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International Tax ADVISORY ■

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Distribution of Foreign Company Stock in Outbound Reorganization Was Indirect Disposition of Intangible Property Subject to Section 367(d) Disposition Rule

In Chief Counsel Advice (CCA) 201321018, the IRS concluded that a U.S. target corporation's Section 361(c) distribution of stock of a foreign corporation pursuant to a reorganization constituted an indirect disposition of intangible property, requiring the target to recognize income under the "Disposition Rule" of Section 367(d).

Facts

A publicly traded U.S. company ("Parent") indirectly acquired the stock of the taxpayer ("Target"), also a U.S. company. Target was owned partly by a domestic subsidiary of Parent and partly by a foreign subsidiary of Parent. Target underwent an outbound reorganization under Section 368(a)(1)(F) (an "F reorganization"), after which it ceased to be a domestic corporation and converted to a foreign corporation ("Foreign NewCo"). Target was deemed to transfer its assets, including intangible property described in Section 936(h)(3)(B), to Foreign NewCo as part of the reorganization.

Target did not report any income under Section 367(d) as a result of the deemed transfer. Rather, Parent reported deemed royalty income with respect to the transfer on its return, on its accountants' advice. The IRS first posited that Parent had underreported its deemed royalty income from Foreign NewCo. Parent protested that its reported royalty reflected an arm's length charge and, alternatively, that neither Parent nor Target (nor anyone) was required to recognize Section 367(d) income because Target ceased to exist in connection with the transfer. However, the IRS also asserted that Target had to recognize gain on the intangible property under Section 367(d)(2)(A)(ii)(II) (the Disposition Rule).

CCA Analysis

Essentially, Parent seemed to believe that, despite the fact that a deemed outbound transfer of intangible property by Target occurred followed by Target's distribution of the foreign transferee's stock, income recognition under Section 367(d) could be avoided. The CCA squarely rejected this position as a contravention of the statute's intent.

Per the Section 367(a) regulations, the IRS considered Target's outbound F reorganization to involve the following transactions: (i) Target transfers its assets, including intangible property, to Foreign NewCo under Section 361(a) in exchange for stock of Foreign NewCo and Foreign NewCo's assumption of Target's liabilities and (ii) Target distributes to its shareholders the stock of Foreign NewCo pursuant to Section 361(c). The CCA reasoned that Target's deemed Section 361(a) transfer was subject to Section 367(d), meaning Target would generally be treated as receiving amounts that reflect annual payments that would be received over the intangible's useful life (the General Rule in Section 367(d)(2)(A)(ii)(I)). Nevertheless, the advice concluded that Target's Section 361(c) distribution of Foreign NewCo stock constituted an indirect disposition of the intangible property, thus "unambiguously" subjecting Target to the Distribution Rule under the Code (particularly in light of the legislative history). Under the Distribution Rule, Target is treated as receiving, at the time of the distribution, the amount that would have been received upon a disposition of the intangible—i.e., an amount based on the intangible's value.

The CCA next discussed regulatory provisions that could potentially modify application of the Disposition Rule to Target. Under Section 1.367(d)-1T(e)(1) of the regulations, when a U.S. transferor's subsequent transfer of stock of the transferee foreign corporation is to a related U.S. person, the related U.S. person is treated as receiving a proportionate share of income under the General Rule—amounts that correspondingly reduce the U.S. transferor's income under the Disposition Rule. In holding that the regulation applied to Target's distribution to its U.S. shareholder, the IRS rationalized that the regulation ensures recognition of "full compensation" for the intangible—by related U.S. persons under the General Rule or by the U.S. transferor under the Disposition Rule.

In contrast, the IRS did not apply Section 1.367(d)-1T(e)(3), which covers a U.S. transferor's subsequent stock transfer to a related foreign person and requires the U.S. transferor to recognize income under the General Rule as if the subsequent stock transfer did not occur. (In other words, the Disposition Rule would drop out entirely.) The CCA concluded that this regulatory "exception" to the Disposition Rule did not apply to Target's distribution to its foreign shareholder because Target went out of existence and thus could not recognize amounts under the General Rule. Parent contested that the exception should apply, but that no amount had to be reported at all under Section 367(d). The IRS rejected this argument as contrary to congressional intent, interpreting the regulation to require a U.S. transferor to continue to recognize amounts under the General Rule (under the regulation) or else remain subject to the Disposition Rule (under the Code).

Conclusion

In summary, the CCA determined that (i) Target's Section 361(c) distribution of Foreign NewCo stock was an indirect disposition of an intangible; (ii) Target was subject to the statutory Disposition Rule on the indirect disposition, except to the extent that its domestic shareholder must include a share of amounts under the General Rule (pursuant to the Section 1.367(d)-1T(e)(1) of the regulations). Although the IRS agreed with Parent's assertion that the current regulations fail to address Target's distribution of Foreign NewCo stock to its foreign shareholder, the IRS concluded that the Code itself supplied the applicable rule (the Disposition Rule) to such distribution. According to the CCA, regulations may modify or fill a gap in the statute, but a lack of regulatory guidance does not imply statutory ambiguity, especially where the statute applies "except to the extent provided in regulations."

The IRS also denied any reliance on Notice 2012-39, which was issued subsequent to the notices of proposed adjustment to Parent and Target and effective long after the dates of the transactions addressed in the CCA. Nevertheless, the forthcoming regulations under Section 367(d), as previewed in the Notice, would seem to adequately address Target's facts (particularly Target's going out of existence).

U.S. Government Now Looking to Foreign Banks' U.S. Correspondent Accounts to Combat Tax Evasion

The United States continues its vigorous efforts to gather data on U.S. taxpayers' concealment of assets overseas. The IRS and Department of Justice (DOJ) are now looking to U.S. correspondent accounts of foreign banks as sources of this information. The correspondent account essentially allows the IRS to access certain records related to offshore accounts, even though the foreign bank has no U.S. branch or presence. For example, a federal court recently granted the IRS' John Doe summons for offshore account data to be served on a U.S. bank where a foreign financial institution has a correspondent account.

Significantly, the IRS is using information gathered from taxpayers in the Offshore Voluntary Disclosure Program as support for the recent summonses. While taxpayers who cooperate through the program are generally safe from criminal prosecution, other noncompliant U.S. accountholders at disclosed banks are unlikely to be so fortunate. The DOJ is also committed to sending a message that foreign banks are subject to U.S. law. Indictments of overseas advisers "conspiring" with U.S. taxpayers to evade tax are intended to deter evasion, even though these advisers may not be formally arrested. Moreover, the U.S. government has at times taken control of U.S. correspondent accounts on the theory that the accounts "facilitate" tax evasion.

As more taxpayers seek refuge in the Offshore Voluntary Disclosure Program, revealing more information to the IRS on offshore accounts, assets, entities and advisers, more summonses and targeted information requests can be expected. Meanwhile, increasing international information exchange and declining bank secrecy, both precipitated in large part by the U.S.'s Foreign Account Tax Compliance Act, or FATCA, are also boosting criminal enforcement.

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