Chapter 17 IRC §367 Transfers of Property to Foreign Corporations

Contents:

17.1 Introduction

Contents:

a. In General

The materials provided in this chapter are intended to provide a general overview of the rules related to Internal Revenue Code (IRC) §367. These materials are intended to provide a starting point for a California examination of issues related to IRC §367, and are not intended as a reference. The rules related to IRC §367 are quite complex, and there may be details and transition rules that are important to consider which are not provided here. You should consult secondary research materials, and the applicable code and regulations, before an adjustment is made pursuant to IRC §367.

Subchapter C of the IRC contains provisions setting forth rules controlling the tax effect of the movement of assets into, out of, and within the corporate structure. These provisions cover rules for incorporations, contributions to capital, distributions, liquidations, and combinations and divisions of corporations.

In general, assets may move into and within corporations without recognition of gain. The movement of assets includes contributions of assets to corporations by their controlling shareholders, most distributions between affiliated corporations (including liquidations,) and mergers and separations. These transactions can be carried out either partly or entirely free of tax at the time they occur. In addition, in most nonrecognition transactions, many of the tax attributes, such as earnings and profits (E&P) and certain losses, remain unchanged and carry over from one corporation to another. Assets retain their basis and character; shareholders retain the basis of their stock.

The federal nonrecognition rules are set up to ensure that any gain is eventually taxed at a future date. For example, the fact that E&P survives nonrecognition transactions ensures taxation of future distributions as dividends. The preservation of unrealized appreciation occurs because the basis of assets is retained. The nonrecognition rules basically ignore the movement of assets between different corporate forms.

However, IRC §367 affects the nonrecognition rules in the area of international corporate transactions. IRC §367 applies to the nonrecognition provisions in many instances where a foreign corporation is involved, sometimes preventing nonrecognition and other times imposing special requirements for nonrecognition.

b. Nonrecognition Provisions on Transfers to a Foreign Entity without IRC §367

Subchapter C of the IRC, specifically IRC §§332, 351, 354, 355, 356 and 361, provides for the nonrecognition of gain by a transferor of assets or stock in connection with certain exchanges involving corporate formations, contributions to capital, distributions, reorganizations or liquidations. As a general rule, the Subchapter C nonrecognition provisions require corporate status of the parties to the exchange to qualify for nonrecognition treatment of the gain. However, when such normal recognition transactions result in transfer of property to a foreign corporation, IRC §367 imposes restrictions on the tax free transfer of certain types of property by override of the normal nonrecognition rules. Absent IRC §367 and other anti-tax avoidance provisions of the Code, appreciated property of United States (US) persons could easily be transferred offshore to foreign corporations beyond the reach of the US taxing jurisdiction by utilizing one of these nonrecognition provisions in the Code.

For example, assume a US parent corporation owns a high value, low basis intangible asset, such as a patent, and would like to sell the asset to a third party. If it does so, the gain would be subject to US tax. Assume, instead, the US parent transfers the intangible asset to an 80% owned foreign subsidiary in exchange for stock, in a transaction that qualifies for IRC §351 treatment. In the absence of IRC §367, the transaction would be a nonrecognition event, and the basis in the patent would be transferred to the US parent corporation's basis in the stock of the foreign corporation. Assume that the foreign corporation then sold the patent to the third party purchaser.

In this example, the foreign corporation would realize income on the sale. However, if the sale of the patent does not produce US source income, the income would not be subject to US taxation, as the US cannot tax foreign entities on foreign source income. Thus, the US parent can indirectly enjoy the benefits and liquidity of the sale by virtue of the control of its foreign subsidiary, but not have a current obligation to pay US tax. The inherent gain in the patent would now be reflected in a higher value for its foreign subsidiary, and the relatively smaller increase in tax basis in the foreign subsidiary stock resulting from the IRC §351 exchange. While that gain might ultimately be taxed if the foreign subsidiary were ever sold, the US parent could control the timing of that event, resulting in the potential for an unlimited, sometimes called "permanent" deferral of gain.

c. Nonrecognition Provisions and the Interaction of IRC §367

IRC §367 was enacted to substantially limit the availability of nonrecognition treatment for gains resulting from transfers of appreciated property between US persons and foreign corporations. It was designed to discourage taxpayers from relying on nonrecognition provisions to effectively transport income subject to the US tax base to the tax base of a foreign entity that is not subject to tax.

IRC §367(a)(1) provides the general rule that, if a US person transfers property to a foreign corporation in any exchange described by IRC §§332, 351, 354, 356 or 361, the foreign corporation will not be considered a corporation for purposes of determining the extent to which gain is recognized as a result of the transfer. Because these nonrecognition code provisions require corporate status for the exchange to receive nonrecognition treatment, any gain realized will be recognized under IRC §367(a), unless the transfer falls within an exception contained within IRC §367.

Referring to the example above, the transfer to the controlled foreign corporation (CFC) would not qualify under IRC §351 because the foreign corporation would not be considered a "corporation." Thus, the transfer to the foreign subsidiary, followed by a sale by the foreign subsidiary to a third party purchaser, would produce immediate taxable income to the parent corporation as a taxable exchange (i.e., the patent transferred at fair market value (FMV) in exchange for subsidiary stock.) Special rules apply if the CFC utilizes the patent in its own business, rather than selling it to a third party. (See the discussion in WEM 17.5, Intangible Property Transfers.)

The scope of IRC §367 is intended to be very broad. With certain exceptions, it applies to virtually any direct, indirect or constructive transfer between a US person and a foreign corporation. In some instances, even transfers that appear not to involve such transfers or exchanges may fall within the scope of IRC §367. IRC §367 generally requires either current gain recognition, or requires the parties to the transaction to enter into a Gain Recognition Agreement (GRA) to avoid current recognition of the gain in question.

d. The Impact of IRC §367 to California

Prior to 1983, California did not conform to IRC §367. Hence, problems related to the deferral of foreign income were not addressed for California income or franchise tax purposes. In a worldwide combined reporting environment, the federal problem did not exist. All income of a unitary business group, including the income of unitary foreign affiliates, was includible in the combined report for purposes of calculating income attributable to California. Thus, if a foreign unitary entity sold an asset that had been previously transferred under an IRC §351 transaction, the gain was recognized as worldwide combined report business income when the subsidiary corporation sold the asset to a third party. Thus, the taxpayer could not obtain the benefits of permanent deferral of income. However before 1983, foreign entities that were not unitary and were not California taxpayers enjoyed the benefits of nonrecognition treatment and were permitted to permanently defer taxation on foreign-source income for California purposes, or to defer taxation until such income was repatriated to the US in a taxable transaction.

After 1983, California conformed to IRC §367 in Revenue and Taxation Code (R&TC) §24561. Thus, gains realized from certain tax-free transfers between unitary US affiliates and nonunitary foreign affiliates could be recognized in certain instances as a result of R&TC §24561.

However, intercompany gains between unitary affiliates, triggered as a result of R&TC §24561, could be deferred or eliminated until the property was transferred to an unaffiliated third-party or converted to nonbusiness use, in the same manner as any other intercompany sales transaction. However, if the foreign corporation was not unitary with its US parent, transfers of appreciated property to the foreign corporation in nonrecognition events could result in income recognition under R&TC §24561.

With the enactment of the water's-edge statutes, the ramifications of R&TC §24561 on certain tax-free transactions extended to transfers between US affiliates and unitary foreign affiliates, excluded from the water's-edge combined report. Because sales between water's-edge members and the excluded members of the unitary group are not intercompany transactions that can be deferred or eliminated, these transfers can result in taxable income under R&TC §24561.

In 1991, R&TC §24561 was repealed and SB 169 added Chapter 8 (commencing with R&TC §24451) to Part II of Division 2 of the Revenue and Taxation Code. R&TC §24451 was repealed and reenacted to generally incorporate "except as otherwise provided," the provisions of the IRC §§301-385, which relate to corporate distributions and adjustments. After 1991, California conformed to IRC §367 in R&TC §24451.

The impact of IRC §367 to California after the reenactment of R&TC §24451 is the same as before. Gains realized from certain tax-free transfers between unitary US affiliates and nonunitary foreign affiliates could be recognized in certain instances. Intercompany gains between unitary affiliates, triggered as a result of R&TC §24451, could be deferred or eliminated until the property is transferred to an unaffiliated third-party or converted to nonbusiness use, in the same manner as any other intercompany sales transaction. However, if the foreign corporation is not unitary with its US parent or is excluded from the water's-edge combined report, transfers of appreciated property to the foreign corporation in nonrecognition events could result in income recognition under R&TC §24451.

17.2 IRC §367 and the California Combined Report

Contents:

a. IRC §367's Interaction with Intercompany Transaction Rules

1. In General

As a general rule, California conforms to federal law with respect to the taxation of inbound and outbound transfers of property between domestic and foreign affiliates under IRC §367. (R&TC §24551.) However, there may be differences, due to either California not conforming to the IRC in its entirety, or due to timing differences in California's conformity to the IRC. For any given tax year, check for any of these differences before proceeding with an examination.

Even if a transaction is described by IRC §367, and would result in taxable income for US tax purposes, if the transaction is between members of a combined reporting group, then the income recognized under California's conformity to IRC §367 may nevertheless be deferred for California purposes as an intercompany transaction.

2. Different Taxing Jurisdictions

California and federal methods to tax differ within their jurisdictions. For federal purposes:

- US incorporated entities are generally taxed on all their income, regardless of whether the source is within or without the US.
- Foreign incorporated entities are generally subject to tax only on their US source income.

For California purposes, only income from sources within California can be taxed. Income is sourced to California pursuant to the apportionment and allocation rules of Chapter 17 of the Corporation Tax Law. In addition, California taxpayers can choose to file on a worldwide or water's-edge basis. This substantial difference in taxing jurisdictions, coupled with substantial differences between federal and state sourcing rules, can significantly alter the tax implications of an IRC §367 transaction for California purposes.

In addition, despite similarities between a combined report and a federal consolidated return, differences still remain. The members of the combined report and those of the federal consolidated return may differ. Pursuant to R&TC §25106.5, in general, California adopted the federal treatment of intercompany transactions for federal consolidated return purposes under Treasury Regulations (Treas. Reg.) §1.1502-13. Conformity to the federal consolidated return regulations became effective for intercompany transactions after January 1, 2001. With respect to E&P and stock basis, California has no provisions similar to the investment adjustments allowed for federal purposes under Treas. Reg. §§1.1502-32 and 1.1502-33. The E&P of each entity in the combined report is calculated on a separate accounting basis, and does not include the E&P of any lower tier subsidiaries. (*Appeal of Young's Market Company*, 86-SBE-198, November 19, 1986.) Likewise, the cost basis of a unitary subsidiary's stock is not adjusted to reflect the E&P of that subsidiary. (*Appeal of Safeway Stores*, *Inc.*, 62-SBE-014, March 2, 1962; *Appeal of Rapid-American Corp.,* 94A-0284; 96-SBE-019, October 10, 1996.)

3. Factors Affecting California Tax Treatment of IRC §367

For California purposes, the tax implications of an intercompany transfer subject to the provisions of IRC §367 will depend upon the:

- Taxpayer's method of filing (e.g., separate entity, worldwide or water's-edge)
- Unitary or nonunitary relationship between the corporations transferring property subject to gain recognition under IRC §367
- Taxpayer's previous method of filing (e.g., separate entity, worldwide or water's-edge)
- Transfer itself

These factors, combined with the differences in the state and federal taxing jurisdictions, and the intercompany transaction rules, can result in significantly different tax consequences for California and federal purposes. Because a transaction that is subject to gain recognition treatment under IRC §367 might also constitute an intercompany transaction between members of a combined reporting group, it is important to first summarize the facts of the transaction and the rules related to such intercompany transaction.

