Stranger in a Strange Land: The Continuing Role of Section 367 in a Dramatically Altered World

2018 U.S. Cross-Border Tax Conference

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Notices

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The information contained herein is of a general nature and based on authorities that are subject to change. Applicability of the information to specific situations should be determined through consultation with your tax adviser.
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# Today’s presenters

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Section 367 – general overview
General Overview

Section 367(a)
— Imposes tax on outbound transfers by a U.S. person to a foreign corporation in an otherwise tax-free transaction (i.e., section 332, 351, or in a reorganization) unless an exception applies.

Section 367(b)
— Applies to inbound liquidations and reorganizations, as well as foreign-to-foreign reorganizations.
— Intended to protect U.S. taxation of E&P of foreign corporations.

Section 367(d)
— Provides special rules for outbound transfers of intangible property.
— Imposes deemed royalty payments for use of transferred property.

Section 367(e)
— Outbound spin-offs and liquidations.
Relevant changes in the TCJA
Repeal of active trade or business exception for outbound transfers

Section 367(a)(3) previously provided an exception to the general recognition rule of section 367(a) for asset transfers if the assets were used in the active conduct of a trade or business outside the United States.

The TCJA repealed this exception, which generally makes all outbound transfers of tangible property subject to tax under section 367.

Thus, tax would be recognized in any outbound asset reorganization or on the incorporation of a foreign branch.
Foreign branch loss recapture rule

New section 91 applies if a U.S. corporation transfers substantially all of the assets of a foreign branch to a specified 10-percent owned foreign corporation (as defined in section 245A) with respect to which it is a U.S. shareholder after the transfer.

The U.S. corporation must include in gross income the “transferred loss amount” with respect to such transfer, which is any excess of:

- Deductible losses incurred by the foreign branch after December 31, 2017, and before the transfer, over
- Taxable income of the branch for a taxable year after the year in which the loss was incurred and through the close of the year of the transfer, plus any amount recognized under section 904(f)(3) on the transfer.

The transferred loss amount is generally reduced by the amount of gain recognized by the taxpayer on the transfer.

Recaptured loss amounts are treated as U.S. source income.
Intangible property rules in section 367(d)

The TCJA revised the definition of intangible property in section 936(h)(3)(B), which is applicable to outbound transfers of intangible property under section 367(d).

Under prior law, section 936(h)(3)(B) defined intangible property as any:

— 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; or
— any similar item,
which has substantial value independent of the services of any individual.
Intangible property rules in section 367(d)

As revised, the definition of intangible property now includes “any goodwill, going concern value, or workforce in place (including its composition and terms and conditions (contractual or otherwise) of its employment).”

— Such items are now clearly subject to section 367(d) deemed royalty treatment rather than section 367(a).

The TCJA also removed “any similar item” and the flush language in the old definition.

— In their place is a new catch-all that applies to “any other item the value or potential value of which is not attributable to tangible property or the services of any individual.”

The revised definition of intangible property is now found in new section 367(d)(4), as section 936 was repealed in the Consolidated Appropriations Act, 2018 (P.L. 115-141).
Intangible property rules in section 367(d)

The TCJA confirms the authority of the IRS to require certain valuation methods applicable to intangible property.

— Section 367(d) was amended to permit regulations that value intangible property transfers on an aggregate basis or on the basis of realistic alternatives.
Outbound planning issues — section 367(a) and (d)
Outbound transfers of tangible and intangible assets

— Section 367 now results in income or gain recognition on all outbound transfers of tangible and intangible property.
— However, tax is imposed at a reduced corporate rate of 21%.
— If the assets transferred are for foreign use, section 367(a) gain or a section 367(d) deemed royalty inclusion could be considered FDII and eligible for a deduction under section 250 that would further reduce the rate to 13.125%.
New deduction for U.S. corporations for foreign-derived intangible income (FDII) reduces the U.S. tax rate on income from certain export sales and licenses and services provided to persons outside the United States.

The current FDII deduction is 37.5%, which produces a 13.125% ETR (the deduction is reduced to 21.875% starting in 2026 for an ETR of 16.406%).

In general, income is included in the computation of FDII if it is derived from (1) sales of property to any foreign person for foreign use, or (2) services provided to any foreign person or with respect to foreign property.

- The computation of FDII excludes certain types of income, including “foreign branch income,” which is defined in section 904(d)(2)(J) as business profits attributable to one or more qualified business units in one or more foreign countries.

