of vote or value) of each of two corporations, and
  - In return for property (money, securities, and other property, but not stock, of the acquiring corporation), one corporation acquires stock of the other corporation from the person so in control,
  - Then such property shall be treated as a distribution in redemption of the stock of the acquiring corporation.

Tax Treatment

- Treated as a redemption of the stock of the acquiring corporation and, where section 301 applies to the distribution, the transfer is treated as a contribution of the stock of the transferred corporation to the acquiring corporation under 351 and a redemption of the shared deemed issued in the 351 transaction.
- The distribution is treated as a dividend to the extent of earnings and profits, then as a return of basis. Any remaining excess is treated as capital gain.
- Earnings and profits sourced first from acquiring corporation and then from issuing corporation.
Notice 2012-15

• Notice 2012-15 reverses the prior IRS position that section 367(a) (or section 367(b) in a foreign-to-foreign exchange) does not apply to the deemed section 351 exchange for stock of the foreign acquiring corporation stock followed by the deemed redemption of that stock.

• The effect of this new position is that a taxpayer must enter into a GRA with respect to the section 351 deemed exchange subject to the 5-year period in which gain could be triggered.

• Issue is the basis adjustment to the stock.
2006 Regulations

- Final section 367 regulations issued in 2006 provided that section 367(a) and (b) would not apply to the deemed contribution in a section 304 transaction because, generally, the income recognized by the transferor should equal or exceed the built-in gain in the transferred stock.
- The 2006 regulations did not account for the recovery of historic basis in existing shares of the acquiring corporation as the IRS view then was that such basis could not be recovered.

2009 Regulations

- Temporary section 367 regulations issued in 2009 reversed this position and required gain recognition (or inclusion of the section 1248 amount) in certain section 304 transactions where historic basis of the acquiring corporation was treated as recovered in the deemed redemption.
- The U.S. transferor could not avoid recognizing this gain by entering into a GRA.
With the issuance of Notice 2012-15, the IRS has again shifted its position with respect to the application of section 367(a) and (b) to section 304 transactions.

Notice 2012-15 states that, under regulations to be issued, section 367(a) and (b) will apply to the deemed section 351 contribution resulting from the 304 sale (regardless of basis recovery).

As a result:

- A GRA will need to be filed in order to avoid gain recognition under section 367(a) on an outbound section 304 sale; and
- The section 1248 amount is required to be included under section 367(b) on a foreign to foreign section 304 sale if it results in the loss of section 1248 shareholder status.

Notice 2012-15 creates the possibility of income in excess of the consideration received on outbound 304 sales if the GRA entered into with respect to the deemed 351 transfer is subsequently triggered.
Section 367(a)(5)
Section 367(a)(5)

- Section 367(a)(5) provides that neither the “party to the reorganization” exception of section 367(a)(2) nor the “active trade or business” exception of section 367(a)(3) will apply to the transfer of assets by a U.S. person pursuant to an asset reorganization.
- This “exception to the exception” will not apply if five or fewer domestic corporations together hold 80% of the voting stock and 80% of the nonvoting stock of the transferor corporation. This treatment is subject to “such basis adjustments and such other conditions as shall be provided in regulations.”
Section 367(a)(5)

Purpose of Section 367(a)(5)

- Section 367(a)(5) was enacted to preserve the amount of gain on assets transferred to a foreign corporation in a reorganization.
- The gain is generally preserved in the stock of the foreign transferee by requiring basis adjustments to the foreign transferee stock received in an asset reorganization.
- The statute limits potential tax-free treatment to situations where the transferor is controlled by a small number of domestic corporations in order to ensure these basis adjustments can be tracked and to ensure “that the bulk of the built-in gain will remain subject to U.S. taxing jurisdiction.” S. Rep. No. 445, 100th Cong., 2d Sess. 62-63 (1988).
Section 367(a)(5)

Potential Extraction of Inside Asset Gain without Section 367(a)(5)

USP

USS contributes assets in exchange for FCo stock in a section 351 transfer. USS’s basis in FCo stock received equals USS’s basis in transferred assets.

Assets

FCo

USS

USS transfers assets in an asset reorganization. USP’s basis in FCo stock received equals USP’s basis in its USS stock.

