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Gain Recognition Agreement Regulations Could Stand Some Clarification

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Code section 367(a)(1) generally provides that if a U.S. person transfers property to a foreign corporation in a transaction that would otherwise qualify for nonrecognition of gain under sections 332, 351, 354, 356, or 361, then, for purposes of determining the extent to which gain is recognized, the foreign corporation is treated as if it were not a corporation.[1] Since the enumerated provisions only apply where property is transferred to a corporation, the effect of section 367(a), where it applies, is to cause the transaction to become taxable. Various exceptions are provided by statute. In addition, section 367(a)(6) contains a broad grant of authority to Treasury to issue regulations providing exceptions to the gain recognition of rule of section 367(a)(1). In practice, those regulations provide the applicable rules.[2]

This column considers several issues that are not consistently or appropriately addressed by those regulations. These issues relate to situations in which a taxpayer has already entered into a gain recognition agreement (a "GRA") with respect to a prior transfer that was subject to the section 367(a) regulations and there is a *subsequent* direct or indirect nonrecognition transfer involving some aspect of the property that was subject to the initial GRA (a "post-GRA transaction"). In order to ease the explanation of these issues, a general background of the applicable rules is first provided.

Background

Section 367(a)(2) Exception. Section 367(a)(2) provides that the gain recognition rule of section 367(a)(1) generally does not apply to a transaction involving the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization.[3] While the statutory exception in section 367(a)(2) only applies to a transfer of stock of a foreign corporation, certain transfers of stock of a domestic corporation are also

[1] Section 367(a) does not apply to losses.

[2] Prior to 1985, it was necessary to obtain a private letter ruling from the Service to avoid gain recognition under section 367(a). After section 367(a) was amended in 1984, the Treasury issued a set of temporary regulations under section 367(a) (the "1986 temporary regulations"). Proposed amendments to the section 367(a) regulations were issued by Treasury in 1991 (the "1991 proposed regulations") and final regulations were issued on June 18, 1998. The current rules are self-operative.

[3] Section 367(a)(3) provides another exception to the gain recognition rule, which applies where the transferred assets consist of a trade or business outside of the United States. Section 367(a)(5) provides, however, that the exceptions in section 367(a)(2) and (3) generally do not apply to transfers by a corporation subject to section 361(a) or (b).

exempted under the regulations.[4] Indeed, the regulations generally exempt an exchange of stock (whether of a foreign or domestic corporation) described in section 354, where the exchange occurs in connection with a recapitalization (under section 368(a)(1)(E)) or an asset-based reorganization (under section 368(a)(1)(C), (D) or (F)).[5] This exception does not apply to certain "indirect transfers," however, in which the corporation that ends up owning the stock or assets of the transferred corporation is a *subsidiary* of the foreign corporation that issues its stock to the transferor.[6] Such indirect transfers include triangular asset-based or stock-based reorganizations, e.g., under section 368(a)(2)(D), as well as successive section 351 transfers in which assets (other than stock or securities) are transferred by a U.S. person to a foreign corporation and are retransferred by the foreign corporation to its controlled subsidiary.[7]

If a U.S. person transfers stock to a foreign corporation in a B reorganization, a section 351 transaction, or an indirect transfer, then gain recognition is required unless the exchange qualifies for one of the exceptions described in Treas. Reg. §1.367(a)-3(b). (A B reorganization, section 351 transaction, or indirect transfer is sometimes referred to below as a "section 367(a) transfer.") A distinction is made in the regulations between the treatment of transfers by less than five-percent shareholders and transfers by larger shareholders. A transfer by a less than five-percent shareholder is exempt from gain recognition (subject to additional requirements applicable to stock of a domestic corporation, which are discussed below) without any further action by the shareholder.[8] A five-percent or greater shareholder is required to enter into a GRA, however, in order to secure nonrecognition. The purpose of a GRA is to ensure that the transaction does not permit a tax-free transaction followed shortly thereafter by a disposition of the transferred stock (or assets) by the foreign transferee corporation.

Additional requirements apply to secure tax-free treatment in a section 367(a) transfer where the transferred stock is issued by a domestic corporation.[9] These requirements are intended to prohibit tax-free "inversions" whereby a domestic corporation ends up being owned by a foreign corporation.[10] The regulations require gain recognition where either: (1) stock

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4 Treas. Reg. §1.367(a)-3.

