ALSTON & BIRD LLP

WWW.ALSTON.COM

International Tax ADVISORY ■

APRIL 15, 2013

IRS Issues Regulations on Outbound Asset Transfers

The IRS recently issued final, temporary and proposed regulations concerning transfers of assets by U.S. corporations to foreign corporations in certain nonrecognition transfers. One set of regulations (TD 9614) operates to preserve corporate-level gain under Code Section 367(a)(5) for outbound transfers that occur after April 17, 2013. The other set of regulations (TD 9615) modifies Section 1.367(a)-3(d) of the regulations, pertaining to a coordination rule between asset transfers and indirect stock transfers, for transactions that occur after March 18, 2013.

Background

Section 367(a) generally requires gain recognition on outbound transfers from U.S. corporations to foreign corporations, thereby taxing certain transactions that would otherwise be tax-free. Although there are a number of statutory exceptions, Section 367(a)(5) provides that such exceptions do not apply to outbound property transfers in a Code Section 361(a) or 361(b) exchange. (Section 361 generally provides for nonrecognition treatment for stock, securities and distributed boot received in a reorganization.)

Preserving Corporate-Level Gain on Outbound Transfers

Proposed regulations issued in 2008 under Section 367(a)(5) offered an elective exception whereby nonrecognition treatment can apply to outbound reorganizations if certain conditions are met. The final regulations adopt this elective exception, with modifications. The proposed regulations had provided that a U.S. transferor could deduct against its realized gain certain liabilities that would give rise to a deduction when paid, to arrive at a net inside gain that, if nonrecognition applies, is preserved in the basis of the stock received in the reorganization by the U.S. transferor's domestic corporate shareholders. Under the final regulations, such deductible liabilities are restricted to those assumed in the Section 361 exchange. The elective exception to gain recognition is denied if a foreign transferee corporation, with a principal purpose to avoid U.S. tax, disposes of a significant portion of the property it received during the 60-month period beginning on the date of transfer from the U.S. transferor.

Coordination Rule between Asset Transfers and Indirect Stock Transfers

Unless an exception applies, certain outbound reorganizations followed by certain transfers to controlled corporations and successive Section 351 transfers comprise "indirect stock transfers" subject to gain recognition under Section 367(a). In an indirect stock transfer where a U.S. corporation transfers property to a foreign corporation, the "coordination rule" provides that Sections 367(a) and 367(d) apply first to the asset transfer before the indirect stock transfer rules of regulations Section 1.367(a)-3(d) apply. Prior rules provided three detailed exceptions to the coordination rule—the Section 367(a)(5) exception, the indirect stock transfer exception and the Section 351 exception.

The new regulations make several changes to the existing rules, largely by reference to new temporary (and proposed) rules. First, the new rules eliminate the "Section 367(a)(5) exception" to the coordination rule, due to the IRS' concern that a number of transactions relied on the exception to repatriate earnings and profits without gain recognition or dividend inclusion (despite prior guidance's attempts to clarify the exception's application). Second, the new regulations modify the basis comparison rule for purposes of the "Section 351 exception." Any basis increase resulting from gain recognition by the U.S. transferor in the initial Section 351 transfer is ignored in determining whether a U.S. transferee's basis in the assets received in a successive Section 351 transfer does not exceed the basis of the U.S. transferor.

The temporary regulations also make several changes to the gain recognition agreement (GRA) requirement under Section 367(a)(5). For example, the five-percent ownership threshold is determined by reference to ownership of the foreign transferee by the U.S. transferor, rather than by members of the control group, a change the IRS believes to be more consistent with the policy of GRAs. Finally, the new rules remove the 120-day provision from the reasonable cause relief procedures for a taxpayer's failure to timely comply with certain requirements. That provision deemed a taxpayer to have established reasonable cause if the IRS did not notify the taxpayer requesting relief within 120 days of the IRS' receipt of the request. The IRS reasoned that its processing time should not be a decisive factor in whether a taxpayer met its obligations.

While the recent regulations represent a comprehensive effort by the IRS to provide more guidance in this area, commentators have expressed some dissatisfaction with the new rules. For example, the IRS rejected proposals to exempt regulated investment companies, real estate investment trusts and S corporations from Section 367(a)(5)—despite the fact that such entities are generally not subject to corporate-level tax. The elimination of the 120-day rule removes certainty for taxpayers seeking reasonable cause relief in what was already a complex set of rules. Overall, the IRS' apparent caution in defining exceptions and relief under Section 367 should alert taxpayers to the IRS' continued focus on (and relative suspicion of) domestic-to-foreign transfers.

Professional Athlete's Endorsements Split between Services and Royalties Income

In a recent case (*Garcia v. Commissioner*, 140 TC 6 (2013)), the Tax Court held that a nonresident professional athlete's income from an endorsement deal should be allocated between personal services income and royalties for use of the taxpayer's "image rights," based on the facts and circumstances. The court further held that, under the U.S.-Switzerland income tax treaty, the U.S. source personal services income was taxable, while the royalties were exempt from U.S. tax.

The taxpayer, a professional golfer and Swiss resident, entered an endorsement contract with a sponsor whereby the sponsor was allowed to use the taxpayer's image, name and voice ("image rights") in marketing campaigns, and the taxpayer agreed to perform certain services (e.g., use the sponsor's products in all golf play, act in advertisements and make personal appearances). The sponsor compensated the taxpayer in exchange for his image rights and services. The taxpayer and the sponsor allocated the compensation 85 percent to royalties for use of the image rights and 15 percent to personal services, and the taxpayer paid U.S. tax only on the U.S. source personal services income. The IRS disputed the taxpayer's (and sponsor's) allocation of the endorsement income, seeking to attribute the "vast majority" to the taxpayer's personal services.

