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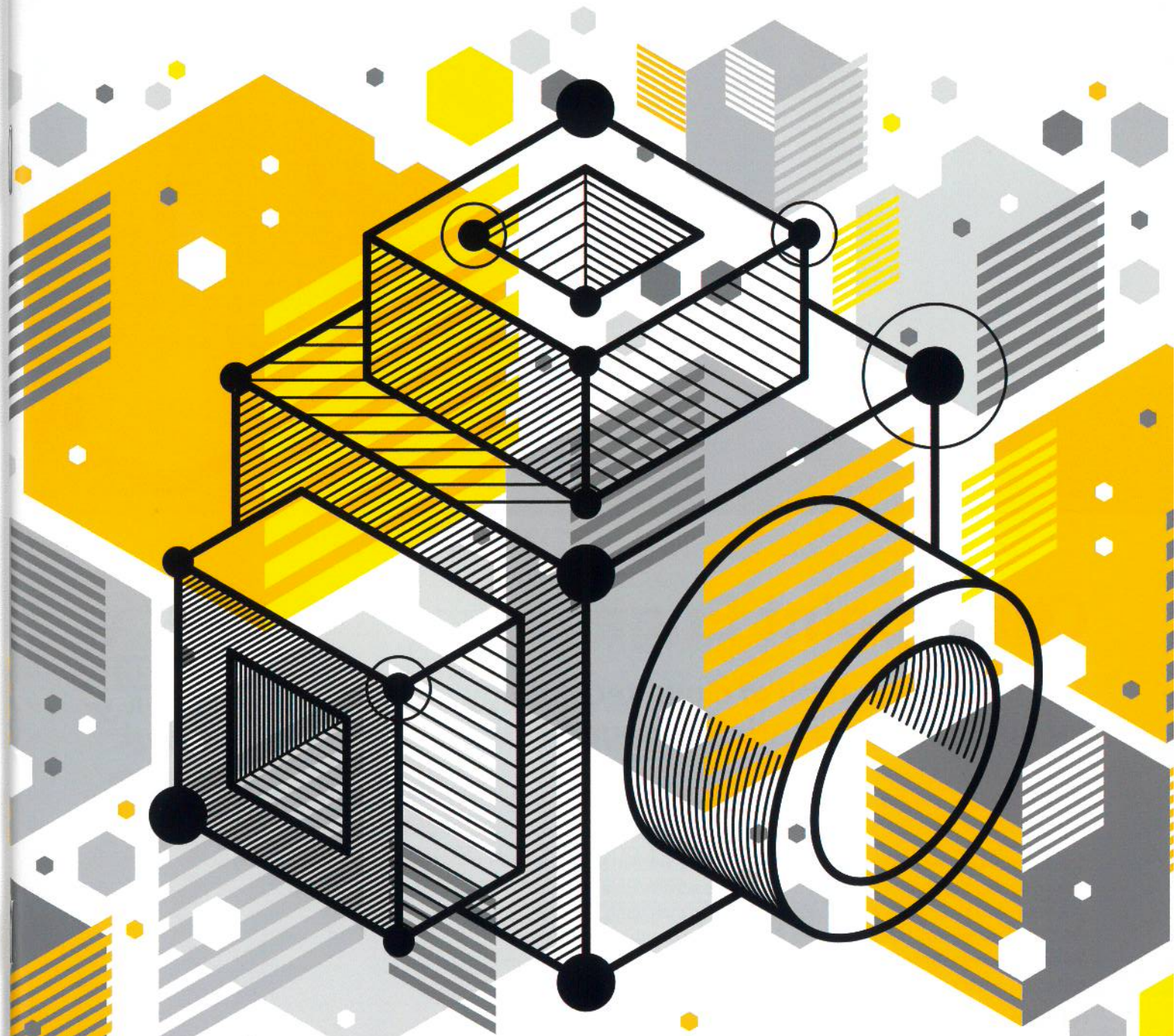

Cross Border Mergers and Acquisitions

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ANTHONY DIOSDI

THIS ARTICLE EXAMINES A NUMBER OF KEY TAX CONSIDERATIONS SPECIFIC TO CROSS-BORDER REORGANIZATIONS.

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MODERN DAY CROSS-BORDER MERGER & ACQUISITIONS

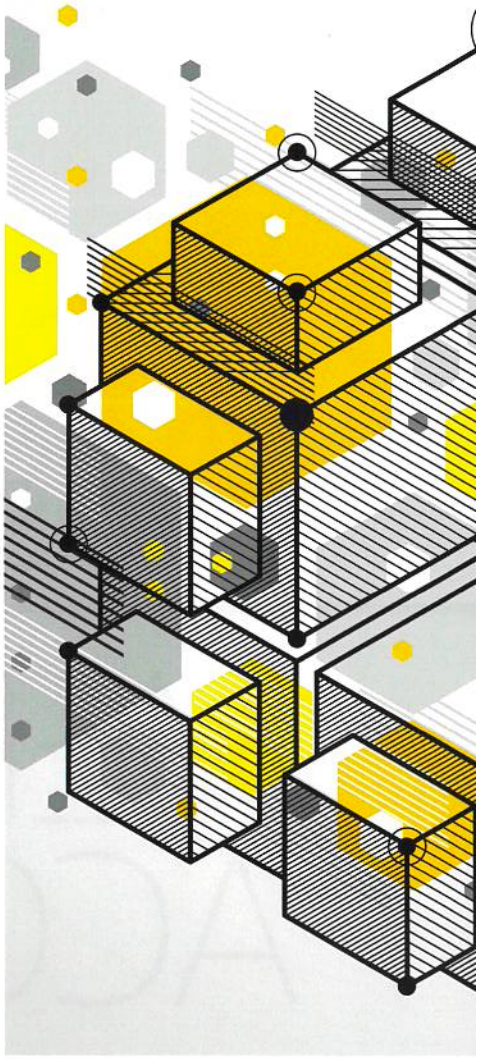
In today's global economy, corporations have operations all over the world. Typically, a U.S. parent corporation owns a group of subsidiary corporations formed within and outside the United States. In such a scenario, the foreign subsidiaries are largely held by one foreign parent corporation. In larger multinational corporations, frequently there are multiple foreign parent corporations.

This article discusses a number of key tax considerations specific to cross-border reorganizations. This article does not provide an exhaustive overview of all tax considerations but rather provides commentary on the most overlooked and misunderstood factors involved in the taxation of an international corporate reorganization.

