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New Proposed Regulations Address Gain Recognition Agreements and Other Outbound Transfer Reporting

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On January 30, 2013, the United States Internal Revenue Service (“IRS”) and U.S. Treasury Department issued a notice of proposed rulemaking (“NPRM”) stating proposed regulations that would revise the reporting regime applicable to outbound stock and property transfers under §§367 and 6038B.¹ The proposed regulations address several different filings, most notably §367(a) gain recognition agreements (“GRAs”). The regulations propose common standards to address untimely and incomplete filings, including a revised coordination of the §367 and §6038B rules.

These new regulations are proposed to be effective for filings that are due on or after the date the regulations are published as final. The new regulations would also apply to requests for late or incomplete filing relief that are submitted to the IRS on or after the date the regulations are finalized. The NPRM does not currently affect the late-filing rules that are in place, including the administrative relief afforded under the IRS Directive on Examination Action with Respect to Certain Gain Recognition Agreements (“the Directive”).²

Background

Section 367 moderates the application of the subchapter C nonrecognition rules to cross-border transactions. Section 367(a) and (e) address transfers of stock and other property by U.S. persons to foreign corporations (outbound transfers),³ and §6038B contains notification requirements applicable to these transfers. Together, §§367 and 6038B provide a regime of substantive and procedural requirements that must be met in order to apply the subchapter C rules to avoid current gain recognition in connection with an outbound transfer.

The proposed regulations address the following filings under §§367(a), 367(e), and 6038B:

¹REG-140649-11, 78 *Fed. Reg.* 6772 (January 31, 2013).

² Directive on Examination Action With Respect to Certain Gain Recognition Agreements, LMSB-4-0510-017 (July 26, 2010).

³ Section 367(e) also addresses certain transfers between foreign corporations. See *Treas. Reg.* §1.367(e)-2(c) (addressing distributions of property in “foreign to foreign” section 332 liquidations).

- The GRA under Treas. Reg. §1.367(a)-8, as well as its associated filings, required to be filed by certain U.S. persons that transfer stock or securities to a foreign corporation;
- The statements under Treas. Reg. §1.367(a)-3(c)(6) and (7), required to be filed by certain domestic target corporations that are transferred to a foreign corporation under Treas. Reg. §1.367(a)-3(c);
- The statement under Treas. Reg. §1.367(a)-3(d)(2)(vi)(B)(1)(ii), required to be filed by a domestic target corporation that is a party to certain indirect stock transfers under Treas. Reg. §1.367(a)-3(d)(1);
- The statements and schedules under Treas. Reg. §1.367(e)-2, required to be filed by a domestic or foreign corporation that liquidates into a foreign parent corporation; and
- Form 926, which generally implements the §6038B requirement for a U.S. person to report the transfer of property to a foreign corporation in a nonrecognition transfer.

At present, a variety of rules apply when a taxpayer seeks to correct one of the above filings that is late or incomplete. Treas. Reg. §1.367(a)-8(p) states that a U.S. transferor that fails to timely file a GRA, or that fails to comply with the GRA rules in any material respect, must demonstrate that its failure was “due to reasonable cause and not willful neglect.” The Directive modifies this rule and provides an abbreviated procedure that is applicable to any late or incomplete GRA filing except for a failure to file a GRA (or a document that purports to be a GRA) with respect to an initial outbound transfer. Pursuant to the Directive, a taxpayer does not have to provide an explanation of the reasons for its failure to timely file or comply. Treas. Reg. §1.367(a)-3(c)(6)(ii) also provides a reasonable cause standard applicable to a failure to timely file the Treas. Reg. §1.367(a)-3(c)(6) statement; however neither the section 367(e)(2) regulations nor the Treas. Reg. §1.367(a)-3(d) indirect stock transfer rules address taxpayers that fail to file required information, nor do they describe a mechanism to address late or incomplete filings.

If the §367 filing requirements are not satisfied, gain recognition may be imposed. §6038B supplements this consequence with a penalty equal to ten percent of the fair market value of the transferred property, up to \$100,000, unless a failure to comply was due to intentional disregard. The §6038B penalty does not apply if the U.S. transferor demonstrates that the failure to comply was due to reasonable cause and not willful neglect.

Proposed §367 Revisions

The proposed regulations would revise the current Treasury Regulations to state common standards applicable to the GRA and other filings under §§367(a) and 367(e).

- The standard applicable to taxpayers seeking to avoid gain recognition by remedying untimely or incomplete GRA filings would be revised from proof that the failure to comply was “due to reasonable cause and not willful neglect” to proof that the failure “was not willful.”⁴ The preamble explains this change by stating that “the existing reasonable cause standard, given its interpretation under the case law, 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. Based on the current operation of

⁴ Prop. Treas. Reg. §1.367(a)-8(p)(1).

the section 367(a) GRA regulation the [IRS and Treasury Department] believe that full gain recognition under section 367(a)(1) should apply only if a failure to timely file an initial GRA or a failure to comply with the section 367(a) GRA regulations with respect to an existing GRA is willful.⁵

