The Form 5471 Series

Episode 9. Restructuring, Reorganization, and Liquidation of a Controlled Foreign Corporation

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The Form 5471 Series: 2023 - 2024

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A. Introduction

In this session - organizations, reorganizations, liquidations

- Apply the Internal Revenue Code generally and Subchapter C in particular to to CFCs.
  - Why? Because we are computing the tax consequences to the United States shareholder, so we apply U.S. tax principles for the U.S. shareholder's U.S. income tax return.
- Remember that every transaction is under suspicion of being a taxable sale or exchange until proven otherwise by a nonrecognition rule.
- The added complexity comes from IRC §1248 and IRC §367.

B. Taxable Dispositions of CFC Stock

B.1. Types of Taxable Dispositions of CFC Stock

Types of taxable transactions

- Sales or exchanges of CFC stock.
- Redemptions of CFC stock.
- Liquidations of CFCs.

Sale or exchange of CFC stock: normal “sale or exchange” + IRC §1248

- Taxable dispositions of CFC stock are treated like sales of domestic corporation stock, generating capital gain . . .
- . . . except that **IRC §1248** recharacterizes a portion of the capital gain as a dividend.
- The amount of the dividend component is the CFC’s earnings and profits not previously included in the income of the United States shareholder. *IRC §1248(a).*
- This is U.S. source gain/loss to the selling U.S. shareholder. *IRC §865(a)(1)*.

Redemption of CFC stock: Subchapter C + IRC §1248

- **Is it a sale**? Treat a redemption as a sale if it is a transaction listed in IRC §302(b)(1) - (5). *IRC §302(a)*.
  - E.g., all of a shareholder's stock is redeemed. *IRC §302(b)(3)*.
  - If it's a sale, IRC §1248 applies. Some of the capital gain is treated as a dividend (to the extent of untaxed CFC earnings and profits).
- **If it isn't a sale**, then it's a dividend. *IRC §302(d)*.
  - If it's a dividend, IRC §1248 does not apply (you don't need a deemed dividend if there is a real dividend happening).

Taxable Liquidations: Subchapter C + IRC §1248

- Liquidations are treated as taxable dispositions of stock. IRC §331(a).
  - Exception: (partly) tax-free 80%+ owned subsidiary liquidations, discussed later. *IRC §332(a).*
- Gain on disposition is capital gain unless recharacterized as dividend income by IRC §1248.
- On the CFC side, there is a deemed disposition of corporate assets. *IRC §336.*
  - That deemed disposition may cause subpart F income or Global Intangible Low-Taxed Income. Pass it through to the U.S. shareholder, then liquidate.

B.2. IRC §1248, Briefly Explained

IRC §1248 - why it exists

- Designed to prevent U.S. shareholders from converting ordinary income into capital gain to play the tax rate arbitrage game.
- In the Bad Old Days (before 2017) non-Subpart F income could be accumulated in the CFC and wouldn't be taxed until distributed to the U.S. shareholder.
- Imagine retaining untaxed income for 30 years in a CFC, then selling the CFC stock (at this point, the CFC is just a giant bucket of retained earnings) to recognize long-term capital gain taxed at favorable rates.
- Since 2017, IRC §§951(a) and 951A pretty make all CFC earnings and profits taxable to the U.S. shareholder, so IRC §1248 has less importance.

IRC §1248 - how it works

- You are a "Section 1248 shareholder" if you own 10% or more of a CFC's stock.
- You have a disposition of CFC stock for a capital gain.
- Figure out the CFC's untaxed earnings and profits attributable to the stock that is sold.
- Treat the Section 1248 shareholder as having received a dividend of that amount immediately before the sale.

C. Tax-Free (Or Not!) Organizations, Reorganizations, and Liquidations

Three categories of transactions that can be tax-free (or not!)

- U.S.-to-foreign transactions (outbound asset transfers).
- Foreign-to-foreign transactions (transfers from one CFC to another).
- Foreign-to-U.S. transactions (inbound asset transfers).

C.1. Outbound Transfers to CFCs

C.1.a. Overview of Outbound Transfers

The basics: taxable exchanges and nonrecognition provisions

- If a U.S. person transfers property to a corporation (foreign or domestic), it's a "sale or exchange". IRC §1001. Until proven otherwise, gain recognition applies.
  - You exchanged an asset for corporate stock, and recognize gain as to the difference between FMV of the asset and your basis in the asset.
  - The corporation exchanged its stock for an asset. It has gain on the "sale" of its stock to you.
- In real life, these transactions are tax-free—they are taxable "exchanges", but specific Code provisions override recognition of gain. E.g., IRC §§351, 361.

Outbound transfer example: IRC §351 capital contribution

- Transfer of an asset to a corporation in return for stock is an "exchange" of one asset for another, therefore a gain recognition event. *IRC §1001*.