SECTION 368(A)(1) CORPORATE REORGANIZATIONS

Any discussion regarding the taxation of cross-border mergers and acquisitions must begin with Section 368(a)(1). In the domestic context, Section 368(a)(1) provides for nonrecognition of gain or loss realized in connection with a considerable number of corporate organizational changes. These include acquisitive and other reorganizations as defined in Section 368(a)(1) and divisive reorganizations under Section 355. They are permitted on a tax-free basis on the rationale that they involve merely changes in the organizational forms for the conduct of business and that there should be no tax penalty imposed on formal organizational adjustments that are dictated by business considerations.

Any discussion regarding the taxation of cross-border mergers and acquisitions must begin with Section 368(a)(1).



Reorganizations, as defined in Section 368(a)(1), include statutory mergers and consolidations, acquisitions by one corporation of the stock or assets of another corporation, recapitalizations, changes in form or place of organizations, and certain corporate transfers in a Title 11 or similar bankruptcy case. If the transaction qualifies as a reorganization, neither gain nor loss will be recognized by the corporation or corporations involved or by their shareholders who may exchange their stock for other stock.[1]

There are generally three requirements for a transaction to qualify as a tax-free reorganization:

- The transaction must have a business purpose.[2]
- The original owners must retain a continued proprietary interest in the reorganized corporation (the "continuity of interest" requirement).[3]
- In an acquisitive reorganization, the acquired corporation must either continue the acquired corporation's historic business or use a significant portion of the acquired corporation's historic business assets in a business (the "continuity of business enterprise" requirement).[4]

The basic types of corporate reorganizations are discussed below:

Type A reorganization. To qualify as a Type A reorganization, the transaction must satisfy all of the applicable merger or consolidation requirements under the corporation laws of the federal or state government.[5] In the typical merger transaction, one corporation is absorbed into another corporation, with only the acquiring corporation surviving. In a typical consolidation, two corporations are combined into a new entity, and both of the old corporate entities disappear.

In addition to qualifying as a state law merger or consolidation, the transaction also must meet the continuity of proprietary interest, continuity of business enterprise, and business purpose tests developed by the courts and incorporated into the Section 368 regulations.[6]

Type B reorganization. In a Type B reorganization, the purchasing corporation acquires a controlling interest in the target corporation from the target's shareholders solely in exchange for all or part of the purchasing corporation's stock.[7] Two significant elements of the Type B reorganization should be noted at the outset.

First, and most important, the purchasing corporation must have control over the target corporation immediately after the stock acquisition from the target shareholders. "Control," for purposes of Section 368, generally requires ownership by the acquiring corporation of "at least 80 percent of the total combined voting power of all classes of stock entitled to vote" and "at least 80 percent of the total number of shares of all other classes of stock."[8] Second, the target shareholders must exchange stock solely for all or part of the acquiring corporation's voting stock or solely for all or part of the voting stock of the acquiring corporation's parent.

Type C reorganization. In a Type C reorganization, substantially all of the assets of a corporation are acquired by another corporation in exchange for part or all of the latter's voting stock or the voting stock of its parent's corporation, followed by the liquidation of the acquired corporation.[9]

Type D reorganization. A Type D reorganization allows certain distributions by one corporation (the "distributing corporation") to its shareholders of stock or securities in another corporation (the "controlled corporation") to be tax-free to the shareholders, and also be tax-free to the distributing corporation.[10]

Type E reorganization. A Type E reorganization involves the recapitalization of a corporation.[11]

Type F reorganization. A Type F reorganization involves "a mere change in identity, or place of organization of one corporation, however effected."[12] The major tax advantage to classification as a Type F reorganization is a preferential set of rules that will apply after the reorganization regarding loss carryovers. For example, after a Type F reorganization, in many cases, the new corporation has an opportunity to use net operating losses of an old corporation against its income.

Type G reorganization. A Type G reorganization involves a "transfer by a corpora-

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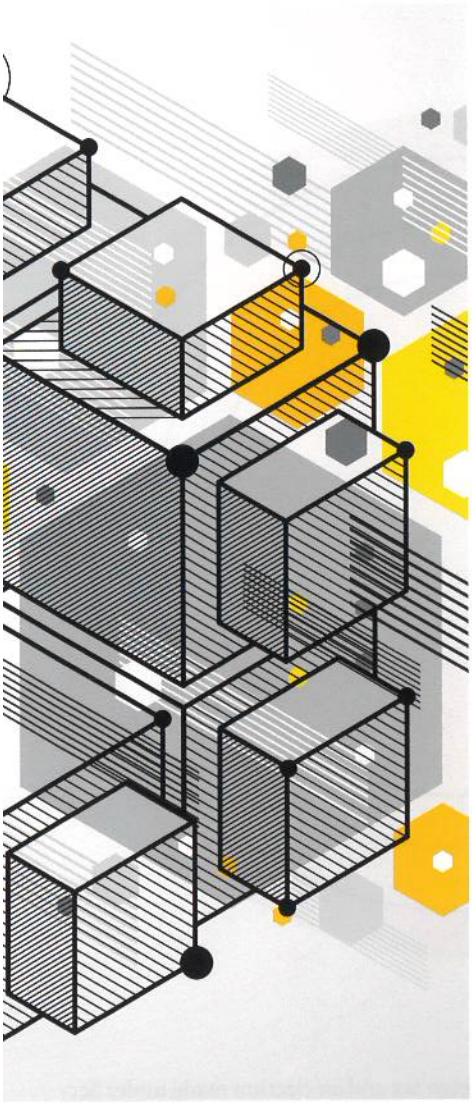


tion of all or part of its assets to another corporation in a Title 11 or similar case; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under Section 354, 355, or 356."[13]

Section 368(a)(1) plays a definitional role for providing nonrecognition of gain or loss in a domestic reorganization. However, the reorganization of one or more foreign corporations will be accorded nonrecognition of gain treatment only to the extent allowable under Section 367 and other relevant provisions of the Internal Revenue Code. The rules governing the taxation of corporate reorganizations differ depending on whether the transaction is deemed to involve an outbound transfer under Section 367(a), which involves a transfer of assets or stock from a U.S. corporation to a foreign corporation, or an outbound transfer under Section 367(b), which involves a transfer of assets or stock from a foreign corporation to a U.S. corporation or from one foreign corporation to another foreign corporation.

