Presentation:

International Income Taxation
Chapter 10
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Overview of §367

**Tax-free treatment under the Subchapter C rules**

§367(a): Governs transfer of appreciated property by U.S. persons beyond the U.S. tax jurisdiction (p. 826)

§367(b): Governs transfers of controlled foreign corporation stock to prevent the elimination of ultimate US taxation on §1248 earnings and profits (p. 867)

§367(d): Special rules for outbound transfers of intangible asset (p. 849)

§721(c): Gives IRS authority to issue regulations requiring gain recognition on transfers to partnerships with foreign partners (p. 855)

§367(e): Special rules for outbound distributions generally qualifying under §355 or §332 (p. 859)
General Rule: Outbound Transfers Taxable

“If, in connection with any exchange described in §332, §351, §354, §356, or §361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation.”

Key Concepts
1. U.S. person as transferor;
2. Transfer of property to a foreign corporation; and
3. Transfer is described in §332, §351, §354, §356, or §361

Policy of Section 367(a): Trigger or preserve for later recognition US persons’ gain in assets transferred to a foreign corporation.

Implication: Unrecognized losses are not impacted by §367(a)’s requirements. Caveat (p. 822): §362(e) limits tax basis upon the corporation acquisition of loss property if the total adjusted bases of the transferred properties exceeds the FMV of transferred properties immediately after the transfer.
§367(a) Exceptions to Gain Recognition (general):

Assets to be used in an active trade or business (§367(a)(3)); §367(d) principles may apply to the contribution of intangible property (p. 830)

Certain transfers of foreign stock or securities (§367(a)(2)); Including application of Indirect Stock Transfer Rules; §367(b) principles also apply (p. 837)

Certain transfers of US stock or securities (§367(a)(2); §7874) (p. 838).
1. Framework for §367(a)(3) Exception
   The general rule of taxability in 367(a)(1) does not apply to property transferred as part of an active trade or business conducted outside of the United States.

2. Exception to the §367(a)(3) Exception
   Where Gain on “Tainted Assets” exists
   - Inventory
   - Installment obligations, accounts receivable, etc.
   - Foreign currency
   - Intangible property*
   - Leased property
   - Recapture of U.S. depreciated property
   - Property expected to be sold
   - Branch Loss Recapture of §367(a)(3)(C)

* Intangible transfers generally subject to 367(d) are not eligible for the §367(a)(3) ATOB Exception, but foreign goodwill would appear to be eligible for §367(a)(3) Exception albeit the analysis is not entirely clear.
In general, a transfer of stock or securities by a U.S. person to a foreign corporation that is described in section 351, 354, 356 or section 361(a) or (b) is subject to section 367(a)(1) and is treated as a taxable exchange, unless an exception applies.

1. Treas. Reg. §1.367(a)-3(b) sets forth the rules when the transferee corporation is a foreign corporation.

2. Treas. Reg. §1.367(a)-3(c) sets forth the rules when the transferee corporation is a domestic corporation.
A transfer of stock or securities of a foreign corporation by a U.S. person to a foreign corporation is not subject to section 367(a)(1) if either—

1) U.S. transferor owning less than 5% of stock of the transferee – no current U.S. income tax effect (reorg); or

2) U.S. transferor owns 5% or more and agrees to enter into a five year gain recognition agreement (GRA) to avoid gain recognition.

**Note on §367(b) Overlap:** Transfers of foreign stock can be described in sections 367(a) and 367(b) and thus are subject to **both sets of rules.**

1. **Caveat:** a foreign corporation is not treated as a corporation under section 367(a)(1), 367(b) does not apply.

2. **Further caveat:** if §367(b) applies, then corporation moves from CFC to non-CFC status, the US S/H picks-up the §1248 amount.
Treas. Reg. §1.367(a)-3(c) provides that no gain is recognized if:

1. U.S. transferors receive less than 50% of the ownership of the transferee post-transaction. For purposes of this test, it is presumed that transferors are U.S. persons. Ownership statements from foreigners must be obtained to show that the 50% US ownership threshold is not exceeded.

2. Transferee is engaged in active conduct of a trade or business outside the US for 36 months prior to the transfer (and no sale anticipated).

