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Converting a Disregarded Foreign Entity to a Corporation: More than Just Checking the Box

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United States multinational companies (“MNCs”) often choose to operate in a foreign country through an entity formed under local law that is treated as a disregarded entity for U.S. federal tax purposes. As a result, the foreign entity’s activities are treated in the same manner under U.S. federal tax rules as those of a sole proprietorship, branch or division of the owner—the MNC.¹

Operating in this manner can be advantageous for the MNC. For example, the foreign country’s tax rate may be close to the U.S. federal corporate tax rate so that the MNC is able to credit fully the foreign taxes paid. Or, if the foreign entity operates at a loss, the MNC could elect to utilize those losses in computing its U.S. federal taxable income.²

Although operating in a foreign country through a disregarded entity can be advantageous, at some point the MNC may conclude that this is no longer the case. For example, if the foreign country lowers its tax rate or the foreign entity turns profitable, the tax benefits recognized by the MNC may end. In such cases, the MNC may want the foreign entity to file an entity classification election (on Internal Revenue Service Form 8832) to be treated as an association taxable as a corporation for U.S. federal income tax purposes.³

If the foreign entity makes such an election, Treas. Reg. § 301.7701-3(g)(1)(iv) provides that the MNC is deemed to contribute all of the assets and liabilities of the foreign entity to the association in exchange for stock of the association.

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IRC §§ 351 and 357

In general, this deemed contribution is a transaction described in section 351 of the Internal Revenue Code (the “Code” or “IRC”).⁴ As the following discussion demonstrates, however, in the context of the international taxation rules, numerous U.S. federal income tax consequences can result from a deemed section 351 transaction.

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as money or other property.⁵ Pursuant to IRC § 357(c), however, if the foreign disregarded entity has liabilities, the MNC would be required to recognize gain to the extent that the amount of the liabilities deemed assumed, plus the amount of the liabilities to which the property deemed transferred is subject, exceeds the aggregate adjusted basis of the property deemed transferred.⁶

IRC § 362(e)(2)

Under IRC § 362(e)(2), there is a limitation on the built-in losses that are deemed transferred, which limitation is applied on an asset-by-asset basis. Specifically, the carryover basis to the “new” foreign corporation for property deemed transferred is limited to the property’s aggregate fair market value. An MNC can elect under IRC

§ 362(e)(2)(C) to apply this limitation to the MNC's basis in the stock deemed received for transferred property, in lieu of making a reduction in the "new" foreign corporation's asset basis.

If the MNC is not sure if the fair market value of an asset deemed contributed is less than its basis in that asset, the MNC may want to make a protective IRC § 362(e)(2)(C) election under Notice 2005-70,⁷ which will have no effect if IRC § 362(e)(2) does not apply.

IRC § 367(a)(1)

In general, IRC § 367(a)(1) limits gain nonrecognition under IRC § 351 where the transferee is a foreign corporation. Unless an exception applies, IRC § 367(a)(1) denies corporate status to a foreign corporation and thereby generally requires gain recognition on a transfer of property to a foreign corporation in a transaction that would otherwise be nontaxable under IRC § 351.

Transfers of depreciated property are also subject to recapture rules.

As a result of the deemed outbound transfer of the foreign assets from the MNC to a "new" foreign corporation, IRC § 367(a)(1) requires the MNC to recognize gain (but not loss) in what would otherwise be a nonrecognition exchange unless an exception applies. The IRC § 367 discussion that follows analyzes those exceptions and the extent of any gain recognition.

IRC § 367(a)(2)

Code section 367(a)(2) provides a favorable exception to IRC § 367(a)(1) for transfers of stock in foreign corporations. Therefore, if the foreign disregarded entity owns stock in one or more foreign corporations, the MNC will not incur taxable gain under IRC § 367(a)(1) upon the deemed transfer if the MNC enters into a Gain Recognition Agreement with respect to the stock deemed transferred.⁸

IRC § 367(a)(3)

IRC § 367(a)(3) contains an exception for certain property that will be used by the transferee foreign corporation in the active conduct of a trade or business outside the United States (the "active trade or business exception"). In general, if the foreign disregarded entity has been operating a business outside of the U.S. prior to its conversion to a foreign corporation, this provision will apply.