Rules governing outbound transfers under Section 367(a)

Section 367 must be considered in any outbound, inbound, or foreign to foreign corporate reorganization. When applicable, Section 367 causes a corporation to not be treated as a corporation for purposes of applying the nonrecognition provisions of the Internal Revenue Code.

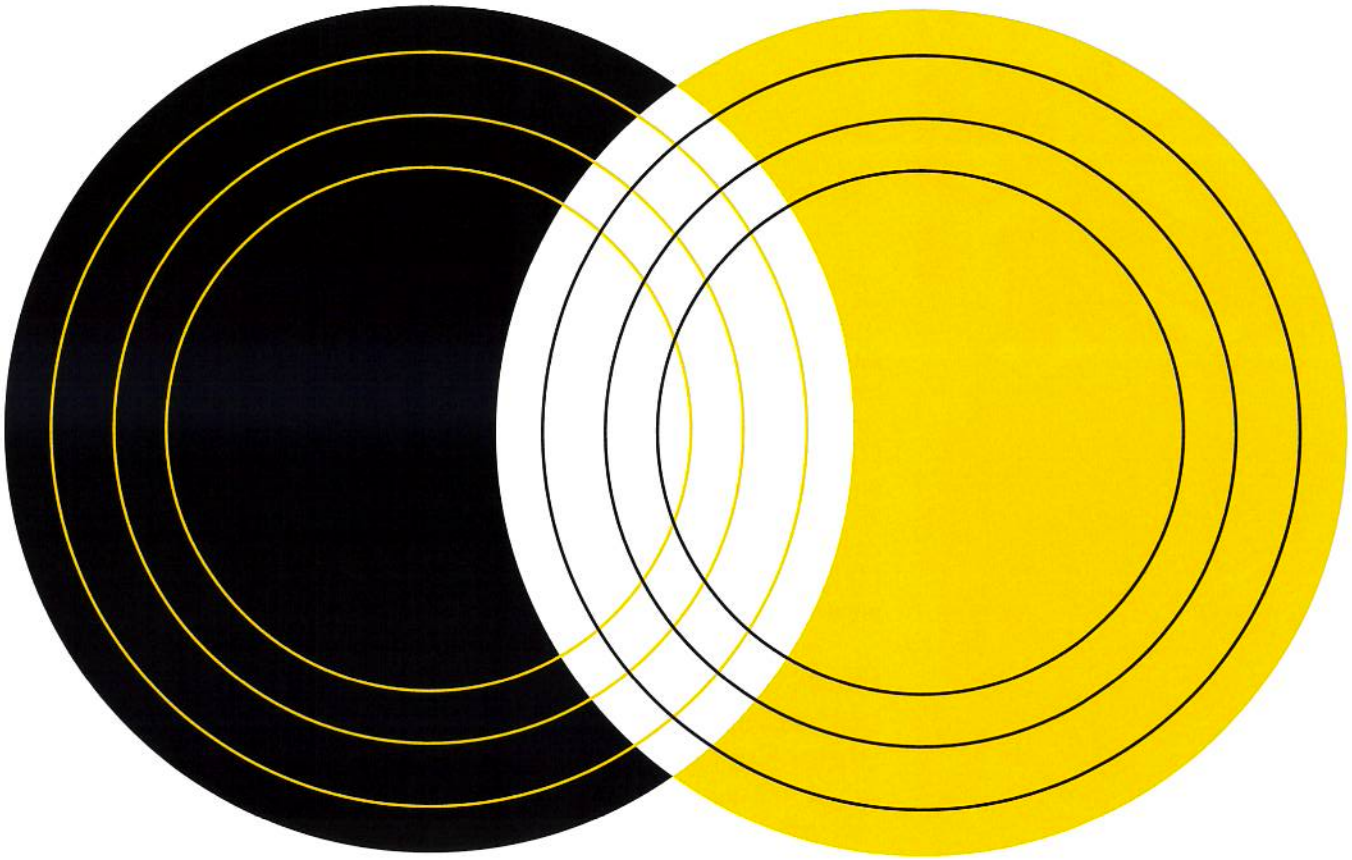
Section 367(a) requires a U.S. person transferring appreciated property to a foreign corporation to recognize a gain on the transfer. The transaction subject to Section 367(a) that is most commonly encountered is probably a transfer of property to a foreign corporation in exchange for its stock under Section 351. Section 367(a) provides a general rule of taxability with respect to outbound transfers of property in exchange for other property in transactions described in Section 332, 351, 354, 356, or 361 by stating that a foreign corporation will not be considered a corporation that could qualify for nonrecognition of gain under one of the enumerated provisions of the Internal Revenue Code.

Section 367(a) imposes a so-called "toll charge" tax on the income realized on transfers of certain tainted assets. Categories of tainted assets under Section 367(a) include: (1) property relating to inventory and certain intellectual property; (2) installment obligations, accounts receivable, or similar property; (3) property with respect to which the transferor is a lessor at the time of the transfer, unless the transferee was the lessee; (4) foreign currency and other property denominated in foreign currency; and (5) depreciable property to the extent that gain reflects depreciation deductions that have been taken against U.S.-source income.

The U.S. transferor's basis in any shares received in an outbound transfer equals the U.S. transferor's basis in the property transferred, increased by the amount of the gain recognized on the transfer. The types of corporate transactions governed by the outbound toll charge provisions include the acquisition of the stock or assets of a U.S. corporation in exchange for stock of a foreign corporation in a reorganization described in Section 368(a), which is normally within the scope of Section 367(a).

Triangular Type A mergers, whether in the form of a forward triangular merger described in Section 368(a)(2)(E), in which the shareholders of the acquired U.S. corporation exchange their stock in the U.S. corporation for stock in a foreign corporation, are treated as an indirect transfer of stock by the U.S. shareholder to the foreign corporation. The same analysis applies to a triangular Type B reorganization in which a U.S. person transfers stock in the acquired U.S. corporation to a U.S. subsidiary of the foreign corporation in exchange for stock of the foreign corporation. A U.S. shareholder is also deemed to make a transfer of stock of a U.S. corporation if substantially all of its assets are acquired by a U.S. subsidiary of a foreign corporation in exchange for stock of the foreign corporation in a Type C reorganization and the U.S. acquired corporation is then liquidated.

