Considerations in Structuring Outbound Investments by U.S. Persons

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July 18, 2023
Poll: 1. What sort of outbound planning is most relevant to your/your client’s business?
Agenda

1. Overview

2. Operating Through a Foreign Corporation
   • Subpart F Income
   • GILTI
   • Section 250 GILTI Deduction

3. Outbound Transfers of Property to Foreign Corporations
   • Section 367
   • Section 91
   • Section 7874

4. Operating from the U.S.
   • Section 250 FDII Deduction
   • Foreign Branch Category Income

5. Summary and Questions
Overview

Operating Trade or Business in the U.S.

- P (U.S.)
- P recognizes income/losses from foreign sales (21% rate)
- No trade or business conducted outside the U.S.
- FDII deduction potentially available (37.5% of FDII – 21.875% for TYBA 12/31/25)

Operating Trade or Business Through
Foreign Branch or Foreign Disregarded Entity

- P (U.S.)
- P recognizes income/losses earned through FB and FDE (21% rate)
- FB and FDE both treated as “foreign branches”; income and foreign income taxes of FB and FDE subject to separate FTC branch basket limitation
- FDII deduction not available to P
- Transactions b/w P, FB, and FDE generally disregarded for U.S. tax purposes
- Potential section 987, DCL, and OFL issues

Operating Trade or Business Through
Foreign Corporation

- P (U.S.)
- P includes subpart F income (21% rate) and GILTI (10.5% rate after section 250 deduction; 13.125% for TYBA 12/31/25) earned by FC
- FC’s income included by P is treated as “PTEP” that can be distributed tax-free to P
- Residual income not taxed to P until distributed; potentially exempt under section 245A
- Foreign income taxes deemed paid by P under section 960(a) and (d), subject to limitations
- FDII deduction not available to P
Operating Through a Foreign Corporation
Operating Through a Foreign Corporation

Subpart F and GILTI
Section 951: Overview

• If a foreign corporation is a controlled foreign corporation (CFC) at any time during any taxable year, every person who is a US shareholder (as defined in section 951(b)) of such corporation and who owns, directly or indirectly through certain foreign entities, stock in such corporation on the last day of the foreign corporation’s tax year on which it is a CFC shall include in gross income, for its taxable year in which or with which foreign corporation’s tax year ends,

  • Its pro rata share of the foreign corporation’s subpart F income for such year, and

  • The amount determined under section 956 with respect to such US shareholder for such year (but only to the extent not excluded from gross income under section 959(a)(2)).
Section 951: Overview – cont’d

• Pro rata share is determined based on a hypothetical distribution construct looking at CFC’s allocable E&P
  • Consider all facts and circumstances, e.g., need to know the dividend entitlement of different classes of stock
• Special rules for:
  • Foreign corporations that are not CFCs for the entire year
  • US shareholders that purchase stock on which a dividend was paid to the previous shareholder in the same year
Section 951(b): US Shareholder

• A “US shareholder,” with respect to any foreign corporation, a United States person (as defined in section 957(c)) who owns (within the meaning of section 958(a)), or is considered as owning by applying the rules of ownership of section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote of such foreign corporation, or 10 percent or more of the total value of shares of all classes of stock of such foreign corporation.
Subpart F Income Categories

• The subpart F income of a CFC is the sum of its:
  • Insurance income as defined section 953 insurance income;
  • Foreign base company income as determined in section 954;
    • Foreign personal holding company income (section 954(c))
    • Foreign base company sales income (section 954(d))
    • Foreign base company services income (section 954(e))
  • International boycott income;
  • Illegal bribes, kickbacks, etc; and
  • Income derived from any foreign country to which section 901(j) applies
Subpart F Income: Exceptions

- Foreign personal holding company income (section 954(c))
  - Same country exception
  - Active financing exception
  - Active insurance income
  - Active trade or business exception: rents and royalties
  - Section 954(c)(6) “CFC look-through”

- Foreign base company sales income (section 954(d))
  - Manufacturing exception (including “substantial contribution” test)

- Foreign base company services income (section 954(e))
  - Same country exception
  - Exception for certain services provided with respect to property manufactured by the CFC
GILTI: Overview

- A US shareholder of any CFC for any taxable year must include in gross income its GILTI for such taxable year.

- GILTI inclusions (and consequences) are similar to a subpart F income inclusions.

- Effective for tax years of foreign corporations beginning after December 31, 2017, and for tax years of US shareholders in which or with which such tax years of foreign corporations end.

Net CFC Tested Income

Aggregate Pro Rata Shares of Tested Income

Aggregate Pro Rata Shares of Tested Loss

Net Deemed Tangible Income Return

10% of Aggregate Pro Rata Shares of QBAI

Certain Interest Expense

QBAI - qualified business asset investment
GILTI: Example

- Tested losses offset tested income
- Foreign taxes of tested loss CFCs are left behind
- QBAI of tested loss CFCs is left behind

![Tree Diagram with CFC1 and CFC2]

- CFC1: Tested Income: $100, Foreign Taxes: $10, QBAI: $0
- CFC2: Tested Loss: $50, Foreign Taxes: $20, QBAI: $100

- $50 GILTI Inclusion
- $4 FTCs
- $5 S78 Gross Up
- $27.5 S250 Deduction
To determine a U.S. shareholder’s deemed paid taxes under section 960(a), (b), and (d), CFC attributes its current year income to section 904 categories, and then “income groups” within the section 904 categories.