The active trade or business exception does not apply to transfers of certain types of property, however, even if that property is used in the active business of the transferee foreign corporation.⁹ Property generally ineligible to be transferred tax-free to a foreign corporation includes:

(1) inventory, and certain property created by the efforts of the taxpayer;¹⁰ (2) installment obligations, accounts receivable, and similar property;¹¹ (3) foreign currency or other property denominated in foreign currency;¹² (4) intangible property within the meaning of Code section 936(h)(3)(B);¹³ and (5) certain property leased by the transferor.¹⁴

Transfers of depreciated property are also subject to recapture rules. Under the depreciation recapture rule, the gain attributable to depreciable property is taxable to the extent of the depreciation deductions previously taken by the MNC.¹⁵ Specifically, if the assets deemed transferred are U.S. depreciated assets, then the MNC will have to include in its gross income for the tax year in which the transfer occurs ordinary income equal to the gain realized that would have been includable in its gross income as ordinary income under IRC §§ 617(d)(1), 1245(a), 1250(a), 1252(a), or 1254(a) if at the time of the transfer the MNC had sold the property at its fair market value.

IRC § 367(a)(3)(C)

Another exception to the active trade or business exception applies to the transfer of a foreign branch with losses previously deducted pursuant to IRC § 367(a)(3)(C). The active trade or business exception will not apply to the gain realized on the deemed transfer of assets of a foreign branch to the extent that cumulative losses incurred by the foreign branch and deducted by the MNC before the transfer exceed gains of the foreign branch in subsequent years.

IRC § 904(f)(3)

IRC § 904(f)(3) also overrides the active trade or business exception. Under IRC § 904(f)(3), if the MNC is deemed to transfer certain assets that could potentially generate foreign-source taxable income, that disposition may trigger recapture of overall foreign loss accounts.

IRC § 367(d)

Even if the MNC concludes that there is little or no taxation under the provisions described above, IRC § 367(d) contains special rules relating to the transfer of intangibles to foreign subsidiaries that will likely apply to the deemed transfer of an active foreign business. IRC § 367(d) provides that intangibles described in IRC § 936(h)(3)(B)¹⁶ are within its purview, with the exception of some items such as foreign goodwill and going concern value.¹⁷

Under IRC § 367(d), the MNC deemed to transfer the intangible property to the "new" foreign corporation is treated as having sold such property in exchange for annual payments that are contingent on the productivity, use, or disposition of the property over the useful life¹⁸ of the property. Such amounts must be commensurate with the income attributable to the intangible asset and included as ordinary income by the MNC. In determining

the amount of ordinary income that the MNC must include annually, IRC § 482 and the Treasury Regulations thereunder generally apply.

IRC § 987

Proposed regulations under IRC § 987 would require that exchange gain or loss be recognized in full upon the incorporation of a branch.¹⁹ Specifically, IRC § 987 gain or loss must be recognized when a qualified business unit (“QBU”) branch²⁰ is terminated, and a termination is deemed to occur when the assets of a QBU are deemed transferred to a new foreign corporation.²¹ The IRC § 987 gain or loss that must be recognized is the currency gain or loss attributable to the QBU’s branch’s undistributed earnings and capital. For foreign tax credit purposes, IRC § 987 gain or loss is generally sourced and characterized under the rules applicable to interest expense.²²

IRC § 1503(d)

In general, under IRC § 1503(d) and the Treasury Regulations thereunder, a “dual consolidated loss” (“DCL”) cannot offset the taxable income of any domestic affiliate in any taxable year for U.S. federal income tax purposes.²³ A DCL is defined as the net operating loss (“NOL”) of a corporation incurred in a year in which the corporation is a dual resident corporation, or the NOL attributable to a separate unit.²⁴

ADCL of a foreign disregarded entity may be used by the MNC to offset its U.S. taxable income, provided that it files an election and certification agreement promising, inter alia, that the loss will not be used to offset the income of another person under the laws of a foreign country.²⁵

If there is a “triggering event” after the MNC uses the DCL, and no exception applies, Treas. Reg. § 1.1503(d)-6(e)(1) requires the MNC to recapture and report as ordinary income the DCL amount. For this purpose, Treas. Reg. § 1.1503(d)-6(e)(1)(vi) provides that a disregarded foreign entity’s conversion to a foreign corporation under Treas. Reg. § 301.7701-3(c) is a triggering event. Although a triggering event requiring recapture occurs, the amount of recapture could be zero (or less than the DCL amount used). In any event, the MNC must attach a separate accounting to its tax return to demonstrate this fact or face recapture of the entire DCL amount.²⁶

Business Purpose

Although not required by the Code or regulations, the Service believes, and certain courts have agreed, that a business purpose is required for a transfer described in Code section 351.²⁷ On the other hand, in the case of a deemed section 351 transaction in the context of an entity classification election, which by its nature will not have any non-tax consequences, the better view is that no business purpose is required.²⁸

Conclusion

Electing on Form 8832 to treat a foreign disregarded entity as a foreign corporation is a simple procedure with complicated results, and requires MNCs to thoroughly examine the transaction and its U.S. federal income tax consequences.

¹See Treas. Reg. § 301.7701-2(a).

²See generally Treas. Reg. § 1.1503(d)-6(d).