1 *See* Sections 354, 356, 361, and 1032.
2 Reg. 1.368-1(b).
3 Reg. 1.368-1(e).
4 Reg. 1.368-1(d).
5 Reg. 1.368-2(b)(1).
6 Reg. 1.368-1(b).
7 Section 368(c).
8 Section 368(c).
9 Section 368(a)(1)(C).
10 Section 368(a)(1)(D).
11 Section 368(a)(1)(E).
12 Section 368(a)(1)(F).
13 Section 368(a)(1)(G).



Section 367(b) in the context of a cross-border reorganization

Section 367(b) and its regulations apply to outbound transfers not covered under Section 367(a). Specifically, in the case of any exchange described in Section 332, 351, 354, 356, or 361 in connection with which there is no outbound transfer subject to Section 367(a)(1), a foreign corporation will be considered to be a corporation. T.D. 8862, 2000-1 C.B. 466-67, describes the policy of Section 367(b) as follows:

> The principal purpose of Section 367(b) is to prevent the avoidance of U.S. tax that can arise when the Subchapter C provisions apply to transactions involving foreign corporations. The basic thrust of Section 367(b) is to implement tax under Section 1248 in transactions that would otherwise be exempt from tax under a tax-free-exchange provision.

Under Section 1248(a), gain recognized on a U.S. shareholder's disposition of stock in a controlled foreign corporation (CFC) is treated as dividend income to the extent of the relevant earnings and profits accumulated while such person held the stock. It should be understood that the relevance of Section 1248 has diminished because of the Section 965 "transition tax."[14] The transition tax eliminated most untaxed offshore earnings and profits. In addition, the global intangible low-tax income or "GILTI" has caused most offshore income that is not classified as subpart F income to be taxed. As a result, most untaxed foreign income that can be reached by Section 1248 is the 10% QBAI[15] under Section 951A(b)(2)(A) or foreign source income deferred as the result of high rates of foreign tax and an election made under Section 954.[16]

Under Section 1248(a), gain recognized on a U.S. shareholder's disposition of stock in a CFC is treated as dividend income to the extent the relevant earnings and profits accumulated during the holding period of the stock or security. Thus, in the case of a U.S. C corporate holder of foreign stock that wishes to dispose of the stock through a tax-free provision of Section 368(a)(1), the Section 1248 conversion of gain into a dividend generally triggers an exemption from tax for such U.S. corporate shareholders pursuant to the Section

[14] Section 965 imposes a one-time transition tax on a U.S. shareholder's share of deferred foreign income of certain foreign corporations' accumulated deferred foreign income. A U.S. shareholder is a U.S. person who directly, indirectly, or constructively owns at least 10% of either the total voting power or total value of a foreign corporation's stock. Section 965 accomplished the transition tax by increasing the subpart F income of each specified foreign corporation that began before 1/1/2018 by the greater of the specified foreign corporation's accumulated deferred foreign income measured in functional currency as of 11/2/2017 or 12/31/2017.

[15] The term qualified business asset investment or "QBAI" means the average of a domestic corporation's aggregate adjusted bases as of the close of each quarter of the domestic corporation's taxable year in specified tangible property that is used in a trade or business of the domestic corporation and is of a type allowable under Section 167. GILTI presumes that tangible property should provide an investment return of no greater than 10%.

[16] Section 954 permits the exclusion of subpart F and GILTI income which is 90% of the maximum U.S. federal corporate rate.

[17] The same recharacterization rules apply to domestic entities involved in a cross-border reorganization that are not C corporations.

Section 367 must be considered in any outbound, inbound, or foreign to foreign corporate reorganization.

245A dividends received deduction. Section 245A(a) allows an exemption for certain foreign income of a domestic corporation that is a U.S. shareholder by means of a 100% dividends received deduction for the foreign-source portion of dividends received from "specified 10-percent owned foreign corporations" by certain domestic corporations that are U.S. shareholders of those foreign corporations within the meaning of Section 951(b).

In the case of a domestic C corporation transferring foreign stock or securities through a Section 368(a)(1) tax-free reorganization, Section 367(b) is largely irrelevant for tax purposes. On the other hand, the situation is different for individual shareholders of a C corporation. For individual U.S. shareholders, the recharacterized income under Section 1248(a) will be taxed as ordinary income rather than long-term capital gains.[17]

Concurrent application of Section 367(a) and (b)

Section 367 was originally aimed at preventing tax-free transfers by U.S. taxpayers of appreciated property to foreign corporations that could sell the property free of U.S. tax. The reach of this provision has been broadened over the years to apply to a broad spectrum of transactions involving transfers both into and out of the United States.

Today, Section 367(a) provides a general rule of taxability with respect to outbound transfers of property in exchange for other property in corporate reorganizations and split-ups. The character and source of gain produced by Section 367 is determined as if the transferor had sold the property to the transferee in a taxable transaction.

Prior to the enactment of the 2017 Tax Cuts and Jobs Act, Section 367(a) required corporations participating in a cross-border reorganization to recognize gain on outbound transfers unless: (1) the transfer qualified for an active trade or business exception, or (2) the assets consisted of stock or securities of a foreign corporation and the U.S. transferor entered into a gain-recognition agreement to preserve gain. As a result of the 2017 Tax Cuts and Jobs Act, Congress eliminated the active trade or business exception. This means that it is no longer possible to incorporate a foreign branch for purposes of a tax-free cross-border reorganization. The only exception to Section 367 that now remains for purposes of tax-free or tax-deferred for purposes of cross-border reorganizations is to transfer stock to a foreign corporation by virtue of a gain-recognition agreement.

Planning opportunities utilizing a gain-recognition agreement

Transfers by a U.S. person of stock or securities of a U.S. corporation to a foreign corporation are generally taxable under Section 367, unless an exception is available. One such exception is the execution of a closing agreement between the IRS and the U.S. transferor under which the transferor must agree to recognize taxable gain on the transferee corporation's later disposition of the transferred stock or securities (a "gain-recognition agreement"). According to Reg. 1.367(a)-3(b)(1), if a U.S. person is a 5% or more shareholder of the vote or value of the transferred foreign corporation immediately after the transfer and files a gain-recognition agreement, the gain-recognition provisions of Section 367(a) are not triggered.

A gain-recognition agreement is an agreement to which the U.S. transferor agrees to recognize gain if the transferred foreign corporation disposes of the transferred stock or securities during the term of the gain recognition and pay interest on any additional tax owing if a "triggering event" occurs. A "triggering event" typically takes place when a foreign corporation disposes of the untaxed U.S. property.