The amount eligible for the FDII deduction is reduced by a fixed 10% return on tangible property.

The FDII deduction is subject to a taxable income limitation.
Section 250 – FDII overview

— Foreign use means any use, consumption, or disposition that is not within the United States.
— A sale of property includes any lease, license, exchange, or other disposition.

Related Party Transactions

— If property is sold to a related party who is not a U.S. person, the sale is not treated as for a foreign use unless:
  - The property is ultimately sold by a related party, or used by a related party in connection with property that is sold or the provision of services, to another person who is an unrelated party who is not a U.S. person, and
  - The taxpayer establishes to the satisfaction of the Secretary that such property is for a foreign use.
— For this purpose, a sale of property is treated as a sale of each of the components thereof.
— If a service is provided to a related party who is not located in the United States, the taxpayer must establish to the satisfaction of the Secretary that the service is not substantially similar to services provided by such related party to persons located within the United States.
— “Related party” means any member of a section 1504(a) affiliated group, determined using a lower 50% threshold and including foreign corporations and insurance companies.
  - Any person (other than a corporation) is treated as a member of the affiliated group if the person is controlled by members of the group (including any entity treated as a member of the group by reason of this sentence) or controls any member.
  - Control is determined under the rules of section 954(d)(3).
— U.S. Co incorporates its foreign branch, FS.

— Is any resulting gain (or deemed royalty income) to U.S. Co on the outbound asset transfer eligible for FDII? Consider:
  - Foreign branch income exception
  - Sale requirement
  - Related party rules
  - Foreign use requirement
Outbound transfer alternatives

What are advantages of Alternatives 1 and 2 versus each other and versus base case?
Other considerations for outbound transfers

Potential for short lived existence of FDII deduction.
Potential for subsequent increases to the 21% U.S. corporate rate.
General limitation foreign tax credit carryforwards post section 965.
Impact on GILTI calculation.
Foreign tax treatment of transfer (e.g., basis step up, amortization).
Deductibility of actual or deemed royalty payments by, or U.S. depreciation/amortization deductions of, FS in its home jurisdiction.
Section 367(a) – outbound stock transfers

— The section 367(a) outbound stock transfer rules were unchanged by the TCJA.
— To what extent is the policy underlying section 367(a) still relevant for policing outbound stock transfers?

Outbound Transfers of U.S. Corporation Stock
— Outbound stock transfer rules for U.S. corporation stock likely to remain in effect (but in many cases outbound transfers of U.S. corporation stock already policed by the inversion rules).

Outbound Transfers of Foreign Corporation Stock
— Are gain recognition agreements (GRAs) for outbound transfers of foreign corporation stock still needed?
  - In general, where a U.S. person transfers foreign corporation stock to a foreign corporation in a transaction subject to section 367(a), the U.S. transferor is not required to recognize gain under section 367(a) if it enters into a GRA with respect to the transferred stock.
— What U.S. tax policy interests with respect to foreign corporation stock continue to exist given the changes to the U.S. international tax system (e.g., sections 245A, 1248(j), and 964(e))? 
  - Do those concerns warrant continued use of GRAs under the current regulations notwithstanding the administrative burdens imposed by those rules on both taxpayers and the IRS?
  - Should preexisting GRAs be terminated?
Outbound stock transfer

U.S. Co

$80 Basis
$100 FMV

FS1 Stock

FS1
$80 PTI
$10 Untaxed E&P

FS2
Inbound planning issues — section 367(b)
Section 367(b) and the regulations thereunder are focused on the proper taxation of a CFC’s earnings, a concern underlying the prior U.S. international tax system of deferral.

The section 367(b) regulations generally operated to prevent the avoidance of U.S. tax by:
— Taxing E&P of foreign subsidiaries in inbound section 381 transactions; and
— Preserving such E&P, or accelerating the inclusion of dividend income, in connection with dispositions of stock in foreign-to-foreign reorganizations.

The section 367(b) rules can impose tax in the form of a deemed dividend from the foreign corporation’s E&P.
— The deemed dividend is treated as a dividend for all U.S. tax purposes.

Section 367(b) after the TCJA
Section 367(b) after the TCJA

What purpose do the section 367(b) regulations continue to serve under current law?

