FINAL REGULATIONS LIMIT IMPORTATION OF BUILT-IN LOSSES

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On March 28, 2016, the I.R.S. issued final regulations (T.D. 9759, or the "Final Regulations")[1] to limit built-in losses of offshore property from being imported into the U.S. through nonrecognition transactions. The Final Regulations are issued under the anti-loss importation provisions of the Internal Revenue Code ("the Code") §§334(b)(1)(B) and 362(e)(1). The regulations apply to tax-free transfers of loss property acquired by corporations in capital contributions, complete liquidations under Code §332, corporate reorganizations under Code §368, and nonrecognition exchanges under Code §351.[2] The Final Regulations apply to transactions occurring on or after March 28, 2016.

Loss importation refers to U.S. companies acquiring offshore depreciated property through tax-free transactions that result in an "importation" of a built-in loss into the U.S. Federal tax system. The imported loss can then be used by a profitable company in the U.S. to offset otherwise taxable gains. The anti-loss importation provisions of Code §§334(b)(1)(B) and 362(e)(1) were enacted under the *American Jobs Creation Act of 2004*[3] to stop the erosion of the corporate tax base through such shifting of loss property into the U.S. The Final Regulations intend to prevent U.S. companies from reallocating such losses and to establish a framework for determining the basis of the built-in loss property when it is transferred to a corporation.[4]

The Final Regulations affect corporations that transfer assets to, or receive assets from, their shareholders in exchange for the corporation's stock. The regulations require the corporations and their shareholders to separately report the fair market value and basis of the property (including stock) transferred in the nonrecognition transfer, which enables the I.R.S. to verify that taxpayers are complying with Code §§334(b)(1)(B), 362(e)(1), and 362(e)(2).[5]

The Final Regulations adopt most of the proposed anti-loss importation regulations that were published on September 9, 2013 ("2013 Proposed Regulations").[6] In addition, the Final Regulations adopt, without changes, proposed regulations issued in March 2005 that implement various statutory amendments to Code §§332 and 351. The I.R.S. invited taxpayers to comment on the 2013 Proposed Regulations,

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1 T.D. 9759, RINs 1545-BF43, 1545-BC88, 03/28/2016.

2 Limitations on the Importation of Net Built-In Losses, 81 F.R. 17066-17083 (Mar. 28, 2016) (amending 26 C.F.R. pt. 1).

3 *American Jobs Creation Act of 2004*, Public Law 108-357, 188 Stat. 1418 (2004).

4 81 F.R. 17066 (Mar. 28, 2016).

5 *Id.*

6 78 F.R. 54971 (Sept. 9, 2013).

but most of the taxpayers' suggestions were not adopted by the I.R.S. in the final version. Notably, the I.R.S. retained the look-through rules in the Final Regulations.

LOSS IMPORTATION PROPERTY

The basic importation transaction being targeted by the Final Regulations occurs when a person (the "Transferor") transfers property to a corporation (the "Acquiring Corporation") that results in an importation of loss into the Federal tax system.[7] The loss importation rule of Code §362(e)(1) provides that when property is transferred to a corporation with a built-in loss (*i.e.*, the property's adjusted basis in the hands of the corporation exceeds its fair market value), the corporation's basis in such property becomes the fair market value. The Final Regulations provide a framework for identifying "loss importation property."

Property is considered to be loss importation property if the following two conditions are met:

- The Transferor's gain or loss on the sale of an individual property immediately before the transfer would not be subject to any Federal income tax.
- The Acquiring Corporation's gain or loss on the sale of the transferred property immediately after the transfer would be subject to Federal income tax.[8]

The Final Regulations use a hypothetical sale analysis to identify loss importation property. The loss importation property is identified by treating the Transferor as a hypothetical seller of the transferred or acquired property to determine whether the hypothetical seller would take the gain or loss into account in determining its Federal income tax liability. All the relevant facts and circumstances must be considered. Examples in the Final Regulations should provide for more detailed guidance.[9]

In one example, a foreign corporation transfers property to a taxable U.S. corporation and the determination of loss importation property takes into account whether the foreign corporation would be required to include the amount of gain or loss under Code §§864 or 897 as income effectively connected with the conduct of a U.S. trade or business. The examples assume that no income tax treaty applies. However, the determination of the foreign corporation's tax on the property disposition takes into account whether the foreign corporation could eliminate U.S. tax pursuant to the business profits or gains provisions of an income tax treaty. In this case, the property would be considered loss importation property.[10] In response to comments that a number of issues could be the subject of further study, such as the effect of tax treaties, nonfunctional currency, and the application of Code §7701(g) (clarification of fair market value in the case of nonrecourse indebtedness), the preamble notes that the I.R.S. and Treasury considered these issues beyond the scope of these regulations and did not address them. The I.R.S. and Treasury are considering whether further study of these issues is to be undertaken.

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7 81 F.R. 17066 (Mar. 28, 2016); Treas. Reg. §1.362-3(a).

8 *Id.*, 17067.

9 *Id.*; Treas. Reg. §1.362-3(c); See examples, Treas. Reg. §1.362-3(f).

