CODE §367 AND UNASSUMING OUTBOUND TRANSFERS

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INTRODUCTION

In purely domestic situations, the Internal Revenue Code (the "Code") provides for the deferral of taxation when certain corporate reorganizations or transactions take place and specific requirements are met. However, the same may not be true when the reorganization or transaction involves a U.S. person and a foreign corporation. In these situations, the Code may trigger gain for the U.S. person. For instance, if a U.S. person contributes shares in a U.S. corporation to another U.S. corporation in a qualifying Code §351 exchange, the U.S. person does not recognize gain on the transaction. However, if the same U.S. person were to contribute shares in a corporation to a foreign corporation, Code §367(a) requires the U.S. person to recognize gain unless certain exceptions apply. This is also the case if a U.S. person is deemed to transfer the shares indirectly, for example by way of a domestic or foreign partnership. An unwary taxpayer with a merely passive interest in the partnership may not realize that he or she has U.S. tax obligations since the transaction took place between foreign entities and their overall interests remain the same.

This article highlights the situation described above where a seemingly foreign transaction may result in U.S. tax consequences to a U.S. person under Code §367(a). While a number of reorganizations can give rise to implications under Code §367, this article will examine the consequences of a Code §351 exchange where a U.S. person directly or indirectly transfers shares in a foreign corporation to another foreign corporation.

SECTION 351 OVERVIEW

A Code §351 Exchange occurs when one or more persons transfer property to a corporation solely in exchange for stock of the transferee corporation and are in control of such corporation immediately after the exchange.[1] The phrase "one or more persons" includes individuals, trusts, estates, partnerships, associations, companies, or corporations.[2] Control is defined as ownership of at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock.[3] Where a transaction qualifies as a Code §351 Exchange, no gain or loss is recognized by either the transferor or

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1 Code §351(a).

2 Treas. Reg. §1.351-1(a); Rev. Rul. 84-111.

3 Code §§351(a) and 368(c).

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transferee corporation.[4] A carryover basis is taken in the shares received, thereby preserving the exposure to tax on a future sale of the shares received.[5]

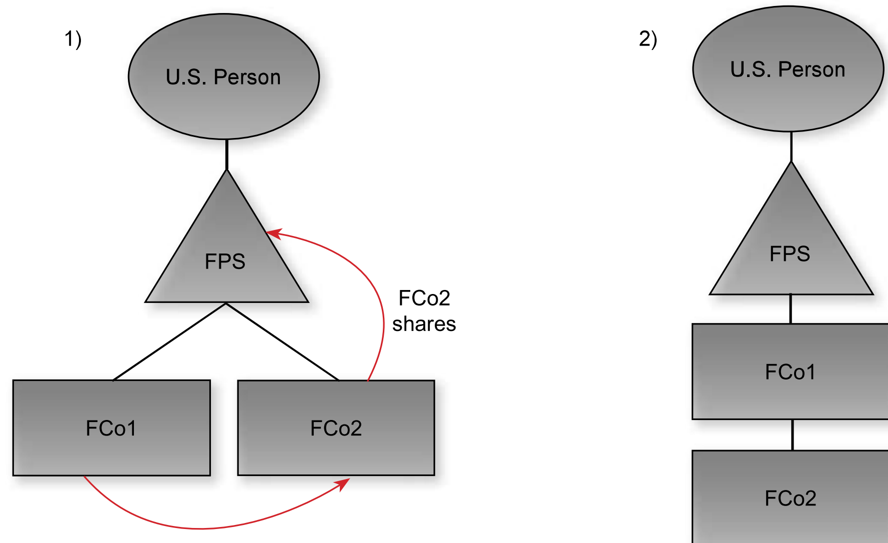
OPERATION OF 367(A)

Notwithstanding the nonrecognition provision under Code §351, Code §367(a) provides that if, in connection with certain exchanges, including Code §351 exchanges, a U.S. person transfers property to a foreign corporation (*i.e.*, an outbound transfer), such foreign corporation will not be considered a corporation for purposes of determining the extent to which gain is recognized. As a result, the nonrecognition treatment under Code §351 is shut off.

