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Final and Temporary Regulations Address Outbound Asset Transfers

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On March 18, 2013, the Internal Revenue Service and Treasury Department issued final and temporary regulations under Internal Revenue Code sections 367(a), 367(b) and 1248(f).[1] These regulations finalize 2008 proposed regulations addressing outbound transfers and distributions under sections 361 and 355.[2] In addition, temporary regulations revise the coordination between the section 367(a) asset and indirect stock transfer rules. The final regulations under sections 367(a)(5), 367(b), and 1248(f) apply to transfers occurring on or after April 17, 2013;[3] the temporary regulations revising the indirect stock transfer rules apply to transactions occurring on or after March 18, 2013.[4]

Section 367(a)(5)

Section 367(a)(1) states a general rule requiring gain recognition on US-to-foreign (outbound) property transfers under section 332, 351, 354, 356, or 361. Section 367(a)(2) and (a)(3) provide exceptions to the gain recognition requirement for certain transfers of stock or active trade or business property. Section 367(a)(5), added to the Code in 1988, provides that the section 367(a)(2) and (a)(3) exceptions do not apply to outbound section 361(a) or (b) transfers unless certain requirements are met. The final regulations under Treas. Reg. §1.367(a)-7 are the first set of effective regulations under section 367(a)(5).

The section 367(a)(5) requirements for nonrecognition, as adopted by Treas. Reg. § 1.367(a)-7, are as follows:

i. The US target corporation (US transferor) is 80 percent controlled (vote and value) by at least one but not more than five US corporate shareholders (Control Group). For this purpose, members of an affiliated group are treated as a single corporation;[5]

1 T.D. 9614, 78 *Fed Reg.* 17024 (March 19, 2013); T.D. 9615, 78 *Fed Reg.* 17053 (March 19, 2013).
2 REG-209006-89, 73 *Fed Reg* 49278.
3 Temp Reg. 1.367(a)-7(f); Reg. 1.367(b)-6(a)(1)(v) and Reg. 1.1248(f)-3(b)(1).
4 Temp Reg. 1.367(a)-3(g)(1).
5 Treas. Reg. §1.367(a)-7(c)(1); (f)(1).

ii. Each Control Group member reduces the basis in the stock received (or deemed received) in the transaction to the extent necessary to preserve the US transferor's asset gain (to the extent such gain is not already being recognized); [6]

iii. The US transferor recognizes certain gain amounts, either by reference to the gain attributable to its shareholders that are not Control Group members,[7] or because such gain could not be preserved by adjusting Control Group members' stock bases; [8] and

iv. The US transferor and each Control Group member complies with reporting requirements, including timely filing an affirmative election to apply the section 367(a)(5) exception and to abide by its terms.[9]

The final regulations also state two rules addressing the scope of section 367(a)(5). First, the regulations provide that section 367(a)(5) applies to all outbound section 361 transfers, regardless of whether the transfer also qualifies under another subchapter C nonrecognition provision, such as section 351.[10] Second, addressing the interaction of section 367(a)(5) and 367(d), the final regulations provide that the Treas. Reg. § 1.367(a)-7 rules apply only to the transfer of "section 367(a) property," which includes all items considered property under the subchapter C nonrecognition provisions, other than "section 367(d) property."[11] Section 367(d) property, in turn, is defined as property described in section 936(h)(3)(B).[12] Commenting on the interaction of sections 367(a) and (d), the preamble to the final regulations states that "income or gain attributable to the transfer of property by a US person to a foreign corporation in a section 351 exchange or a section 361 exchange is taken into either in accordance with section 367(d)(2)(A)(ii)(**I**) or (d)(2)(A)(ii)(**II**), or in accordance with section 367(a) and the regulations thereunder in the case of a section 361 exchange subject to section 367(a)(5)."[13] There is not a 'third category' of property that does not fall under section 367(a) or section 367(d).

Section 367(b)

Treas. Reg. §1.367(b)-4 backstops the application of section 1248 when a US shareholder or foreign corporation transfers stock or assets in a subchapter C nonrecognition transaction. In general, the Treas. Reg. §1.367(b)-4 rules attempt to distinguish between cases where a US shareholder's "section 1248 amount" can be deferred and cases where an immediate inclusion is appropriate because deferral is not possible.