3. U.S. transferor (i) owns less than 5% or (ii) if a 5% or greater U.S. transferor, has a gain recognition agreement (GRA—see next slide).
1. Agreement: U.S. transferor agrees to include in income the gain realized but not recognized if certain events ("triggering events") occur before the close of the fifth full tax year following the year of the transfer.

   **Triggering Events** - generally involves dispositions, directly or indirectly, of stock of the transferee, but the regulations provide detailed exceptions for certain dispositions (including internal non-recognition transactions) that may avoid creating a gain recognition event if further reporting is complied with. See Treas. Reg. §1.367(a)-8(j) and (k).

2. Interest charge imposed on deferred tax;

3. Extends the statute of limitations
   Taxpayer must file a Form 8838 to extend the statute of limitations through the close of **eighth full taxable** year following the transfer

4. Taxpayer must file an annual certification stating that the GRA has not been triggered.
§7874 – two different types of inversion transactions:

1) 80% + stock identity – former shareholders own at least 80%.

Foreign corp. is deemed to be domestic.

2) 60-80% stock identity – corporate level gain recognized on stock and asset transfers.

Inversion respected, but taxable

Plus §4985 excise tax on stock options.
Plus §6043A IRS information reporting.

See Wells, “What Corporate Inversions Teach Us About International Tax Reform,” 127 Tax Notes 1345 (June 21, 2010).
Outbound Transfers of Intangibles

Hypothetical Abuse: (1) incur costs and deduct under §174 against U.S. source income, and then (2) transfer resulting self-created (zero basis) intangible asset to a foreign subsidiary. Subsequent foreign income from using the intangible is immune from U.S. tax (possibly subject to Subpart F rules).

Legislative Response:
1. §367(d) applies to outbound transfer of intangibles

§936(h)(3)(B) Intangibles:
   Patents, trademarks, license, contract, etc value independent of personal services. Same reference as used in section 482

Question: Is foreign goodwill and going concern value a §936(h)(3)(B) intangible?

2. §367(a)(3)(B)(iv) states that ATOB exception does not apply to intangible transfers
1. §482 (and not §367(d)) applies to an actual sale or license of an intangible.  

- **License of Intangible** (Royalties are treated as ordinary and sourced to where intangible is used. If a §482 adjustment is required, §367(d) still does not apply with respect to the required adjustment)

- **Sale of Intangible** (Gain is treated as capital and sourced to the residence of the seller unless consideration is contingent and in that event apply source rules for royalties; if a §482 adjustment is required, §482, not §367(d), still applies).

- **Royalty-Free License or Cross-License of Intangibles** (a U.S. affiliate may grant a royalty-free license to use an intangible to a foreign affiliate in exchange for a royalty-free license to use an intangible owned by the foreign affiliate; if a §482 adjustment is required, §367(d) still does not apply with respect to the required adjustment.)

- **Cost Sharing Arrangements** (see Treas. Reg. §1.482-7)

2. Transfers for no consideration - §367(d) applies.

3. Sham sales or sham licensing arrangements are subject to §367(d) (Treas. Reg. §1.367(d)-1T(g)(4)(ii) states that a sale or license of IP may be disregarded and treated as a transfer subject to §367(d) if the terms do not have economic substance)
1. Contribution of intangibles (exception for foreign-based goodwill) is treated as a sale of intangible property in exchange for deemed annual payments per super-royalty provision of §367(d)(2)(A). The annual payment is ordinary in character from sources without the United States (§367(d)(2)(C)) and §904(d) look-through rules apply.

   **Caveat:** Option to elect to treat transfer of intangibles as a deemed sale at fair market value. Ordinary gross income in the year of transfer, but probably U.S. source.

2. Amount of annual payments are commensurate with income over useful life (but no longer than 20 years). Disposition of transferred intangible by foreign subsidiary accelerates transferor’s gain recognition. §367(d)(2)(A)(ii)(II).
Hypothetical: U.S. taxpayer operates a foreign branch at a loss. These losses reduce U.S. taxable income (since branch loss flow-through). Then, transfers of foreign branch assets to foreign corporation. Foreign profits are then immune from current U.S. income tax (assuming Subpart F is not applicable).