FCo

Assets

Basis $150x Value $200x
Basis $100x Value $200x
Basis $150x Value $200x
Basis $100x Value $200x
Section 367(a)(5)

Potential Extraction of Inside Asset Gain without Section 367(a)(5)

**Built-in asset gain remains in domestic corporate solution**

**Built-in asset gain removed from domestic corporate solution**
Section 367(a)(5)

“Basis Adjustments and Such Other Conditions”

- Section 367(a)(5) provides that the domestic control exception is available “subject to such basis and such other conditions as shall be provided in regulations.”

- Prior to the issuance of proposed regulations in 2008, there was no official guidance on whether the domestic control exception was “self executing.” In other words, it was not clear taxpayers could make basis and other adjustments consistent with the legislative history in order to satisfy section 367(a)(5).

- The preamble to the proposed regulations states that, prior to the issuance of final regulations, “taxpayers may make reasonable adjustments, as described in the legislative history to section 367(a)(5), that are consistent with the policy of section 367(a)(5) so that the exceptions provided by sections 367(a)(2) and 367(a)(3) may apply to [outbound asset reorganizations].”
Section 367(a)(5)

Legislative History

- The legislative history indicates that regulations would “provide this relief only if the U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a) the U.S. corporate shareholders' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the assets of the transferor corporation transferred to the foreign corporation.”

- In addition, the legislative history indicates that regulations would require the “U.S. corporate transferor to recognize immediately any built-in gain that does not remain subject to U.S. taxing jurisdiction by virtue of a substituted stock basis. This would occur, for example, where 20 percent or less of the U.S. corporate transferor is owned by foreign shareholders who receive substituted basis stock in the transferee corporation, which stock would not be subject to U.S. taxing jurisdiction on disposition.”
Section 367(a)(5)

Proposed Regulations

- Prop. Treas. Reg. § 1.367(a)-7 (the “Proposed Regulations”), issued on August 2008, provides proposed rules governing the basis adjustments and other conditions referred to in section 367(a)(5).
- The Proposed Regulations generally provide that a transferor can avoid immediate taxation in an outbound asset transfer (if the U.S. transferor and all control group members so elect) if the following four conditions are satisfied:
  1. The U.S. transferor is controlled at the time of the exchange by five or fewer, but at least one, domestic corporations.
  2. The U.S. transferor recognizes gain equal to (i) the amount of inside asset gain allocable to non-control group members (e.g., foreign shareholders) and (ii) the amount of inside asset gain allocable to a control group member which cannot otherwise be preserved under the regulations.
  3. Each control group member's basis in the foreign corporation stock received is reduced by the amount by which such member’s share of inside gain exceeds the built-in gain or loss in such stock.
  4. The U.S. transferor enters into an agreement whereby the U.S. transferor agrees to recognize the inside asset gain if the foreign acquiring corporation disposes of a significant amount of the section 367(a) property in related transactions which have a principal purpose of avoiding U.S. tax on the inside asset gain.
In a section 361 exchange (an F reorganization) DC Contributes Assets in Exchange for FCo Stock in exchange for all the stock of FA and the FA stock is exchanged for the DC shares held by DP1, DP2 and FP. DP1 and DP2 elect the application of the proposed 367(a)(5) regulations.
Section 367(a)(5)

Example Result

- Under section 367(a)(3)(B), DC must recognize $60x of gain on the transfer of the inventory to FA and FA’s basis in the inventory is increased to $100x under Treas. Reg. § 1.367(a)-1T(b)(4)(i)(B).

- Under section 367(a)(5) and Prop. Treas. Reg. § 1.367(a)-7(b), the transfer of Business A is subject to the general rule of section 367(a) and DC must generally recognize $90x gain on the transfer of Business A to FA.

- However, if the requirements of the Prop. Treas. Reg. § 1.367(a)-7(c) are satisfied, DC’s transfer of Business A to FA may be partially eligible for the active foreign trade or business exception provided by section 367(a)(3).