- But the shareholder does not recognize gain when making a capital contribution to a corporation (and receiving stock in return) if the details of IRC §351 are satisfied. *IRC §351(a)*.

- And the corporation does not recognize gain when receiving a capital contribution (and giving stock in return). *IRC §351(f)*.

- HOWEVER . . . IRC §367(a)(1) may override IRC §351 and make the capital contribution to a foreign corporation subject to gain recognition.

C.1.b. A Brief Explanation of IRC §367(a)(1)

IRC §367(a)(1) plugs a hole created by two features of tax law

- **“Easy restructuring should be tax-free.”** Taxpayers should be able to reorganize their business operations without tax cost—unless they “cash out” in some fashion. These are nonrecognition rules, e.g., tax-free reorganizations.

- **“Foreign corporations are taxable on U.S. source income (ECI and FDAP) only.”** The United States doesn’t/can’t tax foreign taxpayers on their foreign income. These are the source of income rules.

- IRC §367(a)(1) exists to prevent taxpayers using nonrecognition rules to put unrealized gain out of the United States (source of income rules).

The general rule: situation normal unless IRC §367(a)(1) applies

- Transfers to foreign corporations are treated exactly the same as transfers to domestic corporations EXCEPT that IRC §367(a)(1) overrides some nonrecognition rules:

> "If, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation **shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation**." *IRC §367(a)(1).*

- If the transferee entity is not a corporation, then the nonrecognition rule cannot, by its terms, operate. IRC §1001 makes the transaction a taxable exchange.

C.1.c. How To Go Step-by-Step to Analyze an Outbound Transfer

The analysis process for outbound transfers

1. Pretend the foreign corporation is a domestic C corporation.

2. Identify the outbound transfer (from a U.S. person to the CFC-that-you-pretend-is-a-domestic-C-corporation).

3. Does IRC §1001 say this transfer is a taxable sale or exchange?

    3.1. If no, stop. Your analysis is complete.

    3.2. If yes, proceed to the next step.

The analysis process for outbound transfers

4. Can you find a nonrecognition provision to override IRC §1001?

   4.1. If no, stop. You're going to pay income tax whether or not IRC §367(a)(1) applies.

   4.2. If yes, continue to the next step.

5. Reverse the "pretend" step. Acknowledge reality: this is a foreign corporation.

The analysis process for outbound transfers

6. Look at IRC §367(a)(1). Is your nonrecognition provision listed there?

    6.1. If no, stop. You're done. IRC §1001 said you had a taxable sale or exchange, but you found a nonrecognition provision that made the transaction tax-free, and IRC §367(a)(1) doesn't apply.

    6.2. If yes, then gain recognition occurs. Your nonrecognition provision is trumped by IRC §367(a)(1).

    6.3. But you're not done yet. Proceed to the next step.

The analysis process for outbound transfers

7. Look at the exceptions and modifications to IRC §367(a)(1).

    7.1. If there is no applicable exception or modification, then the default rule of IRC §367(a)(1) applies: this is a fully taxable event, because IRC §367(a)(1) overrides the nonrecognition provision you relied on.

    7.2. If one of the exceptions or modifications applies, do whatever it says and get the tax results it provides.

8. You're done.

C.1.d. Example: CFC Formation and Capital Contribution

Example: capital contribution — IRC §351(a)

- You are forming a new corporation.
- Pretend your foreign corporation is just a regular domestic corporation. What are the tax results of a capital contribution in return for stock?
- **Shareholder**: a capital contribution (cash or property) to a corporation is a nonrecognition event for a shareholder. *IRC §351(a)*.
- **Corporation**: the corporation receiving the capital contribution and issuing its stock to the shareholder (an “exchange”) has no gain recognition. *IRC §351(f)*.
- You must satisfy the other requirements of IRC §351, of course.

Example: capital contribution — IRC §367(a)(1)

If, in connection with any exchange described in section 332, **351**, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation **shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation**. *IRC §367(a)(1).*

Example: capital contribution — IRC §367(a)(1) breaks IRC §351(a)

- IRC §351(a) makes transfer of property to a **corporation** into a nonrecognition transaction.

> No gain or loss shall be 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 (as defined in section 368(c)) of the corporation. *IRC §351(a).*

- IRC §367(a)(1) says a foreign corporation is not a corporation for purposes of a IRC §351 capital contribution.

Example: capital contribution — final result

- Exchange of an asset for stock is a taxable exchange. *IRC §1001*.
- IRC §351(a) only applies to transfers to corporations, providing nonrecognition.
- IRC §367(a)(1) says by default a transfer to a foreign corporation is a transfer to a foreign **not-a-corporation**.
- Consequently, the exchange of an asset for stock of the foreign not-a-corporation is not given nonrecognition treatment. IRC §367(a)(1) overrides IRC §351(a).