Result: Branch loss recapture rules are applicable under §367(a)(3)(C).

1. Recapture the gain to the extent of previously unrecaptured losses of the branch.

2. Type of income recapture depends upon whether previously deducted as (1) an ordinary loss or (2) a capital loss. Note: foreign tax credit provision (§904(f)(3)) takes precedence in determining recapture.
§367(e)(2) denies nonrecognition of gain to a U.S. corporation making a liquidating distribution to a foreign parent corporation (80 percent or more). Cf., §§332 & 337.

Exceptions (in regs): (1) when distributed assets are used in a U.S. trade or business; or (2) if a U.S. real property interest.
**General Rule:** No gain recognition on a “foreign to foreign” liquidation. §332.

**Exception:** Gain recognition is required if U.S. trade or business assets are transferred, unless the ten year gain recognition rule is applicable. Why?

**Exception to Exception:** No gain recognition when U.S. real property.
If U.S. corporation distributes stock or securities of a U.S. or foreign subsidiary to a foreign person in a §355(a) transaction the distributing corporation recognizes gain under §367(e)(1).

Exceptions:

1) After distribution both distributing and distributed controlled corps are U.S. real property holding corps.

2) 80% or more of stock of the U.S. corp. is to distributees holding 5% or less of the distributing corp.'s stock, i.e., publicly held.

3) Distributing corp. agrees to file an amended return if foreign distributee of U.S. stock disposes of that stock.
a) Transfer of 500,000 Cayman dollars – tainted (and gain recognition)
b) Cayman dollars accounts receivable – tainted
c) Desktop systems for immediate sale – inventory and tainted
d) Copiers to be leased – likely to be treated as tainted inventory???
e) Interest in word processing program – intangible property specially treated under §367(d).
f) Warehouse in Cayman – not tainted; see the §367(a)(3)(B)(i) reference to §1221 which omits §1221(a)(2). (Also are the copiers under this exception?)
Original Hypo: Word processing program generate $5 million of revenue, so $500,000 is an appropriate royalty. **Result:** The $500,000 is to be included in income each year under §367(d)(2)(A). This amount is subject to periodic adjustments to assure that the payments are commensurate with income.

**Revised Hypo #1:** After 3 years, the word processing program is sold by Cayman sub. to an unrelated buyer. **Result:** AEC is required to recognize gain (then FMV over AEC’s tax basis). Reg. §1.367(d)-1T(f)(1).

**Revised Hypo #2:** AEC sells its AEC Cayman stock. **Result:** AEC will be treated as simultaneously selling the intangible property. The source is foreign source (§865 rules).
**Problem #3**

**Foreign Branch Loss Recapture Rule**

**Hypothetical:** Prior branch losses of $2,500 cumulative. Cayman Branch is transferred to AEC Cayman. Built-in gain on “tainted assets” was $500 and built-in gain on untainted assets was $2,000.

**Result:**

1. $500 of gain on tainted assets is recognized under §367(a)(3)(B).
2. The tentative amount of previously deducted branch losses subject to recapture is $2,500 ($3,000 of cumulative losses reduced by AEC’s net income of $500 in year 3), but this $2,500 amount is reduced by 500 taxable gain recognized on the tainted assets under §367(a)(1) and (a)(3)(B). Thus, $2,000 branch loss recapture treated as (foreign) ordinary income. §367(a)(3)(C).
Hypothetical: Prior branch losses of $2,500 cumulative. Cayman Branch is transferred to AEC Cayman. Built-in gain on “tainted assets” was $500 and built-in gain on untainted assets was $2,000.

Answer:
1. The $500 gain on the transferred tainted assets under §367(a)(3)(B).
2. Branch loss recapture is limited to $1,000 (rather than $2,000) because this is the limit of the gain on untainted assets.
Hypothetical: AEC has an overall foreign losses of $2,000 from the Cayman branch and then earns $1,000 of foreign income in year 4.

