Gain Recognition Agreements in Asset Reorganizations

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The past year has brought many changes to the A reorganization rules. [*See* Morris, *Cross-Border Merger Rules*, M&A TAX REPORT, Feb. 2005, at 1; Morris *"A" Reorganizations Revisited*, M&A TAX REPORT, Mar. 2006, at 3.] One of the most important of these changes is that the regulations now allow foreign mergers and consolidations to qualify for tax-free treatment as A reorganizations. [*See* T.D. 9242, Jan. 23, 2006, and T.D. 9243, IRB 2006-8, 475.] The IRS recently announced that it will update the Code Sec. 367(a) regulations to reflect the foreign mergers and consolidations changes to the A reorganization rules. In particular, the updates will concern gain recognition agreements (GRAs) in certain asset reorganizations. [*See* Notice 2005-74, IRB 2005-42, 1.]

Background

Taxpayers often want to remove assets from the U.S. tax net to minimize, or even avoid, tax on the profits generated from the assets or the gain from their sale. Assets can be shifted outside the United States by taxable sale, or by other tax-deferred transfers. In cases where an asset has a significant built-in gain, a taxable sale may not be practical, leaving a tax-deferred transaction as the sole method of transfer. In many cases, a tax-deferred transfer can be a relatively simple, quick and inexpensive undertaking.

Recognizing the ease with which taxpayers could escape U.S. tax, Congress enacted Code Sec. 367. As a general rule, when Code Sec. 367(a) applies, tax-deferred transfers become immediately taxable. Technically, Code Sec. 367(a) denies nonrecognition treatment for transfers by U.S. persons to foreign corporations. Thus, if Code Sec. 367(a) applies, gain is recognized on transfers that otherwise would be tax-deferred.

Code Sec. 367(a) affects a plethora of transfers made pursuant to tax-deferred exchanges, including Code Sec. 332 liquidations, Code Sec. 351 contributions and transfers made pursuant to reorganizations under Code Sec. 354, 356 or 361. All of these types of tax-deferred transfers can become taxable if Code Sec. 367(a) applies.

The mechanism by which Code Sec. 367(a) overrides these nonrecognition provisions is not complex. Code Sec. 367(a) mandates that a foreign corporation receiving transferred property not be treated as a corporation for purposes of the applicable nonrecognition provisions. Thus, transfers subject to Code Sec. 367(a) will not satisfy the requirements of the particular corporate nonrecognition provisions. As such, the general recognition rules of Code Sec. 1001 should apply.

Yet, Code Sec. 367(a) is not just a simple provision that only overrides nonrecognition treatment. It is riddled with exceptions (as well as exceptions to exceptions). If one of Code Sec. 367(a)'s exceptions applies, a tax-deferred exchange will maintain its tax-deferred status.

One exception to Code Sec. 367(a)'s taxing mandate is for transfers of stock. A U.S. person (*i.e.*, the U.S. transferor) can transfer stock (*i.e.*, the transferred corporation) to a foreign corporation (*i.e.*, the transferee foreign corporation) and achieve tax deferral on the transfer. The transfer can be undertaken as either a contribution to a foreign subsidiary, a liquidation to a foreign parent or part of a global reorganization. Although the general rule of Code Sec. 367(a) would normally prevent nonrecognition on these transactions, the stock transfer exception makes these transfers tax-deferred, provided that certain requirements are met.

For the stock transfer exception to apply, the U.S. transferor must file a GRA. [Reg. §1.367(a)-3(b)(1)(ii) and (c)(1)(iii)(B).] Pursuant to the GRA, the U.S. transferor agrees to include in income the gain realized, but not recognized, on the transfer of the stock (plus interest) upon certain triggering events. The GRA remains in existence up to the close of the fifth full tax year following the year of the transfer. [Reg. §1.367(a)-8(b)(1)(iii) and (3)(I).] Presumably, there is no tax avoidance purpose if a taxpayer waits five tax years before re-transferring the stock of the transferred corporation. Notably, only U.S. transferors owning at least five percent of the foreign corporation can enter into a GRA.

There are many types of triggering events. Generally speaking, a disposition of the transferred corporation's stock is a triggering event. Moreover, a disposition of substantially all of the assets of the transferred corporation is generally treated as a deemed disposition of its stock, and thus is also a triggering event. Furthermore, a disposition of stock of the transferee foreign corporation (which owns the transferred corporation) can also be a triggering event.

Notwithstanding these general rules regarding what may be a triggering event, certain nonrecognition transactions may not be considered a triggering event. For example, the disposition by the U.S. transferor of any stock in the transferee foreign corporation in a nonrecognition transaction may not be a triggering event if the U.S. transferor complies with certain GRA reporting requirements.

In addition, a taxpayer may be able to enter into a GRA in connection with an asset reorganization in which the U.S. transferor goes out of existence. Yet, the interaction of the GRA rules to asset reorganizations is complex, and prior to the issuance of Notice 2005-74, it was not clear precisely how the exceptions applied.

Notice 2005-74 has brought new hope to this convoluted area. The IRS has determined that certain nonrecognition transactions are *not* triggering events when a GRA has been terminated. For example, a Code Sec. 355 distribution or a Code Sec. 332 liquidation can terminate a GRA, provided that immediately after the transaction the basis in the transferred stock is not greater than the U.S. transferor's basis in the stock that immediately prior to the initial transfer which necessitated the GRA. We'll come back to this point later.