For these purposes, a U.S. person is defined in Code §7701(a)(30).[6] The Code defines a U.S. person to include a citizen or resident of the U.S., a domestic partnership, a domestic corporation, and any estate or trust other than a foreign estate or trust.

Moreover, if a domestic or foreign partnership transfers property to a foreign corporation, then a U.S. person that is a partner in the partnership will be treated as having transferred a proportionate share of the property for purposes of Code §367(a).[7]

To illustrate, assume a U.S. person holds a passive interest in a foreign partnership in jurisdiction X. The foreign partnership wholly owns two sister foreign corporations in jurisdiction X, FCo1 and FCo2. As part of a restructuring plan, the foreign partnership contributes shares in FCo1 to FCo2 in exchange for FCo2 shares in a §351 exchange. FCo2 becomes the parent of FCo1. The transaction takes place all within jurisdiction X and qualifies as a nonrecognition transaction under the tax laws of jurisdiction X. Notwithstanding the tax-free nature of the transaction under the tax law of jurisdiction X, Code §367(a) may treat the U.S. person as transferring property to a foreign corporation and deny nonrecognition treatment for U.S. tax purposes.



4 Code §§351(a) and1032(a).

5 Code §§351(h)(2), 358 and 362.

6 Treas. Reg. §1.367(a)-1(d)(1).

7 Treas. Reg. §1.367(a)-1T(c)(3)(i)(A).

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Despite the general operation of section Code §367(a)(1) that restricts the application of the nonrecognition provisions on outbound transfers of property, an exception applies where the transferred property is stock or securities of a foreign corporation. [8] In that case, the regulations provide that the transaction will not be subject to Code §367(a)(1) in either of the following fact patterns:

- The U.S. transferor owns less than 5%[9] of both the total voting power and the total value of the stock of the transferee corporation immediately after the transfer.
- The U.S. person transferor enters into a five-year gain recognition agreement ("G.R.A.").[10] The relevant provisions about a G.R.A. are discussed below.

"A G.R.A. extends the statute of limitations for the year of the transaction for a period of five years, ending at the close of the fifth tax year following the close of the tax year in which the exchange occurs . . ."

GAIN RECONITION AGREEMENT ("G.R.A.")

Definition

A G.R.A. is an agreement made by the U.S. transferor pursuant to regulations promulgated under Code §367. A G.R.A. extends the statute of limitations for the year of the transaction for a period of five years, ending at the close of the fifth tax year following the close of the tax year in which the exchange occurs (the "G.R.A. Period"). Under the G.R.A. provisions., the U.S. transferor is generally not required to recognize gain on an outbound transfer of stock in a foreign corporation but must certify that it will recognize gain if certain triggering events occur within the G.R.A. Period.[11] As explained in more detail below, a triggering event generally includes any subsequent disposition by the transferee foreign corporation of the transferred stock to an unrelated party. If a triggering event occurs during the G.R.A. Period, the transferor must report the deferred gain realized in the earlier transaction either on an amended tax return for the tax year of the initial exchange, or in the tax return for the tax year in which the triggering event occurs.[12] In either case, the taxpayer must pay interest on the deferred tax that is then deemed to be paid late, going back to the initial transfer year.[13]

Triggering Event

A triggering event includes, *inter alia*,[14]

- a complete or partial disposition, directly or indirectly, of the transferred stock in the initial exchange by the initial foreign transferee;

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8 Code §367(a)(2).

9 Applying the attribution rules of Code §318 as modified by Code §958(b). These rules are outlined in greater detail in Section 2(A) below. Each U.S. person will be attributed stock owned by H.Q.H. and any intermediary entity. No other attribution rules outlined in the Code will apply here to increase a U.S. person's interest.