4. Intercompany Transactions

Intercompany transactions are transactions that occur between corporations that are members of the same combined reporting group at the time the transaction occurs. The term “group” means the affiliated corporations, or portions thereof, properly included in a combined report.

California Code of Regulations (CCR) §25106.5-1(a)(1) states, “The general rule is one of deferring gains or losses from intercompany transactions in order to produce the effect of transactions between divisions of a single corporation.” Consequently, the effects of intercompany transactions are properly disregarded in the same manner that they would be disregarded within a single corporate enterprise. When members of a combined reporting group transact business with one another, the transactions have no economic effect on the group as an integrated trade or business (i.e., they do not generate economic income or losses to the unitary enterprise as a whole). Therefore, intercompany sales between members of a combined reporting group are not included in net income subject to apportionment. The effects of those sales are disregarded in the sales factor as well. (*Chase Brass and Copper Co. v. Franchise Tax Bd.* (1977) 70 Cal.App.3d 457, 473; *Appeal of Texaco, Inc.,* 78-SBE-004, January 11, 1978.)

To the extent that a corporation is excluded from the water’s-edge combined report as a result of a water’s-edge election, that corporation is not considered to be a member of the combined reporting group and is treated as a third party for combined reporting purposes. Consequently, transactions with excluded entities are neither deferred nor eliminated, and excluded entities’ income and factors are not taken into account in the allocation and apportionment of the income of the combined reporting group. A member of a combined reporting group will be deemed to have left the group in any year in which it is not properly included in a combined reporting group that includes at least itself and the corporations (or successor thereto) that were directly a party to the transaction.

5. California Treatment of Intercompany Transactions

A. Intercompany Transactions after January 1, 2001

California regulations, providing detailed rules relating to the treatment of intercompany transactions between members of a combined reporting group, became effective for transactions that occur in tax years beginning on or after January 1, 2001. (CCR §25106.5-1.) In general, the regulations adopt the treatment of intercompany transactions for federal consolidated return purposes under Treas. Reg. §1.1502-13. Under those regulations, income from intercompany transactions is generally deferred until immediately before such time that either the:

- Asset leaves the group by a sale or other disposition to a nonmember.
- Buyer and the seller no longer constitute members of the same combined reporting group, including by means of a water's-edge election.
- Purchaser converts the asset to nonbusiness use.

When income from a deferred intercompany transaction is required to be restored, it is apportioned using the apportionment percentages of the members of the group for the taxable year in which the income is restored. Special rules apply for "partially included water's-edge corporations" described by R&TC §§25110(a)(2)(A)(i) and (ii). A taxpayer may elect to report income from an intercompany transaction in the year in which the transaction occurs, if it has made a similar election under Treas. Reg. §1.1502-13(e), or in the event that the regulation does not apply, if the intercompany transaction was reported as current taxable income in the year of the intercompany sale for federal or foreign national tax purposes.

Income from an intercompany distribution between members of a combined reporting group that exceeds the payor's E&P and stock basis, described by IRC §301(c)(3), is deferred in a Deferred Intercompany Stock Account (DISA). In general, the DISA income under IRC §301(c)(3) attaches to the stock, and the gain is taken into account if there is a disposition of the stock of the DISA subsidiary. That income is restored to the extent that the holder of the stock disposes of its stock, even if the distributor remains in the holder's combined reporting group. If the distributor liquidates into the distributee, the deferred income is taken into account ratably over sixty months, unless the taxpayer elects to take such income into account in full in the year of the liquidation. The treatment of intercompany distributions described by IRC §301(c)(3) is provided by subsection (f)(1)(B) of CCR §25106.5-1.

Intercompany transactions are disregarded for purposes of the property factor. The purchaser takes the seller's original cost, prior to the intercompany transaction, so long as the seller and purchaser remain in the same combined reporting group. If the purchaser and the seller leave the same combined reporting group, resulting in a restoration of deferred income, the property factor is adjusted to reflect the purchaser's original cost. Intercompany rents are also disregarded for purposes of the property factor. (CCR 25106.5-1(a)(5)(B).)

Intercompany transactions are disregarded for purposes of the sales factor, even if income from an intercompany transaction is required to be restored as a result of the purchase and the seller leaving the same combined reporting group. If an asset that was sold in an intercompany transaction is later sold to a nonmember, the gross receipt from the sale to the nonmember is reflected in the sales factor of the intercompany purchaser. (CCR 25106.5-1(a)(5)(A).)

To the extent that intercompany dividends are paid out of E&P derived from unitary business income, they are eliminated in computing the California measure of tax. (R&TC §25106.) In determining whether a dividend is paid out of unitary E&P, distributions are deemed to be paid first out of current E&P and then out of prior years' accumulation in reverse order of accumulation. Distributions paid out of nonbusiness E&P, or distributions from E&P accumulated prior to the time the payor corporation became a member of the combined group, are not eliminated from income of the recipient corporation. Although, such dividends may be subject to deduction under R&TC §24411. See WEM Chapter 13 for a complete discussion of the foreign dividend deduction under R&TC §24411.

B. Intercompany Transactions prior to January 1, 2001

Intercompany transactions that occurred before January 1, 2001, are governed by pre-existing elimination and carry over basis practices, even if, in a later year, the asset which was the object of an intercompany transaction is later resold to a nonmember, or the seller and the purchaser discontinue their combined reporting relationship.

The prior practices of the FTB are summarized here.

i. Inventories

Income from intercompany sales of inventory is eliminated from unitary business income. The seller's basis in the inventory will carry over to the buyer in the intercompany sale. Intercompany profits in inventory are eliminated from the property factor.

ii. Intangible Assets

Gain or loss from intercompany sales of intangible assets is eliminated from unitary business income. The seller's basis in the intangible assets will carry over to the buyer in the intercompany sale. The intercompany gain or loss is eliminated from the sales factor.

iii. Fixed Assets and Capitalized Items

The gain or loss on intercompany sales of business fixed assets or capitalized intercompany charges and expenditures between members of a combined group are generally deferred. The exception to this rule occurs when an affiliated group that files a consolidated federal return elects not to defer gain or loss on intercompany transfers. In that case, the federal election will be allowed for the combined report.

Under the general rule, the gain or loss remains deferred as long as both the seller and the purchaser remain in the combined group, and the asset is not sold to outsiders. When either the seller or purchaser is no longer a member of the combined group, or the group for any reason terminates combined reporting, the gain or loss is reportable by the seller at a time immediately preceding the date either corporation ceases to be a member of the group. If the asset is sold to a third party, the deferred gain or loss is reportable by the combined group in the year of sale. A water's-edge election is also a restoration event that will cause previously deferred intercompany gains and losses to be included in income on a pro-rata basis over five years. (FTB Notice 89-601.) The amount of gain recognized upon the occurrence of a restoration event is generally the same amount that would be reportable for federal purposes under similar circumstances in a consolidated return.

If intercompany gain or loss is deferred, the basis of the asset for property factor purposes is the seller's cost.

iv. Other Factor Adjustments

Intercompany sales and other intercompany revenue items are eliminated in computing the numerator and denominator of the sales factor. Intercompany rent charges are also eliminated from the property factor computation. Any item eliminated from income would likewise be eliminated from any apportionment factor.

Chapter 17, Water's-Edge Manual, provides a more extensive discussion of the California tax treatment of intercompany transactions.

6. When IRC §367 and the Intercompany Transaction Rules Apply to the Same Transfer

Federal and state differences may occur when a transfer of property falls within the provisions of IRC §367, and is also an intercompany transaction for California purposes. For federal purposes, IRC §367 will require gain to be recognized in the year of the transaction.

For California purposes, if the transaction:

- occurred in a tax year beginning before 2001;
- was an intercompany transfer (because the corporations were included within the same combined reporting group); and
- involved intangible assets or inventory;

then, the IRC §367 gain would be eliminated, and the transferor's basis would carry over to the transferee. That is, the California intercompany transaction rule would apply. In most cases, this is essentially the same result as if the non-recognition provisions continued to apply to the transaction.

Assume, instead, that the transaction is an intercompany transfer of:

- a business fixed asset occurring in a tax year before 2001; or
- any asset type occurring in a tax year beginning on or after January 1, 2001;

then, IRC §367 applies to the transaction. The gain, required to be recognized under that section, is deferred in the year of the transaction, but will be restored in a subsequent year when a triggering event occurs, in the same manner as any other intercompany transaction.

Note that if a taxpayer reports income under IRC §367 for federal purposes, and fails to make a California adjustment to defer income pursuant to the general rules of CCR §25106.5-1(a), then the taxpayer has effectively elected to report income from the transaction in the same year as was reported for federal purposes. (CCR §§25106.5-1(e)(2)(B) and (C).) Accordingly, if an examination of that tax year subsequently occurs, no adjustment should be made to defer that income.

Because IRC §367 only applies to gains, a nonrecognition transaction involving an asset whose value is less than its tax basis, (i.e., if the asset is sold, it would produce a loss), is unaffected by IRC §367, and the ordinary nonrecognition treatment applies. Thus, the transaction will not constitute an intercompany transaction resulting in a deferred loss.

b. IRC §367 and the California Examination

1. In General

IRC §367 can be a significant issue in the California examination. The taxpayer may have deferred intercompany gains resulting from IRC §367 transactions in prior tax years, which are recognized as income as a result of a triggering event, such as a water's-edge election, a disaffiliation, an asset sale, etc. Or, the taxpayer may have transfers or exchanges during the tax years under examination to which IRC §367 applies. An IRC §367 transaction that occurs during the tax year should be identified by a statement describing the IRC §367 transaction attached to the return.

2. Scoping the Return

In most instances, California's treatment of a transaction subject to IRC §367 will be the same as for federal purposes, absent the application of the intercompany transaction rules or any federal or state law difference. You may determine that the taxpayer has entered into an exchange subject to gain recognition under IRC §367.

There are many sources to review to identify whether the taxpayer entered into an exchange subject to the provisions of IRC §367. These sources can be found in both the federal Form 1120 and the FTB forms 100 or 100W. All returns should be reviewed for these sources:

- Page 1 of the FTB forms 100 or 100W, reporting any state adjustment to a reported gain
- List of Foreign Affiliates, included in the FTB forms 100 or 100W, to identify dispositions during the tax year
- Schedule M-1 or Schedule M-3 detail
- Schedule D and federal Form 4797, to identify gains reported as a result of the application of IRC §367
- Schedule C, attached to the federal Form 1120, for dividend income reported as the result of the application of IRC §1248

- Balance Sheet information, to identify any change that is not explained in the tax return
- Other Income Schedules, reporting ordinary income items as a result of the application of IRC §367
- Other Deduction and Other Expense schedules, reporting research and development expenditures, to identify whether the taxpayer has any intangible asset that may not be recorded on the books or that may have been transferred to a foreign affiliate
- Federal Forms 5471 and 5472, for intercompany transaction information
- Federal Form 926, filed by a US transferor of property to a foreign corporation
- Supporting Disclosure Statements, discussing any transfers, exchanges or dispositions, in particular any written statement that an exchange subject to the provisions of IRC §367 has occurred
- Any applicable Federal Audit Report, to identify adjustments relating to IRC §367 transactions
- Financial Statements or Annual Reports for information on corporate restructuring, or significant asset transfers
- Prior Audit Reports, if available
- Information Document Requests, asking the taxpayer if any exchange of stock or property occurred during the tax year

This list is not meant to be all-inclusive. Any one of these steps could identify the existence of an exchange subject to IRC §367.