- The categories of income are general and passive.

- The income groups within each category are:
  - subpart F income groups (e.g., FPHCI, FBC sales income, FBC services income);
  - tested income group, and
  - residual income group.

- Current year foreign income taxes of the CFC are then attributed to the related income group.

- If a corporate U.S. shareholder has a subpart F or GILTI inclusion, the U.S. shareholder is deemed to have paid the amount of the CFC’s foreign income taxes that are properly attributable to the items of income in the subpart F income groups or tested income group (subject to the section 960(d) haircut).
Operating Through a Foreign Corporation

Section 250 GILTI Deduction
Section 250: GILTI and FDII deductions

- A domestic corporation is allowed a deduction equal:
  - 37.5% of its foreign-derived intangible income (FDII), plus 50% of the sum of its GILTI inclusion and the associated GILTI Section 78 gross-up*

- Section 250(a)(2) taxable income limitation
  - The Section 250 deduction is limited if the domestic corporation’s taxable income (not taking into account the Section 250 deduction) is less than the sum of its GILTI and FDII

* The percentages are reduced to 37.5% and 21.875% for taxable years beginning after December 31, 2025, respectively.
## Taxation of foreign corporate earnings after TCJA*

<table>
<thead>
<tr>
<th>What E&amp;P are taxed currently?</th>
<th>What E&amp;P can be remitted under Section 245A?</th>
<th>What E&amp;P are still taxable?</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GILTI</strong> (§951A)</td>
<td><strong>Net deemed tangible income return</strong> (§951A(b)(2))</td>
<td><strong>E&amp;P not eligible for 245A DRD</strong></td>
</tr>
<tr>
<td><strong>Subpart F income (traditional)</strong></td>
<td></td>
<td><strong>Partially-taxable E&amp;P</strong></td>
</tr>
<tr>
<td>o Deferred foreign income (§965 transition tax; see also §965(b))</td>
<td>o <strong>High-taxed subpart F income</strong> (and eventually high taxed tested income) (§951A(c)(2)(A)(i)(III))</td>
<td>o <strong>§245(a) DRD eligible</strong> – 35% taxable (ECI and certain US dividends)</td>
</tr>
<tr>
<td>o Foreign base company sales &amp; services income (§954(d) &amp; (e))</td>
<td>o <strong>US-source ECI</strong> (§951A(c)(2)(A)(i)(I))</td>
<td>o <strong>Extraordinary disposition account</strong> – 50% taxable (Reg. §1.245A-5)**</td>
</tr>
<tr>
<td>o Foreign personal holding company income (§954(c))</td>
<td>o <strong>FOGEI</strong> (§951A(c)(2)(A)(i)(V))</td>
<td><strong>Wholly-taxable E&amp;P</strong></td>
</tr>
<tr>
<td>o Insurance income (§953)</td>
<td>o <strong>“Gap period” E&amp;P</strong></td>
<td>o <strong>Extraordinary reduction account</strong> (Reg. §1.245A-5)**</td>
</tr>
<tr>
<td>o Full inclusion income (§954(b)(3)(B))</td>
<td>o <strong>“Purchased” E&amp;P earned by a foreign target</strong></td>
<td>o <strong>Hybrid deductions</strong> (Reg. §1.245A(e)-1)**</td>
</tr>
<tr>
<td>o Other categories of subpart F income under §952</td>
<td>o After 2017 to the extent that target was not owned by US shareholders during 2017</td>
<td><strong>Nimble dividend issues?</strong></td>
</tr>
<tr>
<td><strong>Subpart F (TCJA)</strong></td>
<td>o Before 2017 while target was not a DFIC (§965(d)(3))</td>
<td>Shareholders not eligible for DRD</td>
</tr>
<tr>
<td>o Tiered hybrid dividends (§245A(e)(2))</td>
<td>o Before 1987 (§965(d)(3))</td>
<td><strong>Not a “domestic” corporation</strong> (§245A(a))</td>
</tr>
<tr>
<td>o Lower-tier gain on sale of CFC stock (§964(e)(4))</td>
<td><strong>Miscellaneous categories</strong></td>
<td><strong>Doesn’t satisfy holding period</strong> (§246(c)(5), §1248(j), §1059(a))</td>
</tr>
<tr>
<td><strong>Section 956 inclusions</strong></td>
<td></td>
<td><strong>Not a US shareholder</strong> (§245A(a), §951(b))</td>
</tr>
<tr>
<td><strong>§1248 dividends</strong> (§959(e))</td>
<td></td>
<td><strong>Foreign corporation is a PFIC with respect to shareholder</strong> (§245A(b)(2))</td>
</tr>
<tr>
<td><strong>Miscellaneous categories</strong> (certain previously excluded subpart F, etc.)</td>
<td></td>
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</tr>
</tbody>
</table>

* Not exhaustive
** Shareholder level account

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* TCJA = Tax Cuts and Jobs Act

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**Notes:**
- **E&P** refers to earnings and profits.
- **§** denotes sections of the Internal Revenue Code (IRC).
- **DFIC** stands for domestic foreign investment company.
- **PFIC** stands for passive foreign investment company.
- **DRD** stands for dividend reduction.
- **Nimble dividend issues?** refers to situations where dividends are not eligible for certain tax benefits.
- **Extraordinary disposition account** and **Extraordinary reduction account** are accounts used for tax purposes.
- **Hybrid deductions** are deductions related to hybrid entities.