Result:
1. First apply §904(f)(3) which requires $1,000 of foreign source income in year 4 to be treated as U.S. source income to recapture $1,000 of the overall foreign loss (OFL) accumulated through year 3. Remaining amount to recapture is $1,000.
2. The $500 gain on the transferred tainted assets under §367(a)(3)(B).
3. The amount of branch loss to be recaptured would be $1,000 of the previously deducted branch loss under §367(a)(3)(C) ($2,500 - $500 tainted gain - $1,000 of OFL).
Problem #6
Recaptures – Ordering Rules

1) Immediate recapture of $1,000 with respect to the non-intangible portion of the transfer (i.e., the amount not subject to §367(d)). This amount is treated as U.S. source income.

2) As to the $1,000 of gain on the intangible subject to §367(d), the §904(f)(3) recapture amount is credited against payments that AEC-Cayman is deemed to make to AEC (US) under §367(d) in the first two years of the newly incorporated subsidiary’s operations. The first two $500 deemed payments are US source.
Hypothetical: DC owns 40 percent of the stock of FC1. C1 owns five percent of the stock of FC1. FC2, a corporation organized in Germany and unrelated to DC or C1, owns the remaining 55% of the stock of FC1. FC3, a publicly traded corporation organized in Spain, will acquire all of the FC1 stock from DC, C and FC2 under a reorganization plan pursuant to Section 368(a)(1)(B). After the reorganization exchange, DC owns 16% of FC3 and C1 owns 2% of FC3.

Result:
1. C1 gets nonrecognition treatment without more.
2. DC gets nonrecognition treatment if enter into a 5-year GRA.
Hypothetical: DP owns 95% of the DS. C2 owns 5% of DS. DP and C2 transfer to Foreign Parent all of their DS stock in a §368(a)(1)(B) reorganization exchange.

Question A: What are the U.S. income tax consequences to DP and C2 if, DP and C2 each owns less than five percent of Foreign Parent after the exchange?
Answer A: Nontaxable.

Question B: How would your answer change if DP owns more than 5% but less than 45 percent of Foreign Parent after the exchange?
Answer B: C2 gets nonrecognition. DP has nonrecognition treatment if executes a 5-year GRA.

Question C: How would your answer change if the facts are the same as in “A” except that DP owns more than 50 percent of Foreign Parent stock and C2 owns less than 5% of Foreign Parent after the exchange?
Answer C: Taxable to both DP and C2
§684 – gain recognition on transfers of appreciated property to foreign trusts and estates.

§721(c) regulatory authority re contributions of appreciated property to partnerships.
Objectives: Require recognition where §1248 gain would slip out of U.S. tax base or retain §1248 treatment for the future if postponement currently permitted.

General Rule: In the case of any 332, 351, 355, or 361 transfer, to the extent that 367(a) does not apply, a foreign corporation is considered to be a corporation, but 367(b) may modify the taxation of the exchange to protect tax attributes.

Policy of Foreign to Foreign Rules: Trigger or preserve for later recognition US persons’ Section 1248 amount in stock of CFC. Exceptions for foreign to foreign acquisitions where 1248 status preserved.
Foreign to Foreign Transactions: If, immediately before the exchange, the exchanging shareholder is either (i) a §1248 shareholder with respect to the foreign acquired corporation, or (ii) a foreign corporation, and a US person is a §1248 s/h of such foreign corporation and of the foreign acquired corporation; then if either of the following conditions is satisfied, the exchanging shareholder must include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges.

1. Immediately after the exchange, the stock received is not stock in a CFC as to which the US person is a 1248 shareholder; or
2. Immediately after the exchange, the foreign acquiring corporation or the foreign acquired corporation, as the case may be, is not a CFC as to which the US transferor is a §1248 shareholder.

See Treas. Reg. §1.367(b)-4(b).

Example: Lose CFC Status

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
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<tbody>
<tr>
<td>FMV of CFC #1</td>
<td>$100</td>
</tr>
<tr>
<td>USP Basis in CFC #1</td>
<td>$ 50</td>
</tr>
<tr>
<td>E&amp;P of CFC #1</td>
<td>$ 30</td>
</tr>
</tbody>
</table>

Analysis:
1. §367(b) requires USP to include its $30 §1248 Amount in income because CFC#1 loses its CFC status
2. §367(b) inclusion is a dividend eligible for look-through
3. §367(a) GRA amount is $20 (original $50 reduced by $30 §367(b) inclusion)
Foreign to Foreign Transactions: If, immediately before the exchange, the exchanging shareholder is either (i) a §1248 shareholder with respect to the foreign acquired corporation, or (ii) a foreign corporation, and a US person is a §1248 s/h of such foreign corporation and of the foreign acquired corporation; then if either of the following conditions is satisfied, the exchanging shareholder must include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges.