5 Treas. Reg. §1.367(a)-3(a). The likely explanation for this exemption is that the shareholder's position remains unchanged following such a reorganization, since the shareholder still holds stock of the corporation that owns the transferred assets. The transfer of assets by a U.S. target in an outbound asset reorganization would itself generally be taxable at the corporate level under section 367(a)(1) and (5). Note that the omission of A reorganizations from the list of asset reorganizations was not an oversight. Under the existing regulations in effect under section 368(a), an outbound merger involving a foreign acquiror would not qualify as an A reorganization. Treas. Reg. §1.368-2(b)(1). Rev. Rul. 57-465, 1957-2 C.B. 250.

6 Treas. Reg. §1.367(a)-3(d). Indirect transfers are subject to the rules of section 367(a) even if the acquiring subsidiary of the foreign corporation is a *domestic* corporation.

7 The rule for successive section 351 transfers is normally relevant where the transferred assets otherwise qualify for the active trade or business exception in section 367(a)(3). By treating the transaction as an indirect transfer of stock, the regulations generally require the U.S. transferor to enter into a GRA to avoid gain recognition. In addition, gain recognition will generally be unavoidable under the inversion rules described below if the acquiring subsidiary is a domestic corporation.

8 Treas. Reg. §1.367(a)-3(b)(1) and (c)(1)(iii).

9 See generally Treas. Reg. §1.367(a)-3(c).

10 These rules predate the current controversy regarding inversion transactions. The widely reported recent inversion transactions were generally not structured to be tax-free (because of the limitations discussed in the (continued)

constituting fifty percent or more of the vote or value of the acquiring (foreign corporation) is issued in the transaction to U.S. shareholders of the domestic transferred corporation; or (2) more than fifty percent of either the vote or value of the acquiring corporation is owned after the transaction by U.S. persons that were officers, directors, or five-percent shareholders of the transferred corporation.[11] In addition, a transfer of stock of a domestic corporation will only qualify for gain recognition if the acquiring corporation has a "substantial" active trade or business outside the U.S.

Gain Recognition Agreements. A GRA[12] is an agreement by the U.S. transferor to recognize gain with respect to the "subject transaction" (*i.e.*, the transfer of stock by the U.S. transferor in a section 367(a) transfer) in the event that the foreign corporation to which the stock was transferred (the "transferee corporation") disposes of the stock of the corporation it received (the "transferred corporation") at any time prior to the close of the fifth taxable year following the close of the taxable year of the initial transfer.[13] If such an event (a "triggering event") occurs, the taxpayer is generally required to file an amended return for the year in which the subject transaction occurred and to pay interest on the tax resulting from the subject transaction.[14] Alternatively, the taxpayer can elect to recognize the gain from the subject transaction in the year the triggering event occurs, but interest must be paid as if the gain had been recognized in the year of the subject transaction.[15] The GRA also includes a waiver by the taxpayer of the statute of limitations on the assessment of tax upon the gain realized on the transfer for eight years following the taxable year of the transfer.

A triggering event includes any taxable sale or any disposition treated as an exchange under the Code (e.g., a redemption of stock described in section 302(a)), but not a disposition that is treated other than as an exchange under the Code, such as a redemption that is treated as a dividend under section 302(d). The regulations provide that a "disposition of the stock of the transferred corporation [resulting in a triggering event under the GRA] does not include certain . . . nonrecognition transfers (under paragraph (g) of [the regulations]) in which the gain recognition agreement is retained but modified, or certain transfers (under paragraph (h) of [the regulations]) in which the gain recognition agreement is terminated and has no further effect." The rules addressing such post-GRA transactions are considered further below.

If the GRA is being entered into in connection with an indirect transfer, then the foreign corporation that controls the acquiring corporation (and that issued its stock to the U.S. transferor) is treated as the "transferee corporation."[16] If the indirect transfer involves an asset-based transaction, then the corporation with the ultimate ownership of the transferred assets after

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text), but rather relied on the low equity and asset valuations resulting from the current economic environment to reduce or avoid gain recognition.

[11] Unlike the first test, this second test also takes into account stock of the acquiring corporation that was not issued in the transaction at issue.

[12] The rules relating to GRAs are set forth in Treas. Reg. §1.367(a)-8.

[13] Treas. Reg. §1.367(a)-8(b)(3).