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Outbound Transfers of Property to Foreign Corporations
Outbound Transfers of Property to Foreign Corporations

Section 367
Section 367 Background

- Generally, section 367(a) prevents the transfer of certain appreciated property out of the U.S. tax net without the recognition of gain
- Applies to outbound transactions (i.e. transfers to a foreign corporation) under sections 332, 351, 354, 356 or 361
- There are various technical exceptions and workarounds to this gain recognition regime
- The rules (and exceptions) differ depending on whether the property being transferred is:
  - Stock in a domestic corporation
  - Stock in a foreign corporation
  - Tangible assets
  - Other intangibles
- Some fairly significant changes to the rules were made in 2017/2018 regarding the treatment of intangibles, goodwill and going concern value, and transfers of tangible assets more generally
Section 367(a) General Rule

- Section 367(a) applies in the case of a transfer of property by a United States person to a foreign corporation in an exchange governed by sections 332, 351, 354, 356 or 361.*
  - The referenced sections would ordinarily provide for tax-deferral on such transfers in the case of corporation liquidations, formations/contributions, and reorganizations under section 368

- When section 367(a) applies, the foreign corporation is not “considered to be a corporation” for purposes of determining gain recognition
  - 367 does not prevent (allow) the deferral (acceleration) of loss

- Statutory text refers to section 332, but that is now addressed exclusively by section 367(e)(2). Treas. Reg. 1.367(e)-2(a)(2).
Section 367(a) Impact on Basis

• Foreign corporation’s basis in transferred assets that are subject to section 367
  • Section 362(a) (for a 351 transaction)
  • Section 362(b) (for a reorganization)
  • In both cases, basis is the same as in the hands of the transferor, increased by the amount of gain recognized to the transferor. (includes 367 gain, even if foreign corporation “not considered a corporation?”)

• U.S. person’s basis in foreign corporation stock
  • Section 358: basis equals the same as transferor’s basis in the property exchanged, increased by gain recognized on the exchange.
Section 367(a) – United States Person

• “United States person” takes its meaning under section 7701(a)(30)
  • Section 1.367(a)-1(d)(1)

• Includes
  • U.S. citizen or resident
  • Domestic partnership* (however, special rules apply)
  • Domestic corporation
  • Non-foreign trust or estate

• Does not include
  • Non-resident alien or foreign corporation that conducts a U.S. trade or business
Section 367(a) – Other Relevant Definitions

• Section 1.367(a)-1(f)(3): **transfer** is any transaction that constitutes a transfer for purposes of section 332, 351, 354, 355, 356 or 361.

• Section 1.367(a)-1(f)(4): **property** means any item that constitutes property for purposes of section 351, 354, 355, 356 or 361
  • Consider application of *DuPont* case on whether the transfer of an IP right is “property” or a license
  • Services agreements?
  • Leases?
Section 367(a) – Transfers by Partnerships

• Notwithstanding the general rule defining U.S. partnerships as U.S. persons, the regulations contain specific rules for transfers by domestic and foreign partnerships.

• Treas. Reg. 1.367(a)-1T(c)(3)(i)(A)
  • If a domestic or foreign partnership transfers property to a foreign corporation, a U.S. partner in the partnership shall be treated as having transferred a proportionate share of the property.

• In such a case, the U.S. partner’s basis in his/her partnership interest is increased by the amount of gain recognition.

• The partnership’s basis in the foreign corporation’s stock is determined as if the U.S. person newly acquired a partnership interest equal to the amount of gain. Section 754/743 rules applicable if election is made.
Outbound transfer of domestic business assets

• An outbound asset transfer is subject to section 367(a)

• This includes:
  
  • Contributions of assets to a foreign corporation by a shareholder (or shareholder) in control of the foreign corporation in an exchange governed by section 351.
  
  • Outbound asset reorganizations. “A”, “C,” and “D” reorganizations.
    • However, see slide on indirect stock transfer rules for certain exceptions and additional rules.
  