3. The California Examination

The primary audit issues in this area involve situations where:

- There are differences between California and federal law.
- The IRS is not auditing the taxpayer for the same tax year or applicable transaction.
- Intercompany transactions fall within the provisions of IRC §367, including previously deferred intercompany gains that fell within the provisions of IRC §367 that must be recognized as a result of the occurrence of a triggering event.
- A taxpayer elects to report IRC §367 income as taxable under CCR §§25106.5-1(e)(2)(B) and (C).

Because California law generally conforms to federal law with respect to these transactions, you should first determine if the IRS is examining the same issue, for the same tax year. You should verify that any transfer was correctly reported for California purposes. Apply the results of the IRS examination to verify the accuracy of the reported transaction.

During the initial scope of the tax returns or during the course of the audit, you may discover that either the taxpayer entered into a transaction during the tax year to which IRC §367 applies, or a triggering event occurred during the tax year that would require previously deferred gains to be reported. A clear understanding of the type of transaction is key in determining the tax consequences. When warranted, request the taxpayer to provide a step-by-step presentation of the transaction. You would need to identify the transfer involved; the related facts, such as the property description, basis, date of transfer, the transferor and transferee of the property, whether these are members of the combined report; any applicable nonrecognition provisions, if IRC §367 provisions requiring gain recognition apply; and the gain recognizable as a result of IRC §367 for federal purposes.

Once the federal recognizable gain has been determined, you need to ascertain whether:

- California law conforms to federal law with respect to the transfer.
- Gain is subject to elimination or deferral under the intercompany transaction rules.
- Taxpayer elected to currently report the gain.
- Taxpayer has effectively elected under CCR §25106.5-1(e)(2)(B) by currently reporting income recognized for federal purposes under IRC §367, and not making a California adjustment to defer such income for California purposes.
- A triggering event occurred during the tax year that would require previously deferred IRC §367 gains to be recognized.
- If a triggering event did occur, if there are any deferred IRC §367 gains from prior tax years that must be recognized during the tax year under examination. (e.g., Entering into a water's-edge election, selling a unitary affiliate, depreciating or amortizing the transferred property, disposing the transferred property outside of the group, converting the asset to nonbusiness use.)

Identifying previously deferred intercompany gains can be one of the more difficult aspects of examining the IRC §367 issue, especially where foreign-to-foreign transfers are involved. Potential sources for identifying previously deferred gains would include, but are not limited to, prior year:

- Federal Forms 5471 or 5472
- Annual Reports
- Financial Statement Consolidation/Elimination Workpapers
- Audit Reports
- Federal Forms 1120
- FTB forms 100 or 100W

In some situations, the information necessary to fully examine the transaction may not be available, e.g., foreign-to-foreign transactions, or may have been destroyed as part of the taxpayer's business record retention or destruction policy. This is especially true in cases where business transactions occurred many years prior to the year of examination.

17.3 Outbound Property Transfers

Contents:

a. In General

IRC §367(a)(1) generally provides that if a US person transfers property to a foreign corporation in any exchange described by IRC §§332, 351, 354, 356 or 361, the foreign corporation will not be considered a corporation for purposes of determining the extent to which the gain is recognized as a result of the transfer. Because these enumerated nonrecognition code provisions require corporate status for the exchange to receive nonrecognition treatment, any gain realized is recognized under IRC §367(a), unless the transfer falls within an exception contained within IRC §367.

IRC §367(a)(1) applies only to recognize otherwise unrecognized gains from certain transfers of property. It does not apply to transfers that result in otherwise unrecognized losses. In addition, gains recognized as a result of IRC §367 cannot be offset by losses realized under one of the nonrecognition provisions of the Code.

The Code provides that any gain recognized as a result of IRC §367 will not exceed the gain that would have been recognized if a taxable sale of the property had occurred. If the gain recognized exceeds this limitation, a proportionate reduction of ordinary and capital gain income is made so that the taxable gain equals the gain that would have been recognized on a taxable sale. The character of the gain, ordinary income versus capital gain income, is determined as if the transferred property had been disposed of in a taxable exchange. The limitation on the amount of gain recognized applies on an item-by-item basis.

The material that follows explains the impact of IRC §367 on a number of IRC sections that provide for nonrecognition treatment for of certain transactions.

b. IRC §367(a)

For a transaction to fall within the scope of IRC §367(a):

1. A US person must transfer property to a foreign corporation.

2. The resulting gain must not be recognized because the transfer falls within one of these nonrecognition provisions:

   A. Complete liquidation of a domestic subsidiary into a foreign parent corporation. (IRC §332.)
   B. Transfer of property by a domestic corporation to a foreign corporation solely in exchange for stock or securities. (IRC §351.)
   C. Certain reorganizations between domestic and foreign affiliates in exchanges of stock and securities. (IRC §354.)
   D. Receipt of additional consideration on exchange, so-called "boot" (IRC §§354 or 355), between domestic and foreign affiliated corporations. (IRC §356.)
   E. Distributions, solely of stock or securities in another corporation, pursuant to a plan of reorganization between domestic and foreign affiliates. (IRC §361.)

Despite the breadth of IRC §367(a), some exchanges are governed by other subsections of IRC §367. Exchanges under IRC §355, previously addressed by the regulations under IRC §367(a), now fall within the scope of IRC §367(b), (c) and (e). In addition, transfers of certain intangible property under IRC §351 or §361 are specifically addressed by IRC §367(d), rather than by IRC §367(a). Finally, IRC §332 liquidations generally fall within the scope of IRC §367(e).

c. Definitions

The following definitions are relevant to the discussions of outbound transfers under IRC §367(a).

1. US Person

The term "US person" includes any person described in IRC §7701(a)(30). It includes a citizen or resident of the US, a domestic partnership, a domestic corporation, and any estate or trust other than a foreign estate or trust. Certain foreign trusts are considered a “US person” if the trust is subject to supervision of a US court or a US person has the authority to control all substantial decisions of the trust. An individual, electing to be a resident of the US under IRC §6013(g) or (h), is treated as a US person while the election is in effect. A nonresident alien or foreign corporation is not considered a US person because of its actual or deemed conduct of a trade or business within the US during a taxable year.

2. Foreign Corporation

The term “foreign corporation” has the meaning set forth in IRC §7701 and the regulations thereunder. Whether or not a foreign entity should be treated as a corporation is determined in accordance with US tax principles, including the federal “check the box” regulations adopted in 1996. Refer to the IRC and respective regulations for additional information.

3. Property

The term “property” means any item that constitutes property for purposes of IRC §§332, 351, 354, 355, 356 or 361. “Property” includes intangible property, although certain transfers of intangibles are governed by IRC §367(d), rather than IRC §367(a). (See the discussion in WEM 17.5, Intangible Property Transfers.) A right to enter into executory contracts, or other items that do not rise to a level of valuable proprietary right or interest does not constitute property for purposes of these code sections.

4. Transfer

The term “transfer” means any transaction that constitutes a transfer for purposes of IRC §§332, 351, 354, 355, 356 or 361. A cost sharing arrangement, described under Treas. Reg. §1.482-7, or the acquisition of rights to intangible property under such a cost sharing arrangement, is not considered a transfer of property described in IRC §367(a)(1). In addition, IRC §367 applies only to transfers, not to loans, leases, licenses or other transactions involving less than full and irrevocable relinquishment by the transferor of all substantial rights in the property.

5. Transfers Involving Partnerships and Partnership Interests

A. Transfers by Partnerships

If a partnership (foreign or domestic) transfers property to a foreign corporation that falls within the scope of IRC §367(a)(1), then the partners of the partnership who are US persons are treated as having made a direct transfer of their proportionate share of partnership property in an exchange described in IRC §367(a)(1), as determined under the rules and principles of IRC §§701-761. A US person required to recognize gain under the rules of this section is permitted a special basis adjustment. (Treas. Reg. §1.367(a)-1T(c)(3).)

Example

P is a partnership having five equal partners, two of whom are US persons. P transfers property to F, a foreign corporation, in an exchange described in IRC §351. The exchange includes an indirect transfer of property by the partners to F. The transfer of 40 percent of the property is attributable to the partners that are US persons, and is considered a transfer described in IRC §367(a)(1). The gain, if any, recognized on the transfer of 40 percent of each asset is attributed to the two partners that are US persons.

B. Transfers of Partnership Interest

If a US person transfers a partnership interest, in an exchange described by IRC §367(a)(1), then the person is treated as having transferred a proportionate share of the partnership's property, as determined under the rules and principles of IRC §§701-761. US persons, recognizing gain under the rules of this section, are permitted a special basis adjustment. (Treas. Reg. §1.367(a)-1T(c)(3)(ii)(A) and (B).) The active trade or business exception of IRC §367(a)(1), discussed in WEM 17.3(d), Use In A Trade Or Business, is applied to the underlying partnership property, rather than to the partnership interest. A transfer of a limited partnership interest in a US partnership regularly traded on an established securities market is treated as a transfer of stock under Treas. Reg. §1.367(a)-3.

6. Transfers by Trusts and Estates

In general, a transfer of property by an estate or trust is treated as a transfer by that entity, and not as an indirect transfer by its beneficiaries. However, transfers by grantor trusts are treated as a transfer by a US person, if that US person is considered the owner of the assets of the trust under IRC §§671-679. (Treas. Reg. §1.367(a)-1T(c)(4).)

7. Changes in Classification of an Entity Treated as a Transfer

Entities may be classified for tax purposes as corporations, partnerships, associations taxable as corporations, etc. When the classification of an entity is changed, there is deemed to be a liquidation or dissolution of the old entity, and a reincorporation or formation of a new entity. For example, if a foreign partnership changes its classification to an association taxable as a corporation, then there will be a deemed IRC §351 transfer of property to the new corporation followed by a dissolution of the partnership. (Treas. Reg. §301.7701-3(g).) These deemed transactions may be subject to the provisions of IRC §367(a).

The reclassification of foreign entities was expected to become much more frequent after 1997 when the federal "check the box" regulations, which allow taxpayers to elect or change the classification of an unincorporated entity, became effective. Taxpayers who make this election are required to attach a copy of a federal Form 8832, Entity Classification Election, to their federal tax or information return in the year of the election. If this form is attached to a tax year that is being audited, you should determine how the change in classification was reported for California tax purposes, and whether IRC §367(a) is applicable to the deemed transaction.

8. Constructive Transfers under IRC §1504(d)

A termination of a contiguous country election under IRC §1504(d) will result in a constructive transfer, subject to the provisions of IRC §367(a)(1), because the built-in gains, formerly potentially subject to US taxation in a controlled group, are removed from US jurisdiction when the contiguous country corporation is treated as a wholly foreign entity. (Treas. Reg. §1.367(a)-1T(c)(5).)

Example

Domestic corporation Y previously made a valid election under IRC §1504(d) to have its wholly owned Canadian subsidiary, C, treated as a domestic corporation. On July 1, 1986, C fails to continue to qualify for the election under IRC §1504(d). A constructive reorganization described in IRC §368(a)(1)(D) occurs. The resulting constructive transfer of assets by "domestic" corporation C to Canadian corporation C upon the termination of the election is a transfer of property described in IRC §367(a)(1).