Notwithstanding this general policy, Treas. Reg. §1.367(b)-4 has, since 2000, required a section 1248 amount inclusion when a US shareholder transfers stock in a foreign corporation in an outbound asset reorganization, regardless of whether the foreign acquired and acquiring corporations are controlled foreign corporations

[6] Treas. Reg. §1.367(a)-7(c)(3).
[7] Treas. Reg. §1.367(a)-7(c)(2)(i).
[8] Treas. Reg. §1.367(a)-7(c)(2)(ii).
[9] Treas. Reg. §1.367(a)-7(c)(4) and (5).
[10] Treas. Reg. §1.367(a)-7(b).
[11] Treas. Reg. §1.367(a)-7(f)(10).
[12] Treas. Reg. §1.367(a)-7(f)(11).
[13] *See also* Notice 2012-39, 2012-31 IRB 95 (July 13, 2012) (including a very similar statement).

(CFCs) after the reorganization.[14] This rule was criticized as overbroad and a misapplication of the Treas. Reg. §1.367(b)-4 principles.

The new final regulations alter the Treas. Reg. §1.367(b)-4 treatment of outbound asset reorganizations. In particular, a section 1248 amount inclusion is no longer required under Treas. Reg. §1.367(b)-4 as long as immediately after the section 361(a) or (b) exchange the foreign acquired corporation, the foreign acquiring corporation, and foreign controlled corporation (in the case of a triangular reorganization) are CFCs of which the US target corporation is a section 1248 shareholder.[15] (For this purpose, the US transferor's transitory ownership is respected.[16]) Basis adjustments under the section 1248(f) or 367(b) regulations fulfill the Treas. Reg. §1.367(b)-4 policy and insure the preservation of the section 1248 amount for future inclusions, to the extent possible.[17] It is important to note, however, that an outbound asset reorganization can still give rise to a section 1248 amount inclusion, to the extent that basis adjustments do not adequately preserve the section 1248 amount.[18]

Section 1248(f)

The final regulations under section 1248(f) provide exceptions to the operative rule of section 1248(f)(1) requiring a domestic corporation (distributing corporation) that distributes stock of certain foreign corporations under sections 337, 355(c)(1), or 361(c)(1) to include in income the section 1248 amount in the foreign stock distributed. The section 1248 amount is the amount by which the fair market value of stock in a CFC that is held by a US shareholder exceeds that shareholder's basis in the stock, but limited to the extent of the earnings and profits of the foreign corporation attributable to such stock.

In a section 355 transaction, the distributee takes a tax basis in the stock of the distributed corporation that is computed under the rules if Reg. 1.358-2. These rules require the distributee to allocate the tax basis of its stock in the distributing corporation between its stock in the distributing corporation and the distributed corporation in proportion to the fair market value of the two corporations. The pre-transaction tax basis of the distributed corporation is eliminated. Similarly, the holding period of the distributed corporation's stock in the hands of the distributee will equal the distributee's holding period in the distributing corporation's stock. The holding period of the distributing corporation in the distributed corporation is also eliminated. Without section 1248(f), a section 355 transaction in which the distributed corporation is a controlled foreign corporation has the potential to significantly reduce or eliminate the section 1248 amount attributable to the distributed CFC.

The final regulations allow a distributee that is a section 1248 shareholder of the distributed foreign corporation to make adjustments to the tax basis and holding period of the distributed stock to preserve the section 1248 amount. If these adjustments are made, then the section 1248 amount attributable to the distributed foreign corporation's stock does not have to be included in the distributing company's income.

The final regulations provide that the adjustments to section 358 basis **may not**

[14] *See* prior Treas. Reg. §1.367(b)-4(b)(1)(iii), Example 4.
[15] Treas. Reg. §1.367(b)-4(b)(1)(ii)(A).
[16] *See* T.D. 9614 preamble discussion, T.D. 9614 78 *Fed Reg.* 17024, at 17027 .
[17] *See* Treas. Reg. §§1.1248(f)-2(c) *and* 1.367(b)-4(b)(1)(ii)(B)(2).
[18] *See* Treas. Reg. §1.1248(f)-1(b)(3) *and* -2(c).

reduce it below zero. To the extent the excess amount exceeds the section 358 basis in the portion, the domestic distributing corporation must include that portion of the section 1248(f) amount attributable to the portion of the share in gross income as a dividend.