  • “F” reorganizations are also treated as asset transfers for this purpose. See Treas. Reg. 1.367(a)-1(f)(1)(i) (deeming an asset transfer from the transferor to the foreign acquiring corporation)
    • In a pure outbound F reorganization, also see discussion of section 7874 later in this presentation
Outbound transfer of domestic business assets (continued)

- Prior to 2018, former section 367(a)(3) provided a broad exception for outbound transfers to the extent property transferred to the foreign corporation was used by such foreign corporation in the active conduct of a trade or business outside of the United States.
  - Property eligible for the exemption did not include inventory, copyrights, installment obligations and AR, currency transactions, intangibles, or certain leased property.
- This exception was deleted by the TCJA.
- Similarly, a provision requiring the recapture of assets of a foreign branch that previously generated losses used by a US person (i.e. “branch loss recapture”) was removed from section 367.
  - Section 91, discussed later, covers a similar issue under current law.
Example: Incorporation of a Branch

- US corporation operates a foreign branch in Country X through a disregarded entity incorporated in Country X.
- US corporation checks the box on the disregarded entity (X corp).
- Transaction is treated as a transfer by US corporation of the assets held by the disregarded entity to a new foreign corporation (X corp) in exchange for equity. But for section 367(a), this transaction would be within section 351.
- Section 367(a) requires US corporation to recognize *gain* on transfer of appreciated tangible assets.
- Section 367(d) applies to intangible assets.
- Loss on assets with built-in loss is not recognized, and *does not net against gain recognition*.
- Potential application of section 91 for a branch that previously generated losses discussed later.
Outbound transfer of foreign equity

• Where the U.S. person transfers stock or securities of a foreign corporation to another foreign corporation, the transfer is **not** subject to section 367(a)(1) IF
  • The transferor owns less than 5% (taking into account attribution rules of section 318, modified by section 958(b)) of both the total voting power and the total value of the stock of the transferee immediately after the transfer
  OR
  • The transferor enters into a 5-year “Gain Recognition Agreement” (GRA) with respect to the transferred stock and securities. (see Treas. Reg. 1.367(a)-8).
  Treas. Reg. section 1.367(a)-3(b)

• Even where gain is not recognized under section 367(a)(1) (including because the transferor enters into a GRA), must also consider application of section 367(b).
  • For example, in a stock-for-stock exchange where a CFC loses its CFC status, or where the U.S. transferor loses its status as a section 1248 shareholder. See Treas. Reg. 1.367(b)-4(b).
Outbound transfer of domestic equity

• The rules applicable to outbound transfers of domestic equity are significantly less permissive than for foreign equity
• The so-called “Helen of Troy” regulations, originally adopted in 1994, were intended to impose an exit tax to discourage certain types of inversion transactions that resulted in erosion of the U.S. tax base
• Under Treas. Reg. 1.367(a)-3(c)(1), each of the following four conditions must be met:
  • 50% or less of the transferee foreign corporation (TFC), both by vote and by value, is received by U.S. transferors in the transaction. Rebuttable presumption that all transferors are U.S. persons.
  • After the transaction, 50% or less of each of the voting power and value of the TFC is owned by U.S. persons that are either (x) officers or directors of the U.S. target or (y) 5% target shareholders (i.e. any person who owns at least 5% of either vote or value of the target immediately before the transaction)
  • EITHER
    • The transferor owns less than 5% of both the total voting power and the total value of the stock of the TFC immediately after the transfer
    OR
    • The transferor enters into a 5-year “Gain Recognition Agreement” (GRA) with respect to the transferred stock and securities.
  • The “Active trade or business” test is satisfied.
• The U.S. target must also comply with reporting requirements demonstrating each of the above conditions is met
• 318 attribution rules (as modified by section 958(b)) apply for purposes of determining ownership
Example: Transfer of Domestic Equity

- US Target (UST) enters into a merger agreement with Transferee Foreign Corporation (TFC) pursuant to which a newly-formed merger sub of TFC merges with and into UST, with UST surviving. TFC has a single class of common voting stock.

- Transaction intended to qualify as a reorganization under section 368(a)(1)(A) pursuant to section 368(a)(2)(E)

- If the “active trade or business” test is satisfied, then:
  - U.S. transferors of UST stock who own less than 5% of TFC after the transfer are exempt from tax on their gain
  - U.S. transferors who own at least 5% of TFC after the transfer can be exempt from tax on their gain if they enter into and comply with the terms of a GRA

- If the “active trade or business” test is not satisfied, then UST shareholders are subject to tax on their gain, but not their loss

- Consider “busting” the reorg if the ATB test is likely to be failed, to permit UST shareholders to recognize losses
Outbound transfer of domestic equity
Active Trade or Business Test

The “active trade or business test” under Treas. Reg. 1.367(a)-3(c)(3) is satisfied if:

• The TFC or any “qualified subsidiary” or “qualified partnership” is engaged in an ATB outside of the United States, for the entire 36-month period immediately before the transfer
  • Can still be met if the TFC acquires an ATB that has been active through the requisite period, so long as the ATB assets were not owned by the U.S. target or its affiliates, or acquired with a principal purpose to satisfy this test.

• At the time of the transfer, neither the transferors nor the TFC (or qualified subsidiaries or partnerships) intend to substantially dispose of or discontinue that business AND

• The “substantiality test” is satisfied.