10 Treas. Reg. §1.367(a)-3(b)(1).

11 Treas. Reg. §1.367(a)-8(c)(1).

12 Treas. Reg. §1.367(a)-8(c)(1)(iii).

13 Treas. Reg. §1.367(a)-8(c)(1)(v).

14 Treas. Reg. §1.367(a)-8(j).

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- a disposition in one or more related transactions of substantially all of the assets of the transferred corporation except for (i) inventory or property held for sale to customers in the ordinary course of business, (ii) an exchange of stock or securities pursuant to an asset reorganization, and (iii) an exchange of stock by a corporate distributee pursuant to a complete liquidation;
- a complete or partial disposition, directly or indirectly, of the stock of the transferee foreign corporation received by the U.S. transferor in the initial transfer. If the U.S. transferor is an individual, losing U.S. citizenship or ceasing to be a U.S. permanent resident, is treated as a disposition of all the stock of the transferee corporation;
- entering or leaving a consolidated group, in the case of a U.S. corporate transferor;
- the death of a U.S. transferor, or the termination of a trust or estate that was the transferor; and
- failing to comply with the G.R.A. requirements.

Exclusions

Certain dispositions of the transferred stock by the transferee are excluded from the triggering event rules, mainly dispositions that are part of nonrecognition transactions in which the transferor retains an interest, directly or indirectly, in the transferred stocks and securities or assets of the transferred corporation, and provided that the U.S. transferor enters into a new G.R.A. relating to the stock received in the exchange for the remaining term of the existing G.R.A ("New G.R.A.").[15]

Content of a G.R.A.

A G.R.A. includes information about the transferor and a description of the property and the gain that is subject to the agreement. It is signed under penalties of perjury and must be filed with the tax return of the U.S. transferor for the tax year in which the exchange occurs.[16] A G.R.A. is considered timely filed only if included with a timely filed return, and all relevant G.R.A. documents are complete in all material respects.

In connection with filing, the U.S. transferor must agree to extend the statute of limitations on assessments as it applies to the tax on the gain realized but not recognized as a result of the initial transfer through the close of the eighth full tax year following the tax year of the initial transfer.[17] This extension is made by filing Form 8838 (Consent to Extend the Time to Assess Tax Under Section 367—Gain Recognition Agreement) together with the G.R.A.[18] If a New G.R.A. is entered into by a U.S. transferor, the U.S. transferor must also extend the limitations on the initial transfer through the close of the eighth full tax year following the tax year of the

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15 Treas. Reg. §1.367(a)-8(k)(3).

16 Treas. Reg. §§1.367(a)-8(d)(1), (e)(1).

17 Treas. Reg. §1.367(a)-8(f)(1).

18 *Id.*

initial transfer, unless the U.S. transferor for the New G.R.A. is the U.S. transferor for the existing G.R.A.[19]

In addition, the U.S. transferor must include with its timely-filed tax return for each of the five full tax years following the year of the exchange, a certification that contains certain information, including whether any triggering events occurred during the year and the gain that was recognized under the G.R.A. by reason of that event.[20] If no gain recognition event occurred during the taxable year, an annual certificate should be filed confirming the absence of gain.

367(B) CONSIDERATIONS

Code §367(b) applies to exchanges described in Code §351 and to which Code §367(a) does not apply, including where Code §367(a) does not apply as a result of a G.R.A. Under Code §367(b), a foreign corporation generally will be considered as a corporation, thereby allowing nonrecognition treatment to apply, except to the extent provided in the regulations. Treas. Reg. §1.367(b)-4 applies to transactions in which a foreign corporation acquires the stock or assets of another foreign corporation in certain exchanges, including a Code §351 Exchange. Under the §367(b) regulations, income inclusion is required as a result of a transfer of foreign stock in three scenarios:[21]

- Loss of status as a "Code §1248 shareholder"
- Receipt of preferred shares or other stock that allows the transferor to disproportionally participate in the earnings of particular assets
- Certain recapitalizations.