[14] *Id.*

[15] The election must be made in the GRA, not when the triggering event occurs. Treas. Reg. §1.367(a)-8(b)(1)(vii) and (3)(iii).

[16] Treas. Reg. §1.367(a)-3(d)(2)(i).

the completion of the transaction(s) is treated as the "transferred corporation."[17] Thus, in a section 368(a)(2)(D) reorganization, a triggering event will occur if the foreign parent disposes of the stock of the acquiring subsidiary. In addition, the GRA must be modified as appropriate to treat an indirect disposition by the transferee of the stock of the transferred corporation as a triggering event. For example, in the case of a triangular B reorganization, a triggering event will occur if either the transferee corporation disposes of the stock of its subsidiary that acquired the stock of the transferred corporation or the acquiring subsidiary disposes of the stock of the transferred corporation.[18]

The taxpayer is also required to recognize gain in the event of certain transactions that are *deemed* to result in a disposition of the stock of the transferred corporation. A deemed disposition of the stock of the transferred corporation is treated as occurring if the transferred corporation makes a disposition of substantially all of its assets (including stock in a subsidiary corporation or an interest in a partnership). For this purpose, the term "substantially all" has the same meaning as under section 368(a)(1)(C). A deemed disposition would occur and result in a triggering event under the GRA even if the assets were transferred in a taxable transaction.[19]

Termination of the GRA. The following transactions cause a GRA to terminate without triggering gain: (1) a taxable disposition of the stock of the transferee corporation by the U.S. transferor;[20] (2) if the transferred corporation is a domestic corporation that was part of a consolidated group which included the transferor, a transfer by the transferred corporation of all of its assets in a fully taxable transaction;[21] and (3) a distribution by the transferee corporation of the stock of the transferred corporation to the U.S. transferor that qualifies for nonrecognition under section 355 or 337.[22]

Stock-Based Nonrecognition Post-GRA Transactions

The regulations address a number of situations in which post-GRA nonrecognition transactions do *not* result in a triggering event and the GRA continues in effect.

Transfer by the Transferee Corporation. If the transferee corporation transfers the stock of the transferred corporation in a post-GRA transaction that qualifies for nonrecognition under the Code, then the disposition is not treated as a triggering event if the initial transferee corporation receives (or is deemed to receive)[23] in the post-GRA transaction stock in a corporation or an interest in a partnership that acquired the transferred corporation (or stock in a corporation that controls the acquiring corporation) (the "acquiring corporation") and the U.S.

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[17] Treas. Reg. §1.367(a)-3(d)(2)(ii).

[18] Treas. Reg. §1.367(a)-3(d)(2)(v).

[19] The substantially all requirement is met where the corporation transfers at least 70 percent of its gross assets and 90 percent of its net assets. Rev. Proc. 77-37, 1977-2 C.B. 586.

[20] Treas. Reg. §1.367(a)-8(h)(1). Of course, tax may be due in such a case on the disposition of the stock of the transferee corporation.

[21] Treas. Reg. §1.367(a)-8(h)(2).

[22] Treas. Reg. §1.367(a)-8(h)(3). This puts the U.S. transferor into the same position it was in prior to the initial transaction.

[23] It is unclear what the drafters intended by including transactions in which the transferee "is deemed to receive" an interest in the acquiring entity. One possibility is that this refers to mergers under local law in which there would be a deemed transfer by the target of its assets in exchange for the stock of the acquiring corporation, even though under local law the target simply disappears into the surviving corporation.

transferor complies with certain notice and reporting requirements.[24] In addition, the U.S. transferor must agree to modify the terms of the GRA to take into account the post-GRA transaction by agreeing to recognize gain in the event that either: (1) the initial transferee corporation disposes of the interest (if any) it received in the acquiring corporation, or (2) the acquiring corporation (directly or indirectly) disposes of the stock of the transferred corporation.