Transfer of Transferee Foreign Corporation's Stock

Notice 2005-74 provides that if a taxpayer enters into a GRA, as a general rule, it is not allowed to transfer any stock of the transferee foreign corporation. If the original U.S. transferor transfers any portion of the transferee foreign corporation to an acquiring corporation ("successor U.S. transferor") pursuant to an asset reorganization, the exchange will trigger the GRA. Under Notice 2005-74, a taxpayer can avoid triggering the GRA if it satisfies all of the following conditions:

1. The U.S. transferor was a member of a consolidated group in the year in which the GRA was originally entered into ("original consolidated group"), and the common parent of the group ("U.S. parent corporation") entered into the original GRA.
2. Immediately after the asset reorganization, the successor U.S. transferor is a member of the original consolidated group.
3. The U.S. parent corporation of the original consolidated group enters into a new GRA that has the same terms as the original GRA, modified by substituting the successor U.S. transferor in place of the original U.S. transferor.
4. The successor U.S. transferor includes the new GRA with its next tax return.

Example. USP, a domestic corporation, is the common parent of a consolidated group. USP owns 100 percent of the stock of two domestic corporations that are members of the USP group, S1 and S2. S1 owns 100 percent of two foreign corporations, FC1 and FC2. In Year 1, S1 contributes FC1 to FC2 in a Code Sec. 351 contribution, and USP enters into a GRA with respect to that transfer. In Year 4, in a D reorganization, S1 transfers all of its assets, including the stock of FC2, to S2 in exchange for S2 stock. S1 transfers the S2 stock to USP in exchange for the S1 stock held by USP, and the S1 stock is canceled. Immediately after the reorganization, USP and S2 are members of the consolidated group of which S1 was a member, and USP was the common parent which entered into the original GRA in year 1.

The transfer of the FC2 stock will not trigger the GRA that USP entered into in year 1 with regard to S1's contribution of FC1 to FC2 if USP enters into a new GRA. In this new GRA, USP must agree to recognize gain with respect to the transfer subject to the original GRA, and it must agree that S2 will comply with the reporting requirements set forth in Notice 2005-74. The new GRA applies through the close of Year 6 (the remaining term of the original GRA filed by USP).

Re-Transfers of Transferred Corporation

As a general rule, during the period a GRA is in effect, if the original transferee foreign corporation transfers any stock of the transferred corporation to another foreign corporation ("successor transferee foreign corporation") in an asset reorganization, the exchange will trigger the GRA. Under Notice 2005-74, the GRA will not be triggered if both of the following conditions are satisfied:

1. The U.S. transferor (or the U.S. parent corporation) enters into a new GRA pursuant to which it agrees to recognize gain during the remaining term of the original GRA with respect to the transfer subject to the original GRA, substituting the successor transferee foreign corporation in place of the original transferee foreign corporation.
2. The successor U.S. transferor includes the new GRA with its next tax return.

Example. USP, a domestic corporation, owns 100 percent of the stock of three foreign corporations, FC1, FC2 and FC3. In Year 1, USP transfers FC1 to FC2 in a Code Sec. 351 contribution, and enters into a GRA with respect to such transfer. In Year 4, in a D reorganization, FC2 transfers all of its assets, including the stock of FC1, to FC3 in exchange for FC3 stock. FC2 transfers the FC3 stock to USP in exchange for FC2 stock held by USP and the FC2 stock is canceled.

The transfer of the FC1 stock to FC3 in exchange for FC3 stock and the exchange of the FC3 stock for FC2 stock will not trigger the GRA. However, USP must enter into a new GRA pursuant to which it agrees to recognize gain with respect to the original GRA, substituting FC3 as the original transferee foreign corporation. The new GRA applies through the close of year 6 (the remaining term of the original GRA filed by USP). Notably, this transaction could be much more complicated than this simple example portrays, since the reorganization may also be subject to rules of Code Sec. 367(b).

Other Transactions

Notice 2005-74 discusses a few other grey areas. For example, taxpayers may attempt to avoid the GRA transfer limitations by transferring the assets of the transferred corporation, and leaving its stock (which is subject to the GRA) in place.

Another type of transaction analyzed by Notice 2005-74 is a distribution by the transferee foreign corporation to the U.S. transferor of the transferred corporation's stock in a Code Sec. 355 distribution or a Code Sec. 332 liquidating distribution. Notice 2005-74 provides details of the issues created by these (and other) transactions and copious examples to understand how such transactions can not run afoul of a GRA.

Final Thoughts

The IRS expects to issue regulations incorporating the guidance found in Notice 2005-74. Until then, taxpayers can rely on Notice 2005-74, and it can also apply to GRAs with respect to transfers occurring on or after July 20, 1998, provided the tax year is still open.

The IRS acknowledges that Notice 2005-74 won't solve all of the open issues surrounding GRAs and asset reorganizations. In fact, it openly admits that there could be other types of asset reorganizations that should not trigger a GRA. It has solicited practitioners' comments whether certain upstream and downstream reorganizations (including those in which the same corporation becomes both the transferee foreign corporation and transferred corporation) as well as whether divisive D and G reorganizations should trigger a GRA. Other areas under consideration are triangular reorganizations and transfers of the transferred corporation back to the U.S. transferor (or other U.S. person). Thus, it is fair to say that we can expect much more from the IRS on this topic in the coming years.

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