For California purposes, the mere making of a water’s-edge election is not an IRC §367 event. Thus, if a contiguous country corporation was in a worldwide combined report, and its domestic parent made a contiguous country election for federal purposes, for tax years beginning on or after January 1, 1996, the contiguous country corporation would be automatically excluded from the water’s-edge combined report. For California purposes, after January 1, 1996, any contiguous country corporation would be excluded from the water's-edge combined report. Before January 1, 1996, it would not be likely that a contiguous country corporation would be included in the water's-edge combined report. Thus, for California purposes, the termination of a federal contiguous country election will not have a California tax effect resulting from the conformity to IRC §367, because there will have been no transfer of appreciated property from the California tax base.

9. Contributions to Capital

IRC §367(c)(2) and the regulations thereunder set forth the rules with respect to treating a contribution to capital of a foreign corporation as a transfer described in IRC §367(a)(1). The contribution of property to the capital of a foreign corporation is treated as an exchange of such property for stock equal to the FMV of the property transferred, whether or not stock is transferred. (See the discussion in WEM 17.4, Other Property Transfers.)

d. Use in a Trade or Business

1. In General

IRC §367(a)(3) provides a significant exception to the automatic gain recognition imposed by IRC §367(a) when property is transferred for use in the active conduct of a trade or business in a foreign country. With limited exceptions, IRC §367(a)(1) will not apply when property is transferred for use by the foreign corporation in the active conduct of a trade or business outside the US, and the US transferor complies with the reporting requirements of IRC §6038B and the regulations thereunder. Assets that produce passive income, such as interest or rent, ordinarily will not satisfy the active trade or business exception, and "tainted assets" are specifically excluded from this exception. (See the discussion of tainted assets at WEM 17.3(d)(4).)

To determine whether the transfer meets the requirements for the active trade or business exception, consider the following:

- What is the trade or business of the transferee?
- Do the activities of the transferee constitute the active conduct of that trade or business?
- Is the trade or business conducted outside the US?
- Is the transferred property used or held for use in that trade or business?

All of the above are subject to a facts and circumstances test when deciding whether the activities of a foreign corporation constitute a trade or business. The rules concerning these four determinations are provided in Treas. Reg. §1.367(a)-2T(b) and are summarized as follows.

A. Trade or Business

A trade or business is generally defined as a specific unified group of activities that constitute (or could constitute) an independent economic enterprise carried on for profit. To constitute a trade or business, a group of activities must ordinarily include every operation, which forms a part of, or a step in, a process by which an enterprise may earn income or profit. One or more of such activities may be carried on by independent contractors under the direct control of the foreign corporation, so long as it meets the active conduct test described by Treas. Reg. §1.367(a)-2T(b)(3).

Any activity giving rise to expenses that could be deductible only under IRC §212, expenses for the production of income, if the activities were carried on by an individual, or the holding for one's own account of investments in stock, securities, land, or other property, including casual sales thereof, considered alone, do not constitute a trade or business.

B. Active Conduct

In general, a corporation actively conducts a trade or business only if the officers and employees of the corporation carry out substantial managerial and operational activities. A corporation may be engaged in the active conduct of a trade or business, even though incidental activities of the trade or business are carried out on behalf of the corporation by independent contractors. While the activities of independent contractors are not considered in determining whether the officers and employees of the corporation carry out substantial managerial and operational activities, the activities of officers and employees of related entities who are made available to, and are supervised on a day-to-day basis by, the transferee foreign corporation are considered.

Whether a trade or business producing rents or royalties is actively conducted is determined under the principles of Treas. Reg. §1.954-2.

C. Outside the US

Generally, the primary managerial and operational activities of the trade or business must be conducted outside the US. In addition, immediately after the transfer, the transferred assets must be located outside the US. The transfer of domestic business assets to a foreign corporation would not be subject to this exception if the domestic business continued to operate in the US after the transfer. However, it is not necessary that every item of property transferred be used outside of the US. As long as the primary managerial and operational activities of the trade or business are conducted outside of the US and substantially all of the transferred assets are located outside the US, incidental items of transferred property located in the US may be considered to have been transferred for use in the active conduct of a trade or business outside the US.

D. Use in the Trade or Business

Generally, property is considered used or held for use in a foreign corporation’s trade or business if it is:

i. Held for the principal purpose of promoting the present conduct of the trade or business.
ii. Acquired and held in the ordinary course of the trade or business.
iii. Otherwise held in a direct relationship to the trade or business. Property is considered held in a direct relationship to a trade or business if it is held to meet the present needs of that trade or business, not its anticipated future needs.

Thus, property will not be considered to be held in a direct relationship to a trade or business if it is held for the purpose of providing for future diversification into a new trade or business, future expansion of trade or business activities, future plant replacement, or future business contingencies.

2. Property Subsequently Transferred by Transferee Corporation

If a foreign corporation receives property in an exchange described by IRC §367(a)(1), and as part of the same transaction transfers the property to another person, then the active trade or business exception will not apply unless:

A. The initial transfer is followed by one or more subsequent transfers as described in IRC §§351 or 721;
B. Each subsequent transferee is either a partnership in which the preceding transferor is a general partner or a corporation in which the preceding transferor owns common stock; and
C. The ultimate transferee uses the property in the active conduct of a trade or business outside the US.

Transfers within six months of the initial transfer will be considered "part of the same transaction." Transfers after this six-month period may be considered "part of the same transaction" if the step-transaction principles apply.

3. Special Rules for Certain Property

The treasury regulations provide for special rules for determining the applicability of IRC §367(a)(1) to specific property transfers. The treatment of any property described in that section is controlled exclusively under the rules of that section.

A. Depreciated Property Used in the US

If a US person transfers US depreciated property (as defined in Treas. Reg. §1.367(a)-4T(b)(2)) to a foreign corporation in an exchange described by IRC §367(a)(1), then the US person will include in its gross income for the taxable year in which the transfer occurs ordinary income equal to the gain that would have been includible in the transferor's gross income under IRC §§617(d)(1), 1245(a), 1250(a), 1252(a) or 1254(a), whichever is applicable, as if the transferor had sold the property at its FMV. Depreciation recapture is required regardless of whether any exception to IRC §367(a)(1) otherwise applies.

US depreciated property subject to this rule includes mining property; IRC §1245 property; IRC §1250 property; farmland; or oil, gas or geothermal property, used in the US. For property used both within and without the US, the amount of required depreciation recapture is determined by the ratio of US use to total use multiplied by the full recapture amount.

For purposes of the ratio described above:

- "Full recapture amount" is the amount that would otherwise be included in the transferor's income under paragraph (b)(1) of Treas. Reg. §1.367(a)-4T.
- "US use" is the number of months that the property either was used within the US or was subject to the depreciation by the transferor or a related person.
- "Total use" is the total number of months that the property was used (or available for use), and subject to depreciation, by the transferor or a related person.

This rule is effective for transfers occurring on or after June 16, 1986.

B. Property to be Leased by the Transferee

Tangible property transferred to a foreign corporation that will be leased to other persons by the foreign corporation will be considered to be transferred for use in the active conduct of a trade or business outside of the US only if the:

- Transferee's leasing of the property constitutes the active conduct of a leasing business;
- Property is not used or expected to be used by the lessee in the US; and
- Transferee has need for substantial investment in assets of the type transferred.

The active conduct of a leasing business requires that the employees of the foreign corporation perform substantial marketing, customer service, repair and maintenance, and other substantial operational activities with respect to the transferred property outside of the US. Real property located outside the US is also subject to this rule. (Treas. Reg. §1.367(a)-4T(c)(1).)

The treasury regulations provide for special rules for "De minimis leasing by transferee" and "Aircraft and vessels leased in foreign commerce." (See Treas. Reg. §§1.367(a)-4 and 1.367(a)-4T for more information.)

The rules of "aircraft and vessels leased in foreign commerce" apply to transfers of property occurring on or after May 2, 2006. However, transferors may elect to apply Treas. Reg. 1.367(a)-4 provisions to transfers occurring on or after October 22, 2004. (See treasury regulations for more information.)

C. Property to be Sold

Property is not considered used in the active conduct of a trade or business if, at the time of the transfer, it is reasonable to believe that in the reasonably foreseeable future, the transferee will sell or otherwise dispose of the property other than in the ordinary course of business. (Treas. Reg. §1.367(a)-4T(d).)

D. Compulsory Transfers

Property is presumed to be transferred for use in the active conduct of a trade or business outside the US, if both the:

- Property was previously in use in the country in which the transferee foreign corporation is organized.
- Transfer is either legally required by the foreign government or compelled by a genuine threat of immediate expropriation.

Treas. Reg. §1.367(a)-4T(f).

E. Other Special Rules

The treasury regulations provide for special rules for oil and gas working interests, and transfers to Foreign Sales Corporations. (See Treas. Reg. §1.367(a)-4T(e) and (h) for more information.)

4. Tainted Assets

IRC §367(a)(3)(B) provides that transfers of certain property cannot qualify for the active conduct of a trade or business exception. Thus, a transfer of these assets, sometimes described as “tainted assets,” is subject to IRC §367(a)(1), even if the transfer is a compulsory transfer described in Treas. Reg. §1.367(a)-4T(f). If the transferred property meets the criteria as a "tainted property" gain is immediately subject to taxation under IRC 367(a)(3)(B). Tainted assets include the following.

A. Inventory

Property described by IRC §§1221(a)(1) or (3), relating to inventory, copyrights, etc., is excluded from the business asset exception. Raw materials, supplies, partially completed goods, and finished products are considered inventory for purposes of that section. That classification also includes property held primarily for sale to customers in the ordinary course of the taxpayer’s trade or business. In addition, certain copyright, literary, musical, or artistic composition, letter or memorandum, and similar property are considered tainted assets. (Treas. Reg. §1.367(a)-5T(b).)

B. Installment Obligations, Accounts Receivable and Similar Property

To the extent the principal amount of such property has not previously been included in income, these assets are considered tainted property. (Treas. Reg. §1.367(a)-5T(c).)

C. Foreign Currency or Other Property Denominated in Foreign Currency

Foreign currency and other property denominated in foreign currency, including installment obligations, futures contracts, forward contracts, accounts receivable, or any other obligation entitling its payee to receive payment in a currency other than US dollars is considered property subject to the provisions of IRC §367(a)(1). There are special exceptions to this provision, including the allowance of netting of gains and losses realized as part of the same transaction. (See Treas. Reg. §1.367(a)-5T(d) for more information.)

D. Intangible Property

A transfer of certain intangible property under IRC §§351 or 361 is subject to IRC §367(d), and thus not governed by IRC §367(a). Thus, the active trade or business exception is not available for such assets. (See the discussion at WEM 17.5, Intangible Property Transfers.) A transfer of intangible property pursuant to a complete liquidation of a US subsidiary into its foreign parent, otherwise governed by IRC §332, is subject to IRC §367(e)(2). (See the discussion at WEM 17.6, IRC §355 Distributions and IRC §332 Liquidations.)

E. Leased Tangible Property

IRC §367(a)(1) applies to a transfer of tangible property if the transferor is a lessor at the time of the transfer. In such instances, the transfer will be treated as a transfer of tainted assets, unless either the property:

1. Will not be leased by the transferee to third persons, and the transferee was the lessee of the property at the time of the transfer.
2. Will be leased by the transferee to third persons, and the transferee satisfies the active leasing business or de minimis tests.

