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Common Sense and Section 367

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In today's increasingly global economy, many U.S. companies are expanding their foreign presence. They may do so by greenfield investment or through the acquisition of competitors with substantial foreign operations. Greenfield investment generally involves a parent company starting a new venture abroad, often in a developing country. The parent typically constructs new facilities and generates new jobs. In exchange, the parent may be offered tax breaks and other incentives.

However it is orchestrated, expansion and acquisition can provide exciting times for a growing company. It can even be exciting for tax planners. With careful planning in the early stages of an expansion or acquisition, companies can effectively set the table for a low global effective tax rate with minimal cash tax leakage.

On the other side of the coin, with opportunities come risks. And tax risks in this context abound. Without careful planning, companies may box themselves in, setting tax traps that can later be sprung in ways that can seem quite punitive. One such provision in the context of international tax planning is Code Sec. 367, which governs transfers of property involving foreign corporations.

Two-Way Street

Code Sec. 367 operates to override certain tax-free reorganization provisions in the Code, including the tried-and-true Code Sec. 368 reorganization rules. Even Code Sec. 332 liquidations of subsidiaries can become taxable by virtue of Code Sec. 367. In the context of U.S. companies' expanded focus on global markets, Code Sec. 367 most commonly applies to the outbound transfer of assets.

The provision can apply where a U.S. parent company hands off stock of a foreign corporation to another foreign corporation.

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Nevertheless, Code Sec. 367 can also apply to the transfer of assets by a foreign corporation to a U.S. parent company. Such a transaction might commonly occur as U.S. and foreign operations are aligned after an acquisition, merger or consolidation.

These rules can provide some traps for the unwary. Actually, these rules are delicate enough that they can even provide traps for the wary. The IRS has issued proposed regulations that would provide some common-sense clarification to the current finalized Code Sec. 367 regulations. However, these remain in proposed form.

That by itself might not be too upsetting. Yet a recent Private Letter Ruling has raised questions about the IRS's intentions in this increasingly important minefield. This has only added confusion regarding how to properly report transactions in a manner consistent with the proposed regulations.

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Logic and Taxing the Last Clear Chance

As noted above, Code Sec. 367 overrides tax-free reorganization treatment in certain transactions involving U.S. and foreign corporations. That sounds simple. You cannot count on tax-free treatment if foreign companies and transfers are involved. The rationale behind Code Sec. 367 is that the United States should not afford tax-free treatment to transactions where assets are leaving the U.S. tax base. After all, they will not be subject to tax in subsequent transactions.

With all the talk of inversion transactions over the last year, it should be remembered that Code Sec. 367 has been with us for a long time. And in essence, Code Sec. 367 works to tax transactions that represent the "last clear chance" to impose U.S. taxation. The logic of the "last-clear-chance" rule is easiest to understand if one considers the tax-free reorganization rules in the first place.

Remember, Code Sec. 367 overrides tax-deferral provisions, not tax breaks that are permanent. Put another way, in enacting the tax-free reorganization provisions, Congress determined that some situations do not represent an appropriate time to impose tax. Eventually, though, tax will apply.

Indeed, through the various carryover basis provisions applicable to tax-free reorganizations, the government effectively preserves its ability to tax any built-in gain in a subsequent transaction involving the same asset(s). It is taxed later, just not now. And when we come to assets going outside the United States, when can we tax them if they are gone?

If a potentially tax-free transaction involves the transfer of assets from a U.S. corporation to a foreign corporation, deferral is not appropriate. After all, the subsequent disposition of the transferred assets by the foreign corporation would generally not be subject to U.S. tax. The need to tax it before it's too late also recalls the U.S. exit tax that individuals can face when giving up U.S. citizenship or long-term permanent residency.

Despite the last-clear-chance principles underlying Code Sec. 367, careful tax planning can often beat it. Sometimes, U.S. multi-nationals can move assets from the United States to foreign jurisdictions without incurring significant U.S. taxation. For example, one exception allows U.S. companies to transfer active trade or business assets to certain foreign corporations without triggering the application of Code Sec. 367.

