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International Tax ADVISORY

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IRS Provides Final Rules on Gain Recognition Agreements

On November 18, the IRS issued final regulations concerning outbound property transfers to foreign corporations and, specifically, gain recognition agreements related to such transfers.

Background & 2013 Proposed Regulations

Under Section 367(a) of the Code, if a U.S. person transfers property to a foreign corporation in a Section 332, 351, 354, 356 or 361 transfer or exchange, the foreign corporation generally is not treated as a corporation for purposes of determining the U.S. transferor's gain on the transfer. This rule typically means that the U.S. person will recognize gain on what would otherwise be a non-taxable transfer.

The regulations offer exceptions to the general rule of Section 367(a) for certain transfers of stock or securities to a foreign corporation. If a U.S. person transfers foreign stock or securities and owns 5 percent or more of the transferee foreign corporation after the transfer, the general recognition rule will not apply if the transferor enters a gain recognition agreement (GRA). Section 1.367(a)-8 of the Treasury Regulations describes the terms of a GRA, which generally require the U.S. transferor to agree to recognize some or all of the gain realized on the transfer if certain "gain recognition events" occur during a five-year period following the taxable year of the transfer.

Failure to comply "in any material respect" with any requirements of the GRA regulations or the terms of an existing GRA constitutes a gain recognition event. Under old rules, such a failure could trigger full gain recognition unless the U.S. transferor rectified the situation and showed reasonable cause for the failure. Regulations under Section 367(e) apply rules analogous to the GRA provisions to the liquidation of a U.S. subsidiary into its foreign parent, although those regulations do not state the consequences of failures to comply. Additional reporting obligations for property transfers to foreign corporations, apart from GRAs, arise under Section 6038B (i.e., Form 926) and other Section 367(a) regulations.

In 2013, the IRS issued proposed regulations under Sections 367(a) and 6038B that would generally relax the consequences of failures to file GRAs or to meet other reporting obligations in connection with transfers to foreign corporations. Those proposed rules provided that a U.S. transferor must show that a failure to file a GRA or comply with an existing GRA's terms was not willful to avoid consequent gain recognition. Moreover, the proposals included procedural rules to clarify and harmonize the reporting requirements and consequences for noncompliance under Sections 367(a) (including GRAs), 367(e)(2) and 6038B. Shortly after the release of the proposed regulations, the IRS issued temporary regulations that changed the rules for when gain is recognized in certain outbound stock transfers and altered the procedures to obtain reasonable cause relief.

2014 Final Regulations

The final regulations issued last month generally incorporate the 2013 proposed rules, with some modifications, and amend and delete parts of the 2013 temporary regulations. Significantly, the non-willful relief provisions under the proposed regulations have been retained and extended to certain previously filed requests (including those that were denied under the harsher "reasonable cause" standard) and failures to comply with other non-GRA-related Section 367(a) reporting. There are also relaxed procedural rules for consents to extend the tax assessment period, which must be filed to request relief under the GRA rules or in connection with outbound liquidations.

While the regulations provide significant relief, the new rules are not all taxpayer-friendly. The final regulations revoke a 2010 directive that had allowed taxpayers to correct, without showing reasonable cause, failures in GRA-related documents associated with a timely filed GRA. Additionally, the Section 6038B regulations now require more specific information to be reported on Form 926—including fair market value, basis and gain recognized—whenever a GRA is filed for an outbound transfer of stock or securities. The new rules also implement a new limitations period relating to failure to comply with GRA provisions: The period is now based on when the taxpayer furnishes missing information to the IRS (rather than on when the IRS receives notice of the failure).

Terminating Lawful Permanent Resident Status

To end "lawful permanent resident" status or to rely on a treaty tie-breaker to claim nonresident status, an individual must take affirmative steps. Unfortunately, the taxpayer in *Gerd Topsnik v. Commissioner*, 143 T.C. No. 12 (2014), did not and, as a result, remained taxable as a U.S. resident despite his so-called "informal" abandonment of U.S. residence.