10 81 F.R. 17067 (Mar. 28, 2016).

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Once property has been identified as importation property, the Acquiring Corporation determines its basis in the importation property under generally applicable rules and, if that aggregate basis exceeds the aggregate value of all importation property transferred in the transaction, the transaction is a loss importation transaction subject to the anti-loss importation rules. If the aggregate basis of the importation property does not exceed such property's value, the anti-loss importation rules do not apply (see below for more detail).

Property Acquired from Grantor Trusts, Partnerships, and S-corporations

The Final Regulations apply a look-through rule when the Transferor of the property is a grantor trust, a partnership, or an S-corporation because these are treated as flow-through entities for U.S. Federal income tax purposes. In such cases, the determination of whether gain or loss from a hypothetical sale is subject to Federal income tax is made by reference to the tax treatment of the gain or loss in the hands of beneficial owners, *i.e.*, the grantors, the partners, or the S-corporation shareholders. If the organizing instrument of the grantor trust, the partnership, or the S-corporation allocates gain or loss in different amounts (*e.g.*, a partnership agreement provides for a special allocation) the determination of whether gain or loss from a hypothetical sale is subject to U.S. Federal income tax is made by reference to the person to whom, under the terms of the instrument, the gain or loss on the entity's hypothetical sale would actually be allocated. This analysis must also consider the entity's net gain or loss actually recognized in the tax period in which the transaction of property occurred.[11]

Various concerns addressed in the comments on the 2013 Proposed Regulations related to partnership issues. In particular, commenters suggested that the look-through rule should not apply to publicly-traded partnerships. However, the I.R.S. did not follow this, or any other, suggestion in the Final Regulations, which merely clarify that the partnership agreement and any applicable rules of law are taken into account in determining how to allocate an item to a partner.[12]

The I.R.S. did acknowledge a commenter's request for clarification on the interaction of the regulations proposed under Code §§362(e) and 704(c)(1)(C).[13] However, the I.R.S. stated that it will address these issues in the Final Regulations under Code §704(c)(1)(C).[14]

Anti-Avoidance Rule for Certain Entities

Under the Code, certain entities are able to shift occurrences of Federal income tax by distributing income or gain to its owners. The entities that are able to shift tax in this way include U.S. trusts, estates, regulated investment companies ("R.I.C.'s"), real estate investment trusts ("R.E.I.T.'s"), and cooperatives. The I.R.S. was concerned that the anti-loss importation provisions would be undermined if the ability of these entities to shift incidences of Federal income tax was disregarded. Conversely, the I.R.S. was also concerned that applying a look-through rule to the owners

11 *Id.*; Treas. Reg. §1.362-3(d)(2).

12 *Id.*,17068-9.

13 79 F.R. 3041 (Jan. 16, 2014).

14 81 F.R. 17069 (Mar. 28, 2016).

of such entities would impose a significant administrative burden.[15] Therefore, the regulations adopt an anti-avoidance rule for such entities that transfer property pursuant to a nonrecognition transaction.

The anti-avoidance rule applies to U.S. trusts, estates, R.I.C.'s, R.E.I.T.'s, and co-operatives that transferred property directly or indirectly (including through another similar entity) in a Code §§362(a) or 362(b) transaction, in which property is acquired by the issuance of stock in the corporation or in a corporate reorganization. Such entities are subject to a look-through rule if property is directly or indirectly transferred to, or acquired by, the entity as part of a plan to avoid the anti-loss provisions. Under the look-through rule, the entity is presumed to distribute the proceeds of its hypothetical sale, and the tax treatment of the gain or loss in the distributees' hands determine whether a gain or loss was taken into account in determining Federal income tax liability. If the distributee is also one of the listed entities, the rule looks through to the ultimate owners of the entity's interests. Whether or not the property is importation property is determined by reference to the deemed distributees or, in the case of tiered entities, to the ultimate deemed distributees.[16]

Although commenters suggested modifying the treatment of certain trusts, the Final Regulations did not adopt any suggestions and fully implemented the 2013 Proposed Regulations relating to the anti-avoidance and look-through rules of these entities.[17]

"If the aggregate basis of the importation property exceeds the aggregate value of all importation property transferred, the transaction is a loss importation transaction that is subject to the anti-loss importation provisions."

Gain or Loss Affecting Certain Income Inclusions

In order to address taxpayer concerns about the treatment of property transferred by or to a controlled foreign corporation ("C.F.C."), the regulations expressly provide that gain or loss recognized on a hypothetical sale by a C.F.C. is not considered subject to Federal income tax solely by reason of an income inclusion under Code §951(a). Similarly, the regulations also provide that gain or loss recognized by a passive foreign investment company ("P.F.I.C.") is not subject to Federal income tax solely by reason of an inclusion under Code §1293(a).[18]

In response to the comments, the Final Regulations treat debt-financed property as subject to Federal income tax in proportion to the amount of such gain or loss that would be includible in the tax exempt Transferor's unrelated business taxable income ("U.B.T.I.") on a sale under Code §§511 through 514.[19] The Final Regulations provide that a transfer which includes debt-financed assets will be bifurcated

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15 *Id.*,17067.