Under the TCJA:

— Pre-TCJA earnings are taxed under the section 965 deemed repatriation rules.
— CFC earnings are subject to current tax under Subpart F or the GILTI rules in section 951A.
— All other CFC earnings generally are exempt from U.S. tax, as section 245A generally provides U.S. corporate shareholders with a 100% dividends received deduction on repatriation.
— Section 1248(j) treats the section 1248 amount on the sale of stock as a dividend that qualifies for tax-free treatment under section 245A.
  - Section 964(e) provides for essentially the same treatment to a selling CFC upon a sale by an upper-tier CFC of stock in a lower-tier CFC.
**Facts**

- USP contributes the stock of FS to Newco U.S., after which FS elects to be treated as a disregarded entity for U.S. tax purposes.
  - The transactions should qualify as an inbound “F” reorganization.

- Alternatively, FS elects to be a disregarded entity and is deemed to liquidate directly into USP in a section 332 transaction.
Analysis

— Under prior law, the transaction would generally result in USP including the all E&P amount with respect to its FS stock in gross income as a dividend (generally, the E&P of FS attributable to the stock held by USP).

— Under the TCJA, any all E&P amount dividend should be eligible for the dividends received deduction under section 245A and effectively exempt from U.S. tax.

— The result would be the same in a foreign-to-foreign reorganization that resulted in the inclusion of dividend income equal to USP’s section 1248 amount in the stock of FS (i.e., such amount would be exempt from U.S. tax under section 245A).

— Always consider impact on BEAT; cf. section 311 distribution of assets from FS to USP.
Post 2017 IP restructuring plan – example

Issue

— USP is contemplating restructuring its foreign IP by having CFC2 (the owner of the IP) transfer it to New CFC in return for a note or NQPS – a transfer for “boot” (a section 351(b) contribution).

— Assume USP has entered into a GRA with respect to the transfer of CFC2 shares into CFC1 less than 5 years ago.

— Triggering event exception is generally not available when “boot” is received.

Solution

— Consider making an election to treat CFC1 as a DRE (i.e., a section 332 liquidation) which terminates the GRA, prior to the contemplated section 351(b) transfer.

— The deemed dividend inclusion of all E&P amount per section 367(b) might be tax-free per section 245A.
Out from under planning – section 1248 and section 367(b) alternatives

Alternative 1 – Section 1248

— US transfers stock of CFC to its foreign parent, FP, in a section 311(b) distribution or in a sale.
— Before the transfer of CFC stock, E&P may be created at CFC level through a taxable transfer to a lower-tier CFC.

CFC Stock (section 311(b) distribution or sale)

Alternative 2 – Section 367(b)

— CFC sells its assets to FP and then liquidates into U.S.

CFC Assets

Liquidation

(1)

(2)

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Out from under planning – section 1248 and section 367(b) alternatives

Alternative 1 – Section 1248

CFC Stock (section 311(b) distribution or sale)

Alternative 2 – Section 367(b)

(1) CFC Assets

(2) Liquidation

— Alternative 1: Section 1248(j) provides that dividends arising under section 1248 on the sale or exchange by a U.S. corporation of foreign corporation stock are treated as a dividend for purposes of applying section 245A.
— Alternative 2: May be easier to implement but the liquidation/inbound will close CFC’s taxable year, meaning USP will be required to recognize the section 951A inclusion on day of liquidation.
  - The inclusion of all E&P amount from the inbound/liquidation, per section 367(b), only includes non PTI E&P amounts, and hence, section 245A is relevant only to the extent there is E&P amount which was not previously taxed.
  - If, however, the CFC has a fiscal year-end in 2018, the sale of the assets may not result in section 951A/951(a) inclusion, and therefore the section 367(b) deemed dividend inclusion may qualify for section 245A tax-free treatment.
Section 367 and Spin-offs
U.S. distributing distributes CFC controlled
U.S. distributing distributes CFC controlled — section 367 consequences under tax reform

Distribution to Foreign Persons
— Distribution is treated as a fully taxable disposition of CFC stock. Section 367(e)(1); Treas. Reg. § 1.367(e)-1(b)(1).
— To the extent of E&P of CFC, gain is subject to tax under section 1248 which may result in participation exemption treatment under section 245A.

Distribution to US Individuals
— To the extent of E&P of CFC, gain is subject to tax under section 1248 which may result in participation exemption treatment under section 245A.

Distributions to US Corporations
— Distribution may be treated as a fully taxable disposition of CFC stock to the extent of the E&P of CFC. Section 1248(f).
— To the extent of E&P of CFC, gain is subject to tax under section 1248 which may result in participation exemption treatment under section 245A.
CFC distributing distributes CFC controlled – consequences under treas. Reg. § 1.367(b)-5

If a CFC distributes either domestic or foreign controlled corporation stock in a section 355 distribution:

— The distributee shareholder compares pre and post-distribution section 1248 amounts as to stock of CFC distributing and CFC controlled.