Section 361 Outbound Stock Transfers

Treas. Reg. §1.367(a)-3(e) was withdrawn and reissued as a proposed and temporary regulation. The previous version of Treas. Reg. §1.367(a)-3(e) provided that the outbound transfer of stock or securities in a section 361 exchange is subject to gain recognition under section 367(a)(1), unless the requirements of section 367(a)(5) and any regulations thereunder are satisfied. One requirement is that any control group member that owns (with attribution) five percent or more of the stock (by vote or value) of the transferee foreign corporation immediately after the transaction must enter into a gain recognition agreement (GRA), to the extent of any gain realized by the control group member. Under Treas. Reg. §1.367(a)-3T(e), the domestic transferor is not required to recognize gain realized to the extent that each “qualified US person” (generally, any US person except domestic partnerships or special corporate entities not subject to US tax) that satisfies the five percent test in the foreign acquiring corporation (measured prior to the section 361(c) distribution of the stock of the foreign acquiring corporation) enters into a GRA for the transferred stock. However, the US transferor must recognize the realized gain in transferred stock that is attributable to any shareholder that is not a qualified US person or does not otherwise satisfy the 5 percent ownership requirement.

Indirect Stock Transfers

Background

Section 367 modifies the application of the subchapter C non-recognition rules to cross-border transactions. Sections 367(a) and (d) address transfers of assets and stock by US persons to foreign corporations (outbound transfers). Under section 367(a), a foreign corporation generally is not treated as a corporation for purposes of applying the subchapter C non-recognition rules. However, under some circumstances, such transfers may be subject to the non-recognition rules under subchapter C, provided that the domestic transferor files a GRA and complies with various requirements under the regulations. Certain transactions could be covered by both the asset transfer and stock transfer rules. Regulations under section 367(a) generally provide guidance to coordinate the application of the asset transfer and stock transfer rules to transactions that could be covered by both sets of rules. Generally, the coordination rules state the asset transfer rules apply first, and then the indirect stock rules apply. There were three exceptions to this general rule: the indirect stock transfer exception, the section 367(a)(5) exception and the section 351 exception. T.D. 9615 eliminates the section 367(a)(5) exception to the general coordination rule, and addresses the remaining two exceptions.

The temporary regulation provides that if a domestic target corporation transfers assets to a foreign acquiring corporation in an exchange described in section 351 or 361, and the foreign acquiring corporation contributes some or all of the acquired assets to a domestic subsidiary, the domestic target corporation (solely for purposes of section 367) is deemed to have transferred the assets directly to the domestic subsidiary in exchange for stock of the domestic subsidiary, followed by a contribution of that stock to the foreign acquiring corporation. To the extent that the domestic target corporation has gain realized in the assets transferred, it is required to recognize gain under sections 367(a), unless it satisfies the requirements under Treas. Reg. §1.367(a)-3(c) for filing a gain recognition agreement. Among other requirements, the shareholders of the domestic target corporation must own no more than 50% of the voting power and value of the foreign acquiring corporation to file a GRA.

Under Notice 2008-10, a domestic target corporation that transfers its assets in a section 361 exchange to a foreign acquiring corporation in exchange for stock and non-qualified property (boot) must recognize any gain realized unless the domestic target corporation's gain realized in the assets transferred is preserved through adjustments to the tax basis of the stock of the acquired foreign acquiring corporation received in the section 361 exchange. Thus, if the unrecognized gain in stock of the foreign acquiring corporation that is received by the domestic target corporation in the section 361 exchange is equal to or exceeds the gain realized in the assets of the domestic target corporation, then the domestic target corporation is not required to recognize gain, even if the remaining consideration is non-qualified property. However, the temporary regulations eliminate this exception under section 367(a)(5), requiring the domestic target corporation to recognize the built in gain in its assets if it is not otherwise allowed to file a GRA.

Treas. Reg. §1.367(a)-3T(d)(2)(vi)(B)(2) retains the existing coordination rules governing cascading section 351 transactions. Under existing rules, if a domestic transferor corporation realizes gain when it contributes assets to a foreign corporation in a transaction governed by section 351, and the transferee foreign corporation re-contributes the assets to its domestic subsidiary in a transaction governed by section 351, the transfer is not subject to section 367(a) and (d) to the extent that the tax basis of the assets is no greater in the hands of the domestic subsidiary. This rule is retained in the current temporary regulations. Note: this transfer is still an indirect stock transfer that would have to qualify for a GRA to avoid gain recognition.