1. Immediately after the exchange, the stock received is not stock in a CFC as to which the US person is a 1248 shareholder; or
2. Immediately after the exchange, the foreign acquiring corporation or the foreign acquired corporation, as the case may be, is not a CFC as to which the US transferor is a §1248 shareholder.

See Treas. Reg. §1.367(b)-4(b).

Example: Retain CFC Status

<table>
<thead>
<tr>
<th>FMV of CFC #1</th>
<th>USP Basis in CFC #1</th>
<th>E&amp;P of CFC #1</th>
</tr>
</thead>
<tbody>
<tr>
<td>.............</td>
<td>$100</td>
<td>$  50</td>
</tr>
<tr>
<td>.............</td>
<td>$  50</td>
<td>$  30</td>
</tr>
</tbody>
</table>

Analysis:

1. §367(b) does not require USP to include its $30 §1248 Amount in income because CFC#1 retains its CFC status
2. §367(a) GRA amount is $50.
General Rules for Inbound Acquisitions:

1. Where a domestic corporation acquires the assets of a foreign corporation in a §332 liquidation or an asset acquisition described in §368(a)(1), if the exchanging shareholder is (i) either a US shareholder of the foreign acquired corporation or (ii) a foreign corporation with respect to which there are one or more US shareholders, then the exchanging shareholder must include in income as a deemed dividend the “all earnings and profits amount” with respect to its stock in the foreign acquired corporation.

2. Excess foreign tax credits carry over and are allowable under §901 subject to other limitations (e.g., §383, §904 and §907).

3. NOLs can be carried over only to the extent the underlying losses were effectively connected with the conduct of a US trade or business (or attributable to a PE).

Treas. Reg. §1.367(b)-3(b)(3).
Liquidation of Foreign Subsidiary into Foreign Parent –

Not a gain recognition event.

E&P moves up.

Treas. Reg. § 1.367(b)–1(b)(1).
Southern Cross, Inc. owns all of the stock of Southern Cross Holdings which in turn owns all of the stock of Bahia S.A. The shares of Bahia S.A. held by Southern Cross Holdings have a fair market value of $5,100 and a basis of $100. Bahia S.A. E&P of $3,000, $1,000 of which is attributable to Subpart F income for the current tax year. Bahia S.A. has paid cumulative foreign taxes of $600, $200 of which is attributable to Subpart F income included by Southern Cross Holdings in its gross income. Southern Cross Holdings distributes all of its Bahia S.A. stock to Southern Cross, Inc., in exchange for 20% of Southern Cross, Inc.’s stock in Southern Cross Holdings in a transaction that meets the requirements of Section 355. To what extent must Southern Cross Holdings recognize gain on the disposition of its Bahia S.A. stock? Will gain be recognized by Southern Cross, Inc. on the exchange?

**Result:** Nonrecognition. Treas. Reg. §1.367(b)-5(b)(1).
North American Co. owns all the stock of Australian Overseas, Ltd. which in turn owns all of the stock of Pacific Co., a U.S. corporation. North American’s shares in Australian Overseas have a fair market value of $9,000 and a basis in North American’s hands of $1,500; Australian Overseas’ shares in Pacific Co. have a fair market value of $1,000. Australian Overseas has earnings and profits of $9,000. In the current year, North American exchanges 10% of its Australian Overseas shares for all of Australian Overseas’ shares in Pacific Co. in a transaction that meets the requirements of Section 355. What are the U.S. tax consequences to North American?

**Result:** North America reduces basis in Australia Overseas by its pre-distribution §1248 Amount. Historic basis in Australia Overseas Ltd. gets allocated between the Australia Overseas Ltd. Stock and the Pacifico stock. See Treas. Reg. §1.367(b)-5(g) Ex. 1.