

# IRC Section 367 Outbound Transfers of Assets: Identifying Transactions, Reporting Requirements and Exceptions

WEDNESDAY, DECEMBER 1, 2021, 1:00-2:50 pm Eastern

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# I. Introduction

- IRC Section 367 taxes transfers of intangible and tangible property to foreign corporations that would otherwise qualify for nonrecognition treatment under Sections 332, 351, 355, and 368. Section 367(a) commonly applies to transfers of assets to a foreign corporation in exchange for stock and other methods of foreign restructuring while **Section 367(d) affects transfers of intangible property**, including goodwill, going concern value, and workforce in place.
- There are exceptions to Section 367 treatment. Specific transactions and taxpayers can qualify for nonrecognition treatment by entering into a gain recognition agreement (GRA) with the IRS. Not reporting these transactions as required by IRC Section 6038(b) or qualifying for an exception under the regulations could subject the taxpayer to substantial penalties.



## II. Qualifying Transactions

- Section 367(a) transactions
  - If, in connection with any exchange described in Sections 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.
  - Exception for transfers of stock and securities
- Section 367(b) transactions
  - Transfers of stock and securities in Sections 332, 351, 354, 356 or 361 transactions
  - Overrides otherwise tax-free character of inbound liquidations and reorganizations for foreign corporations with previously untaxed E&P
  - Overrides otherwise tax-free character of outbound and foreign-to-foreign transactions where a U.S. person loses “section 1248” status as a result of such transactions

***Food for Thought:*** What happens when a transaction falls within multiple Sec. 367 prongs?

Are there any Sec. 1248 amounts left post Sec. 965 + GILTI?

## II. Qualifying Transactions – Sec. 367(a) Example

Skipper, a U.S. citizen, wholly-owns and is the only officer of USMinnow, a domestic corporation in the cruise business. In what would otherwise constitute a tax-free share-for-share transaction or a Type B merger under Sec. 368, Skipper exchanges 100% of his shares of USMinnow for 3% of the voting shares of CANwhale, a Canadian corporation, which has operated a cruise business specializing in three-hour tours for years. Skipper, who wants to stay in the cruise business, does not recognize gain as a result of satisfying the limited-interest exception as follows:

- 1) Skipper receives less than 50% of CANwhale (only 3%);
- 2) As the only shareholder, officer or 50% shareholder of USMinnow, Skipper does not own more than 50% of CANwhale, the transferee foreign corporation, immediately after the transfer (Skipper only owns 3%).
- 3) CANwhale has operated for more than 36 months and neither Skipper nor CANwhale intends to discontinue or dispose of CANwhale's trade or business;
- 4) Skipper acquires less than 5% of CANwhale; and
- 5) CANwhale is a substantially larger company than USMinnow and its value is, at the time of the exchange, greater.

## II. Qualifying Transactions – Sec. 367(b) Examples

- *Type A merger.* Assume that CANwhale merges with and into USMinnow. Further assume that CANwhale's shares are worth \$1 million at the time of the merger and that CANwhale's shareholders have a \$100,000 tax basis in their shares. Finally, assume that the merger consideration received by CANwhale's shareholders consists of USMinnow's shares with a fair market value of \$1 million. Although the merger occurs with a foreign corporation, the merger qualifies as a Type A merger under Sec. 368. The individual "U.S. shareholders" of CANwhale must include in income as a dividend the earnings and profits of CANwhale. See Treas. Reg. Section 1.367(b)-3(b)(3)(i).
- *Type B reorganization.* Same facts as discussed on our previous slides. Because the merger does not fall into the scope of Sec. 367(a), Sec. 367(b) applies.
- *Type C reorganization.* Assume that CANwhale transfers "substantially all" of its properties to CANcan solely in exchange for all or a part of CANcan's voting stock. The individual "U.S. shareholders" of CANwhale must include in income as a dividend the earnings and profits of CANwhale. See Treas. Reg. Section 1.367(b)-3(b)(3)(3)(ii) (Ex. 5).

## II. Qualifying Transactions – Sections 367(d) and (e)

- Section 367(d) transactions
  - Imposes a “super-royalty” on otherwise tax-free outbound transfers of IP in Sec. 351 or Sec. 361 transactions
  - 2017 TCJA amended the definition of intangible assets to explicitly include goodwill, going concern value, and workforce-in-place for post 12-31-2017 transactions
- Section 367(e) transactions
  - a Sec. 355 distribution of a domestic or foreign subsidiary by a domestic parent company to a foreign shareholder;
  - A Sec 332 liquidation by a domestic or foreign subsidiary into its foreign parent.