— To the extent the distribution causes a reduction in the section 1248 amount with respect to either CFC distributing or CFC controlled, the distributee reduces its basis and/or has an income inclusion in the CFC with the reduction.

— It may also increase its basis in the other corporation by the amount of such reduction (for example, if it reduced basis in distributing it may be able to increase basis in controlled by the same amount).

Treas. Reg. § 1.367(b)-5(c)(4).

Definitions

— **Pre-Distribution Amount** – Distributee’s section 1248 amount computed immediately before the distribution, but only to the extent attributable to Distributing and/or Controlled (as applicable).

— **Post-Distribution Amount** – Distributee’s section 1248 amount with respect to Distributing and/or Controlled stock (as applicable) computed immediately after the distribution.

— **Section 1248 Amount** – Net positive E&P that would have been includible in income as a dividend under section 1248 if the stock was sold by the shareholder.

— **Section 1248** – If a U.S. person owns more than 10% of the voting stock of a foreign corporation at any time during the 5-year period ending on the date of the sale when the foreign corporation was a CFC, gain recognized on the sale or exchange of such stock is treated as a deemed dividend to the extent of the foreign corporation’s E&P attributable to the stock.
CFC distributing distributes CFC controlled – section 367 consequences under tax reform

Under old law, taxpayers sought to allocate E&P in a spin-off in such a manner as to minimize the likelihood of a deemed dividend under section 367(b).

Now, because of section 245A, a deemed dividend under section 367(b) may be tax exempt.

Further, because of the basis redistribution rule described on the prior slide, taxpayers can potentially use Treas. Reg. § 1.367(b)-5 to affirmatively shift basis between CFCs in a spin-off in a tax-efficient manner.
Killer B regulations and tax reform
Killer B regulations – illustrative transaction

**Facts**
- FS acquires $100 of USS voting stock for $100 of property (e.g., cash, note).
- FS uses the USS voting stock to acquire all of the stock of FT from USP in a reorganization under section 368(a)(1)(B). USP files a GRA.

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**Legend**
- USS = P
- FS = S
- FT = T
Killer B regulations – overview

Treas. Reg. § 1.367(b)-10 can apply to a triangular reorganization where S and T are foreign corporations if S acquired the stock of P used in the reorganization in exchange for property (as defined in section 317(a)).

In that instance, the transfer of property is treated as a distribution.

Note that if the amount of the deemed distribution that is subject to U.S. tax under sections 301(c)(1) and 301(c)(3) is less than or equal to the amount of gain recognized under section 367(a), there is no deemed distribution (the “Coordination Rule”).
Killer B regulations – notice 2016-73: overview of modifications

Notice 2016-73 announced forthcoming regulations that modify the application of section 367(a) and section 367(b) with respect to triangular reorganizations.

Modifications to Section 367(a): Section 367(a) will only apply to a triangular reorganization that is an indirect stock transfer to the extent the stock received by T’s shareholder in exchange for the T stock was not acquired by S in exchange for property.

Modifications to Treas. Reg. § 1.367(b)-10:
— The Coordination Rule does not apply if T is a foreign corporation.
— The term “property” includes NQPS.

Modifications to Treas. Reg. § 1.367(b)-4: To the extent T’s shareholder exchanges T stock for P stock that was acquired by S in exchange for property, T’s shareholder must:
— Include a deemed dividend the section 1248 amount attributable to the T stock exchanged for P stock that was acquired by S in exchange for property, and
— After increasing its tax basis in the T stock resulting from the deemed dividend, recognize all gain attributable to the T stock exchanged for P stock that was acquired by S in exchange for property.
The Killer B Regulations were designed to prevent CFCs from repatriating cash to the United States without incurring any additional U.S. tax.

In light of section 245A, the policy reasons for the regulations no longer exist.

However, there may be instances where taxpayers still seek to undertake transactions that would otherwise be covered by the Killer B Regulations. These may include:

— Transactions intended to move cash into the United States without moving E&P (designed to minimize U.S. withholding tax for inbound companies upon the future distribution of that cash);
— Transactions designed to minimize local country withholding taxes; and
— Transactions designed to work around local country legal prohibitions on distributions (e.g., distributable reserve requirements).
Thank you