5. Recapture of Branch Losses

A. In General

The treasury regulations provide an exception for gain recognition under IRC §367(a)(1) for assets transferred for use in the active conduct of a trade or business outside the US. However, the active trade or business exception does not apply to assets of a foreign branch of a US person that are transferred to a foreign corporation, if the foreign branch incurred losses previously deducted on the US tax return of the US person (transferor.) For such transfers, the transferor recognizes a gain equal to the sum of the previously deducted branch losses, including any ordinary and capital losses. (See Treas. Reg. §§1.367(a)-6 and 1.367(a)-6T for more information.)

B. Definitions

These definitions are only relevant to the discussion of the branch loss recapture rules.

i. Foreign Branch

For purposes of IRC §367(a)(3)(c), the term “foreign branch” means an integral business operation carried on by a US person outside the US. Whether the activities of a US person constitute a foreign branch operation must be determined based on all the facts and circumstances. Evidence of the existence of a foreign branch includes, but is not limited to, the existence of a separate set of books and records, and the existence of an office or other fixed place of business used by employees or offices of the US person in carrying out business activities outside the US. (Treas. Reg. §1.367(a)-6T(g)(1).)

ii. Branch Assets

Branch assets include all tangible property, any foreign goodwill, going-concern value, and intangible property for purposes of computing the gain limitation.

C. Rules Regarding Gain Recognition

Under the treasury regulations, the recapture of previously deducted branch ordinary losses is treated as ordinary income, and the recapture of previously deducted branch capital losses are treated as capital gain income. For federal purposes, the recognized gain is treated as foreign-sourced income.

i. Amount of Branch Loss Recapture

Treas. Reg. §1.367(a)-6T(d) provides rules for determining the previously deducted losses of a foreign branch, whose assets are transferred to a foreign corporation in an exchanged described in IRC §367(a)(1). The required amount of branch loss recapture is equal to the sum of previously deducted branch ordinary loss for each branch loss year reduced by expired net ordinary losses, and the previously deducted branch capital loss for each loss year reduced by expired net capital losses. This amount is reduced, proceeding from the first branch loss year to the last branch loss year, to reflect expired foreign tax credits (FTC) and expired investment credits. In addition, the previously deducted losses are reduced by any taxable income of the foreign branch recognized through the close of the taxable year of the transfer. Finally, the previously deducted branch losses are reduced by any gain recognized under IRC §367(a)(1), other than by reason of this provision, upon transfer of the assets of the foreign branch to the foreign corporation. The amount subject to the branch loss recapture rule cannot exceed gain realized on the transfer of assets of the foreign branch.

The computation of the branch loss recapture amount is done on a branch-by-branch basis if more than one branch is being transferred to a foreign corporation. The gains of one branch cannot be used to offset losses from another branch.

ii. Anti-Abuse Rule

Treas. Reg. §1.367(a)-6T(h) provides that if a US person transfers property of a foreign branch to a domestic corporation for the principal purpose of avoiding the effect of the foreign branch loss recapture provision, and the domestic corporation thereafter transfers the property of the foreign branch to a foreign corporation, then, solely for purposes of this section, the US person will be treated as having transferred the property of the branch directly to the foreign corporation.

A principal purpose of avoiding the branch loss recapture rule is presumed if the domestic corporation transfers the property within two years of receiving it from a foreign branch. This presumption can be rebutted by clear evidence that the second transfer was not contemplated at the time of the first, and that the avoidance of the branch loss recapture rule was not a principal purpose of the transfer.

e. Outbound Transfers of Stock or Securities

Under IRC §367(a)(2), special rules apply to transfers of stock or securities to a foreign corporation. In general, a transfer of stock or securities by a US person to a foreign corporation will usually be subject to IRC §367(a)(1), unless one of the exceptions listed below applies. However, in many cases, gain can be avoided by execution of a GRA, as described below in WEM 17.3.

1. Transfers of Domestic Stock or Securities

A direct, indirect, or constructive transfer of domestic stock or securities by a US person to a foreign corporation is an IRC §367(a) transfer, subject to potential gain recognition, if it falls under IRC §§351; 354, pursuant to a reorganization described in IRC §§368(a)(1)(B), 356, or 361(a) or (b). However, IRC §367(a) generally does not apply to an exchange of stock pursuant to a reorganization described in IRC §§368(a)(1)(C), (D), (E) or (F), unless the transfer is considered an “indirect” stock transfer, as described below in WEM 17.3. In addition, IRC §367(a) does not apply to a deemed transfer under IRC §351, resulting from the application of IRC §304(a)(1).

However, a gain will not be recognized if the domestic corporation complies with the reporting requirements of Treas. Reg. §§1.367(a)-3(c)(1) and (6), and the following conditions are met:

A. The amount of foreign stock *received* by the US transferors does not exceed 50 percent of the total voting power or total value of the foreign corporation.

B. Immediately after the exchange, the amount of the foreign transferee's stock owned by 5 percent US shareholders, including pre-existing shareholders of the foreign corporation, and officers or directors of the transferred domestic corporation, does not exceed 50 percent of the voting power or value of the foreign corporation.

C. The foreign corporation meets the active trade or business requirement, defined in Treas. Reg. §1.367(a)-3(c)(3), for the 36-month period before the transfer. In general, the foreign corporation must have been engaged in an active trade or business outside of the US for the entire 36-month period before the transfer.

If these conditions are met, a shareholder that is not a 5 percent US transferor shareholder does not have to recognize gain. A 5 percent US transferor shareholder that is required to recognize gain because the above conditions are not satisfied can nevertheless avoid gain recognition if a five-year GRA agreement under Treas. Reg. §1.367(a)-8 is executed. (See WEM 17.3 below.)

2. Transfers of Foreign Stock or Securities

A transfer of foreign stock by a US person to a foreign corporation is not subject to IRC §367(a)(1) if the US person is a less than 5 percent shareholder or is a 5 percent shareholder who enters into a GRA. (Treas. Reg. §1.367(a)-3(b).)

3. Indirect Transfers of Stock or Securities Subject to IRC §367

In addition to providing for gain recognition for stock or securities transactions that directly fall within the scope of IRC §367(a)(1), that section applies to indirect and constructive transfers as well.

"Indirect" transfers of stock or securities falling within the scope of IRC §367(a)(1) include forward triangular mergers, reverse triangular mergers, triangular "B" reorganizations, and triangular "C" reorganizations, when the shareholders of the target corporation receive, in exchange for their stock, stock in the controlling parent corporation. Also included are certain “cascading IRC §351 transfers” when assets, other than stock or securities, are transferred to a foreign corporation that subsequently transfers some or all of the assets to a controlled subsidiary.

The “indirect transfer” rules recognize that these transactions have substantially the same economic effect as transfers of stock directly to the foreign corporation. If a transfer of stock or securities is considered “indirect,” then the transaction is treated the same as a “direct” transfer of stock or securities. It is subject to the same rules as applicable to the direct transfers described above.

4. Gain Recognition Agreement (GRA)

Even if gain is required to be recognized under the conditions described above, a transfer of stock or securities will not be subject to taxation under IRC §367(a)(1) if the transferor enters into a GRA. A GRA is a binding agreement where a US shareholder agrees to recognize gain on stock transferred to a foreign corporation if the foreign corporation disposes of the stock within a specified period (usually five full taxable years) from the last day of the tax year in which the US person transferred the stock or securities to the foreign corporation. A GRA is subject to an annual certification requirement for each of the five full taxable years following the taxable year of the initial transfer. The annual certification essentially must state whether any subsequent event, commonly known as a “triggering event,” would require recognition of the GRA’s gain. Certain subsequent nonrecognition exchanges will not trigger gain recognition.

If a transfer occurs within the specified period of the agreement, the US person will recognize the gain on an amended return for the year the US person transferred the property to the foreign corporation. The statute of limitations remains open for this purpose. In certain cases, the gain can be reported on the return of the year of the transfer, if the taxpayer pays interest back to the time of the original transaction subject to the GRA. Basis adjustments are made to reflect the recognized gain.

If the shareholder disposes of the stock of the foreign corporation in a taxable event, the GRA terminates without gain recognition.

f. Special Rule for Asset Reorganizations

In general, under IRC §361(a), gain or loss is not recognized by a corporation as the result of a transfer of its assets to another corporation pursuant to a reorganization. Nevertheless, IRC §367(a)(5) generally requires recognition of gain by a domestic corporation whose assets are acquired by a foreign corporation pursuant to an outbound reorganization. In such a case, the active trade or business exception, described above, does not apply. However, gain is not required to be recognized for certain transfers involving a corporation controlled by five or fewer US corporate shareholders.

For the exception to apply, five or fewer domestic shareholders must hold 80 percent of the stock of the transferring corporation. For that purpose, stock held by an affiliated group of corporations, defined by IRC §1504, without regard to whether the corporations file a consolidated return, is aggregated, and treated as held by a single shareholder. Special rules are provided to determine the shareholders' basis in the stock of the acquiring corporation.

17.4 Other Property Transfers

Contents:

a. In General

If an exchange is not described in IRC §367(a), then IRC §367(b) provides authority to promulgate regulations to recharacterize an exchange described in IRC §§332, 351, 354, 355, 356 or 361, if necessary or appropriate, to prevent the avoidance of federal income tax. In the case of any exchange described in IRC §§332, 351, 354, 355, 356 or 361 in connection with which there is no outbound transfer subject to IRC §367(a)(1), a foreign corporation will be considered to be a corporation. Accordingly, if the transfer is not described in the regulations pursuant to IRC §367(b), the normal nonrecognition rules apply without limitation. In some cases, a transaction might be subject to both IRC §367(a) and the treasury regulations pursuant to IRC §367(b). If IRC §367(a)(1) applies to a portion of the transaction, IRC §367(b) may apply to the remaining portion of the transaction. For rules coordinating the concurrent application of sections 367(a) and (b), see Treas. Reg. §1.367(a)-3(b)(2).

IRC §367(b) is aimed at preventing tax avoidance resulting from certain transfers of assets into the US taxing jurisdiction, and certain foreign-to-foreign transfers. As a general rule, under the IRC §367(b) regulations, inbound transfers will result in immediate deemed dividend treatment, while foreign-to-foreign exchanges may or may not. In the latter case, if income recognition is not required, E&P adjustments may apply. In the case of foreign-to-foreign transfers, the primary tax avoidance concern of the statute and regulations is the circumvention of IRC §1248.

Note: California does not conform to IRC §1248. Thus, to the extent that a transaction described under the Treas. Reg. under IRC §367 would produce income under IRC §1248, those regulations will not apply. In general, the transactions that have effect under IRC §1248 are the foreign-to-foreign transactions described.

The IRC §367(b) regulations apply in three contexts:

1. A transaction involving the discontinuation of the existence of a foreign corporation by a transfer of assets to a US person by liquidation or reorganization of the foreign corporation, called “a domestication transfer.”

2. An exchange of stock of one foreign corporation for another foreign corporation in an otherwise nonrecognition transaction (foreign-to-foreign exchanges):
   A. When the US shareholder experiences a loss in the amount of the potential income that would have been subjected to tax under IRC §1248 had the stock been sold.
   B. An exchange that results in an excessive shift of E&P, which allows a shareholder to obtain a greater FTC under IRC §902.