C.1.e. Outbound Transfers: Exceptions/Modifications

Outbound transfers of intangible property — IRC §367(d)

- An outbound transfer of intangible property is a gain recognition event, but governed by IRC §367(d) rather than IRC §367(a).

- IRC §367(d) treats the transfer of intangible property to a foreign corporation as a sale with annual payments based on contingent use of the property in question.

- Generally, this requires an annual payment over the useful life of the intangible property (20 years maximum), rather than a one-time lump sum of gain recognition.

Regulations: exceptions/modifications to IRC §367(a)(1)

> "For circumstances in which section 367(a)(1) does not apply to a U.S. transferor's transfer of property to a foreign corporation, and thus the foreign corporation is considered to be a corporation, see §§ ~~1.367(a)–2~~, 1.367(a)–3, and 1.367(a)–7." *Reg. §1.367(a)-1(b)(2).*

- Reg. §1.367(a)-2 is obsolete after the Tax Cuts and Jobs Act.
- Reg. §1.367(a)-3: transfer of stock or securities to a foreign corporation, based on IRC §367(a)(2).
- Reg. §1.367(a)-7: outbound reorganizations, based on IRC §367(a)(4).

Outbound transfer of stock or securities — IRC §367(a)(2)

> "Except to the extent provided in regulations, paragraph (1) shall not apply to the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization." *IRC §367(a)(2).*

- Two ways to get nonrecognition from an outbound transfer of stock or securities:
  - The transferor owns less than 5% of the transferee corporation after the transfer; no gain recognition agreement required. *Reg. §1.367(a)-3(b)(1)(i).*
  - The transferor owns more than 5% of the transferee corporation after the transfer and signs a gain recognition agreement with the IRS. *Reg. §1.367(a)-3(b)(1)(ii).* If a specified type of transaction does not occur within five years of the transfer, then nonrecognition treatment is given. *Reg. §1.367(a)-8.*

Outbound reorganization — IRC §367(a)(4)

> "[IRC §367(a)(2)] shall not apply in the case of an exchange described in subsection (a) or (b) of section 361. Subject to such basis adjustments and such other conditions as shall be provided in regulations, the preceding sentence shall not apply if the transferor corporation is controlled (within the meaning of section 368(c)) by 5 or fewer domestic corporations. For purposes of the preceding sentence, all members of the same affiliated group (within the meaning of section 1504) shall be treated as 1 corporation." *IRC §367(a)(4)*

- IRC §361 is what makes an IRC §368 reorganization tax-free.
- Thus, assume a reorganization is taxable unless you fit into this exception. See Reg. §1.367(a)-7 for how this works.

The combined effect of IRC §§367(a)(2), 367(a)(4)

- *Transfers of foreign stock using any nonrecognition rule except IRC §361—apply IRC §367(a)(2)*
    - You can get nonrecognition treatment for transfer of foreign stock to a foreign corporation for any type of transaction EXCEPT some reorganizations.
- *Transfers of foreign stock using the IRC §361 nonrecognition rule—apply IRC §367(a)(4)*
    - You can only get nonrecognition when you do an IRC §368(a) outbound reorganization that gets nonrecognition treatment under IRC §361 if five or fewer U.S. shareholders own 80% or more of the transferor entity.

Warning about IRC §367(a)(4) and Reg. §1.367(a)-7

- "**Byzantine even by tax law standards . . . .**" BNA Portfolio 6100-1st: U.S.-to-Foreign Transfers Under Section 367(a), Section V.

- An "**international M&A PhD course**." Ron Dabrowski, then-IRS deputy associate chief counsel (international) commenting on the upcoming Reg. §1.367(a)-7 regulations, quoted in *Detailed Outbound Asset Transfer Guidance Imminent*, Tax Notes Today, 2012 TNT 215-2 (Nov. 6, 2012).

- The moral of this story: any cross-border corporate reorganization should be viewed as a budget-busting project until proven otherwise. And if you feel dumb when working on one of these projects (I certainly do), welcome to the club.

C.2. Foreign-to-Foreign Transactions

Why does the Internal Revenue Code care about foreign-to-foreign?

- If two foreign corporations do a merger or reorganization or some other type of transaction, why does the U.S. tax system care?

- Answer: because the U.S. tax system cares about the taxation of U.S. shareholders of foreign corporations.

- The primary tax policy to understand: preventing the “convert ordinary income into long-term capital gain” scheme that taxpayers love to use.

- Achieved by ensuring that IRC §1248 continues to apply to U.S. shareholders before and after the reorganization.

Types of foreign-to-foreign transactions

- Tax-free reorganizations — IRC §368
- Tax-free capital contributions — IRC §351
- Tax-free subsidiary liquidations — IRC §332

Foreign-to-foreign exchanges are default nonrecognition transactions

> "In the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in subsection (a)(1), a foreign corporation **shall be considered to be a corporation** except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes." *IRC §367(b)(1).*

- Therefore, foreign-to-foreign transactions are nonrecognition events by default, unless you do something to make them taxable.

