EXPANSION OF NON-WILLFUL STANDARD FOR RELIEF FROM NON-FILING OF GAIN RECOGNITION AGREEMENT REDUCES COMPLIANCE BURDENS

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BACKGROUND

Outbound transfers (as defined) of stock or assets, as well as reorganization transactions that involve a foreign party to the reorganization, are subject to Code §367 and the regulations thereunder. Code §367(a) deals with outbound transfers of stock or assets and attempts to prevent the removal of appreciated property from U.S. taxing jurisdiction before its sale or other disposition. Code §367(b) applies to certain inbound and foreign-to-foreign reorganization transactions and is aimed at preserving the ability of the United States to tax, either currently or at a future date, the accumulated earnings and profits of a foreign corporation attributable to the stock of that corporation held by U.S. shareholders.

In the case of an outbound transfer of assets consisting of tangible property for use by the transferee, a foreign corporation in the active conduct of a trade or business outside of the United States, no gain under §367(a)(1) is triggered.[13] Otherwise, gain under Code §367(a) equal to the fair market value in excess of tax basis is triggered. Code §367(a)(2) and Treas. Reg. §1.367(a)-3, in pertinent part, provide for exceptions to the general Code §367(a) gain recognition for outbound transfers of stock or securities. These sections provide for non-recognition of gain where appropriate, upon entering into a gain recognition agreement (a "G.R.A.").

Under a G.R.A., gain recognition under §367(a) generally can be avoided on the condition that a G.R.A. is entered into by any U.S. transferor who owns at least 5% of the transferee foreign corporation immediately after transfer.[14] The 5% threshold for requiring a G.R.A. is determined based on the greater of vote or value, taking into consideration attribution rules. A U.S. shareholder who does not own 5% or more of the stock does not have to sign a G.R.A. in order to claim non-recognition treatment for their exchange of stock for stock. The foreign parent corporation that issues stock or securities to these U.S. transferors is treated as the transferee foreign corporation for purposes of applying the G.R.A. provisions.[15]

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[13] Code §367(a)(3) and Treas. Reg. §1.367(a)-1T(b)(2)(ii).
[14] Treas. Reg. §1.367(a)-3(b)(1)(ii).
[15] Code §1.367(a)-3(d)(2)(i)(A).

If there is a triggering event by an actual or deemed disposition of the transferred stock or securities by the transferee foreign corporation during the terms of the G.R.A., the U.S. transferor must recognize the gain that was realized but not recognized on the initial transfer.[16]

The term of a G.R.A. generally runs for five full taxable years following the close of the taxable year of the initial transfer.[17] Certain events can trigger early termination of a G.R.A. without triggering the gain recognition requirements before the five-year expiration.

Under prior law, if a U.S. transferor failed to timely file an initial G.R.A. or failed to comply in any material way with applicable Code §367(a) regulations or an existing G.R.A., full gain recognition resulted unless the failure to file or comply was cured and it was shown that such failure was due to reasonable cause and not willful neglect. However, the reasonable cause standard, as interpreted in case law, might not have been satisfied by U.S. transferors in many common situations, even though the failure was neither intentional nor due to willful neglect.

In 2013, the I.R.S. issued proposed regulations that would apply a non-willful standard (defined generally as gross negligence, reckless disregard, or willful neglect) rather than the reasonable cause standard. The proposed regulations would apply the non-willful standard to avoid recognizing gain under Code §367(a)(1) on the initial outbound transfer as a result of a failure to timely file an initial G.R.A. or as a result of a failure to comply in all material respects with the applicable Code §367(a) regulations or the terms of an existing G.R.A.

Extension of Relief for Non-Willful Failures to Other Reporting Obligations

The I.R.S. has determined that it is appropriate to extend the relief for failures that are not willful to certain other reporting obligations under Code §367(a) that were not covered by the 2013 proposed regulations. Accordingly, Treas. Reg. §1.367(a)-2 (providing an exception to gain recognition under Code §367(a)(1) for assets transferred outbound for use in the active conduct of a trade or business outside of the U.S.) and Treas. Reg. §1.367(a)-7, (regarding application of Code §367(a) to an outbound transfer of assets by a domestic target corporation in an exchange described in Code §361) are revised so that a taxpayer may, solely for purposes of Code §367(a), be deemed not to have failed to comply with reporting obligations

[16] Treas. Reg. §§1.367(a)-8(c)(1)(i), -8(j).