3. In addition, regulations under IRC §367(b) require gain recognition for certain distributions described by IRC §355, involving foreign corporations, that are not domestication transfers.

b. Domestication Transfers

In the case of a liquidation or reorganization of a foreign entity to a domestic shareholder, the policy of the IRC §367(b) regulations is to prevent taxpayers from avoiding dividend treatment with respect to the loss of accumulated E&P by the foreign entity. The deemed dividend treatment generally applies only to 10 percent US shareholders (as defined by IRC §951(b)), and applies even if the foreign corporation is not a CFC, as defined by IRC §957.

If a US stockholder owns less than 10 percent of the foreign corporation, it is generally required to report capital gain (but not loss) with respect to the domestication transaction. Although, the stockholder may elect deemed dividend treatment instead. If the FMV of the stock is less than $50,000 (and the taxpayer is not a 10 percent US shareholder), no gain or deemed dividend is recognized.

If a foreign corporation liquidates or reorganizes into another foreign corporation, and the latter corporation is owned by at least a 10 percent US shareholder, the foreign corporation is treated as having received a deemed dividend, as well. The deemed dividend does not typically have immediate US tax consequences to the foreign corporation, but the deemed dividend could constitute Subpart F income to the 10 percent US shareholder, if the surviving foreign entity is a CFC.

An “F” reorganization of a foreign corporation to a domestic corporation is treated as a liquidation of assets of the foreign corporation to the shareholders, which can result in deemed dividend or gain treatment as described above. Similar transactions are treated as “F” reorganizations, including:

1. Reclassification of a corporation into a partnership or disregarded entity.
2. Making an election under IRC §1504(d) to include a preexisting foreign “contiguous country” corporation in a US consolidated return. (See the discussion above related the California tax effect of a federal contiguous country election.)
3. When a foreign corporation becomes a “stapled stock” entity and is treated as a domestic corporation under IRC §269B.

Treasury regulations would also apply deemed dividend treatment to a “foreign divisive transaction,” a special class of distribution described by IRC §355, in which the distributing corporation is a foreign corporation and the controlled corporation that is distributed is a domestic corporation. (Proposed Treas. Reg. §1.367(b)-(8)(d).)

If a deemed dividend applies, the dividend is limited to the “all earnings and profits” amount. The deemed dividend applies only to E&P of the distributing corporation, and not to any lower tier subsidiaries of the distributing corporation. “All earnings and profits” include only those E&P that accrued during the period the stock was held by the 10 percent US shareholder. “All earnings and profits” are generally determined under the standard E&P rules of IRC §316, as modified by IRC §364. Additional modifications are made under rules prescribed by IRC §1248(d), to remove previously taxed income under IRC §951 (subpart F), under IRC §1248, or as income effectively connected with a US trade or business. If the foreign corporation has a deficit in its E&P (even if it has current year E&P), the deemed dividend rules do not apply.

c. Foreign-To-Foreign Exchanges

Certain transfers of stock between foreign entities can result in deemed dividend treatment or result in adjustment of E&P. Two general conditions will trigger the deemed dividend or E&P adjustment:

1. Loss of a US person's status as an IRC §1248 shareholder.
2. An acquisition that results in excess shifting of E&P, resulting in a transfer of the benefits of the FTC from one entity to another.

1. Loss of Status as an IRC §1248 Shareholder

For federal income tax purposes, IRC §1248 generally requires a 10 percent US shareholder that sells stock of a CFC, in lieu of capital gain treatment, to report a portion of that gain as a deemed dividend, taxable as ordinary income. In some cases, the E&P of lower tier foreign corporations may also be taken into account.

If the stock of a CFC that is potentially subject to IRC §1248 is transferred to another foreign corporation in a nonrecognition transaction, and the shareholder no longer would be subject to IRC §1248 with respect to the foreign corporation received in exchange, the deemed dividend policy with respect to IRC §1248 can be avoided. The IRC §367(b) regulations prevent that from happening by denying nonrecognition treatment, and forcing deemed dividend treatment under IRC §1248 (or requiring an E&P adjustment) to the extent of the loss of IRC §1248 status. However, if a shareholder receives stock of a foreign corporation that itself constitutes a CFC, and the shareholder immediately satisfies the 10 percent ownership test with respect to the acquired corporation, the deemed IRC §1248 dividend is not triggered.

As noted above, California does not conform to IRC §1248. Thus, to the extent income is required to be taken into account under the IRC §367(b) regulations under principles of IRC §1248, those regulations do not apply for California purposes. Basis adjustments attributable to the application of IRC §1248 likewise do not apply for California purposes.

2. Excess Shifting of E&P

If nonrecognition exchange results in an excessive potential shifting of E&P, either gain recognition is required, or adjustments are required to be made to E&P. The policy of this rule is to prevent a taxpayer from obtaining an inappropriate IRC §902 FTC. IRC §902 allows a taxpayer to obtain a FTC with respect to dividend received from a foreign corporation subject to tax in a foreign country.

For example, assume a domestic corporation owns stock in a foreign corporation (FC1) that had substantial E&P, but was not subject to foreign income tax. If the domestic corporation causes FC1 to merge with another foreign corporation (FC2) that paid a high rate of foreign income tax, the domestic corporation might be able to use the E&P of FC1 in a dividend from the merged entity to claim a FTC attributable to taxes paid by FC2. In general, the shift of E&P is "excessive" if the exchanging shareholder is not sufficiently at risk with respect to the combined businesses of the acquired and acquiring corporations. If an excessive E&P shift occurs, a deemed dividend may result, to the extent of the shareholder's IRC §1248 amount.

Even if a foreign-to-foreign exchange does not result in a trigger of an IRC §1248 dividend, adjustments to E&P may be required. The special adjustments following such an exchange are made for the purpose of applying IRC §367(b) or IRC §1248 to subsequent exchanges.

In addition, the IRC §367 regulations provide detailed rules regarding the computation of E&P involving domestication transactions, and other transactions, such as foreign-to-foreign liquidations and reorganizations.

Because California does not conform to IRC §1248 and does not apply rules related to the FTC, income required to be taken into account for federal purposes resulting from an excess shifting of E&P will not be taken into account for California purposes. In addition, basis adjustments attributable to the application of IRC §1248 likewise do not apply for California purposes.

d. IRC §355 Exchanges

The IRC §367(b) regulations apply special rules for IRC §355 transactions in which the distributing corporation or the controlled corporation whose stock is distributed is a foreign corporation. However, before IRC §367(b) regulations are applied, IRC §367(e) (see the discussion in WEM 17.6), IRC §355 Distributions, IRC §332 Liquidations, or IRC §1248(f) sections are applied first. Regulations under IRC §367(b) apply, if at all, only to the realized gain in excess of the amounts realized under IRC §§367(e), 355, 332, or 1248(f).

1. Distribution by Domestic Corporation of Stock of a Foreign Controlled Corporation

Income recognition is not required with respect to an IRC §355 distribution of a foreign controlled corporation by a domestic corporation to another corporation. However, if the distributee is an individual, then, solely for purposes of determining the gain recognized by the distributing corporation, the controlled corporation is not be considered to be a corporation, and the domestic distributing corporation must recognize the IRC §311 gain (but not loss) realized on the distribution. (Treas. Reg. §1.367(b)-5(b)(1)(ii).) Such a distribution is presumed to be to an individual, but can be rebutted using certain shareholder identification requirements as provided in the regulation. (Treas. Reg. §1.367(b)-5(b)(3).) The individual shareholder does not recognize gain on such a transaction.

Special rules apply if the distributee is a partnership, trust or estate. (See Treas. Reg. §1.367(b)-2(k) for more information.)

2. Distribution by a Foreign Corporation of Stock of a Domestic Corporation to a Foreign Corporation

Treas. Reg. §1.367(b)-5 does not apply to a distribution made by a foreign corporation that is not a CFC to a US shareholder. In this situation, IRC §355 distribution rules will apply. If there is an IRC §355 distribution by a foreign corporation, the regulations under IRC §367(b) are primarily concerned with the preservation of IRC §1248. If, as a result of the distribution, the shareholder experiences a potential loss of IRC §1248 income, the distributee must reduce its basis in the stock of the distributing corporation which the controlled corporation received in the distribution. If the basis reduction exceeds available basis, the distributee must recognize an IRC §1248 deemed dividend, to the extent of the excess. Special rules apply to IRC §355 distributions that are not pro-rata to the shareholders, “split offs,” which require deemed dividend treatment in lieu of basis adjustments.

In addition to the foregoing, the IRC §367(b) regulations provide special rules for the computation of E&P after the IRC §355 distribution.

See the discussion above related to California non-conformity to IRC §1248. Thus, a deemed dividend resulting from a distribution by a foreign corporation of stock of a domestic corporation to a foreign corporation will not result in California income. In addition, basis adjustments attributable to the application of IRC §1248 likewise do not apply for California purposes.

e. Effect of Deemed Dividend Treatment

When discussing the effect of the deemed dividend treatment, it is important to distinguish between a "Section 1248" and "all earnings and profit amount" deemed dividend. A deemed dividend under Section 1248 is not treated as a dividend at the corporate level and does not reduce the corporation's earnings and profits. A deemed dividend through the regulations under IRC §367(b) is generally treated as if it were a normal dividend, including potential for subpart F treatment. For federal purposes, to prevent double taxation of the same amounts, IRC §959 treats Section 1248 previous deemed distributions as previously taxed earnings and profits and, thus, not taxable on later distributions. In general, the basis of the taxpayer's stock is increased by the amount of the deemed dividend under IRC §959(b), except that the basis adjustment does not apply until after the amount of the deemed dividend has initially been determined. (Treas. Reg. §1.367(b)-2(e)(3).)

A deemed dividend of the "all earnings and profit" is also treated as a dividend for California purposes, and is potentially eligible for one of California's dividend received deductions, such as R&TC §24411.

17.5 Intangible Property Transfers

Contents:

a. In General

Worldwide transfers of intangible property (IP) or rights to IP may occur as part of a sale, license, capital contribution, corporate restructure, provision of services, cost sharing agreements, or any combination of the above. As a general rule, IRC §367(a) does not apply to outbound transfers of intangible property (within the meaning of IRC §936(h)(3)(B)) in a transaction described by IRC §351 or §361, when the transferor is a US person. Rather, IRC §367(d), and the regulations thereunder, control the treatment of outbound transfers of such intangible property. Under IRC §367(d)(2)(A), the transfer of an intangible asset in an exchange described in IRC §351 or §361 will be treated as a transfer pursuant to a "deemed" sale in which the actual payments made are contingent upon the productivity, use or disposal of the intangible property. Sales and licenses of intangibles are not subject to IRC §367(d), since these transactions are not described in IRC §351 or §361. However, IRC §482 may apply to such sales and licensing transactions.

Under IRC §367(d), a US transferor must include in income amounts that reasonably reflect the amounts that would have been received annually had the US transferor entered into a contract for the sale of the intangible property in exchange for payments contingent upon the productivity or use of the intangible over the property's useful life. When the intangible property is disposed of by the transferee, the transferor must include in income the amount that would have been received had the transferor sold the intangible property in an exchange for payments which are contingent upon the disposition of the asset. The amount taken into account will be commensurate with the income attributable to the intangible property transferred.