In regard to the first scenario, a Code §1248 shareholder is a U.S. shareholder that owns directly or indirectly at least 10% of a foreign corporation's voting stock at any time during the five-year period ending on the date of the transaction, provided that such foreign corporation was a controlled foreign corporation ("C.F.C.") at the time when the shareholder owned 10% of its stock.[22] For an exchange to involve the loss of status as a Code §1248 shareholder and be taxable under the Code §367(b) regulations, the U.S. transferor must be a Code §1248 shareholder with respect to the acquired foreign corporation immediately before the transaction[23] and must no longer be a Code §1248 shareholder immediately after the transaction.[24] If the foreign corporation that issued the shares being transferred is not a C.F.C., a U.S. transferor cannot be considered a Code §1248 shareholder and income inclusion cannot result from this scenario under Code §367(b).

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[19] Treas. Reg. § 1.367(a)-8(f)(2).

[20] Treas. Reg. § 1.367(a)-8(g).

[21] Additional scenarios become relevant for purposes of Code §367(b) where property is transferred from a foreign corporation to a U.S. person, *i.e.*, an "inbound transfer". See, Treas. Reg. §1.367(b)-3.

[22] Treas. Reg. §1.367(b)-2(b), Code §1248(a)(2), 1248(c)(2).

[23] Treas. Reg. §1.367(b)-4(b)(1)(i)(A).

[24] Treas. Reg. §1.367(b)-4(b)(1)(i)(B).

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In order for a transaction to fall within the second scenario, three tests must be met:[25]

- In the first test, the acquired foreign corporation and the acquiring foreign corporation are not part of the same affiliated group immediately before the transaction. An affiliated group includes corporations that have a common parent corporation that owns 80% or more of the total voting power and value of each.[26]
- In the second test, a U.S. corporation directly or indirectly owns 10% or more of the voting power or value of the transferee foreign corporation.
- In the third test, the exchanging shareholder receives preferred stock in consideration for common stock or preferred stock that is fully participating with respect to dividends, redemptions, and corporate stock.

Finally, the Code §367(b) regulations provide that income inclusion would occur in certain recapitalizations described in Code §368(a)(1)(E). A recapitalization generally refers to reshuffling of a capital structure, within the framework of an existing corporation.[27] In a recapitalization, the corporation itself does not ordinarily receive property other than its surrendered stock or securities.

REPORTING REQUIREMENTS

Code §6038B requires transfers subject to Code §367(a) to be reported on I.R.S. Form 926.[28] The U.S. transferor must attach the Form 926 and with attachments to such person's timely filed U.S. income tax return for the taxable year that includes the date of the transfer.[29] A U.S. person is not required to file Form 926 if the U.S. person owned less than 5% of the transferee corporation and the transfer qualified for nonrecognition treatment.[30] When a G.R.A. is filed, an exemption from filing may be available.

Failure to file Form 926 triggers a penalty equal to 10% of the fair market value of the transferred property at the time of the exchange, unless the U.S. person demonstrates the failure was due to reasonable cause and not to willful neglect.[31] The penalty will not exceed $100,000 unless the failure was due to intentional disregard.[32]

CONCLUSION

When a U.S. person is considered to transfer shares in a foreign corporation to another foreign corporation, especially indirectly through a partnership, he or she

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[25] See, Treas. Reg. §1.367(b)-4(b)(2)(i).

[26] Within its meaning in Code §1504(a) with certain modifications mentioned in Treas. Reg. §1.367(b)-4(b)(2)(i)(A).

[27] *Helvering v. Southwest Consolidated Corp.*, 315 U.S. 194.

[28] Treas. Reg. §1.6038B-1(b)(1)(i).

[29] *Id.*

[30] Treas. Reg. §1.6038B-1(b)(2)(i)(A).

[31] Code §6038B(c).

[32] Code §6038B(c)(3).

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may not contemplate the U.S. tax consequences of a seemingly foreign transaction with no material effect on his or her holdings. As illustrated, though, the Code is not so generous. It will look to tax the U.S. person under Code §367(a) or (b) unless an exception applies. U.S. persons with direct or indirect foreign holdings should be cognizant of the decisions made by foreign corporations, as even a minor restructuring could result in U.S. tax liability and corresponding interest and penalties.

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