Transfer by the U.S. Transferor. The regulations also provide that if the U.S. transferor disposes of the stock of the transferee corporation in a post-GRA nonrecognition transaction, then no gain is triggered under the GRA as long as the U.S. transferor complies with reporting requirements similar to those applicable to situations (described above) in which the transferred corporation transfers the stock of the transferred corporation in a covered post-GRA nonrecognition transaction.[25] The regulations state that if those requirements are satisfied, then "the U.S. transferor shall continue to be subject to the terms of the [GRA] in its entirety." This language may suggest that, unlike the situation in which the transferee corporation transfers the stock of the transferred corporation, the U.S. transferor is apparently not required to modify the GRA.[26] This rule seems sensible if the transaction involved is a transfer by the U.S. transferor of the stock of the transferee corporation to another corporation or a partnership in a post-GRA transaction qualifying under section 351 or 721, or in a B reorganization, since the initial transferee corporation would still own the stock of the transferred corporation, so the terms of the GRA are still applicable. In addition, the regulations need not require the GRA to be modified to address a transfer by a new foreign acquiring corporation of the stock of the initial transferee corporation, since the transfer by the U.S. transferor of the stock of the acquiring corporation to the foreign acquiring corporation would be a separate section 367(a) transaction that will be subject to the requirements of Treas. Reg. §1.367(a)-3(b), including, if applicable, a new GRA. Of course, if the acquiring corporation is domestic, the acquiring corporation obtains the transferred stock with a carryover basis, preserving gain to be recognized in the U.S. tax net. As suggested by the discussion below, the drafters of the regulations do not appear to have had asset-based reorganizations in mind in the context of this exception.

Transfer by the Transferred Corporation. As noted above, a disposition by the transferred corporation of substantially all of its assets is ordinarily treated as a deemed disposition of the

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24 Treas. Reg. §1.367(a)-8(g)(2).

25 Treas. Reg. §1.367(a)-8(g)(1).

26 It is not entirely clear whether this interpretation of the regulations is correct. First, Treas. Reg. §1.367(a)-8(e)1)(i), quoted above, states that the exemptions in paragraph (g) of the regulations apply to nonrecognition transfers in which the GRA is retained but modified. In addition, as noted in the text, Treas. Reg. §1.367(a)-8(g)(1) requires the U.S. transferor to comply with reporting requirements similar to those contained in paragraph (g)(2) of the regulations. While the term "reporting requirements" does not, on its face, seem to include a modification of the GRA, Treas. Reg. §1.368(a)-8(e)(3), which also refers to the "reporting requirements" of paragraph (g)(2), states explicitly that this includes the modification of the GRA described in paragraph (g)(2)(iii). Nevertheless, the statement in paragraph (g)(1) that "the U.S. transferor shall continue to be subject to terms of the gain recognition agreement in its entirety" is not repeated in paragraphs (g)(2) or (3) of the regulations, which suggests that the reporting requirements applicable under paragraph (g)(1) are different in this respect from those applicable under paragraphs (g)(2) and (3). Moreover, the proposed regulations that preceded the current regulations included a blanket exemption for nonrecognition transfers of the stock of the transferee corporation by the U.S. transferor without requiring that the U.S. transferor comply with any additional reporting or other procedural requirements. See former Prop. Reg. §1.367(a)-3(c)(4), which appears at 1991-2 C.B. 1070, 1077.

stock of the transferred corporation and is a triggering event under the GRA, but a disposition by the transferred corporation of all or a portion of its assets in a nonrecognition transaction is not a triggering event under the GRA if the transferred corporation receives in exchange stock or securities in a corporation or an interest in a partnership that acquired the assets of the transferred corporation.[27]

Section 332 Liquidation of the Transferred Corporation. Another exception to the deemed disposition triggering event rule applies where the transferred corporation is liquidated into the transferee corporation under sections 337 and 332, as long as the transferee corporation does not dispose of substantially all of the assets formerly held by the transferred corporation within the remaining term of the GRA.[28] Solely for this purpose, a nonrecognition transfer is not counted for purposes of the substantially all determination if the transfer satisfies the requirements of paragraph (g)(3) of the regulations (which normally apply to nonrecognition post-GRA transfers of stock of the transferred corporation by the transferee corporation).

Asset-Based Nonrecognition Post-GRA Transactions

The rules described thus far relating to the impact under a GRA of post-GRA nonrecognition transactions effectively address the issues arising in stock-based post-GRA transactions, such as B reorganizations and section 351 transactions. In contrast, the impact under a GRA of post-GRA asset-based reorganizations is far less clear.