In most cases, a gain-recognition agreement term is 60 months following the end of the taxable year in which the initial transfer is made. This means, in certain cases, with a properly drafted gain-recognition agreement, the adverse federal income tax consequences associated with a cross-border merger or reorganization involving a U.S. corporation can be deferred up to five years, interest-free.

If a U.S. person is a 5% or more shareholder with respect to the stock of a transferee foreign corporation, the shareholder may be eligible to file a gain-recognition agreement to avoid immediate gain recognition under Section 367(a)(1). A gain-recognition agreement may be very valuable to eliminate (or defer) the tax consequences associated with the outbound transfer of stock in a cross-border merger or reorganization.

The regulations contain very specific rules as to what needs to be in a gain-recognition agreement. At a minimum, a gain-recognition agreement should contain the following:

- A gain-recognition agreement must specifically state that it is a gain-recognition agreement in accordance with Reg. 1.367(a)-8.
- A gain-recognition agreement must adequately describe the stock or securities being transferred through the agreement. In order to satisfy the conditions and requirements of Reg. 1.367(a)-8(c)(3), the gain-recognition agreement should provide the following: (a) a calculation of the amount of the built-in gain (i.e., the fair market value of the stock or securities over the tax basis) in the transferred stock or securities that are subject to the gain-recognition agreement, reflecting the basis and fair market value on the date

Section 367(a) imposes a so-called "toll charge" tax on the income realized on transfers of certain tainted assets.

of the initial transfer; (b) a description of the shares transfer agreement used to transfer the stock or securities; (c) the amount of any gain recognized by the U.S. transferor on the initial transfer of stock or securities; (d) the percentage (by vote and value) that the transferred stock (if any) represents of the total stock outstanding of the transferred corporation on the date of the initial transfer.

- The gain-recognition agreement should state the name, address, place of incorporation, and the taxpayer identification number (if any) of the transferee corporation.
- The gain-recognition agreement should state the date on which the U.S. transferor acquired the transferred stock or securities.
- The gain-recognition agreement should state the name, address, and place of incorporation of the transferred foreign corporation, and a description of the stock or securities received by the U.S. transferor in the initial transfer, including the percentage of stock (by vote and value) of the transferred foreign corporation received in such exchange.
- The gain-recognition agreement should include a statement of the initial transfer described in Reg. 1.367(a)-3(e), a statement that the conditions of Section 367(a)(5) and any regulations under that section have been satisfied, and a description of any adjustments to the basis of the stock received in the transaction or other adjustments made pursuant to Section 367(a)(5) and any regulations under that section.
- The gain-recognition agreement should include a statement describing the application of Section 7874 or the corporate inversion rules to the transaction.
- If a U.S. transferor (i.e. a corporation that makes a transfer or conveyance of property) is involved in the reorganization, a statement should be included in the gain-recognition agreement indicating whether the U.S. transferor was a Section 1248 shareholder (as defined in Reg. 1.367(b)-2(b)) of the transferee corporation immediately before the initial transfer, and whether the U.S. transferor is a Section 1248 shareholder with respect to the transferred foreign corporation immediately after the initial transfer, and whether any reporting requirements or other rules contained in the regulations under Section 367(b) are applicable, and, if so, whether they have been satisfied.
- If the initial transfer involves a transfer by a partnership, the gain-recognition agreement should include a complete description of the transfer, including a description of the partners in the partnership.
- If the transaction involves the transfer of property other than the transfer of stock or securities and the transaction is subject to the indirect stock transfer rules of Reg. 1.367(a)-3(d), the gain-recognition agreement should include a statement indicating whether: (a) the reporting requirements under Section 6038B[18] have been satisfied with respect to the transfer of such property; (b) whether gain was recognized under Section 367(a)(1); and (c) whether Section 367(d) applied to the transfer of such property.
- A gain-recognition agreement must include a statement in which the U.S. transferor agrees to comply with all the conditions and requirements of Reg. 1.367(a)-8, including to recognize gain under the gain-recognition agreement in accordance with Reg. 1.367(a)-8(c)(1)(i) to extend the period of limitations on the assessment of tax.
- The gain-recognition agreement must include a statement that the U.S. transferor is informed of any events that affect the gain-recognition agreement, including triggering events or other gain-recognition events.
- The gain-recognition agreement must provide a description of the event (such as a triggering event) and the applicable exception, if any, that gave rise to a new gain-recognition agreement (such as a triggering event exception), including the date of the event and the name, address, and taxpayer identification number (if any) of each person that is a party to the event.
- The gain-recognition agreement should state if the U.S. transferor elects or does not elect to include income in any gain-recognition agreement during the year during which a gain-recognition event occurs.
- The gain-recognition agreement should include a statement describing any disposition of assets of the transferred corporation during such taxable years other than in the ordinary course of business.

Section 338 election

Not all acquiring corporations will want to acquire corporate shares of the target. The acquisition of corporate stock may expose a buyer to potential negative tax consequences of the target corporation. On the other hand, a foreign corporate buyer of the assets of a corporation will not likely inherit the U.S. tax exposure of a U.S. target corporation. In addition, an asset purchase generally provides the buyer with the opportunity to select the desired assets, leaving unwanted assets behind.

In a taxable purchase of the target's stock, an election can be made to treat the purchase of stock as a purchase of the target's assets, provided certain requirements are satisfied. The buyer, if eligible, can make a unilateral election under Section 338(g) or, if available, a joint election under Section 338(h)(1) to recharacterize a taxable stock acquisition as a deemed asset acquisition. The main advantage to the buyer is the step up on the basis of the assets deemed acquired to the fair market value on the date of purchase. It also eliminates the historic earnings and profits and ends the target's tax year. After the 2017 Tax Cuts and Jobs Act, this step-up is of enhanced value because, in addition to permitting increased depreciation and amortization deductions, this increased asset basis generally has the effect of reducing future GILTI inclusions (by both reducing the amount of "tested income" and increasing the amount of "qualified business asset investment").

When a Section 338 election is made, the target CFC is deemed to sell its assets and must recognize any gain from the deemed asset sale. If the seller is a domestic corporation, the CFC target's gain on non-trade or business assets typically is classified as subpart F income, and the remaining gain (with respect to trade or business assets) instead is classified as tested income for GILTI purposes. The CFC's tax year closes, and its subpart F income and GILTI through the date of the sale are included in the gross income of the domestic seller.