• For these purposes
  • a “qualified subsidiary” is a foreign corporation whose stock is at least 80% owned (by vote and value) directly or indirectly by the TFC.
  • A “qualified partnership” is a partnership in which TFC has (x) at least a 25% interest in capital and profits, and (y) has active and substantial management functions
  • Both definitions excludes subs that were affiliated with the UST in past 36 months, or acquired by TFC with a principal purpose of satisfying the ATB test.
Outbound transfer of domestic equity

Substantiality

• The TFC is deemed to satisfy the substantiality test if, at the time of the transfer, the FMV of the TFC is >= the FMV of the U.S. target.

• The regulations mandate certain adjustments to the FMV calculations (see 1.367(a)-3(c)(3)(iii))
  • Anti-Stuffing:
    • TFC value excludes the value of certain assets acquired by the TFC or a qualified subsidiary or partnership outside of the ordinary course of business within the prior 36 months if
      • The assets, or the proceeds thereof, produce, or are held for the production of, passive income as defined in section 1297(b) OR
      • The assets were acquired for the principal purpose of satisfying the substantiality test
    • However, the acquisition of stock of a qualified subsidiary or an interest in a qualified partnership counts towards TFC value, but only to the extent such value is not attributable to the types of assets described above
    • TFC value also excludes the value of assets received within 36 months before the acquisition, if those assets were owned by the U.S. or an affiliate, within the 36 month period before the transaction
  • Anti-skinny down
    • U.S. target value is increased by the amount of non-ordinary course distributions made within the past 36 months before the acquisition. See 1.7874-10.
    • These are mechanical rules with no exceptions other than a de minimis exception
Outbound transfer of domestic equity
Substantiality (cont’d)

• Disconnects between the adjustments required by 367(a) and those required under the section 7874 anti-inversion rules can create numerous traps and complications
  • E.g., Anti-stuffing, Treatment of options.

• How and when is “value” measured?

• How do you treat value owned by TFC’s U.S. subsidiaries?

• How to apply anti-stuffing rule when assets are acquired for other TFC assets (or other non-stock consideration)? i.e. where the acquisition does not affect the value of TFC

• How do the passive asset rules treat acquisitions of less than 80% of a target subsidiary?
Indirect stock transfers

• Certain triangular reorganizations involving asset transfers are treated as indirect stock transfers under Treas. Reg. 1.367(a)-3(d).
  • Forward and Reverse triangular mergers (under sections 368(a)(2)(D) and (a)(2)(E)) with a foreign acquiring corporation
  • Triangular B reorganizations to an acquiring corporation with domestic or foreign parents
  • Triangular C reorganizations with a foreign-parented acquirer
  • Certain controlled asset transfers after reorgs not described above

• Coordination with asset transfer rules
  • Subject to certain exceptions, transactions that qualify for the indirect stock transfer rules must still be tested under the more standard asset-transfer 367(a)(1) rules if a U.S. person transfers assets to a foreign corporation under 351 or 361.
  • Treas. Reg. section 1.367(a)-3(d)(2)(vi); 1.367(a)-3(d)(3) Exs. 6B, 6C, 8-8C.

• Section 367(b) must also be considered where applicable (including if the acquired corporation is foreign)

• Depending on the facts, these rules can result in 2 levels of tax or more.
Outbound transfer of intangible property

• If a U.S. person transfers intangible property to a foreign corporation in an exchange described in sections 351 or 361, special rules under section 367(d) apply instead of section 367(a).

• In such a case, the U.S. person transferring the property is treated as if it effectively receives a deemed royalty. It is treated as if it:
  • Sold the intangible property in exchange for payments which are contingent upon the productivity, use or disposition of such property AND
  • Receiving for such sale, amounts (commensurate with the income attributable to the intangible) which reasonably reflect the amounts they could have received annually over the useful life of the property
    • If the property is subsequently directly or indirectly sold, an amount equal to what the transferor would have received at such time.

• An account receivable may be set up for each payment the U.S. person is deemed to receive, but does not actually receive.
Outbound transfer of intangible property (cont’d)

• Intangible property includes:
  • Patent, invention, formula, process, design, pattern or know-how
  • Copyright, literary, musical, or artistic composition,
  • Trademark, trade name, or brand name,
  • Franchise, license, or contract,
  • Method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data,
  • Goodwill, going concern value, or workforce in place, or
  • Other item the value or potential value of which is not attributable to tangible property or the services of any individual
Outbound transfer of intangible property (cont’d)

• “Useful life” is the entire period during which the intangible is reasonably anticipated to affect the determination of taxable income, at the time of transfer.
  • Taxpayers can elect to cap at 20 years
Outbound transfer of intangible property
Subsequent Transfers of TFC Stock

• If U.S. transferor transfers stock of TFC to an unrelated person within useful life
  • the transferor is treated as having sold the intangible property to the new acquirer
  • recognizes US source gain equal to the FMV at that time, minus the transferor’s tax basis in the intangible at the time of the original asset transfer
  • No loss recognized
  • If gain is recognized, corresponding adjustments made to taxation of stock sale
  • Adjustment to TFC’s E&P and basis adjusted to reflect a FMV transfer of the IP

• If U.S. transferor transfers stock of TFC to a related U.S. person within useful life
  • The “successor U.S. transferor” treated as having received right to all or a portion of remaining annual royalty payments
  • U.S. transferor’s tax from stock sale transaction reduced