Suppose the transferred corporation is the target in a post-GRA C reorganization in which substantially all of the transferred corporation's assets are acquired by an acquiring corporation (domestic or foreign) in exchange for voting stock of the acquiring corporation. This transfer by the transferred corporation of substantially all of its assets would apparently not result in a deemed disposition triggering event as long as the transaction complies with the requirements of paragraph (g)(3) of the regulations, since the assets are exchanged for an interest in the acquiring corporation. In order for this transaction to qualify as a tax-free reorganization under section 368(a)(1)(C), however, the transferred corporation is also required to liquidate and distribute the stock of the acquiring corporation to its shareholder (the initial transferee corporation) in a transaction qualifying under section 354. The distribution by the transferred corporation does not seem to be protected by the exception in paragraph (g)(3), since the transferred corporation (*i.e.*, subsidiary) will not receive stock of the transferee corporation (*i.e.*, parent) in consideration for the transfer. Moreover, the liquidation of the transferee would probably not qualify under section 332.[29] Instead, the liquidation normally would be protected from gain recognition solely by reason of section 361(c)(1). Accordingly, the section 367(a) regulations do not technically appear to protect the liquidation from being treated as a triggering event under the GRA. [30]

A similar issue appears to exist where the initial transferee corporation is the target in a post-GRA C reorganization, in which the assets of the transferee corporation (including the stock of the transferred corporation) are acquired in exchange for voting stock of the acquiring

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[27] Treas. Reg. §1.367(a)-8(g)(3).

[28] Treas. Reg. §1.367(a)-8(e)(3)(i)(B). It is interesting to note that the GRA is not required to be modified in this case, even though it is no longer applicable by its literal terms.

[29] *See FEC Liquidating Corp. v. U.S.*, 548 F.2d 924 (Ct. Cl. 1977) (former section 337 held not to apply to a sale of acquiror stock by the target in a C reorganization before the liquidation of the target).

[30] The exception for liquidations described in the preceding paragraph of the text expressly applies only where the liquidation of the transferred corporation qualifies under section 332.

corporation. In order for the transaction to qualify as a C reorganization, the initial transferee corporation will have to liquidate and distribute the stock of the acquiring corporation to its shareholders. This transfer would apparently not qualify for any of the exceptions in the regulations.[31]

Another vivid illustration of the apparent gap in the regulations appears in Treas. Reg. §1.367(a)-8(e)(3)(B), discussed above, which provides an exception to the deemed disposition rule that normally applies where the transferred corporation disposes of substantially all of its assets. Under that exception, "The transferee foreign corporation will not be deemed to have disposed of the stock of the transferred corporation" if a transfer of substantially all of the transferred corporation's assets occurs in a liquidation of the transferred corporation into the transferee corporation under sections 337 and 332. It is evident that in connection with such a liquidation of the transferred corporation, two transactions occur simultaneously. One is the surrender by the transferee corporation of its shares in the transferred corporation for cancellation; the second is the distribution by the transferred corporation of its assets to its parent (the transferee corporation). Each of these transactions is a disposition that would itself normally be a triggering event under the GRA (either as an actual disposition or a deemed disposition). Literally, the exception of Treas. Reg. §1.367(a)-8(e)(3)(B), appears to provide only that the distribution by the transferred corporation of its assets will not result in a deemed disposition of the stock of the transferred corporation. It does not address the impact of the surrender of the transferred corporation's stock by the transferee corporation.[32] Thus, while it seems clear that such a surrender would not be a triggering event (otherwise the exception to the deemed disposition rule for the distribution occurring in exactly the same transaction would be senseless), the regulations do not include a separate exception to provide this result.

Analysis

The foregoing discussion suggests that the drafters of the section 367(a) regulations viewed the section 332 liquidation as primarily an asset-level transaction and, whether intentionally or as a result of an oversight, did not separately address the stock surrender that

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[31] Under Treas. Reg. §1.367(a)-8(g)(2), the transfer by the initial transferee corporation of the stock of the transferred corporation in exchange for stock of the acquiring corporation would not result in a triggering event under the GRA, assuming the GRA is modified and the other applicable reporting requirements are followed. In addition, the exception in Treas. Reg. §1.367(a)-8(g)(1) would apply to the transfer by the U.S. transferor of its stock of the initial transferee corporation in the liquidation of that corporation, but would appear *not* to protect the liquidating distribution of the stock of the acquiring corporation by the initial transferee corporation. The GRA termination rule of Treas. Reg. §1.367(a)-8(h)(3), discussed above, would also not apply here, since the liquidation of the initial transferee corporation would not qualify under section 332. *See FEC Liquidating Corp., supra*. It also seems wrong as a policy matter to allow the GRA simply to terminate here, given that the U.S. transferor is not reacquiring the stock of the transferred corporation in the liquidation of the initial transferee corporation. Rather, the U.S. transferor is receiving the stock of the acquiring corporation.

