

Part III - Administrative, Procedural, and Miscellaneous

Regulations Under Section 367(a) Applicable to Certain Outbound Reorganizations and Section 351 Exchanges

Notice 2008-10

SECTION 1. OVERVIEW

The Internal Revenue Service (IRS) and the Treasury Department (Treasury) will issue regulations under section 367(a) of the Internal Revenue Code (Code) to clarify how the two exceptions to the rule in §1.367(a)-3(d)(2)(vi) of the Income Tax Regulations (coordination rule) provided by §1.367(a)-3(d)(2)(vi)(B) apply to certain outbound reorganizations described in section 368(a) and certain successive transfers to which section 351 applies. This notice is issued in response to certain transactions designed to avoid U.S. income tax. The regulations issued pursuant to this notice will apply to transactions occurring on or after December 28, 2007.

SECTION 2. TRANSACTIONS AT ISSUE

The IRS and Treasury are aware that certain taxpayers are engaging in transactions intended to repatriate cash or other property from foreign subsidiaries without the recognition of gain or a dividend inclusion. In one such transaction, for example, USP, a domestic corporation, owns 100 percent of the stock of FA, a foreign

corporation, and USP's basis in its FA stock is \$100x. USP also owns 100 percent of the stock of UST, a domestic corporation, and USP's basis in its UST stock equals its fair market value of \$100x. UST's property consists of property with zero tax basis, such as self-created intangibles or fully depreciated tangible property. UST sells its property to FA in exchange for \$100x cash and, in connection with the transaction, UST liquidates and FA transfers all of the property acquired from UST to U.S. Newco, a newly formed domestic corporation, in exchange for 100 percent of the U.S. Newco stock (the Transaction). Other variations of the Transaction may be available. For example, FA may purchase the stock of UST from USP for \$100x and, in connection with the acquisition, UST merges into a domestic limited liability company (LLC) wholly owned by FA that is disregarded as separate from FA for U.S. tax purposes. FA then contributes all of its LLC interests to U.S. Newco, a newly formed domestic corporation, in exchange for 100 percent of the U.S. Newco stock.

Taxpayers take the position that, pursuant to §1.367(a)-3(d)(2)(vi)(B)(1)(i), UST's transfer of property to FA is not subject to section 367(a) or (d) because the basis adjustment requirement of section 367(a)(5) is satisfied if USP reduces by \$100x its basis in the FA stock that it held prior to the Transaction.

SECTION 3. BACKGROUND

Section 367(a)(1) provides that if, in connection with an exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a

corporation. Section 367(a)(2) provides that, except to the extent provided in regulations, section 367(a)(1) shall not apply to the transfer of stock or securities of a foreign corporation that is a party to a reorganization. Section 367(a)(3) provides that, except to the extent provided in regulations, section 367(a)(1) shall not apply to the transfer of property used in an active foreign trade or business. Section 367(a)(6) grants regulatory authority to provide additional exceptions to the general rule of section 367(a)(1).

Section 367(a)(5) provides that in the case of an exchange described in section 361(a) or (b) (section 361 exchange), the exceptions to section 367(a)(1) provided under sections 367(a)(2) and (a)(3) shall not apply. Therefore, the general rule under section 367(a)(5) is that a transfer of property by a domestic corporation (U.S. transferor) to a foreign corporation in a section 361 exchange is subject to section 367(a)(1). Section 367(a)(5) also provides, however, that subject to basis adjustments and other conditions to be provided in regulations, the general rule will not apply (and the transfer may therefore be eligible for the exceptions under sections 367(a)(2) and (a)(3)) if the U.S. transferor is controlled (within the meaning of section 368(c)) by five or fewer domestic corporations.

Regulations have not been issued under section 367(a)(5). However, the legislative history of section 367(a)(5) explains how the required basis adjustments would have to be made:

It is expected that regulations will provide this relief only if the U.S. corporate shareholders in the transferor agree to take a basis in the stock they receive in a foreign corporation that is a party to the reorganization equal to the lesser of (a)

the U.S. corporate shareholders' basis in such stock received pursuant to section 358, or (b) their proportionate share of the basis in the property of the transferor corporation transferred to the foreign corporation.

S. Rep. No. 100-445, 100th Cong., 2d Sess. at 62 (Aug. 3, 1988). Thus, the gain realized, but not recognized, by the U.S. transferor in connection with the section 361 exchange must be preserved in the stock received by certain corporate shareholders of the U.S. transferor in the reorganization.