The Tax Court allocated the endorsement income 65 percent to royalties and 35 percent to personal services. In a similar case involving the same sponsor (*Goosen v. Commissioner*, 136 T.C. 547 (2011)), the Tax Court had held that a 50-50 split between royalties and personal services income was proper. However, the court distinguished the prior case and found that the taxpayer's prominent role as a "Global Icon" for the sponsor demonstrated that use of the image rights represented a greater share of the contract value.

The court further determined that the royalties were not subject to U.S. tax under the Royalties article of the U.S.-Switzerland treaty. The IRS contended that, under the Artistes and Sportsmen article of the treaty, the payments for the taxpayer's image rights were taxable as "predominantly attributable" to the taxpayer's performances. The Tax Court disagreed, concluding that the image rights constituted intangible property separate from the taxpayer's personal services in the United States and generated royalties exempt from U.S. tax under the treaty. On the other hand, the court held that all of the taxpayer's U.S. source personal services income was taxable.

This case is yet another illustration of how income characterization and sourcing issues can affect the taxation (or non-taxation) of a nonresident, especially where an income tax treaty is in play. All taxpayers, but especially professional athletes, artists and entertainers, should be mindful of these issues to negotiate and structure endorsement and similar agreements tax-efficiently, given that income from these contracts can generate distinct types of income subject to significantly different tax treatment.

President Obama's 2014 Budget Proposals Address U.S. International Tax Rules

On April 10, the President released his federal budget proposals for fiscal year 2014. A number of proposals would reform U.S. international tax provisions, including:

- deferring interest expense deductions allocable to foreign-source income until such income is subject to U.S. tax;
- determining foreign tax credits on a consolidated or pooled basis, taking into account the earnings and profits and foreign taxes of all foreign subsidiaries of a taxpayer;
- taxing as subpart F income certain returns associated with intangible property transferred from a U.S. person to a controlled foreign corporation;
- disallowing the deduction for nontaxed reinsurance premiums paid to affiliates not subject to U.S tax;
- limiting income shifting from transfers of intangibles;
- restricting earnings stripping by expatriated entities by revising Section 163(j);
- modifying foreign tax credit rules for dual capacity taxpayers;
- taxing gain on the sale of a partnership interest on a look-through basis;
- preventing the use of leveraged distributions from related foreign corporations to avoid dividend treatment;

- extending the application of Section 338(h)(16) to "covered asset acquisitions" as defined in Section 901(m);
- removing foreign taxes from Section 902 corporations' foreign tax pool when associated earnings are eliminated;
- exempting certain foreign pension funds from tax under the Foreign Investment in Real Property Tax Act (FIRPTA) on dispositions of U.S. real property interests; and
- providing for reciprocal information reporting in connection with the Foreign Account Tax Compliance Act (FATCA), by authorizing the U.S. Treasury to issue regulations requiring U.S. financial institutions to report information with respect to accountholders who are nonresident aliens, non-U.S. entities or U.S. entities substantially owned by non-U.S. persons.

Many of the above proposals have appeared in previous years' budget proposals, though this year the administration advances them in the context of seeking revenue-neutral business tax reform. Still, a number of commentators worry that some of these proposals would exacerbate the complexity of the U.S. corporate and international tax regimes.

For more information, contact Edward Tanenbaum at (212) 210-9425 or Heather Ripley at (212) 210-9549.

If you would like to receive future *International Tax Advisories* electronically, please forward your contact information to **tax.advisory@alston.com**. Be sure to put "**subscribe**" in the subject line.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Tim L. Fallaw
404.881.7836
tim.fallaw@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Matthew P. Moseley
202.239.3828
matthew.moseley@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Jennifer H. Weiss
404.881.7453
jennifer.weiss@alston.com

ALSTON & BIRD LLP

WWW.ALSTON.COM

ATLANTA: One Atlantic Center ▪ 1201 West Peachtree Street ▪ Atlanta, Georgia, USA, 30309-3424 ▪ 404.881.7000 ▪ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ▪ Place du Champ de Mars ▪ B-1050 Brussels, BE ▪ +32 2 550 3700 ▪ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ▪ 101 South Tryon Street ▪ Suite 4000 ▪ Charlotte, North Carolina, USA, 28280-4000 ▪ 704.444.1000 ▪ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ▪ 18th Floor ▪ Dallas, Texas, USA, 75201 ▪ 214.922.3400 ▪ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ▪ 16th Floor ▪ Los Angeles, California, USA, 90071-3004 ▪ 213.576.1000 ▪ Fax: 213-576-1100
NEW YORK: 90 Park Avenue ▪ 12th Floor ▪ New York, New York, USA, 10016-1387 ▪ 212.210.9400 ▪ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ▪ Suite 400 ▪ Durham, North Carolina, USA, 27703-85802 ▪ 919.862.2200 ▪ Fax: 919.862.2260
SILICON VALLEY: 275 Middlefield Road ▪ Suite 150 ▪ Menlo Park, California, USA, 94025-4004 ▪ 650-838-2000 ▪ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ▪ 950 F Street, NW ▪ Washington, DC, USA, 20004-1404 ▪ 202.756.3300 ▪ Fax: 202.756.3333
VENTURA COUNTY: 2801 Townsgate Road ▪ Suite 215 ▪ Westlake Village, California, USA, 91361 ▪ 805.497.9474 ▪ Fax: 805.497.8804