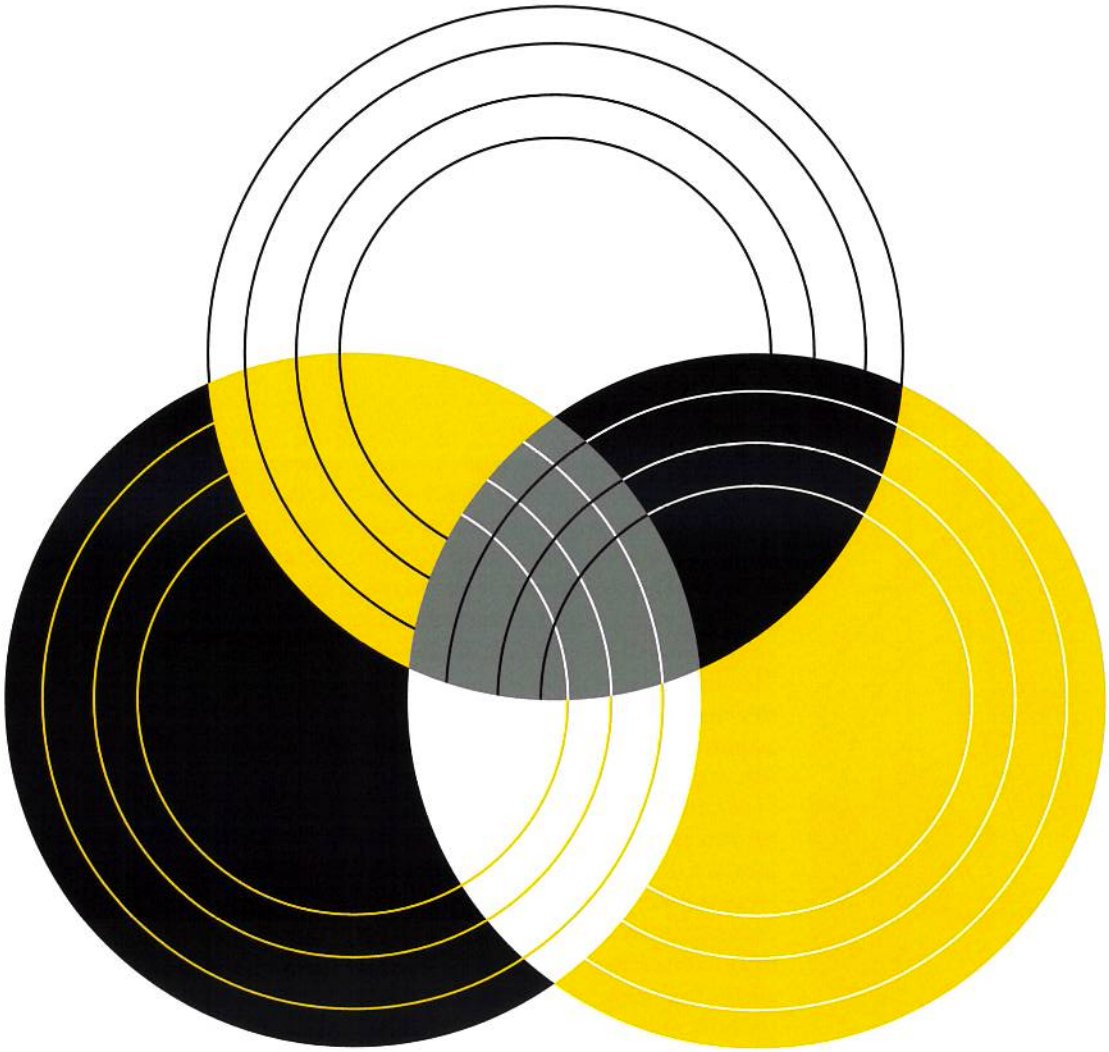
With a Section 338 election, the domestic seller also will be taxed on the gain from the sale of the CFC stock, with the basis of such stock being increased to account for any inclusions under subpart F and GILTI for the year (including the subpart F and GILTI income generated by the deemed asset sale). Subject to holding period requirements, the stock gain will be recharacterized as a dividend under Section 1248. However, dividends reclassified under Section 1248 may be eligible for a deduction under Section 245A. Section 245A(a) allows a deduction equal to the foreign-source portion of a dividend received from a specified 10% owned foreign corporation.[19] Consequently, Section 1248 dividends may be eligible for a deduction under Section 245A. However, this deduction is only available to the extent of the CFC's previous year's untaxed earnings and profits that cannot be classified as subpart F income or GILTI, as well as earnings arising from gain on the deemed sale of assets that are not subject to subpart F or GILTI.

A selling corporation may also prefer utilizing a Section 338 election. This is because there may be a preference among U.S. corporate sellers toward dividend characterization under Section 1248 (i.e., a stock sale), which may be exempt from U.S. tax under Section 245A, as compared to gain that may be classified as either GILTI or subpart F income (i.e., an asset sale), which would trigger a 10.5% or 21% U.S. corporate tax. If sufficient earnings and profits exist, corporate sellers may thus be expected to prefer stock sales over asset sales. In the absence of sufficient earnings and profits, utilizing a Section 338 election to convert subpart F income or gain taxable at 21% to GILTI at 10.5% may be preferable.

Domestic corporate buyers of a foreign corporation's assets classified as a CFC will generally also prefer making a Section 338 election as a result of the Section 245A deduction. However, the U.S. shareholders of a domestic corporation may have serious negative tax consequences as the result of a Section 338 election. The 100% dividends received deduction under Section 245A is only available to domestic C corporations. This deduction is not available for individual shareholders. This means that gain realized from a Section 338 election will result in a subpart F or GILTI inclusion to the individual shareholders of the domestic acquiring corporation. Assuming an individual shareholder does not make a Section 962 election,[20] gain from a deemed asset sale will be taxed at ordinary rates.

[18] Section 6038B requires U.S. persons who transfer property to a foreign corporation to report the transaction on IRS Form 926. This reporting requirement applies to outbound transfers of both tangible and intangible property. The penalty for a failure of a U.S. person to properly report a transfer to a foreign corporation equals 10% of the fair market value of the property transferred or $100,000.

[19] The term "specified 10% foreign corporation" is defined as any foreign corporation with respect to which any domestic corporation owns at least 10%. *See* Section 245A(b)(1).