# III. Types of Assets

- Property
  - The term “property” means any item that constitutes property for purposes of Section(s) 351, 354, 355, 356, or 361, as applicable.
- Stock and Securities
- Intangible Property
  - Prior to TCJA
  - After TJCA – the “platform intangibles”

## IV. Gain Recognition Agreement (“GRA”)

- A gain recognition agreement provides parameters under which the U.S. transferor, in a transaction to which Section 367(a) applies, will recognize gain if the foreign corporation disposes of transferred property during the five-year term of the gain recognition agreement. See Treas. Reg. Section 1.367(a)-3(b).
- The terms of a gain recognition agreement discuss “triggering events” that could cause an early termination of the gain recognition agreement and trigger recognition of gain on the transfer. If a trigger event occurs, the U.S. transferor must:
  - 1) report the gain on an amended return for the year of transfer;
  - 2) adjust the basis of assets on which the gain was recognized; and
  - 3) pay additional penalties and interest on the tax assessed from the recognition event.



## IV. GRA - Interaction Between 367(a) and 367(b)

*Facts:* USMinnow now owns all of the stock of CANwhale, a CFC. USMinnow's basis in CANwhale's stock is \$50, the value of such stock is \$100, and the previously untaxed E&P amount with respect to such stock is \$30. Foreign individuals unrelated to USMinnow or CANwhale wholly own CANcan, a second foreign corporation. USMinnow transfers all of the stock of CANwhale to CANcan in exchange for 20% of the voting stock of CANcan in a B Reorganization. As 80% of CANcan remains under the control of foreign persons after the transfer, CANcan is not a CFC.

*Analysis with GRA:* If USMinnow enters into a GRA with respect to the transfer of CANwhale stock, the exchange is also subject to Sec. 367(b) because it is not subject to Sec. 367(a). USMinnow must recognize the Sec. 1248 amount of \$30 under the Sec. 367(b) regs due to the exchange of shares in a CFC for shares in a non-CFC. USMinnow is entitled to a basis step-up in the both the CANwhale stock exchanged and the CANcan stock received in the amount of the deemed dividend. Therefore, only the remaining \$20 of built-in gain remains subject to the GRA.

*Analysis without GRA:* If USMinnow does *not* enter into a GRA with respect to the transfer of CANwhale stock, USMinnow remains subject to Sec. 367(a) and therefore must recognize the full amount of built-in gain of \$50 in the year of the transfer, \$30 of which will be recharacterized as a dividend. Sec. 367(b) does not apply.

# V. Downward Attribution Rules

- The 5% Shareholder, the 10% shareholder and the Sec. 1248 Shareholder tests
- 2017 TCJA repealed downward attribution limitation under Sec. 958(b)(4)
- TR Sec. 1.332-8 promulgated in 2020 to address repeal of Sec. 958(b)(4) - generally applies to distributions in complete liquidation occurring on or after October 1, 2019
- 2020 final Sec. 367(a) regulations provide a gain-recognition agreement triggering-event exception if, immediately after a disposition, the U.S. transferor meets certain requirements, including retaining a direct or indirect interest in the transferred stock or securities. The final regulations finalize the rule to apply Section 958(b) without regard to the repeal of Section 958(b)(4)

# VI. Managing Your Sec. 367 Reporting Requirements

- Section 6038B requires the U.S. persons involved to notify the IRS of the existence of these transactions.
- A U.S. person who transfers property to a foreign corporation must attach Form 926, Return by Transferor of Property to a Foreign Corporation, to their U.S. federal tax return for the year of the transfer.
- The penalty for a failure of a U.S. person to properly report a transfer to a foreign corporation equals to 10% of the fair market value of the property transferred.
  - The penalty cannot exceed \$100,000 unless the failure is due to an intentional disregard of the reporting rules.

# VII. Mitigation Strategies

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## 'Cause it's Getting Harder and Harder to Breathe...

- Repeal of the active business exception by TCJA
- Selecting transactional form – stock v. assets
- Entering into a cost-sharing arrangement instead of an outbound transfer of intangibles (BUT TCJA “strikes” again with platform contribution rules)
- Opting to structure as a taxable transaction
  - Taxable exchange election
  - USRPI exception
  - Two-Step Dance - taxable dispositions that do not trigger GRA