The rules regarding the treatment of transfers of stock or securities to foreign corporations are contained in §1.367(a)-3. Certain outbound reorganizations followed by transfers to controlled corporations and certain successive transfers of property to which section 351 applies constitute "indirect stock transfers" and are subject to §1.367(a)-3. See §1.367(a)-3(d)(1). Such indirect stock transfers are subject to gain recognition under section 367(a)(1), unless they qualify for the exceptions contained in §1.367(a)-3(b) (for transfers of foreign stock) or -3(c) (for transfers of domestic stock). See §1.367(a)-3(d)(1).

The general coordination rule of §1.367(a)-3(d)(2)(vi)(A) provides, in general, that if, pursuant to an indirect stock transfer, a U.S. person transfers (or is deemed to transfer) property to a foreign corporation in an exchange described in sections 351 or 361, such transfer is subject to sections 367(a) and (d), prior to the application of the indirect stock transfer rules of §1.367(a)-3(d). Section 1.367(a)-3(d)(2)(vi)(A). This general coordination rule, however, is subject to two exceptions (Exception One and Exception Two).

Exception One is available for certain section 361 transfers of property made

pursuant to a reorganization to the extent the foreign acquiring corporation transfers the acquired property (re-transferred property) to a domestic corporation controlled within the meaning of section 368(c) (domestic controlled corporation) as part of the same transaction. However, Exception One applies only if the domestic controlled corporation's basis in the re-transferred property is no greater than the basis the U.S. transferor had in such property and either (i) the domestic acquired corporation is controlled (within the meaning of section 368(c)) by five or fewer domestic corporate shareholders, appropriate basis adjustments as provided in section 367(a)(5) are made to the stock of the foreign acquiring corporation, and any other conditions provided in regulations under section 367(a)(5) are satisfied; or (ii) the indirect transfer of stock of the domestic acquired corporation satisfies the requirements of §1.367(a)-3(c)(1)(i), (ii), and (iv), and (c)(6), and the domestic acquired corporation attaches a statement to its tax return for the taxable year of the transfer. Section 1.367(a)-3(d)(2)(vi)(B)(1)(i) and (ii).

Exception Two is available for transfers described in §1.367(a)-3(d)(1)(vi) where a U.S. person transfers property to a foreign corporation in a section 351 exchange, to the extent that such property is transferred by such foreign corporation to a domestic corporation in another section 351 exchange, but only if the domestic transferee's basis in the property is no greater than the basis that the U.S. transferor had in such property. See §1.367(a)-3(d)(2)(vi)(B)(2).

SECTION 4. REGULATIONS TO BE ISSUED UNDER SECTION 367(a)

The IRS and Treasury will issue regulations under section 367(a) to clarify how

the two exceptions to the general coordination rule of §1.367(a)-3(d)(2)(vi)(A) are to be applied.

The rule of Exception One contained in §1.367(a)-3(d)(2)(vi)(B)(1)(i) will be modified to clarify that the basis adjustment required as provided in section 367(a)(5) must be made to the stock of the foreign acquiring corporation received by domestic corporate shareholders of the U.S. transferor in the reorganization such that the appropriate amount of unrecognized gain in the U.S. transferor's property is reflected in such stock. Thus, the basis adjustment requirement cannot be satisfied by adjusting the basis in stock of the foreign acquiring corporation held by such shareholders prior to the reorganization. The regulations will clarify that to the extent the appropriate amount of unrecognized gain in the U.S. transferor's property cannot be preserved in the stock of the foreign acquiring corporation received in the reorganization, then the U.S. transferor's transfer of property to the foreign acquiring corporation shall be subject to sections 367(a) and (d).

Section 1.367(a)-3(d)(2)(vi)(B)(2) will be modified to clarify that Exception Two shall not apply to a section 351 transfer that is also a section 361 exchange. Thus, a section 351 transfer that is also a section 361 exchange may only qualify, if at all, for Exception One.

SECTION 5. EFFECTIVE DATE

The regulations described in this notice will apply to transactions occurring on or after December 28, 2007. No inference is intended as to the treatment of transactions described herein under current law, and the IRS may, where appropriate, challenge

such transactions under applicable provisions or judicial doctrines.

SECTION 6. COMMENTS

The IRS and Treasury are studying other transactions and structures that have the effect of repatriating earnings of foreign corporations without the recognition of gain or a dividend inclusion. Comments are requested in this regard. Comments are also requested regarding more fundamental changes that can be made in this area, including possible changes to the coordination rule.

SECTION 7. DRAFTING INFORMATION

The principal authors of this notice are John Seibert and Daniel McCall of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and Treasury Department participated in its development. For further information regarding this notice contact Mr. Seibert or Mr. McCall at (202) 622-3860 (not a toll-free call).