OUTBOUND TRANSFERS OF STOCK IN CODE §351 “TAX-FREE” EXCHANGES

Certain transfers of appreciated property in the course of a corporate organization, reorganization, or liquidation can be made without recognition of gain to the transferor or to the corporation involved. When a transaction involves an “outbound transfer,” (i.e., a transfer from a U.S. person1 to a foreign corporation) Code §367(a)(1) provides that, for purposes of determining gain, the foreign corporation is not considered a corporation. This rule means that the corporate nonrecognition rules do not apply to outbound transfers. There are, however, a number of exceptions to this general rule.2

Under prior law, to avoid gain recognition a taxpayer had to obtain a private letter ruling from the I.R.S. concluding that the transfer did not have the avoidance of Federal income taxes as one of its principal purposes. However, in 1984, Congress eliminated the private letter ruling requirement and created objective rules, which were based on the private letter rulings the I.R.S. had issued in the prior years.3 Congress also added special rules for the outbound transfer of intangibles. A common theme in the rules is the prevention of tax avoidance through the transfer of appreciated assets outside the U.S.

Only when an outbound transfer meets one of the exceptions to Code §367(a)(1) can gain recognition be avoided. In this article we discuss the exceptions to gain recognition under Code §367(a) on outbound transfers of shares of stock of foreign and domestic corporations in Code §351 exchanges.

CODE §351 “TAX-FREE” EXCHANGE

In general, no gain or loss is recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.4 “Control” is defined to mean the ownership of stock possessing at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the total number of shares of all other classes of stock of the corporation.5

For example, if a U.S. person transfers property (such as shares of stock in a

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2 Code §367(d) involves outbound transfers of certain forms of intangible property. Those rules are not discussed in this article.
4 Code §351.
5 Code §368(c).
corporation) to a domestic corporation solely in exchange for stock in the domestic corporation, and the U.S. person controls the transferee domestic corporation after the transfer, Code §351 generally provides that no gain or loss is recognized on the transfer.

**OUTBOUND §351 EXCHANGE OF SHARES OF A FOREIGN CORPORATION**

### Example 1

A domestic corporation (“D1”) owns 100% of a controlled foreign corporation (“CFC1”). D1 also owns 100% of another controlled foreign corporation (“CFC2”). D1 transfers all of the stock of CFC1 to CFC2 solely in exchange for stock of CFC2. The exchange meets the requirements of Code §351.

![Diagram](attachment:image.png)

Although the transfer by D1 (a U.S. person) of the shares of CFC1 to CFC2 (a foreign corporation) would generally meet the nonrecognition requirements of a Code §351 tax-free exchange, Code §367(a)(1) provides that, in general, gain will be recognized under these circumstances.

An exception from gain recognition is provided for certain transfers of shares of a foreign corporation. If a U.S. person transfers stock or securities of a foreign corporation to a foreign corporation in a transaction that qualifies as a Code §351 exchange, gain is not recognized if

- the U.S. person owns less than 5% (applying attribution rules), directly or indirectly, of both the total voting power and the total value of the stock of the transferee foreign corporation immediately after the transfer; or
- the U.S. person enters into a five-year gain recognition agreement (“G.R.A.”) with respect to the transferred stock or securities.

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6 Code §367(a)(2) and Treas. Reg. §1.367(a)-3(b).
7 Treas. Reg. §1.367(a)-3(b).
In Example 1, D1 owns more than 5% of the shares of CFC2. Consequently, the only way that D1 can avoid gain recognition on the outbound transfer of the shares of CFC1 is if D1 enters into a G.R.A.

Under the G.R.A., D1 must agree to recognize gain and pay tax if the shares of CFC1 are disposed of within a five-year period, or if certain other triggering events occur. In connection with the filing of a G.R.A., D1 must extend the period of limitations on assessments of tax with respect to the gain realized but not recognized on the transfer of the CFC1 shares through the close of the eighth full taxable year following the taxable year during which the transfer occurs. D1 would extend the period of limitations by filing Form 8838, Consent to Extend the Time to Assess Tax Under Section 367—Gain Recognition Agreement.

In addition, for each of the five full taxable years following the taxable year of the initial transfer, D1 must include a certification that the shares of CFC1 have not been disposed as part of its timely-filed return.

**Other Considerations**

Although not applicable to Example 1, if D1’s ownership in CFC2 is below 10% — such that as a result of the exchange D1 is no longer considered a “1248 shareholder” with respect to CFC1 — D1 would be required to include, in its income, a deemed dividend of an amount essentially equal to D1’s pro rata share of CFC1’s undistributed earnings while CFC1 was owned by D1.

In an earlier article we mentioned that, in the international context, it is common to restructure foreign entities in a way that can qualify as a D-reorganization through the use of the “check-the-box” rules. In Example 1, if D1 had, pursuant to a plan, contributed the shares of CFC1 to CFC2, and then CFC1 had elected to be treated as a disregarded entity of CFC2, the combined steps may be treated as a D-reorganization.