[32] It is possible that Treas. Reg. §1.367(a)-8(e)(3)(B) was meant to exempt not only the distribution by the transferred corporation but also the surrender of stock of the transferred corporation by the transferee corporation occurring in the section 332 liquidation. However, the language of the exception, quoted above, suggests otherwise. Rather than stating that in a liquidation, the transferee corporation will be deemed not to have disposed of the stock of the transferred corporation (even though it actually did), the regulation states merely that the transferee corporation will not be deemed to have disposed of the stock of the transferred corporation (implying that it is merely an exception to the deemed disposition rule that would otherwise apply). In addition, the location of the exception, in paragraph (e)(3), which addresses the deemed disposition rule, suggests that this was all the exception intended to address.

accompanies the asset-level distribution by the liquidation corporation. The broader inference that may be drawn from this is that the failure of the regulations to address the stock transfers that accompany asset-based reorganizations should not be taken to mean that asset-based reorganizations are not eligible for the reorganization exemptions in the regulations. Indeed, a careful analysis of the history of the section 367(a) regulations suggests that the failure of the regulations to clearly address asset-based reorganizations was more likely an oversight and that the regulations should be read even now to allow nonrecognition transactions such as asset-based reorganizations without triggering gain under a GRA.

As noted above, the regulations do avoid a triggering event in the event of a nonrecognition transaction in which the assets of the transferee or transferor are exchanged for stock of an acquiring corporation. It appears that the drafters may simply have overlooked the fact that every asset-based reorganization is accompanied as well by a distribution of stock of the new acquiring corporation or its parent. Alternatively, the drafters may have meant for transfers in a tax-free distribution occurring as part of a reorganization under section 361(c)(1) to be covered by the exception applicable to liquidations.

The Preamble to the regulations supports the conclusion that all nonrecognition transfers were intended to be exempt from the gain triggering rules. The Preamble states: "Consistent with the proposed regulations, the final regulations clarify that post-GRA nonrecognition transactions (e.g., nonrecognition transactions in which the U.S. transferor transfers the stock of the [transferee corporation], the [transferee corporation] transfers the stock of the transferred corporation, or the transferred corporation transfers substantially of all of its assets) generally do not trigger the GRA, provided that the U.S. transferor reports the transaction and amends the GRA to reflect the post-GRA transaction."

A reading of the 1991 proposed regulations also suggests that post-GRA asset-based reorganizations were intended not to result in triggering events. Those regulations included a broad exemption from the deemed disposition rules for any transfer by the transferred corporation that is made to the transferee corporation (provided that the transferee corporation retains the assets for the remaining term of the GRA) including in a liquidating distribution. This exemption, which is the predecessor to the current exception to the deemed disposition rule contained in Treas. Reg. §1.367(a)-8(e)(3)(i)(B), was not limited to transactions qualifying under section 332 and would have protected the second-step liquidation following an asset reorganization from triggering gain under the GRA.[33] The 1991 proposed regulations nevertheless failed to address the impact of the transfer of the stock of the transferred corporation by the transferee in the liquidation of the transferred corporation in an asset-based reorganization or otherwise.

The 1986 temporary regulations similarly provided that any transfer of assets by the transferred corporation to the transferee corporation, including in a liquidation of the transferred

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[33] See former Prop. Reg. §1.367(a)-3(c)(3), appearing at 1991-2 C.B. 1070, 1077. The 1991 proposed regulations did not directly address liquidations of the transferred corporation at all, but did include a somewhat cryptic reference to a section 332 liquidation of the transferee in the reporting requirements applicable to nonrecognition transfers by the transferee, which, as under the final regulations, were exempt only where the transferee received stock in the acquiring corporation in consideration for the transfer of its assets. The regulations provided that, "Except when the transferee foreign corporation is liquidated into the United States transferor in a liquidation qualifying under section 332, and the United States transferor receives in the distribution the property transferred in the initial transfer, the United States transferor [must enter into a modified GRA]. Former Prop. Reg. §1.367(a)-8(e)(3). Id., at 1081.

corporation, would not result in a deemed disposition under the GRA,[34] and provided that a transfer of the stock of the transferred corporation in a liquidation of the transferee corporation did not trigger gain under the GRA.[35] The 1986 temporary regulations also failed to address whether a transfer of stock of the transferred corporation by the transferee corporation in liquidation of the transferred corporation in connection with an asset-based reorganization qualifies for exemption.