• If U.S. transferor transfers stock of TFC to a related non-U.S. person within useful life
  • U.S. transferor continues to include deemed royalty on the original schedule
Outbound transfer of intangible property

Subsequent Transfers by TFC of Intangible

• If TFC transfers intangible to an unrelated person during the useful life
  • U.S. transferor recognizes US source gain equal to the FMV at that time, minus the transferor’s tax basis in the intangible at the time of the original asset transfer
  • No loss recognized

• If TFC transfers intangible to a related person during the useful life
  • Original Rule: Deemed royalty continues for original U.S. transferor on the original schedule (1.367(d)-1T(f)(3))
  • This may make sense where the transferee is foreign, but not if the transfer is back to the United States, where
    • the transferee will pay tax in the U.S. on the income from the transferred intangible
    • The deductions (incl. reductions to E&P) that would be available to the original TFC are not available in the United States

• Proposed Regulations issued on May 3 address this issue for transfers to related U.S. persons
  • Terminates the application of section 367(d) if the transfer is to a “Qualified domestic person” and certain reporting requirements are satisfied
  • Requires gain recognition for U.S. transferor in certain circumstances (i.e. where the basis to the intangible property would be changed, compared to the original basis the U.S. transferor had in the property)
    • Domestic transferee’s basis is (1) FMV in the case of a non-transferred basis transaction, or (2) lessor of (x) original basis or (y) TFC’s current basis, plus the greater of gain recognized by (x) U.S. transferor or (y) TFC on the disposition.
  • Qualified Domestic Person – the original U.S. transferor, or a qualified successor or related person that is an individual or corporation with certain exceptions. Partnerships are not included
Gain Recognition Agreements

• As discussed, various exceptions from gain recognition under section 367 require a U.S. transferor or other parties to the transaction to enter into a “gain recognition agreement”. See Treas. Reg. 1.367(a)-8

• When a GRA is entered into, certain events occurring after the transaction, and within the first 5 taxable years after the transaction closes, could cause the U.S. transfer to have the deferred gain triggered into income. These transactions can include:
  • Full or partial transfers of foreign company stock received by the U.S. transferor
  • Full or partial transfers of the U.S. property received by the TFC
  • Full or partial transfers of assets of a U.S. target that was transferred to a TFC

• There are various exceptions to these triggering events (typically transactions that preserve the deferred gain at the right location), and many require the parties to the original GRA to amend (and restart the clock) or enter into new GRAs.
Outbound Transfers of Property to Foreign Corporations

Section 91
Section 91 – Branch Loss Recapture

• Section 91 requires a domestic corporation to include the “transferred loss amount” (TLA) upon a transfer of substantially all of a foreign branch’s assets to a 10-percent owned foreign corporation.

• TLA = excess of:
  • Sum of losses (A) which were incurred by the foreign branch after 12/31/2017 and before the transfer, and (B) with respect to which a deduction was allowed to the taxpayer; OVER
  • Sum of (A) taxable income of the branch for a taxable year after the taxable year in which the loss was incurred and through the close of the taxable year of the transfer, and (B) amounts recognized under section 904(f)(3) on account of the transfer.

• TLA is reduced (but not below zero) by gain recognized by the taxpayer on account of the transfer (other than 904(f)(3) gain) (the section 91(c) amount).
  • Section 91(c) amount is reduced by gain that would have been recognized under former section 367(a)(3)(C) with respect to pre-1/1/2018 losses.

• Income included under section 91 is treated as U.S. source income.

• Regulatory authority for “proper” basis adjustments.
Outbound Transfers of Property to Foreign Corporations

Section 7874
Section 7874 Anti-Inversion Rules

• Section 7874 of the Code includes a separate anti-inversion regime for U.S. companies seeking to combine with foreign entities in a transaction that results in a foreign holding company

• Unlike the rules in section 367, section 7874’s rules apply whether the transaction is taxable or tax-free.

• Under the general rule, if a foreign corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by a domestic corporation, or substantially all of the properties constituting a trade or business of a domestic partnership, the application of the anti-inversion regime depends on the percentage of stock in the foreign acquiring corporation received by the former shareholders of the domestic entity, by reason of holding stock in the domestic entity.

• If the former shareholders receive:
  • At least 80% of the stock (by vote or value): the foreign acquiring corporation will be treated as a domestic corporation for U.S. tax purposes
  • At least 60% (but less than 80%) of the stock: other significant rules and penalties (including certain excise taxes) will apply
Section 7874 Anti-Inversion Rules

• 60% inversions. Among the consequences of a 60% inversion:
  • For 10 years after the transaction, the domestic entity must recognize gain on any transfers of stock or issuance of licenses to a foreign related person, without reduction for any tax attributes.
  • Insiders are subject to an excise tax on “specified stock compensation” issued within 6 months before and after the inversion transaction
  • “Hopscotch” loans are subject to section 956. This term generally refers to obligations and stock of foreign entities to CFC’s of the acquired domestic entity (e.g. loans between the lower-tier CFC and the foreign acquirer)
  • The “third country” rule (described later) will effectively cause 60% inversions to become 80% inversions if a third country acquirer is involved
  • Retroactive loss of preferential deemed repatriation rate for pre-TCJA foreign E&P (i.e. tax imposed at 35% rate) for inversions occurring within 10 years after TCJA was enacted.
  • Gross receipts reductions (i.e. COGS) are treated as “base erosion payments” under BEAT rules
  • Anti-conduit rules under 1.7701(l)-4 disregard post-inversion “de-CFC” transactions and similar transactions
  • Additional consequences under section 367(b) regulations
Section 7874 – Ownership Fraction