The amounts included in income by the US transferor as a result of the application of IRC §367(d) are treated as US source ordinary income, to the extent that the intangible property would have produced US source income if it had actually been sold or licensed. However, the transferee is permitted to reduce its E&P by such amounts to the extent such amounts are included in income of the transferor.

b. Intangible Property Defined

The definition of intangible property is contained in IRC §367(d). Intangible property is defined broadly by referencing IRC §936(h)(3)(B), to mean any of the following:

A. Patent, invention, formula, process, design, pattern, or knowhow
B. Copyright, literary, musical, or artistic composition
C. Trademark, trade name, or brand name
D. Franchise, license, or contract
E. Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data
F. Other similar item

Such property is treated as intangible property for purposes of IRC §367(d), and the regulations thereunder, without regard to whether it is used:

- Or developed in the US or in a foreign country
- In manufacturing activities or in marketing activities

However, intangible property described above is limited to those intangibles that have substantial value, independent of the services of any individual.

c. Exceptions

Although the definition of intangible property is quite broad, two exceptions exist. The regulations exclude foreign goodwill and going concern from intangible property governed by IRC §367(d). “Marketing intangibles,” such as trademarks and trade names, are not included in goodwill or going concern value, and are thus subject to IRC §367(d). Foreign goodwill or going concern value is the residual value of a business operation conducted outside of the US after all other tangible or intangible assets have been identified and valued. For purposes of IRC §367 and the regulations thereunder, the value of the right to use a corporate name in a foreign country is treated as foreign goodwill or going concern value. Although a transfer of foreign goodwill or going concern value pursuant to IRC §351 or §361, is not subject to IRC §367(d), it may be subject to IRC §367(a), and may be eligible for the trade or business exception under IRC §367(a)(3).

Also excluded from the scope of IRC §367(d) is intangible property described in IRC §1221(a)(3), including certain copyrights, literary, musical or artistic compositions, letters or memorandums, or similar property meeting the conditions of that section. Those intangibles are governed by IRC §367(a), and are not subject to the active trade or business exception under that section. (IRC §367(a)(3)(B)(i).)

If the tangible property transferred has additional value attributable an intangible, such as a trademark (a so-called “embedded intangible”), the transaction is not governed by IRC §367(d), and would be subject to IRC §367(a). A working interest in oil and gas properties is not considered to be intangible property for purposes of IRC §367(d) and the regulations thereunder.

d. The Toll Charge

The amount required to be included in income of the US transferor varies depending upon whether the:

- Intangible property is disposed of by the transferee
- Intangible property is used by the transferee in its trade or business
- Transferee’s stock is disposed of to a related or unrelated person

1. In General

When intangible property is transferred to a foreign corporation in an exchange subject to IRC §367(d), in an exchange described in IRC §351 or §361, the US transferor will include in income over the useful life of the property, annual payments contingent on the productivity or use of the property, not to exceed 20 years. The income is treated as ordinary income. The amount included in income should reflect the appropriate arm’s length charge for the use of the property. The appropriate charge is determined under the provisions of IRC §482 and regulations thereunder. (Treas. Reg. §1.482-2(d).) The US or foreign source of such income for federal income tax purposes is determined in the same manner as if an actual royalty income from the intangible had been received. The deemed payment is reduced by any royalty or other periodic payment made or accrued by the transferee to an unrelated person for the right to use the intangible property. The E&P of the transferee corporation are reduced by the amount of the deemed payment, and for purposes of subpart F of the IRC, the deemed payment may be treated as an expense apportioned and allocated to subpart F income. (Treas. Reg. §1.367(d)-1T(c).)

If the transfer arrangement covers more than one year, then the amount charged for use of the intangible property in each taxable year may be adjusted to ensure the commensurate with income standard is met. The annual adjustment is made on a fact and circumstance basis, over the entire period during which the property has value.

2. Transfer of Stock of Transferee to an Unrelated Person

If intangible property is transferred by a US person to a foreign corporation in an exchange subject to IRC §367(d), and within the useful life of the intangible property the US transferor disposes of the stock of the transferee foreign corporation to an unrelated person (within the meaning of paragraph (h) of Treas. Reg. §1.367(d)-1T), then the US transferor will be treated as having simultaneously sold the intangible property to the person acquiring the stock of the transferee. Any resulting gain (but not loss) must be recognized.

The gain is computed as the difference between the FMV of the intangible property and the US transferor's former adjusted basis in that property (determined on the date of the original transfer to the transferee foreign corporation whose stock was sold). Any gain that would have been required to be recognized by the US transferor as the result of any other code provision will be reduced by any gain recognized as a result of the application of IRC §367(d). Basis adjustments are required by the unrelated person acquiring the foreign corporation's stock. (Treas. Reg. §1.367(d)-1T(d).)

3. Transfer of Stock of Transferee to a Related Person

If:

- Intangible property is transferred by a US person to a foreign corporation,
- The exchange is subject to IRC §367(d),
- Transferred within the useful life of the intangible property, and
- The US transferor disposes of the stock of the transferee foreign corporation to a related US person (within the meaning of paragraph (h) of Treas. Reg. §1.367(d)-1T),

Then, the following rules apply:

Each US related person:

A. Receiving the stock of the transferee foreign corporation, is deemed to have received a right to receive a proportionate share of the contingent annual payments that have otherwise been deemed to be received by the US transferor.

B. Is required to include in gross income over the useful life of the property a proportionate share of the amount that would have been included in the income of the US transferor as US source income.

The rules of this section would apply to any subsequent transfer of the stock in the transferee foreign corporation to another related person. In addition, the regulations mandate certain required adjustments to various tax attributes of the parties subject to the exchange. (Treas. Reg. §1.367(d)-1T(e)(2).)

4. Transfer of Stock in Transferee to Related Foreign Corporation

If intangible property is transferred by a US person to a foreign corporation in an exchange subject to IRC §367(d), and within the useful life of the intangible property, the US transferor disposes of any of the stock of the transferee foreign corporation to one or more related foreign corporations, then the US transferor will continue to include in income the deemed payment that would have been required under IRC §367(d). (Treas. Reg. §1.367(d)-1T(e)(3).)

5. Disposition of Transferred Intangible Property by Transferee Foreign Corporation

If a US person transfers intangible property to a foreign corporation subject to the provisions of IRC §367(d) and the regulations thereunder, and within the useful life of the intangible property the transferee foreign corporation subsequently disposes of the intangible property to an unrelated person, then both the following applies. The US transferor is required to:

A. Recognize gain equal to the excess of the FMV of the transferred intangible property on the date of disposition and the US transferor's former adjusted basis in the property.
B. Include as income a deemed payment for any part of the taxable year that the intangible property was held by the transferee foreign corporation, and will not thereafter be required to recognize any deemed payments with respect to the transferred intangible property.

If the transferee subsequently transfers the intangible property to a related person, the gain recognition rules do not apply. The new owner is substituted for the original transferee, and the deemed annual payments continue as before. (Treas. Reg. §1.367(d)-1T(f).)

6. Special Rules

Several special rules apply, and are discussed here, related to exchanges or transfers affected by IRC §367(d).

A. Establishment of Accounts Receivable

If a US person is required to recognize income as a result of a deemed annual payment resulting from either a transfer of intangible property to a foreign corporation or disposition of the transferred intangible property by the transferee foreign corporation, but the amount deemed to be received is not actually paid, there must be a reconciliation between the amounts deemed paid and the amounts actually paid, if any. The US person may reconcile those amounts by establishing an account receivable from the transferee foreign corporation equal to the amount deemed paid.

A separate account receivable must be established for each tax year. The accounts receivable established under this regulation may be paid without further US income tax consequences to the US transferor or the transferee foreign corporation. No interest is paid or accrued on an account receivable created under this regulation, nor is any bad debt deduction allowed under IRC §166 with respect to any failure to receive payment on an account. (Treas. Reg. §1.367(d)-1T(g)(1)(i).)

Any account receivable outstanding three taxable years after the account is established (or if the taxpayer fails to establish an account receivable), the corresponding amount to the amount deemed paid, will be treated as a contribution of capital to the foreign transferee and will increase the transferor's basis in the transferee's stock. (Treas. Reg. §1.367(d)-1T(g)(1)(ii).)

B. Treating a Transfer as a Sale

A US person that transfers intangible property to a foreign corporation in a transaction subject to IRC §367(d) may elect to recognize as ordinary income the difference between the FMV of the intangible property and the US transferor's adjusted basis in the property if it meets one of the following conditions:

- The intangible property constitutes an operating intangible asset, as defined by Treas. Reg. §1.367(a)-1T(d)(5)(ii). An operating intangible asset is any intangible property of a type not ordinarily licensed or otherwise transferred in transactions between unrelated parties for consideration contingent upon the licensee's or transferee's use of the property. Examples of operating intangibles may include long-term purchase or supply contracts, surveys, studies and customer lists.
- The transfer of the intangible property is either legally required by the government of the country in which the transferee corporation is organized as a condition of doing business in that country, or is compelled by a genuine threat of immediate expropriation by the foreign government.

- A transfer that meets all of the following conditions:
    1. The US person transferred the intangible property to the foreign corporation within three months of the organization of that corporation and as part of the original plan of capitalization of that corporation.
    2. Immediately after the transfer, the US person owns at least 40 percent but not more than 60 percent of the total voting power and total value of the stock of the transferee foreign corporation.
    3. Immediately after the transfer, at least 40 percent, but not more than 60 percent, of the total voting power and value of the stock is owned by foreign persons unrelated to the US transferor.
    4. Intangible property constitutes at least 50 percent of the FMV of the property transferred to the foreign corporation by the US transferor.
    5. The transferred intangible property will be used in the active conduct of a trade or business outside the US, and will not be used in the connection with manufacture of sale of products in or for use or consumption in the US.

The election to treat the transfer as a sale is made in accordance with the notification requirements of IRC §6038B and the regulations thereunder, and including the appropriate amounts in gross income in a timely filed tax return for the year of the transfer. (Treas. Reg. §1.367(d)-1T(g)(2).)

C. Intangible Property Transferred from Branch with Previously Deducted Losses

If income is required to be recognized under IRC §904(f)(3) and the regulations thereunder, or under Treas. Reg. §1.367(a)-6, upon transfer of intangible property of a foreign branch that had previously deducted losses, then the income recognized under those sections will be credited against the amount required to be recognized in the current or future taxable years as a result of IRC §367(d). The amount recognized under IRC §904(f)(3) or Treas. Reg. §1.367(a)-6, with respect to the transferred intangible property, shall be determined in accordance with the formula provided in the regulation. For more information, refer to Treas. Reg. §1.367(d)-1(g)(3).

D. Coordination with IRC §482

IRC §367(d) will not ordinarily apply where there is an actual sale or license of intangible property by a US person to a foreign corporation. If an adjustment is required under IRC §482 for the actual sale or license, IRC §367(d) will not apply to the required adjustment.

If a US person transfers intangible property to a related foreign corporation in a transaction described by IRC §§351 or 361, no sale or license subject to adjustment under IRC §482 will have deemed to have occurred. Instead, the US person shall be treated as having made a transfer of intangible property that is subject to IRC §367(d).

A purported sale or license of an intangible asset may be disregarded and treated as a transfer subject to IRC §367(d) in the following situation:

- The sale or license is made to a foreign corporation in which the transferor holds or is acquiring an interest.
- The economic substance of the sale differs so significantly from the terms of the sale or license that would have been obtained between unrelated persons, that the sale or license is a sham.

The terms of the purported sale or license, for purposes of applying the rule of the regulation under IRC §367(d), is determined by reference to the nominal terms of the agreement and to the actual practice of the parties under the agreement.

A sale or license of intangible property should not be disregarded under the regulation of IRC 367(d) solely because other property of an integrated business is simultaneously transferred to the foreign corporation by the US transferor in a transaction described in IRC §367(a)(1). (Treas. Reg. §1.367(d)-1T(g)(4).)