- “Willful” is to be interpreted in a manner consistent with its meaning in the context of other civil penalties,⁶ and includes a failure due to gross negligence, reckless disregard, or willful neglect, determined based on all the facts and circumstances.⁷ The proposed regulations contain specific examples applying the willful standard to GRAs, illustrating: an isolated oversight that is not willful,⁸ a taxpayer’s course of conduct that is relevant to the willfulness determination,⁹ a knowing omission of material information that is willful,¹⁰ and a deliberate and therefore willful decision to not file a GRA.¹¹
- The proposed regulations revise the IRS’ procedures for processing requests for late filing relief. In particular, the regulations remove the current 120-day deadline for the IRS to process a request for relief.¹² The preamble to the proposed regulations explains that “the IRS and the Treasury Department do not believe that the IRS’s processing time with respect to a relief request should be determinative of whether a U.S. transferor has satisfied its obligations under the section 367(a) GRA regulations.”¹³
- The proposed regulations provide guidance addressing when a GRA is considered timely filed and what gives rise to a failure to comply with the GRA requirements in a material respect. A GRA is timely filed only when every document that is required to be filed as part of the GRA is timely filed and completed in all material respects.¹⁴ The regulations provide an example illustrating the “completed in all material respects” requirement; according to the example, the standard is not met where a taxpayer omits the fair market value of the transferred stock and instead states that the value is “available upon request.”¹⁵
- The proposed regulations extend the “not willful” and “complete in all material respects” standards from the GRA rules to the filings under Treas. Reg. §§1.367(a)-3(c), 1.367(a)-3(d), and §367(e)(2).¹⁶

Proposed §6038B Revisions Requirements

The proposed regulations would revise the integration and coordination of the §6038B filings and penalty provisions with the §367 rules.

⁵ 78 Fed. Reg. 6774.

⁶ As an example, the preamble to the proposed regulations cites §6672. 78 Fed. Reg. 6774.

⁷ Prop. Treas. Reg. §1.367(a)-8(p)(1).

⁸ Prop. Treas. Reg. §1.367(a)-8(p)(3) Example 1.

⁹ Prop. Treas. Reg. §1.367(a)-8(p)(3) Example 2.

¹⁰ Prop. Treas. Reg. §1.367(a)-8(p)(3) Example 3.

¹¹ Prop. Treas. Reg. §1.367(a)-8(p)(3) Example 4.

¹² See Treas. Reg. §1.367(a)-8(p)(1). In addition, the proposed regulations revise the language describing the requirement that taxpayers request relief shortly after discovering a missed or incomplete filing. The current regulations refer to a U.S. transferor requesting relief “as soon as” becoming aware of the omission; the proposed regulations would replace “as soon as” with “promptly after.” Compare Treas. Reg. §1.367(a)-8(p)(2) and Prop. Treas. Reg. §1.367(a)-8(p)(2).

¹³ 78 Fed. Reg. 6774.

¹⁴ Prop. Treas. Reg. §1.367(a)-8(d)(1)(ii).

¹⁵ Prop. Treas. Reg. §1.367(a)-8(p)(3) Example 3.

¹⁶ Prop. Treas. Reg. §§1.367(a)-3(f) and 1.367(e)-2(e)(3). The proposed regulations also modify the information that must be reported under §367(e)(2), including adding a requirement to report the basis and fair market value of the distributed property. Prop. Treas. Reg. §1.6038(e)-1(e)(4)(i).

- The §6038B penalty would apply to a failure to comply in any material respect with the GRA, §367(a) and §367(e) rules.¹⁷ For this purpose, “completed in all material respects” has the same meaning as under the proposed §367 rules. However, the “not willful” standard would not be extended to §6038B reporting. Instead, the current “reasonable cause and not willful neglect” standard would apply.¹⁸ As a result, the proposed regulations contemplate a class of noncompliance that falls between the two standards; in other words, missed or incomplete filings that satisfy the not willful test, but fail reasonable cause and are thus subject to the §6038B penalty but not §367 gain recognition. In this regard the preamble states that “[t]he IRS and Treasury Department believe that the penalty imposed by section 6038B generally should be sufficient to encourage proper reporting and compliance.”¹⁹
- The proposed regulations would revise the coordination of the Form 926 and GRA filings. Treas. Reg. §1.6038B-1(b)(2) currently provides that a U.S. transferor that properly files a GRA does not have to file the Form 926. The proposed regulations would eliminate this exemption and require a U.S. transferor that executes a GRA to also complete certain portions of the Form 926, including a statement of the basis and fair market value of the transferred property.²⁰

Effective Dates

As mentioned, the regulations are proposed to be effective for filings that are due on or after the date the regulations are published as final, and would also apply to requests for late or incomplete filing relief that are submitted to the IRS on or after that date.²¹ While the administrative relief granted by the Directive remains available, it is unclear how long this opportunity will continue. As a result, taxpayers should again consider taking advantage of the abbreviated procedures in the Directive before it is rescinded.²²

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¹⁷ Prop. Treas. Reg. §1.6038B-1(b)(1)(i). In the context of GRA filings, the preamble to the proposed regulations refers to this provision as a clarification. 78 Fed. Reg. 6774.

¹⁸ *Id.* The reasonable cause and not willful neglect standard under §6038B is based in the statute. See §6038B(c)(2).

¹⁹ 78 Fed. Reg. 6774.

²⁰ Prop. Treas. Reg. §1.6038B-1(b)(2)(iv).

²¹ Prop. Treas. Reg. §§1.367(a)-3(g)(1)(ix), §1.367(a)-8(r)(1)(i), §1.367(e)-2(g), and §1.6038B-1(g)(5).

²² See Alison Bennett, “Danilack Says Service Will Soon Pull Directive on Gain Recognition Agreements,” *Daily Tax Report* (BNA) 235 DTR G-10 (Dec. 7, 2012).