To date, the Service has not issued any rulings addressing whether the final regulations exempt asset reorganizations from triggering gain under a GRA. At least one private letter ruling did describe a transaction that raised the issue.[36] In that ruling, which also involved a series of other transactions not relevant to this discussion, the taxpayer proposed to have its domestic subsidiary ("DSub 2") transfer stock in a foreign subsidiary ("FSub 2") to another foreign subsidiary ("FSub 1") as a contribution to capital following which FSub 2 was to be amalgamated into a foreign subsidiary of FSub 1 ("FSub 3"). These transactions should probably have been integrated and treated as a triangular C reorganization.[37] Under such an analysis, the transaction should have been viewed as a single indirect transfer under section 367(a) not involving any post-GRA transaction. The ruling states, however, that DSub 2 will enter into a GRA with respect to these transactions and that "the GRA will take into account the Amalgamation so that, pursuant to section 1.367(a)-8(g)(2)(iii), DSub 2 will agree to recognize gain attributable to the [contribution] if FSub 1 disposes (directly or indirectly) of its interest in FSub 3 [within the term of the GRA]." The reference to Treas. Reg. §1.367(a)-8(g)(2)(iii), which deals with post-GRA transfers by the transferee corporation of the stock of the transferred corporation, indicates that, for some reason, the taxpayer (with the Service's apparent acquiescence) analyzed the contribution and amalgamation transactions separately and took the position that the amalgamation of FSub 2 was a post-GRA asset-based reorganization transaction. The Service issued a number of other rulings in connection with additional proposed transactions, but explicitly refused to express any opinion regarding the extent to which section 367(a) and (b) would apply to the contribution and amalgamation.

The Service did issue one favorable ruling addressing whether the exemption for nonrecognition post-GRA nonrecognition transactions subject to the 1986 temporary regulations applied to a post-GRA D reorganization.[38] That ruling notes that the taxpayer was aware that although it could satisfy the requirements of former Treas. Reg. §1.367(a)-3T(g)(7) with respect to the transfer of the stock of the transferred corporation by the initial transferee corporation in

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[34] Former §1.367(a)-3T(g)(3)(iii).

[35] Former §1.367(a)-3T(g)(3)(i). The 1986 temporary regulations otherwise provided a narrower exception for nonrecognition transactions generally, to cover only transfers of the stock of the transferred corporation by the transferee corporation in exchange for stock of an acquiring corporation.

[36] PLR 200105031.

[37] See Rev. Rul. 67-274, 1967-2 C.B. 141 (acquisition of the stock of a target followed by the liquidation of the target is integrated and treated as a C reorganization); PLR 200049008 (rulings 18 & 19 apply the principle of Rev. Rul. 67-274 to a D reorganization); Rev. Rul. 2001-46, 2001-42 I.R.B. 321 (holding that Rev. Rul. 67-274 continues to apply notwithstanding the promulgation of Treas. Reg. §1.338-3(d)). Another possibility is to characterize the transaction as a D reorganization, though this seems less clear since no stock of FSub 3 was issued to DSub 2. Under Code section 368(a)(2)(A), a transaction that could qualify as a reorganization under either section 368(a)(1)(C) or section 368(a)(1)(D), is treated as described only in the latter provision.

[38] PLR 200015038.

exchange for stock of the acquiring corporation, it literally might not be able to satisfy those requirements with respect to the distribution of the stock of the acquired corporation by the initial transferee corporation under section 361(c). The Service held that the post-GRA transaction would not result in a triggering event as long as it otherwise qualifies as a nonrecognition transaction and as long as the taxpayer enters into a modified GRA (for the term of the existing GRA) that satisfies the requirements of former Treas. Reg. §1.367(a)-3T(g).

Conclusion

The regulations should be read to permit a GRA to be modified to avoid a triggering event where either the transferee corporation or the transferred corporation is later acquired in an asset-based reorganization. The drafters of the existing regulations appear to have meant for an exception to apply to such transactions, even though the existing exceptions do not explicitly apply to the liquidation of the target that accompanies every post-GRA C, nondivisive D and F reorganization. It would be wise to clarify the regulations in this respect.