Factual Background

The taxpayer, a German citizen, had applied for lawful permanent resident status (i.e., a green card) in 1977. Between that year and 2003, he declared himself a lawful permanent resident at the customs border, and in 2003 renewed his status. In 2010, the taxpayer filed Form I-407, formally abandoning and surrendering his green card.

In 2004, the taxpayer sold stock in a California corporation in an installment sale, with an upfront payment in 2004 and annual installments through 2009. He filed (late) U.S. tax returns for 2004 and 2005 reporting the corresponding installment payments, but did not file U.S. tax returns for subsequent years. The IRS made substitute returns on the taxpayer's behalf for 2006 through 2009. Subsequently, the taxpayer filed for a refund of his 2005 taxes and filed nonresident income tax returns for the 2006 through 2009 period showing no taxes due in each year.

The taxpayer argued that, while he did not formally abandon his green card until 2010 (by filing Form I-407), he had "informally" abandoned U.S. residence as early as 2003 when he sold his home in Hawaii and moved back to Germany. Thus, he claimed that he was a German resident during all of the years in issue and consequently not subject to U.S. tax under the U.S.-Germany income tax treaty's residence tie-breaker rules and the capital gains article (which generally permits taxation only by the country of residence). The IRS disagreed, noting that the taxpayer had not formally abandoned his green card until 2010, and countered that the taxpayer was not a German resident in the relevant years based on the facts. Therefore, the IRS determined that all of his installment payments were subject to U.S. tax.

Tax Court Decision

The Tax Court, not surprisingly, sided with the IRS—sometimes the facts (and the rules) get in the way. In response to the taxpayer's claim that he informally abandoned his lawful permanent resident status, the court pointed out that, while immigration law may recognize such a claim, the tax law does not. Section 7701(b)(6) and the regulations thereunder are clear that lawful permanent resident status continues until the status is judicially or administratively determined to be abandoned (or revoked by an administrative or judicial order). The regulations specifically state that taxpayer-initiated abandonment requires the individual to file Form I-407 (or equivalent letter of intent) and surrender their alien registration receipt card to a consular officer. The court also cited legislative history to the effect that, even if an alien comes to the United States so infrequently that he or she is not legally entitled to permanent resident status for immigration purposes, he or she will continue to be a resident for tax purposes unless and until the status is officially lost or abandoned.

Having concluded that the taxpayer was a U.S. resident for tax purposes during the years in issue, the court then turned to the taxpayer's treaty-based claim. In light of the treaty's savings clause, the court observed that the taxpayer's argument could prevail only if the facts indicated that he was a German tax resident, both as an initial matter and after application of the treaty's residence tie-breaker rules. The court reviewed the taxpayer's economic and social ties to Germany, noting that the taxpayer was born in Germany, had a German passport and driver's license and owned improved real estate in Germany where he had homes available to him. While these facts were helpful to the taxpayer's position under the tie-breaker rule's "center of vital interests" test, other facts significantly discounted his claim. The German Competent Authority confirmed that the taxpayer had not registered in the community where he owned real estate, it was not clear that the taxpayer had a domicile or habitual residence in Germany and most detrimentally, the taxpayer registered as a taxpayer with "limited liability" in Germany—i.e., as a nonresident taxed only on German-source income. Because the taxpayer was not subject to German taxation as a resident (based on residence or domicile or a similar basis), he was not a "German resident" under the treaty, precluding application of the tie-breaker rules. Consequently, the capital gains article of the treaty would not relieve the taxpayer from U.S. tax on the installment sale income.

Takeaways

Green card holders who want to terminate U.S. tax resident status must take the official steps outlined under U.S. *tax* law—even if, for immigration purposes, they may not be entitled to U.S. resident status. (Of course, lawful permanent residents who are "long-term residents" should consider that formally abandoning their green card may trigger the mark-to-market "exit tax" of Section 877A.) Alternatively, green card holders who want to rely on treaty tie-breaker rules to claim taxation as a U.S. nonresident should look to minimize their social and economic contacts in the United States and establish significant connections to the treaty partner country, including being taxable as a resident of that country. Invoking the treaty is not without pitfalls, though: Apart from the potential application of the Section 877A exit tax, the regulations warn that filing nonresident U.S. income tax returns may jeopardize a green card holder's immigration status.

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