Regulations under section 7874 contain numerous (significant) adjustments to the “ownership fraction” received by the former shareholders of the domestic entity. These rules generally work against the taxpayer by making the fraction higher. Among the adjustments:

• Affiliate-owned stock is ignored (except where it isn’t)
• Transfers of stock after the transaction are ignored (except where they are not)
• Treas. Reg. 1.7874-2(h) treats options as stock for purposes of measuring ownership by value.
• Treas. Reg. 1.7874-4 disregards certain stock of the foreign acquiring corporation (by excluding it from the denominator of the fraction) that was transferred in an exchange related to the domestic entity acquisition. Generally it applies to stock issued for passive assets, for obligations of other group members or shareholders, or other property acquired with a principal purpose of avoiding section 7874
• Treas. Reg. 1.7874-7 disregards stock of the foreign acquiring corporation that is “attributable” to passive assets, regardless of when issued. (i.e. the “cash box” rule). This rule applies if more than 50% of the gross value of foreign group property is attributable to passive assets described above.

(continued...)
Section 7874 – Ownership Fraction (cont’d)

- Treas. Reg. 1.7874-8 applies in the case of a foreign acquiring corporation (or affiliates) that have acquired multiple domestic entities over time. In these serial acquisitions, acquisitions of the acquirer within a 36-month trailing period must be considered, and the shares issued in those transactions ignored.
  - Multiple foreign acquirers that acquire the same domestic entity can be aggregated under section 1.7874-2(d).
  - Multiple domestic entities at the same time (or pursuant to a plan) are also aggregated under 1.7874-2(e).
- Treas. Reg. 1.7874-9 is the third-country rule. It disregards all stock of the foreign acquirer issued to shareholders of a foreign target in a transaction where both a domestic and foreign entity are acquired, and the acquiring foreign entity is tax resident in a different jurisdiction than the acquired foreign target, and where the ownership fraction is at least 60%.
- Treas. Reg. 1.7874-10 deems more stock to be issued to a domestic target’s shareholders in circumstances where the domestic target has made “non-ordinary course distributions” in the prior 3 years. Generally, NOCDs exist for a given year if any payments to shareholders in a 12 month period exceed 110% of the average of such payments in the prior 36 months.
  - This is a mechanical test that cannot be overcome even if there was no relation of the distributions to the inversion transaction.
- The interaction of these different adjustments can be very complicated and produce unexpected results.
Operating from the U.S.
Operating from the U.S.

Section 250: FDII Deduction
Section 250 FDII Deduction

FDII = Deemed intangible income (DII)

DEI = gross DEI – properly allocable deductions
Gross DEI = gross income excluding certain categories of income

Deemed Tangible Income Return = 10% of QBAI (adjusted basis in tangible property)

Foreign-derived deduction eligible income (FDDEI)
Sale of property to a foreign person for a foreign use
Services provided to any person, or with respect to property, not located in the US

Deduction eligible income (DEI)

Attributing cost-of-goods-sold (COGS) to gross receipts

For purposes of determining gross DEI and gross FDDEI, COGS is attributed to gross receipts using any reasonable method that is applied consistently. (Reg. § 1.199-4 similarly provides that COGS is allocated to domestic production gross receipts under a reasonable method and may provide useful guidance.)

COGS must be attributed to gross receipts for determining gross DEI or gross FDDEI even if costs are associated with activities undertaken in an earlier taxable year (including a pre-enactment year)
<table>
<thead>
<tr>
<th>FDDEI Sales</th>
<th>FDDEI Services</th>
</tr>
</thead>
</table>
| ► Property sold by the taxpayer:  
  ► To a foreign person, and  
  ► For a foreign use  
► Sale includes sale, lease, license, exchange or other disposition, including Section 367 transfer  
► Sale presumed to be to a foreign person in certain cases  
► General property is presumed to be for a foreign use in certain cases  
► Intangible property is for foreign use if location of end-user is outside US  
► Related party restrictions  
  ► Sale to foreign related party must be followed by sale or service to unrelated foreign person  
  ► Not applicable to sales of intangible property  | ► Services provided by the taxpayer:  
  ► To any person not located in the US, or  
  ► Generally, with respect to property not located in the US  
► Exception provided for certain services with respect to property temporarily located in the US  
► Specific treatment for digital services, including advertising services  
► Related party restrictions  
  ► Service provided to related party must not be substantially similar to service provided by related party to persons located in US |

A transaction that includes elements of both sale and service is classified according to its overall predominant character
FDDEI sales: substantiation requirements
Reg. § 1.250(b)-4(d)(3)