16 *Id.*; Treas. Reg. §1.362-3(d)(5).

17 81 F.R. 17069 (Mar. 28, 2016).

18 *Id.*,17067; Treas. Reg. §1.362-3(d)(3).

19 If a tax-exempt entity transfers debt-financed property (as defined in Code §514), the disposition of such property would be subject to Federal income tax. Consequently, the property could not qualify as loss importation property – even if there was only a *de minimis* amount of indebtedness and only a small portion of any gain or loss would be subject to Federal income tax. Commenters noted the "cliff effect" and resulting potential for avoidance of the anti-loss importation provisions for certain tax exempt entities. This loophole was closed by the Final Regulations.

and the rest of the property will be subject to the anti-loss importation provisions the same way that property is tentatively divided to calculate gain or loss amongst multiple property owners.[20]

LOSS IMPORTATION TRANSACTION

Once the importation property has been identified as such, the Acquiring Corporation must then determine the aggregate basis and aggregate value of all importation property acquired in the transfer, without regard to the anti-loss importation provisions of Code §362(e).[21] Note that the "value" of property is generally its fair market value without regard to any liabilities assumed in the transaction.[22]

The regulations emphasize that basis and value of importation property must be determined in the aggregate and that all importation property acquired in a transaction must be considered, regardless of the number of transferors.[23] This aggregate rule differs from the transferor-by-transferor approach of Code §362(e)(2), which focuses on whether a transferor would otherwise duplicate loss by retaining loss in stock and transferring property with a net built-in gain.[24]

If the aggregate basis of the importation property exceeds the aggregate value of all importation property transferred, the transaction is a loss importation transaction that is subject to the anti-loss importation provisions. Accordingly, the Acquiring Corporation's basis in each importation property is equal to its value immediately after the transaction. If the aggregate basis of the importation property does not exceed such property's value, the anti-loss importation provisions do not apply (but may still be subject to loss duplication rules of Code §362(e)(2)).[25]

The regulations implement special valuation rules for partnerships. Since a partner's share of partnership liabilities is generally included in its basis of its partnership interest, the property may have a built-in loss. Thus, the regulations redefine "value" for partnership interests by taking liabilities into account. The Final Regulations specifically provide that the value of a partnership interest would be the sum of cash that the Acquiring Corporation receives for such interest, increased by any liabilities of the partnership that were allocated to the Acquiring Corporation with regard to such transferred interest under Code §752.[26]

In response to comments, the Final Regulations expressly provide that, for Federal income tax purposes, the transferee's, or Acquiring Corporation's, basis is generally considered determined by reference to the Transferor's basis, notwithstanding the application of the anti-loss importation or anti-duplication provisions to a transaction.

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20 81 F.R. 17070 (Mar. 28, 2016); Treas. Reg. §1.362-3(d)(4); see also Treas. Reg. §1.362-3(e).

21 *Id.*, 17068; Treas. Regs. §§1.362-3(b) and 1.362-3(c)(3).

22 Treas. Reg. §1.362-3(c)(4)(i).

23 Treas. Reg. §1.362-3(c)(3).

24 81 F.R. 17068 (Mar. 28, 2016); Treas. Regs. §1.362-3(b) and (c)(3).

25 Treas. Reg. §1.362-4(3); 81 F.R. 17068 (Mar. 28, 2016); Treas. Regs. §1.362-3(b) and (c)(3).

26 *Id.*; Treas. Reg. §1.362-3(c)(4).

However, solely for the purposes of determining the adjustment to the basis of partnership property under Code §755, a determination of basis under the anti-loss importation provisions is treated as not made by reference to the Transferor's basis.[27]

FILING REQUIREMENTS

The Final Regulations modify the information reporting requirements for corporate nonrecognition transactions to assist with the I.R.S.'s administration of the anti-loss importation provisions and the anti-duplication provisions of Code §362(e)(2). Taxpayers, both entities and individual shareholders, are required to separately disclose the aggregate basis and value of the transferred property (including stock) in all nonrecognition transactions under Code §332 liquidations and Code §§362(a) or 362(b).[28]

CONCLUSION

While the Final Regulations aim to prevent companies from importing losses from offshore property into the U.S. through nonrecognition transfers as well as limit erosion of the U.S. corporate tax base, they also provide planning opportunities. They permit U.S. acquirors to step up the basis of built-in gain importation property in addition to stepping down the basis of built-in loss importation property. As reflected in the comments and the preamble, however, the Final Regulations leave various issues open with respect to, *inter alia*, certain entities and look-through rules as well as treaty implications. Furthermore, these anti-loss importation regulations impose a substantial burden and compliance cost on taxpayers by requiring the separate reporting of the basis and value of the property acquired through such corporate nonrecognition transfers. Tax advice should be sought by U.S. acquirors prior to such envisaged transfers to evaluate the impact of anti-loss importation rules in advance and identify planning opportunities accordingly.

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[27] 81 F.R. 17070; Treas. Reg. §1.362-3(b)(4).

[28] 81 F.R. 17068.