Section 964(e) considerations

Another tax provision that corporation shareholders involved in a cross-border corporate acquisition should consider is Section 964(e)(4). Generally, Section 964(e)(1) provides that if a CFC sells or exchanges stock in another foreign corporation, the gain recognized on the sale or exchange is treated as a dividend to the same extent as it would have been under Section 1248(a) if the CFC were instead a U.S. person. If the shares of the entity which is being sold was a CFC at any time during the prior five years, gain generally is classified as a dividend to the extent of the shareholder's proportionate amount of the target CFC's earnings and profits.

Under Section 964(e)(4)(A), the "foreign source portion" (which is 100% assuming the CFC was not engaged in a trade or business and had no 80% owned U.S. subsidiary to which the amounts are attributable) of any amount characterized as a dividend under Section 964(e)(1) is treated as subpart F income, is includible in the gross income of U.S. shareholders of such CFC, and is eligible for the Section 245A deduction in the same manner as if the income was classified as a non-subpart F dividend. Because Section 245A is available only to U.S. C corporations, gains realized by U.S. C corporation shareholders from such a disposition are exempt from U.S. tax, while the same gain realized by an individual U.S. shareholder is taxable as ordinary income.[21]

Special rules for intangibles under Section 367(d)

Section 367(d) provides special rules for the transfer of intangibles to foreign corporations. Cross-border mergers and acquisitions present special problems if the transferring corporation wishes to transfer intangibles to a foreign corporation. Gain-recognition agreements cannot be utilized to avoid recognition under Section 367(d).

In order to better understand Section 367(d), it is important to understand the history of Section 367(d). Prior to 1984, U.S. corporations would develop intangibles and deduct the costs associated with developing the intangible against its U.S.-source income. U.S. corporations would then often transfer intangibles to a foreign corporation tax-free. Even if a toll-charge tax was imposed at the time of transfer, the tax would not necessarily adequately compensate the government. Thus, Sections 367(d) and 482 were enacted.

Under Section 367(d), intangibles are treated as a special class of a tainted asset. Section 367(d)(4) defines the term "intangible property" to include a patent, invention, formula, process, design, pattern, know-how, copyright, literary composition, musical composition, artistic composition, trademark, trade name, brand name, franchise, license, contract, method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, technical data, goodwill, going concern value, or workforce.

In every case involving the transfer of such assets in a transaction falling within Section 351 or 361, the transferor will be treated as having sold the property in ex-

Transfers by a U.S. person of stock or securities of a U.S. corporation to a foreign corporation are generally taxable under Section 367, unless an exception is available. One such exception is the execution of a gain-recognition agreement.

change for payments that are contingent on the productivity, use or exchange for payments that are contingent on the productivity, use, or disposition of such property. These imputed or constructive royalty payments must reflect the amounts that would have been received annually in the form of such payments over the useful life of such property.[22] These imputed or constructive royalty payments must reasonably reflect the amounts that would have been received annually in the form of such payments over the useful life of such property.

Section 367(d) provides that in the case of intangible property in a Section 351 or 361 exchange, the royalty income with respect to such transfer is to be commensurate with the income attributable to the intangible. This means that the constructive royalty is calculated in an amount that represents an arm's length charge for the use of the property under the regulations of Section 482. Under certain circumstances, a U.S. transferor may transfer intangibles to a foreign corporation taxed entirely at the time of transfer as a taxable sale if certain circumstances are satisfied.

In the context of a cross-border reorganization, the transferor of intangible property to a foreign corporation will be treated as having sold "intangible property" discussed above in exchange for payments that are contingent on the productivity, use, or disposition of such property. Section 367(d) provides that in the case of any transfer of intangible property, the transferor corporation must recognize royalty income with respect to such transfer to be commensurate with the income attributable to the property. This means a constructive royalty must be calculated in an amount that represents an arm's length charge for the use of the intangible property (as per the regulations under Section 482).

Example. An example as to how Section 367(d) operates in a typical cross-border reorganization is discussed below.

DC, a U.S. corporation, owns all of the stock of FS, a foreign corporation. (FS is a controlled foreign corporation (within the meaning of Section 957(a)). DC incurs and deducts under Sections 162 and 174 various expenses relating to the development of a patented invention. After completing development of the patented invention, DC transfers the patent to FS in a transaction that, in the absence of Section 367(d), would qualify for nonrecognition treatment under the Internal Revenue Code. FS will use the patent in its trade or business. Section 367(d) will treat DC as having sold the patent to FS in exchange for payments that are contingent on the productivity, use, or disposition of the patent. These constructive royalty payments are calculated in an amount which reflects an arm's length charge for the use of the patent over the useful life of the patent.

In light of the deemed royalty regime, a taxpayer may find it advantageous to structure the transfer of intangible property to a foreign corporation as an actual license rather than as a contribution. One advantage of an actual license may be eligible to be taxed under the Foreign Derived Intangible Income or FDII provisions of the Internal Revenue Code,[23] which could be significantly less than the deemed royalty regime of Section 367(d). One disadvantage of an actual licensing agreement is that the royalty payments may be subject to foreign withholding taxes, although tax treaties often reduce or eliminate the withholding rate.

Anti-inversion rules

Parties involved in cross-border reorganizations must be mindful of the anti-inversion rules of Section 7874. These rules may apply to (1) cause a domestic corporation to recognize gain on the transfer of assets or (2) cause an acquiring foreign corporation to be treated as a domestic corporation for all purposes of the Internal Revenue Code. Section 7874 identifies two different types of corporate inversion transactions and provides a different set of tax consequences to reach each type of inversion transaction.

The first type of inversion is a transaction in which, pursuant to a plan or series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80% or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50% ownership (i.e., the "expanded affiliated group"), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group. Section 7874 denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Internal Revenue Code.