<table>
<thead>
<tr>
<th>Transaction Type</th>
<th>Binding Contract</th>
<th>Credible Evidence Ordinary Course of Business</th>
<th>Written Summary Prepared by Seller</th>
<th>Proof that Product is Designed for Foreign Use</th>
<th>No Specific Requirement Provided</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign person status</td>
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<tr>
<td>Substantiation of Foreign Use</td>
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<tr>
<td>Property delivered to end user</td>
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<td>Property sold for resale</td>
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<td>Sales of digital content</td>
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<td>International transportation property</td>
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<td>Property subject to manufacturing</td>
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<td>Intangible Property</td>
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</table>
FDDEI services: substantiation requirements
Reg. §1.250(b)-5(e)(4)

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<tr>
<th>Transaction Type</th>
<th>Binding Contract</th>
<th>Credible Evidence Ordinary Course of Business</th>
<th>Written Summary Prepared by Seller</th>
<th>No Specific Requirement Provided</th>
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<tr>
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<td>Substantiation that service is provided outside US</td>
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<td>Property Services</td>
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<tr>
<td>Proximate Services</td>
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<td>General Services: Consumers</td>
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<tr>
<td>General Services: Business Recipients</td>
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<td>✔</td>
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Operating from the U.S.

Foreign Branch Income
US FTC regime

- Foreign taxes paid or accrued directly by a US taxpayer are creditable under Section 901.
- Allowable FTC is determined separately for each section 904(d) “basket”
  - Passive basket
  - General basket
  - GILTI basket
  - Foreign branch basket
  - Treaty basket(s)
- Section 960 is the sole mechanism for a domestic corporation to be treated as paying foreign taxes paid by a foreign corporation, but only for foreign taxes paid or accrued by a CFC.
Section 904(d)(1)(B): Foreign Branch Basket

• “Foreign branch income” means the business profits of a US person that are attributable to 1 or more qualified business units (QBU) in 1 or more foreign countries.

• A QBU is any separate and clearly identified unit of a trade or business of a taxpayer for which that separate books and records are maintained. Reg. §1.989(a)-1(b).
  • A PE under the relevant US tax treaty is a per se foreign branch

• Subject to certain exceptions (e.g., sales of disregarded entities), gross income is attributable to a foreign branch to the extent the gross income (as adjusted to conform to US tax principles) is reflected on the separate set of books and records of the foreign branch.
  • Passive category income, income from US activities, and income arising from stock are excluded from foreign branch income
  • Financial services income can be foreign branch income
Section 904(d)(1)(B): Foreign Branch Basket – cont’d

- Books and records method.
- The decision to sell foreign disregarded entity assets versus foreign disregarded entity stock has heightened importance.

![Diagram](image-url)
Section 904(d)(1)(B): Foreign Branch Basket
Disregarded Payment Rules

• Reg. §1.904-4(f)(2)(vi) provides certain rules for reallocating income from the foreign branch basket to the general limitation basket, or vice-versa, with respect to certain disregarded payments:
  
  • **Payments by a foreign branch to a foreign branch owner:** Gross income attributable to the foreign branch is reduced and gross income attributable to the foreign branch owner is increased;
  
  • **Payments by a foreign branch owner to a foreign branch:** Gross income attributable to the foreign branch owner is reduced and gross income attributable to the foreign branch is increased; and
  
  • **Payments by a foreign branch to another foreign branch:** Gross income attributable to the payor foreign branch is reduced and gross income attributable to the payee foreign branch is increased.

• Interest payments, remittances, and contributions are generally excluded from the disregarded payment rules

• Special rules for payments to and from “non-branch taxable units”
Section 904(d)(1)(B): Foreign Branch Basket
Disregarded Payment Rules

- P earns $1000 from its services to 3rd parties, and records such income on its books and records.
  - $400 is foreign source income related to services performed by FDE outside of the U.S.
  - $600 is U.S. source income related to services performed by P in the U.S.
- P compensates FDE for its services with an arm’s-length payment of $400.
- $400 of P’s foreign source gross income is assigned to the foreign branch basket.
Section 904(d)(1)(B): Foreign Branch Basket
Disregarded transfers of Intangible Property

• Transfers of Intangible property from a foreign branch owner to a foreign branch, and vice-versa, are subject to special rules, applying the principles of sections 367(d) and 482.

• These special rules for transfers of intangible property do not apply to the following:
  • Transfers of intangible property prior to December 7, 2018; or
  • Transfers by a foreign branch or branch owner that owns the IP transitorily (i.e., neither developed or exploited by the foreign branch or foreign branch owner (or predecessor) prior to transfer, other than in the ordinary course of business during period of transitory ownership).
Section 904(d)(1)(B): Foreign Branch Basket
Disregarded transfers of Intangible Property

- P transfers intangible property, within the meaning of section 367(d)(4), to its foreign disregarded entity.
- Income earned by FDE is reassigned to P’s general category under the principles of section 367(d).
- Assuming a deemed payment of $100 were to arise with respect to the transfer in a given year pursuant to section 367(d), P’s general basket income would increase by $100 and foreign branch basket income would decrease by $100.
Summary and Questions