Another exception allows U.S. taxpayers to transfer the stock of foreign corporations to certain other foreign corporations. The price tag in many such cases will be the U.S. taxpayer agreeing to recognize gain on the stock if certain triggering events occur within a five-year period after the transfer of the stock (*i.e.*, a gain recognition agreement).

Inbound Transfers

Code Sec. 367 can override tax-free treatment on certain transfers of foreign assets by controlled foreign corporations ("CFCs") to the United States. The current final regulations issued under Code Sec. 367 provide that where assets of a CFC are repatriated to the United States in a tax-free transaction, the U.S. owners of the CFC must include in income as a deemed dividend the "all E&P" amount attributable to their stock of the CFC.

For example, assume that U.S. Parent has owned all the stock of a CFC since its incorporation. If U.S. Parent liquidates the CFC, U.S. Parent is deemed to receive a dividend from the CFC equal to the CFC's earnings and profits (E&P) pursuant to Reg. §1.367(b)-3(b)(3). This is so notwithstanding the fact that the transaction otherwise qualifies as a tax-free liquidation pursuant to Code Sec. 332.

The policy behind this rule is relatively simple. E&P of U.S. corporations represents earnings that have *already* been subject to U.S. corporate level tax. On the other hand, U.S. tax on earnings of foreign corporations is generally deferred until such amounts are repatriated to the United States.

In the case of a CFC's liquidation into its U.S. Parent, all of the assets (including the CFC's E&P) are transferred to U.S. Parent. Since E&P of a domestic corporation has already been subject to U.S. corporate level tax, the liquidation of CFC into U.S. Parent effectively represents the last clear chance to impose U.S. tax on the CFC's E&P.

Proposed Regulations Under Code Sec. 367(b)

In cases where less than all of the foreign corporation's assets are repatriated to the United States, what is the proper amount of E&P to include? Current Reg. §1.367(b)-3 provides only that in the case of an exchange of foreign corporation stock held by U.S. shareholders in a transaction described in Code Secs. 332 or 368(a)(1) (*e.g.*, a "D" reorganization), the U.S. shareholders must include in income the all E&P amount with respect to the stock of the foreign acquired corporation.

Proposed regulations issued in November 2000 attempt to clarify this rule in the context of a partial repatriation of a foreign corporation's assets. For example, where a foreign corporation spins off a domestic corporation to its domestic parent in a transaction qualifying as a D reorganization and a Code Sec. 355 spin-off, Proposed Reg. §1.367(b)-8(d) provides a special rule. The E&P inclusion is limited to the amount of the foreign corporation's E&P that is allocated to the controlled domestic corporation under the rules of Reg. §1.312-10(a).

Reg. § 1.312-10(a) provides that in the case of a D reorganization followed by a distribution of stock to which Code Sec. 355 applies, the E&P of the distributing corporation should be allocated in part to the controlled corporation (*i.e.*, the corporation that is distributed). Where the controlled corporation is a new company, the apportionment of E&P is generally done on the basis of the fair market value of the business(es) transferred to the new company.

The principle behind this rule makes sense. The main goal of the inclusion of the all E&P amount is to prevent the repatriation of foreign earnings to the United States in a tax-free manner. In other words, the United States should tax the E&P if the transaction in question represents the last clear chance to impose U.S. tax on the earnings.

Importantly, Proposed Reg. §1.367(b)-8(d) taxes only the E&P that is attributed to the domestic corporation that is being spun off—*i.e.*, the E&P that will not be subject to U.S. tax if it is not taxed at the time of the spin-off transaction. A rule that would tax all of the E&P of the distributing foreign corporation is not consistent with this "last-clear-chance" principle since E&P allocated to the foreign corporation by virtue of its retained assets should be subject to tax when such earnings are repatriated to the United States.

Other Code Sec. 367 Considerations

Code Sec. 367 can require income to be included or basis to be reduced in the stock of the distributing corporation and/or the controlled corporation. Specifically, Reg. §1.367(b)-5 requires a comparison of the Code Sec. 1248 amount that would be recognized on the sale of the distributing corporation or the controlled corporation immediately before the transaction, with the Code Sec. 1248 amount that would be recognized on the sale of such stock immediately after the transaction.