- The requirements of Prop. Treas. Reg. § 1.367(a)-7(c)(1) are satisfied because DC is controlled (within the meaning of section 368(c)) by DP1 and DP2, both of which are domestic corporations, at the time of the section 361 exchange.
Section 367(a)(5)

Recognition of Inside Asset Gain

- Under Prop. Treas. Reg. § 1.367(a)-7(c)(2)(i), DC must recognize $18x gain on the transfer of Business A with respect to FP, a non-control group member. The $18x gain equals the product of the inside gain ($90x) and FP's 20% ownership interest (by value) in DC at the time of the section 361 exchange.

- Under Prop. Treas. Reg. § 1.367(a)-7(f)(6), the $90x inside gain is the amount by which the aggregate gross fair market value ($200x) of the section 367(a) property (the inventory and Business A) exceeds the $110x inside basis.

- Under Prop. Treas. Reg. § 1.367(a)-7(f)(5), the inside basis equals the $50x aggregate basis of the section 367(a) property transferred in the section 361 exchange, increased by the $60x gain recognized by DC on the transfer of the inventory to FA, but not by the $18x gain recognized by DC under Prop. Treas. Reg. § 1.367(a)-7(c)(2)(i) with respect to FP.

- Under Prop. Treas. Reg. § 1.367(a)-7(e)(1), the $18x gain recognized under Prop. Treas. Reg. § 1.367(a)-7(c)(2)(i) is treated as recognized with respect to Business A.
Section 367(a)(5)

Inside Gain can Otherwise be Preserved

- DC is not required to recognize gain under Prop. Treas. Reg. § 1.367(a)-7(c)(2)(ii) with respect to either DP1 or DP2. DP1's share of inside gain ($45x) does not exceed the product of the section 367(a) percentage (100%) and the fair market value of the FA stock ($100x) received in exchange for its DC stock.
  - DP1's share of inside gain is determined based on its 50% ownership interest (by value) in DC at the time of the section 361 exchange.
  - The section 367(a) percentage is the ratio of the aggregate gross fair market value of the section 367(a) property transferred by the U.S. transferor in the section 361 exchange to the aggregate gross fair market value of all property transferred by the U.S. transferor in the section 361 exchange.
- DP2's share of inside gain ($27x) does not exceed the product of the section 367(a) percentage (100%) and the fair market value of the FA stock ($60x) received in exchange for its DC stock.
  - DP2's share of inside gain is determined based on its 30% ownership interest (by value) in DC at the time of the section 361 exchange.
Section 367(a)(5)

Basis Adjustments

Under Prop. Treas. Reg. § 1.367(a)-7(c)(3), DP1's section 358 basis in the FA stock ($120x) received in exchange for its DC stock must be reduced by $65x, the amount by which DP1's share of inside gain ($45x) exceeds DP1's $20x outside loss.

- DP1's share of inside gain is determined based on its 50% ownership interest (by value) in DC at the time of the section 361 exchange.
- Because DC does not recognize gain on the section 361 exchange with respect to DP1, DP1's share of inside gain is not reduced under Prop. Treas. Reg. § 1.367(a)-7(c)(3)(i)(A).
- DP1's $20x outside loss equals the product of the section 367(a) percentage (100%) and the amount by which the fair market value ($100x) of the FA stock received by DP1 in exchange for its DC stock is less than the section 358 basis of such FA stock ($120x).
- As adjusted, DP1's basis in its FA stock is $55x.

Similarly, under Prop. Treas. Reg. § 1.367(a)-7(c)(3), DP2's section 358 basis in the FA stock ($50x) received in exchange for its DC stock must be reduced by $17x, the amount by which DP2's share of inside gain ($27x) exceeds DP1's $10x outside gain.

- As adjusted, DP2's basis in its FA stock is $33x.
Section 367(a)(5)

Forthcoming Final Regulations

- Final regulations are expected to be released in the near future.
- Among the areas that may be covered by the final regulations are:
  - The potential use of net operating losses to offset all or a portion of inside asset gain.
  - Relief for control group members which have significant unrealized loss in their U.S. transferor shares.
  - Allowing indirect ownership to satisfy the control group requirement.
  - The term, if any, of the 367(a)(5) “gain recognition agreement.”
  - Further guidance on what type of asset transfers may trigger the gain recognition agreement.