³See generally Treas. Reg. § 301.7701-3(c).

⁴IRC § 351(a) provides that no gain or loss will 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 IRC § 368(c)) of the transferee corporation. IRC § 351(b)(2) provides that no loss will be recognized even if consideration in addition to transferee stock is received by the transferor. Although generally not present in a deemed IRC § 351 transaction, when property other than stock of the transferee is received by a transferor, gain realized will generally be recognized to the extent of the cash and the fair market value of other property received. IRC § 351(b).

⁵IRC § 357(a).

⁶Although IRC § 357(b) is rarely applicable, it provides that if liabilities are assumed by a transferee corporation for the purpose of avoiding federal income tax on the exchange or, if not for such a purpose, for a non-bona fide purpose, then the liability assumption is treated as money received by the transferor in the exchange.

⁷IRB 2005-41.

⁸Treas. Reg. §§ 1.367(a)-3(b)(1)(ii), (c)(5)(iii); Treas. Reg. § 1.367(a)-8.

⁹IRC § 367(a)(3)(B).

¹⁰IRC § 367(a)(3)(B)(i) (applying to property excluded from the definition of a capital asset under IRC § 1221(1) or (3)).

¹¹IRC § 367(a)(3)(B)(ii).

¹²IRC § 367(a)(3)(B)(iii).

¹³IRC § 367(a)(3)(B)(iv).

¹⁴IRC § 367(a)(3)(B)(v).

¹⁵Treas. Reg. § 1.367(a)-4T(b).

¹⁶IRC § 936(h)(3)(B) defines an intangible as any (1) patent, invention, formula, process, design, pattern, or know-how, (2) copyright, literary, musical, or artistic composition, (3) trademark, trade name, or brand name, (4) franchise, license, or contract, (5) method, program, system, procedure, campaign, survey, study, forecast, estimate, customer list, or technical data, or (6) similar item that has substantial value independent of the services of any individual.

¹⁷Treas. Reg. § 1.367(d)-1T(b). Foreign goodwill or going concern value is the residual value of a business operation conducted outside of the U.S. after all other tangible and intangible assets have been identified and valued. For purposes of IRC § 367 and the regulations thereunder, the value of the right to use a corporate name in a foreign country is treated as foreign goodwill or going concern value. See Treas. Reg. § 1.367(a)-1T(d)(5)(iii).

¹⁸The useful life is the period during which the property has value but it cannot exceed 20 years. See Treas. Reg. § 1.367(d)-1T(c)(3).

¹⁹REG-208270-86 (Sept. 7, 2006).

²⁰A “QBU branch” is a QBU that has a different functional currency from the functional currency of the taxpayer and that does not use the dollar approximate separate transactions method

of accounts. Prop. Treas. Reg. §§ 1.987-1(a)(1), 1.987-1(a)(2).

²¹Prop. Treas. Reg. § 1.987-3(c)(1).

²²Prop. Treas. Reg. § 1.987-2(f)(1).

²³IRC § 1503(d)(1).

²⁴Treas. Reg. § 1.1503(d)-1(b)(i) and (ii). The term “separate unit” includes a disregarded foreign entity.

²⁵See, e.g., Treas. Reg. § 1.1503(d)-6(d) (requiring a “Domestic Use Election and Agreement”).

²⁶See Treas. Reg. § 1.1503(d)-6(h)(2).

²⁷See generally Rev. Rul. 55-36, 1955-1 C.B. 340 and *Caruth v. United States*, 688 F. Supp. 1129 (N.D. Tex. 1987), *aff’d* on other issues, 865 F.2d 644 (5th Cir. 1989). To the extent a business purpose requirement is applicable in the context of a deemed IRC § 351 transaction, presumably the taxpayer would be deemed to have formed the foreign entity (and thus benefited from its limited liability and its other local legal and tax attributes) at the time of the entity classification election, thereby putting deemed IRC § 351 transactions on par with actual IRC § 351 transactions.

²⁸*Dover Corporation v. Commissioner*, 122 T.C. 324, 351 n.19 (2004) (“... the check-the-box regulations [do not] require that the taxpayer have a business purpose for such an election or, indeed, for any election under those regulations”); but see ILM 200840040 (Jun. 12, 2008) (holding under the step transaction doctrine and IRC § 269, that a disregarded entity’s election to be treated as an association taxable as a corporation should not be respected, resulting in \$2 million of gain recognition). IRC § 269 may also apply to disallow the utilization of a deduction, credit, or other allowance acquired in certain stock or asset acquisitions if the principal purpose for which the acquisition was made was the evasion or avoidance of federal income taxes. Other than ILM 200840040, there is no authority that provides for the application of IRC § 269 in the context of a deemed IRC § 351 transaction. □

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