[17] Treas. Reg. §1.367(a)-8(c)(1)(i) (first sentence). Before the 1998 Final Regulations, the G.R.A. term in certain cases was ten years. Pursuant to 1998 Treas. Reg. §1.367(a)-3(h), if a taxpayer elected to apply the 1998 Final Regulations retroactively to all prior transfers occurring after December 16, 1987, any ten-year G.R.A. that was in effect (had not been triggered in full) on the July 20, 1998, the general effective date of the 1998 Final Regulations would be deemed to be converted into a five-year G.R.A. Cf. F.S.A. 200221046 (taxpayer's five-year G.R.A. should have been a ten-year G.R.A.). Although the F.S.A. was issued after the 1998 Final Regulations, it addressed outbound transfers that preceded such regulations' general effective date, and there was no indication in the F.S.A. that the taxpayer had made an election to apply the 1998 Final Regulations retroactively to all prior transfers occurring after December 16, 1987.

under Treas. Reg. §1.367(a)-2 and Treas. Reg. §1.367(a)-7 by demonstrating that the failure was not willful. Additionally, Prop. Treas. Reg. §1.367(a)-7 of the temporary 2013 regulations regarding reasonable cause relief is removed.

T.D. 9704 and the Final Regulations on Point

"This lowering of the burden of proof from reasonable cause to non-willful allows the late-filing taxpayer to more easily meet the standards to receive non-recognition."

In T.D. 9704, the I.R.S. finalized the 2013 proposed regulations and issued temporary regulations, effective November 19, 2014. The G.R.A. is to be filed pursuant to requirements set forth in the regulations.[18] The U.S. target company is also subject to certain reporting requirements under Code §367 regulations.[19] The I.R.S. retained the approach taken in the proposed rules that eliminates the need for taxpayers to prove reasonable cause in seeking relief from penalties and gain recognition after failure to fully or properly file a G.R.A. or for the target company to make its required filings. The I.R.S. allows for non-recognition treatment provided the failure to file was not willful. This lowering of the burden of proof from reasonable cause to non-willful allows the late-filing taxpayer to more easily meet the standards to receive non-recognition. The I.R.S. also adopted their approach retroactively. As a result, the I.R.S. has said that taxpayers can resubmit prior filings under the new rules, even if the I.R.S. may have rejected them before.

However, the I.R.S. withdrew its directive (LMSB-4-0510-017) allowing broad relief for taxpayers to come in and fix faulty or missing G.R.A. filings. The significance of this retraction is reflected in Example 3 of the final regulations.[20] In that example, a taxpayer filed a G.R.A. with the statement that information on fair market value was "available upon request." Because the taxpayer "knowingly omitted" the information, it was subsequently deemed to have been a willful failure. The I.R.S. did allow a one-time failure to file a G.R.A. based on "accidental oversight" to be acceptable, and it allowed for non-recognition in that case.[21]

Enhanced Form 926 Filings Needed

Code §6038B requires that a U.S. person who transfers property to a foreign corporation (such as stock or securities) and enters into a G.R.A. is required to file Form 926, *Return by a U.S. Transferor of Property to a Foreign Corporation*. The I.R.S. will now require more information on the Form 926 for these §367 reorganizations.

CONCLUSION

The I.R.S. has signaled a willingness to be flexible in failures to adhere to the strict reporting requirements of the §367 regulations. However, that flexibility is not unlimited. Thus, taxpayers should still act with care in both structuring their outbound reorganizations and complying with all documentation and filing requirements to insure that non-recognition tax treatment is achieved.

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18 Treas. Reg. §1.367(a)-8.
19 Treas. Reg. §1.367(a)-3(c)(6).
20 Treas. Reg. §1.367(a)-8(p)(2)(ii), Ex. 3.
21 Treas. Reg. §1.367(a)-8(p)(2)(ii), Ex. 1.