E. Determination of FMV

The FMV of the transferred property is the amount of the single payment that would have been paid by an unrelated purchaser in an arm's-length transaction. The allocation of a portion of the purchase price to intangible property agreed to by the parties to the transaction shall not necessarily be controlling. (Treas. Reg. §1.367(d)-1T(g)(5).)

F. Other Anti-Abuse Rules

If a US person transfers intangible property to a domestic corporation and within two years it transfers the stock of the corporation to a related foreign corporation to avoid the effects of IRC §367(d), then the US person will be presumed as having transferred the intangible property directly to the foreign corporation for purposes of IRC §367(d). The presumption may be rebutted by clear evidence that the subsequent transfer of the stock of the domestic transferee corporation was not contemplated at the time the intangible property was transferred to that corporation and that avoidance of IRC §367(d) was not a principal purpose of the transaction. (Treas. Reg. §1.367(d)-1T(g)(6).)

17.6 IRC §355 Distributions and IRC §332 Liquidations

Contents:

a. In General

IRC §367(e) was enacted as part of the 1986 Tax Reform Act, and provides for the treatment of certain distributions described in IRC §355 or liquidations under IRC §332 as follows.

1. Distributions Described in IRC §355

IRC §367(e)(1) provides, "In the case of any distribution described in section 355 (or so much of section356 as relates to section355) by a domestic corporation to a person who is not a United States person, to the extent provided in the regulations, gain shall be recognized under principles similar to the principles of this section."

2. Liquidations under IRC §332

IRC §367(e)(2) provides, "In the case of any liquidation to which section 332 applies, except as provided in regulations, subsections (a) and (b)(1) of section 337 shall not apply where the 80-percent distributee (as defined in section 337(c)) is a foreign corporation."

b. IRC §355 Distributions

IRC §367(e)(1) and the regulations thereunder address certain distributions described in IRC §355. Although the regulations under IRC §367(a) refer to transactions described in IRC §355, IRC §367(a) technically does not control the treatment of IRC §355 transactions because a corporate status of the transferee is not required for the IRC §355 nonrecognition provisions to apply. Special rules under IRC §367(e)(1) were enacted to clarify the interaction of IRC §§367(a) and 355.

The general effect of the rules under IRC §367(e)(1) is that, if a domestic corporation distributes stock or securities in a foreign corporation to a distributee that is not a US person, the distributing corporation recognizes gain (but not loss) with respect to the stock or securities distributed. This rule prevents a foreign person from avoiding all US tax with respect to gain that would have been federal taxable income had the distributed corporation been sold.

1. Required Gain Recognition

If a distribution is made to which IRC §355 applies, and the distributing domestic corporation transfers stock in a foreign corporation to a non-US person, then the distributing domestic corporation will recognize gain on the distribution under IRC §367(e)(1).

The amount of gain recognized is equal to the excess of the FMV of the stock or securities over the corporation's adjusted basis in the stock. Special basis averaging rules apply. Hence, distributing high basis stock to foreign shareholders (which is a taxable event,) and low basis stock to US shareholders (which is not taxable,) cannot be done. The distribution is not treated as a dividend by the distributee. Accordingly, an IRC §355 distribution subject to gain recognition under IRC §367(e) will not be subject to the US withholding tax on dividends. For information on the gain computation refer to Treas. Reg. 1.367(e)-1(b)(3).

2. Presumption that the Distributee is not a US Person

The regulations under IRC §367(e)(1) provide that an IRC §355 distribution is presumed to be to persons that are not qualified US persons. If the stock is regularly traded on a qualified exchange or market, the distributing corporation must specifically identify all 5 percent shareholder recipients and certify that the distribution was made to 5 percent US shareholders. If the distribution is made to less than 5 percent shareholders, the distributing corporation may rebut the presumption by a reasonable analysis of shareholder records and relevant information, including a reasonable statistical analysis. If the stock is not regularly traded on a qualified exchange or other market, the distributing corporation must specifically identify the qualified US shareholders and certify that the stock was distributed to them, regardless of the percentage of ownership. Special rules apply for distributions to pass-through entities. (Treas. Reg. §1.367(e)-1(d).)

c. IRC §332 Liquidations

1. In General

Although IRC §367(a) refers to transactions under IRC §332, that subsection does not apply in the specific situation of a complete liquidation of a subsidiary where at least 80 percent of the stock is owned by a foreign corporation. Rather, IRC §367(e)(2) controls the treatment of the complete liquidation of a subsidiary in an outbound liquidation.

IRC §367(e)(2) provides that in the case of a liquidation described by IRC §332, IRC §337 shall not apply where the distributee is a foreign corporation, except as provide by regulations. (IRC §337 normally provides that no gain or loss is recognized to the distributing corporation in the context of an IRC §332 liquidation.) Thus, IRC §367(e)(2) applies to both a liquidation of a domestic corporation to a foreign corporation, and to foreign-to-foreign liquidations.

The gain required to be recognized is the excess of the FMV of each distributed item over the distributing corporation's adjusted basis in each item of property. This is the only provision that permits loss to be recognized as a result of the application of IRC §367 to any exchange. Ordinary and capital losses are recognized to the extent they do not exceed the ordinary and capital gains recognized on the liquidation. In addition, losses on property contributed to the distributing corporation within the preceding five years are not recognized. Finally, losses recognized under IRC §367(e)(2) are not subject to loss disallowance or deferral under IRC §267. (Treas. Reg. §1.367(e)-2.)

2. Distribution of Partnership Interests

This section provides that if the domestic corporation distributes a partnership interest in complete liquidation, then the domestic corporation will be treated as having distributed a proportionate share of the property of the partnership. This rule applies to second tier and lower partnership interests as well. For any gain recognized, the foreign corporation's basis in the distributed partnership interest will be increased. Furthermore, the foreign corporation's basis in the distributed partnership interest will be decreased by any losses recognized. These rules do not apply to any limited partnership interest regularly traded on an established securities market.

3. US Trade or Business Exception to Gain Recognition

A domestic corporation liquidating into a foreign corporation will not be required to recognize gain or loss under IRC §367(e)(2) if the property was used by the distributing corporation in the conduct of a US trade or business and will also be used by the foreign corporation in the conduct of a US trade or business. This exception is conditioned on the following:

A. The foreign distributee corporation, uses the property in the active conduct of an effectively connected trade or business in the US for ten years beginning on the date of distribution;
B. The domestic liquidating corporation attaches a required statement to its timely filed US income tax returns which include the distributions in the liquidation; and
C. The foreign distribute corporation attaches a copy of the required property description to its timely filed US income tax return for the tax year that includes the date of distribution.

If the property is no longer used in the conduct of an effectively connected US trade or business within the 10-year period, then the distributee must recognize gain (but not loss) attributable to such property.

This nonrecognition exception does not apply to intangible property described in IRC §936(h)(3)(B), which is subject to the provisions of IRC §367(d). For more information on the treatment of intangible property, refer to Section 17.5, Intangible Property Transfers.

For more information, refer to Treas. Reg. §1.367(e)-2(b)(2)(i).

4. Exception to Gain Recognition for Distribution of US Real Property Interests

A domestic corporation does not recognize gain under IRC §367(e)(2) on the distribution of a US real property interest (other than stock in a former US real property holding corporation which is treated as a US real property interest for five years) in complete liquidation of the domestic corporation into a foreign corporation. This is because the distributee takes a carryover basis in the property, and will be taxable on a subsequent sale of that property under IRC §897. This exception takes precedence over the US trade or business exception, where the liquidation meets both exceptions. (Treas. Reg. §1.367(e)-2(b)(2)(ii).)

5. Exception to Gain Recognition for Outbound Liquidation of Stock of a US Subsidiary

Generally, gain is not required to be recognized with respect to an outbound liquidation under IRC §332 of an 80 percent, directly owned US subsidiary. To qualify, the distribution must not have a principal purpose of avoidance of US tax. In addition, the distributing corporation must attach a required distribution statement to its US tax return. For purposes of the application of the regulation under IRC §367(e), a corporation is an 80 percent domestic subsidiary corporation, if:

- The subsidiary corporation is a domestic corporation (but not foreign corporation that has made an election under IRC §897(i) to be treated as a US corporation for purposes of IRC §897);
- The domestic liquidating corporation owns at least 80 percent of the total voting power of the stock of such corporation; and
- The domestic liquidating corporation owns at least 80 percent of the total value of all stock of such corporation.

For more information, refer to Treas. Reg. §1.367(e)-2(b)(2)(iii).

6. Distribution by a Foreign Corporation

A foreign corporation is generally not required to recognize gain if it makes a distribution of property in complete liquidation under IRC §332 to another foreign corporation that owns at least 80 percent of the voting stock of the liquidating corporation. However, the foreign distributing corporation must recognize gain (but not loss) if the property distributed to another foreign corporation was formerly used in connection with the conduct of a US trade or business within ten years prior to the date of the liquidation, and would have been subject to IRC §864(c)(7) on a disposition. If the liquidating foreign corporation distributes property that is currently in a US trade or business to another foreign corporation, gain (but not loss) will be recognized by the distributing foreign corporation unless the property is used by the distributee for ten years in the conduct of a US trade or business, and the distributor and distributee attach a required statement to its tax returns for the taxable year which includes the distribution.

A distribution of a US real property interest by a foreign corporation to another foreign corporation under IRC §332 does not require gain recognition under IRC §367(e)(2). Instead, the taxability of the transaction is governed by the regulations under IRC §897.

For more information, refer to Treas. Reg. §1.367(e)-2(c).

17.7 More Aspects of IRC §367

Contents:

a. Transactions Treated as Exchanges

1. IRC §355 Distributions

For purposes of IRC §367, IRC §367(c) requires that any distribution described in IRC §355, or in IRC §356, to the extent it relates to IRC §355, will be treated as an exchange, regardless of whether it is an exchange or not. Thus, this section requires that these transactions be treated as an exchange even though nothing is actually given up by the taxpayer. For example, shareholders participating in an IRC §355 spin-off may receive a distribution of stock in a subsidiary corporation, but not relinquish any shares of the parent corporation. Nevertheless, under IRC §367(c)(1), the shareholders in such a transaction will be treated as having participated in an exchange.

IRC §367(c) applies to distributions, and if there is no transfer described in IRC §367(a)(1), then IRC §367(b) will apply. Accordingly, a foreign corporation will be considered a corporation on a distribution to which IRC §355 applies to the extent provided in the regulations adopted under IRC §367(b).

2. Contributions of Capital to a Controlled Corporation

IRC §367(c) provides that any transfer of property to a foreign corporation is a contribution to capital of such foreign corporation by one or more persons, who immediately after the transfer own stock possessing at least 80 percent of the total combined voting power of all classes of stock of such corporation. This transfer will be treated as an exchange of property for stock of the foreign corporation equal to the FMV of the property transferred. Thus, a contribution to capital of an already 100 percent owned foreign subsidiary will be considered an exchange, even though the foreign subsidiary does not issue additional stock with respect to that contribution.

b. Transactions with More Than One Applicable IRC Section

In certain instances, transfers of property subject to the provisions of IRC §367 may be described in more than one of the nonrecognition provisions of the Code. The IRC, in some instances, has provided clarification. In addition, the treasury regulations provide the following additional clarification:

1. Treas. Reg. §1.367(b)-4 applies to an exchange of stock by a US shareholder in an exchange described in IRC §351 or an exchange described in IRC §354 made in a reorganization described in IRC §368(a)(1)(B).