In the event that the post-transaction amount is less than the pre-transaction amount with respect to either the distributing or controlled corporation, the basis of the stock of corporation must be reduced by the difference. Finally, if the difference in the Code Sec. 1248 amounts would result in a basis reduction below zero, income must be recognized in this amount.

Letter Ruling 201441016

The IRS recently issued a private letter ruling addressing the U.S. federal income tax treatment of divisive D reorganization involving a CFC and its U.S. parent. The facts of LTR 201441016 involved a wholly owned CFC that was operating various U.S. businesses through disregarded entities. In order to improve the overall efficiency of the business, it was determined that the U.S. businesses currently owned by the CFC should be owned directly by U.S. Parent.

To effectuate this transaction, CFC formed U.S. NewCo, a corporation for U.S. federal income tax purposes. CFC then contributed the various U.S. disregarded entities that it owned to U.S. NewCo. Next, as part of the overall plan, CFC distributed the stock of U.S. NewCo to U.S. Parent in a transaction that was intended to satisfy the requirements of Code Sec. 355.

The IRS ruled that the transaction should be treated as a D reorganization. Moreover, the IRS ruled that no gain or loss should be recognized by CFC or U.S. Parent on the contribution of assets to U.S. NewCo, or on the distribution of U.S. NewCo to U.S. Parent. The ruling further concluded that U.S. Parent's basis in the stock of U.S. NewCo and CFC should equal the pre-transaction basis that U.S. Parent had in CFC, allocated based on the fair market value of the stock of CFC and U.S. NewCo.

Also, the ruling concluded that the E&P of CFC should be allocated between CFC and U.S. NewCo in accordance with Reg. §1.312-10(a). The ruling next concluded that U.S. Parent should recognize as a deemed dividend the all E&P amount with respect to the stock of CFC pursuant to Reg. §1.367(b)-3(b)(3). Importantly, the ruling makes no reference to the 2000 proposed regulations.

Even more puzzlingly, the ruling does not contain any guidance on when the all E&P amount with respect to the stock of CFC should be determined for purposes of the inclusion. Practically speaking, it would seem that the all E&P inclusion should be limited to the E&P allocated to U.S. NewCo, as provided in the proposed regulations. Taxation of this E&P is appropriate one must say, since it effectively becomes E&P of a U.S. corporation in the transaction.

After all, it has presumptively been subject to U.S. tax. In contrast, the remaining E&P of CFC will presumably be subject to U.S. tax when such E&P is repatriated to the United States in the form of dividends. Surely that means that current taxation of CFC's remaining E&P would appear to be premature.

Ultimately, LTR 201441016 appears to provide more questions than answers regarding the current IRS thinking around the application of Reg. §1.367(b)-3 in partial asset repatriations. In the absence of the clear guidance found in the proposed regulations, taxpayers are left to wonder. Is the IRS applying a mechanical reading of Reg. §1.367(b)-3 and requiring the inclusion of the entire amount of a distributing CFC's all E&P amount? Is the IRS doing so even when only a small portion of the CFC's assets are repatriated to the United States?

Uneasy Progress

Without careful planning, Code Sec. 367 can operate with a heavy hand. It can turn many tax-free transactions into transactions with potentially expensive cash tax exposure. Although various exceptions to Code Sec. 367 facilitate the outbound transfer of assets from the United States to a foreign jurisdiction, fewer exceptions apply to the inbound transfer of assets from a CFC to a U.S. parent company.

To make matters worse, the proposed regulations that would provide common-sense clarification to the current Code Sec. 367 regulations remain in proposed form. Indeed, they have remained as such for almost 15 years! Many practitioners have assumed that transactions could safely be reported in a manner consistent with the proposed regulations.

Maybe, but LTR 201441016 calls this conventional wisdom into question. In order to avoid any confusion created by LTR 201441016, the IRS should clarify its position on the proper amount of the all E&P inclusion in certain partial asset repatriations falling within the scope of Reg. §1.367(b)-3.