

# Temporary Regulations Close Repatriation Loophole in Stock Transfers to Foreign Corporations

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On February 10, 2009, the Internal Revenue Service (IRS) issued temporary regulations (“Temporary Regulations”) on the application of Section 367 of the Internal Revenue Code (“Code”) in cross-border stock transfers governed by Code Section 304. The Temporary Regulations are intended to stop a transaction used by some taxpayers to repatriate cash to the United States tax-free and address an aspect of that transaction, which takes place under Code Section 304, previously addressed in 2006 final regulations. The Temporary Regulations apply to transfers or distributions on or after Feb. 11, 2009.

## Background

Code Section 367(a)(1) generally provides that if a U.S. person transfers property to a foreign corporation in certain tax free exchange provisions (including Code Section 351), the foreign corporation will not be considered a corporation for purposes of determining the extent to which the U.S. person recognizes gain on such transfer. Code Section 367(b)(1) provides that in the case of certain exchanges (including Code Section 351) in connection with which there is no transfer of property described in Code Section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations.

Code Section 304(a)(1) generally provides that, for purposes of Code Section 302 and 303, if one or more persons are in control of each of two corporations and, in return for property, one of the corporations (the acquiring corporation) acquires stock in the other corporation (the issuing corporation) from the person(s) in control, then such property shall be treated as a distribution in redemption of the stock of the acquiring corporation. To the extent Code Section 301 applies to the distribution, the transferor and the acquiring corporation are treated as if (1) the transferor transferred the stock of the issuing corporation to the acquiring corporation in exchange for stock of the acquiring corporation in a transaction to which Code Section 351(a) applies and (2) the acquiring corporation then redeemed the stock it is deemed to have issued. Under Code Section 304(b)(2), the determination of the amount of the property distribution that is a dividend is made as if the property is distributed by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits.

In early 2006, the IRS issued final regulations providing that Code Sections 367(a) and (b) would not apply to certain transfers of stock of a foreign or domestic corporation to a foreign acquiring corporation to which Code Section 351 applies by reason of Code Section 304(a)(1). These regulations were premised on the supposition that the policies under Code Sections 367(a) and (b) were preserved, even if a deemed Code Section 351 exchange was not subject to Code Sections 367(a) and (b), because generally the income recognized by the transferor in the

transaction (dividend income, capital gain or both) should equal or exceed the built-in gain in the transferred stock. Essentially, the IRS turned off Code Sections 367(a) and (b) to the deemed Code Section 351 transaction. However, taxpayers maintained that a transferor would not recognize income equal to or greater than the built-in gain in the transferred stock if, under Code Section 301(c)(2), the transferor was permitted to recover the basis of shares of the foreign acquiring corporation held before (and after) the transaction. As a result, the IRS has turned back on the Code Section 367 regulations in situations in which basis in previously owned shares is used.

### **The Basic Transaction**

The 2006 final regulations discussed a transaction in which a U.S. parent sells a subsidiary (domestic or foreign) to a foreign acquiring subsidiary. For example, a domestic corporation (USP) owns all of the stock of each of two foreign corporations, FC1 and FC2. The stock of FC1 has a basis in USP's hands of \$0x and a fair market value of \$100x. The stock of FC2 has a basis and a fair market value of \$100x. Neither FC1 nor FC2 has earnings and profits. USP sells the stock of FC1 to FC2 for \$100x in cash.

This sale sets in motion several Code sections as discussed above. Under Section 304(a)(1), USP is deemed to have transferred the FC1 stock to FC2 in exchange for FC2 stock in a transaction to which Code Section 351 applies, and then FC2 is considered to have redeemed the stock deemed issued to USP for the \$100x paid. In the 2006 final regulations, the IRS maintained that the \$100x gain is taxable because there was no tax basis to recover in the stock of FC1. However, taxpayers argued that USP had no gain from the \$100 payment because it could reduce the basis of the FC2 stock that USP already owned prior to the transfer of the FC1 stock. Without more, USP would have repatriated a total of \$100x tax free.

### **The Temporary Regulations**

The Temporary Regulations Section 1.367(a)-9T modify the application of Code Sections 367(a) and (b) to the deemed Code Section 351 exchanges by providing an exception to the general rule. For situations in which a distribution received by an exchanging shareholder would reduce (in whole or in part) the basis of stock of a foreign acquiring corporation that was held by a U.S. person before the transaction - other than the stock deemed issued to the U.S. person in the deemed Code Section 351 exchange - the U.S. person recognizes gain under Code Section 367(a)(1) equal to the amount by which the gain realized by the U.S. person with respect to the transferred stock in the deemed Code Section 351 exchange exceeds the amount of the distribution received by the U.S. person in redemption of the foreign acquiring corporation stock that is treated as a dividend under Code Section 301(c)(1) and included in the U.S. person's gross income under Treas. Reg. Section 1.367(a)-9T(b). Moreover, the exceptions to the application of Code Section 367 provided in the regulations will not apply to situations covered by the Temporary Regulations. For example, a U.S. person cannot avoid gain recognition under the Temporary Regulations by entering into a gain recognition agreement with respect to the deemed Section 351 exchange.

Accordingly, the repatriation opportunity presented by the scarcity of offshore earnings and profits is rendered much less attractive in light of the fact that USP must report taxable income in connection with the extraction of the \$100x from FC2.