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# International Tax Advisory

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*Insights Into Recent Regulatory, Judicial and Legislative Developments*

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## Proposed Regulations Point to Future Guidance on Outbound Asset Transfers

On August 19, Treasury and the IRS issued proposed regulations that would provide long-awaited guidance on certain asset transfers made by U.S. transferors to foreign corporations. The overall purpose of the proposed regulations is to ensure that the gain associated with transferred underlying assets or foreign stock is either recognized immediately or preserved for future recognition.

### *Proposed regulations under section 367(a)(5)*

Section 367(a)(1) imposes a general gain recognition rule upon a U.S. transferor of property to a foreign corporation in certain types of exchanges. The purpose of the rule is to ensure that the U.S. person recognizes built-in gain associated with transferred assets that otherwise would escape U.S. taxing jurisdiction. This gain recognition rule potentially may not apply if (1) the U.S. transferor transfers stock of a foreign corporation that is a party to an exchange or an otherwise tax-free reorganization, or (2) the transferee foreign corporation uses the transferred assets in an active trade or business outside the United States.

In certain section 361 exchanges with foreign corporations, section 367(a)(5) can override these two exceptions so that the U.S. transferor will currently recognize gain on the exchange. For example, if a U.S. subsidiary (the U.S. transferor) of a U.S. parent corporation transfers its assets to a foreign corporation in exchange for all of the stock of the foreign corporation and then liquidates into its U.S. parent, the U.S. parent receives the stock of the foreign corporation in the liquidation. Because the U.S. parent now has a carryover basis in the foreign corporation stock, rather than a basis in the assets that were originally transferred to the foreign corporation, any built-in gain in the transferred assets in the hands of the U.S. transferor would disappear if the U.S. parent's carryover basis in the foreign corporation stock is greater than the U.S. transferor's basis in the transferred assets. Section 367(a)(5) is designed to impose current gain recognition in such cases.

However, section 367(a)(5) provides that, "subject to such basis adjustments and such other conditions as shall be provided in regulations," its gain recognition rule will not apply if the U.S. transferor is controlled by five or fewer U.S. corporations (with members of the same affiliated group being treated as one corporation). In this case, either the reorganization exception or the active trade or business exception to the section 367(a)(1) gain recognition rule would continue to apply. The proposed regulations would address the gap left by the statute by providing an elective exception to the section 367(a)(5) gain recognition rule. The proposed regulations also point to further guidance on the control requirement in the statute.

The elective exception would permit recognition of the built-in gain to be deferred, but only where the built-in gain in the transferred assets remains subject to corporate-level taxation in the hands of the controlling U.S. shareholders of the U.S. transferor through their ownership of stock initially received by the U.S. transferor in the section 361 exchange. Five requirements must be satisfied for the elective exception to apply. First, a control group consisting of five or fewer corporations (but at least one) must directly own at least 80 percent of the stock of the U.S. transferor (measured by vote and by the number of shares of non-voting stock) at the time of the asset transfer. Second, in the

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case of any shareholders of the U.S. transferor that are not members of the control group, the U.S. transferor must currently recognize gain equal to the product of the transferred assets' built-in gain and any such shareholders' aggregate ownership interest (measured by value) in the U.S. transferor at the time of the exchange. The proposed regulations also provide a formula for gain recognition where a control group member cannot preserve the built-in gain in the transferred assets because it disposes of the foreign corporation stock. Third, each control group member must reduce its basis in the stock that the U.S. transferor receives in the exchange and then distributes to the control group member under a formula designed to preserve the built-in gain in the transferred assets that are subject to the rules of section 367(a). In the case of successive spin-offs of the distributed stock, only the final distributee is required to reduce its basis in the stock. Fourth, the U.S. transferor generally must file a gain recognition agreement with its tax return, certifying that it will recognize gain if the foreign acquirer effects certain dispositions of the transferred assets. Fifth, the U.S. transferor and each control group member must include an election statement with its tax return for the taxable year of the section 361 exchange.

## Regulations Under Section 367(b) and 1248

Under sections 367(b) and 1248(a), a U.S. transferor of stock of a controlled foreign corporation (CFC) must generally include in gross income as a dividend any gain on the sale or exchange of the CFC stock to another foreign corporation (a section 1248 dividend), but only if (1) the U.S. transferor owns 10 percent or more of the CFC (by vote) during the five-year period ending with the sale or exchange (a section 1248 shareholder) and (2) the foreign acquiring corporation is not a CFC *or* the U.S. transferor is not a section 1248 shareholder with respect to the foreign acquiring corporation. The generally acknowledged purpose of these provisions is to ensure gain recognition when gain on the CFC stock would otherwise escape U.S. taxing jurisdiction.

However, an example provided in the current regulations requires a U.S. transferor to recognize a 1248 dividend in a section 361 exchange even if the U.S. transferor is a section 1248 shareholder of the transferred CFC and the foreign acquiring corporation is a CFC. Practitioners have found the example to be inconsistent with the purpose of the rules because, even if the U.S. transferor distributes the stock of the foreign acquiring corporation to a U.S. parent corporation and liquidates into the parent, the U.S. parent would own at least 10 percent of the foreign acquiring corporation and gain on the potential sale of foreign acquiring corporation stock is preserved.

The proposed regulations would respond to this concern by requiring a U.S. transferor to recognize a section 1248 dividend only where, immediately after the section 361 exchange, the foreign acquired corporation or the foreign acquiring corporation is not a CFC with respect to which the U.S. transferor is a section 1248 shareholder.

The proposed regulations also would clarify that, with particular exceptions, a U.S. corporation generally must recognize a section 1248 dividend where the U.S. corporation distributes stock of a CFC of which it is a section 1248 shareholder in a section 337 liquidation or in certain section 355 distributions.

Daniel McCall, an IRS attorney who drafted the proposed regulations, has publicly stated that taxpayers cannot currently rely on the proposed regulations. Taxpayers should plan accordingly until the publication of final regulations in this area.

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