If the combined steps are treated as a D-reorganization, the transaction is not treated as though D1 made an outbound transfer. Instead, it is treated as if CFC1’s assets are transferred directly to CFC2 in exchange for CFC2 stock, and then as though CFC1 liquidates, distributing the CFC2 stock to D1. In this situation, D1 is treated as surrendering its stock in CFC1 for shares of stock of CFC2, but D1 is not treated as though it transferred shares of CFC1 stock to CFC2. As a result, D1 is not required to enter into a G.R.A.

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8 Treas. Reg. §1.367(a)-8.
9 Id., (f)(1).
10 Id., (g).
11 Treas. Reg. §1.367(b)-4(b).
12 The amount required to be included is known as the “§1248 amount.” Treas. Reg. §1.367(b)-2(c).
OUTBOUND §351 EXCHANGE OF SHARES OF A DOMESTIC CORPORATION

Example 2

A domestic corporation (“D1”) owns 100% of another domestic corporation (“D2”). D1 also owns 100% of a controlled foreign corporation (“CFC1”). D1 transfers all of the stock of D2 to CFC1 solely in exchange for stock of CFC1. The exchange meets the requirements of Code §351.

Before:

After:

As described above, although the transfer by D1 (a U.S. person) of the shares of D2 to CFC1 (a foreign corporation) would generally meet the nonrecognition requirements of a Code §351 tax-free exchange, Code §367(a)(1) provides that, in general, gain will be recognized under these circumstances.

An exception from gain recognition is provided for certain transfers of shares of domestic corporations. If a U.S. person transfers stock or securities of a domestic corporation to a foreign corporation in a transaction that qualifies as a Code §351 exchange, gain is not recognized if the domestic corporation complies with certain reporting requirements and if each of the following four conditions is met:

• 50% or less of both the total voting power and the total value of the stock of the transferee foreign corporation is received in the transaction, in the aggregate, by U.S. transferors.

• 50% or less of each of the total voting power and the total value of the stock of the transferee foreign corporation is owned, in the aggregate, immediately after the transfer by U.S. persons that are either officers or directors of the U.S. target company or that are 5% target shareholders.

• Either
  ○ the U.S. person is not a 5% transferee shareholder, or

14 Treas. Reg. §1.367(a)-3(c).
15 Treas. Reg. §1.367(a)-3(c)(6).
A U.S. person is a 5% transferee shareholder and enters into a five-year agreement to recognize gain.

- The active trade or business test is satisfied.\(^{16}\)

In Example 2, D1 is the only transferor. D1 receives 100% of the stock of CFC1 issued in the transaction. Consequently, the first requirement is not met – U.S. transferors received 100% of the stock received in the transaction and not 50% or less of the stock received in the transaction. D1 cannot avoid recognition of gain on its transfer of the shares of D2 to CFC1.

The second requirement is also not met because D1 is a U.S. person that is a 5% (or greater) shareholder of CFC1, and D1 owns greater than 50% of the stock of CFC1.

The fourth requirement, the “active trade or business test,” has three of its own separate requirements. First, the transferee foreign corporation must have been engaged in an active trade or business outside the U.S. for the entire 36-month period immediately before the transfer.\(^{17}\) Second, at the time of the transfer, neither the transferors nor the transferee foreign corporation can have an intention to substantially dispose of or discontinue such trade or business.\(^{18}\) Third, the fair market value of the transferee foreign corporation must be equal to, or greater than, the fair market value of the U.S. target corporation.\(^{19}\)

The third requirement of the active trade or business test is referred to as the “substantiality test.”\(^{20}\) The substantiality test essentially requires that the acquisition has to be a “big foreign fish” swallowing a “little U.S. fish.”

**Caveat: Anti-Inversion Rules of Code §7874**

It is important to note that when a U.S. person transfers assets of a U.S. corporation or shares of a U.S. corporation to a foreign corporation, the “anti-inversion” rules of Code §7874 can apply. These complex and potentially draconian rules can cause the foreign corporation to which the assets are transferred to be taxed as a U.S. corporation.\(^{21}\)

In Example 2, if the anti-inversion rules of Code §7874 were to cause CFC1 to be taxed as a U.S. corporation, there would be no outbound transfer. The transfer of the stock of D2 to CFC1 would be considered a transfer to a U.S. corporation, and the Code §367 gain recognition rules discussed above would not be applicable.

The anti-inversion rules of Code §7874 would not apply to Example 2 because the transaction would qualify for the “internal group restructuring” exception.\(^{22}\)

\(^{16}\) Treas. Reg. §1.367(a)-3(c).

\(^{17}\) Id., (3)(i)(A).

\(^{18}\) Id., (3)(i)(B).

\(^{19}\) Id., (3)(i)(C). The I.R.S. will entertain requests for private letter rulings relaxing the requirements of the active trade or business test if the taxpayer can demonstrate substantial compliance. Treas. Reg. §1.367(a)-3(c)(9).

\(^{20}\) Treas. Reg. §1.367(a)-3(c).

\(^{21}\) Code §7874 and the regulations issued thereunder.

\(^{22}\) Treas. Reg. §1.7874-1(c)(2).

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