Three ways you can make a foreign-to-foreign exchange taxable

"If a foreign corporation (the transferee foreign corporation) acquires the stock of a foreign corporation in an exchange described in section 351 or the stock or assets of a foreign corporation in a reorganization described in section 368(a)(1) (in either case, the foreign acquired corporation), then an exchanging shareholder must, **if its exchange is described in paragraph (b)(1)(i), (b)(2)(i), or (b)(3)** of this section, include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges." *Reg. §1.367(b)-4(b).*

How do you make a foreign-to-foreign exchange taxable? /1

- **Loss of IRC §1248 shareholder status** — *Reg. §1.367(b)-4(b)(1)(i).*
- An IRC §1248 shareholder is a U.S. person who owns (directly or constructively) 10% or more of the stock of a CFC, by vote or value. *IRC §1248(a)(2).*
- Explanation: If you are an IRC §1248 shareholder before the exchange and you are not an IRC §1248 shareholder after the exchange, then the IRS can no longer impose the deemed dividend rules of IRC §1248 when you sell the CFC stock.

How do you make a foreign-to-foreign exchange taxable? /2

- **E & P shifting transaction** — *Reg. §1.367(b)-4(b)(2)(i).*

- This involves a reorganization that shifts earnings and profits out of an affiliated group and (here is the tell in this poker game) the exchanging shareholder receives preferred stock as part of the exchange.

- Explanation: by changing the type of stock owned, you can shift earnings and profits to different shareholders; this affects much indirect foreign tax credit is available to a shareholder.

How do you make a foreign-to-foreign exchange taxable? /3

- **IRC §368(a)(1)(E) recapitalization** within 24 months (before or after) an E & P shifting transaction — *Reg. §1.367(b)-4(b)(3)*.

- Explanation: this is an anti-step transaction provision — a way to stop people from doing in two steps what would otherwise be a prohibited E & P shifting transaction.

The tax effect of losing nonrecognition treatment

- If a foreign-to-foreign exchange becomes taxable, then the "section 1248 amount" attributable to the U.S. shareholder's stock is treated as a deemed dividend to the U.S. shareholder under IRC §1248. *Reg. §1.367(b)-4(b).*

- "Section 1248 amount" means the "net positive earnings and profits (if any) that would have been attributable to such stock and includible in income as a dividend under section 1248 and the regulations thereunder if the stock were sold by the shareholder." *Reg. §1.367(b)-2(c)(1).*

C.3. Foreign-to-U.S. Transactions

Inbound liquidations and reorganizations

Transactions

- Transactions
  - IRC §332 liquidation of a foreign subsidiary into a domestic parent.
  - IRC §368 asset acquisition of foreign corporation assets by a domestic corporation.
- Treatment
  - An inbound liquidation or reorganization of a CFC will cause a deemed dividend of the CFC's untaxed earnings and profits allocable to the U.S. shareholder. *Reg. §1.367(b)-3(b)(3)(i).*

D. Conclusion

Formations, reorganizations, and liquidations of CFCs, in summary

- Generally, apply the Code without regard to the fact that this is a foreign corporation.
- For **disposition** of CFC stock, add **IRC §1248** to your analysis.
- This recharacterizes some of the capital gain as a deemed dividend to the seller.
- Policy objective: prevent conversion of ordinary income—dividends—into capital gain.

Formations, reorganizations, and liquidations of CFCs, in summary

- For **U.S.-to-foreign** corporation transfers, add **IRC §367(a)** to your analysis.
- This generally causes recognition of gain on the asset transferred to the foreign corporation.
- Policy objective: prevent transfer of unrealized gain to a seller outside the U.S. tax system.

Formations, reorganizations, and liquidations of CFCs, in summary

- For **foreign-to-foreign** transactions, add **IRC §367(b)** to your analysis.
- This generally allows nonrecognition of gain unless a U.S. taxpayer loses IRC §1248 shareholder status as a result of the transaction.
- If the U.S. shareholder loses IRC §1248 status, then a deemed dividend of untaxed earnings and profits occurs.
- Policy objective: taxpayers should be able to restructure their businesses tax-free if they don't cash out.

Formations, reorganizations, and liquidations of CFCs, in summary

- For **foreign-to U.S.** transfers that would otherwise be nonrecognition events (subsidiary liquidations, IRC §368 asset reorganizations), add the **IRC §367(b)** regulations to your analysis.

- This generally means a deemed dividend of untaxed CFC earnings and profits.

- Policy objective: if you avoided subpart F income or Global Intangible Low-Taxed Income inclusions from the CFC up to now, it's time to square up accounts with Uncle Sam.

Follow-up? Questions? Comments?

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