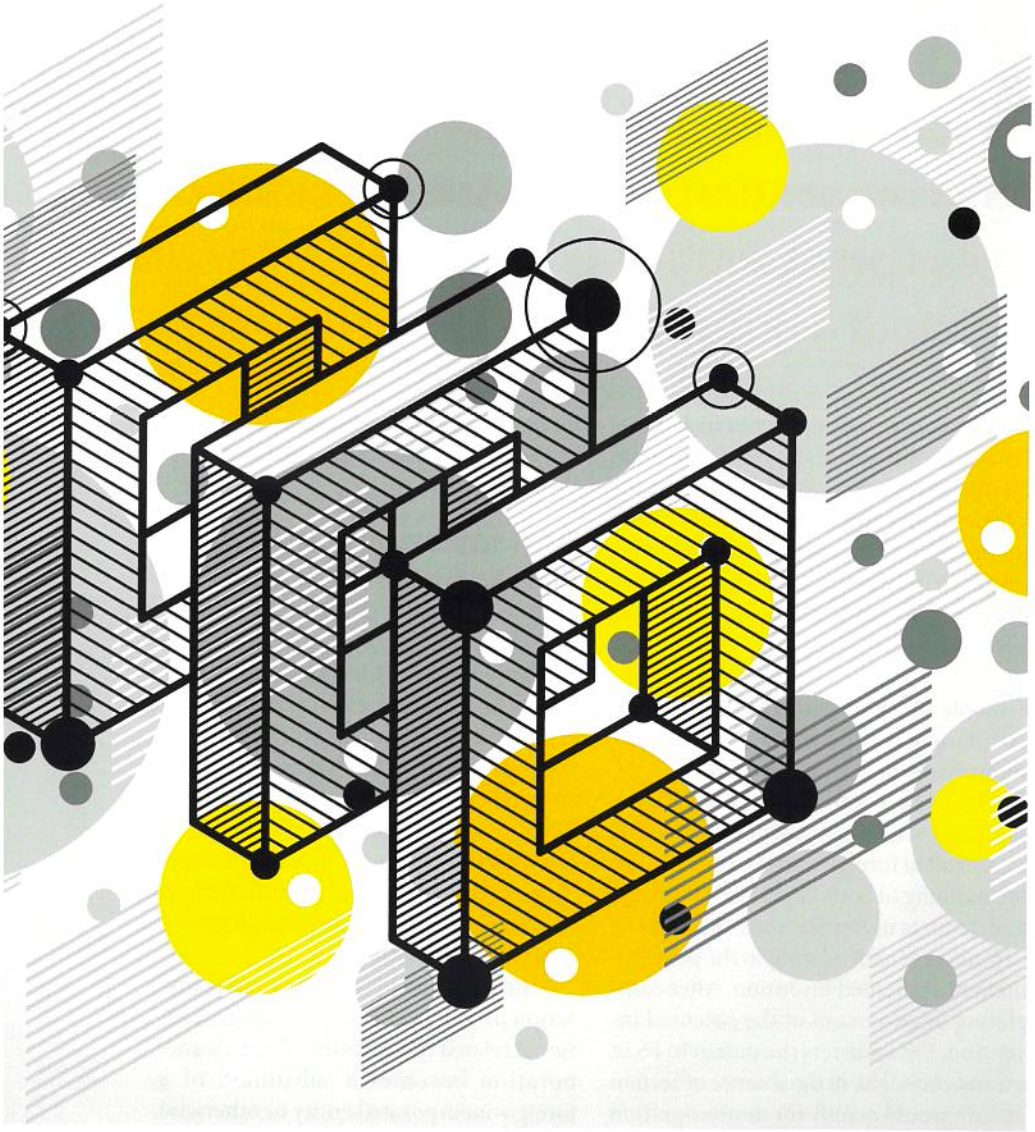
In determining whether a transaction meets the definition of an inversion, stock held by members of the expanded affiliated group that includes the foreign incorpo-

[20] Section 962 permits U.S. shareholders of a CFC to elect to be subject to corporate income tax rates (under Sections 11 and 55) on the amounts that are included in their income under Section 951(a) and Section 951A.

[21] See Hot Topic Compliance Issues for the International Tax Practitioner (2020), Renea M. Glendinning and Alfredo R. Tamayo.

[22] Section 367(d)(2)(A)(ii)(I).

[23] For U.S. C corporations that sell goods or provide certain services to foreign customers, there is a deduction pursuant to Section 250 that reduces the effective tax rate on qualifying income to 13.125%.



rated entity is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded.

The second type of inversion is a transaction that would meet the definition of an inversion transaction described above, except that the 80% ownership threshold is not met. In such a case, if at least a 60% ownership threshold is met, then a second set of rules applies to the inversion. Under these rules, the inversion transaction is respected (i.e., the foreign corporation is treated as foreign), but any applicable corporate-level "toll charges" for establishing the inverted structure are not offset by tax attributes such as net operating losses or foreign tax credits.

The anti-inversion rules do not apply where: (1) the transferee is a foreign partnership; (2) less than substantially all of the assets are transferred; or (3) substantial activities are conducted in the country where the new holding company is located. According to the regulations, the substantial activities test is satisfied only if the following requirements are satisfied:

Group employees

- The number of group employees based in the relevant foreign country is at least 25% of the total number of group employees on the applicable date.
- The employee compensation incurred with respect to group employees based in the relevant foreign country is at least 25% of the total employee compensation incurred with respect to all group employees during the testing period.

Group assets

- The value of the group assets located in the relevant foreign country is at least 25% of the total value of all group assets on the applicable date.
- The value of the group assets located in the relevant foreign country is at least 25% of the total value of all group assets on the applicable date.
- The group income derived in the relevant foreign country is at least 25% of the total group income during the testing period.

Any time U.S. corporate shares or assets of a domestic corporation are transferred to a foreign corporation, the anti-inversion rules must be carefully considered.

Reporting requirements

In order that the IRS will be informed of outbound transfers by Section 367, Section 6038B requires the U.S. corporations and persons involved to notify the IRS of the existence of these transactions. A U.S. corporation and U.S. person who transfers property to a foreign corporation must attach Form 926 (Return by Transferor of Property to a Foreign Corporation) to their regular tax return for the year of the transfer. The penalty for failing to timely file a Form 926 equals 10% of the fair market value of the property transferred or $100,000.

Conclusion

Section 367 imposes a toll charge tax on the income realized on the transfer of certain tainted assets. Acquisition of the stock or assets of a U.S. corporation in exchange for stock of a foreign corporation in a merger or reorganization described in Section 368 is normally within the scope of Section 367. In certain cases, a gain-recognition agreement can be utilized to mitigate the immediate income tax consequences of Section 367. Even if a gain-recognition agreement can be utilized to mitigate the immediate gain recognition associated with Section 367(a), Section 367(d) may trigger a deemed royalty for any intangible transfer abroad. Finally, the U.S. has anti-inversion rules under Section 7874 that must be carefully considered in any cross-border reorganization or asset acquisition. ●