Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: **AM 2017-005**
Release Date: 11/24/2017

CC:INTL:B04
PRESP-118563-17

UILC: 367.03-00

date: November 15, 2017

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subject: Effect of Short Taxable Years on Gain Recognition Agreements and Related Filings

This memorandum addresses the determination of the gain recognition agreement (GRA) term under §1.367(a)-8 and related requirements regarding annual certifications and the extension of the period of limitations on assessments. This memorandum should not be used or cited as precedent.

FACTS

UST is a domestic corporation that files a federal income tax return on a calendar year basis. UST owns all the stock of TFD, a foreign corporation. The TFD stock has a fair market value that exceeds its adjusted basis.[1]

On June 30 of Year 0, in an exchange to which section 351 applies, UST transfers all the stock of TFD to TFC, a foreign corporation, solely in exchange for TFC stock ("the TFD transfer"). In connection with the TFD transfer, UST: (i) enters into a gain recognition agreement ("GRA") pursuant to §1.367(a)-3(b)(1)(ii) and §1.367(a)-8 ("GRA1"); (ii) files Form 8838 pursuant to §1.367(a)-8(f); and (iii) files Form 926 pursuant to §1.6038B-1(b)(2)(i)(B)(1). Accordingly, UST does not recognize the built-in gain in the TFD stock under section 367(a)(1) as a result of the TFD transfer.

USP is a domestic corporation and the common parent of an affiliated group of corporations ("the USP group") that files a consolidated federal income tax return with a

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[1] The section 1248 amount (within the meaning §1.367(b)-2(c)) with respect to the TFD stock is zero.

fiscal year ending April 30. On June 30 of Year 3, USP acquires all the stock of UST (the "acquisition") in a transaction that is not a reverse acquisition under §1.1502-75(d). UST thus becomes a member of the USP group and thereafter remains a member of the USP group. UST's taxable year ends for federal tax purposes at the end of June 30 of Year 3, and UST files a separate return for the period from January 1 of Year 3 through June 30 of Year 3. Section 1.1502-76(b)(1)(ii)(A)(1).

Following the acquisition, UST enters into a new GRA ("GRA2") to meet the triggering event exception provided in §1.367(a)-8(k)(11). Pursuant to §1.367(a)-8(d)(3), USP files the GRA on behalf of UST by including it with the USP group's consolidated federal income tax return.

ISSUES

(1) How to determine the GRA term (as defined in §1.367(a)-8(c)(1)(i)) for GRA 1 and GRA 2?

(2) For which taxable years must UST file an annual certification (as described in §1.367(a)-8(g))?

(3) Through which date must UST extend the period of limitations on assessments of tax pursuant to §1.367(a)-8(f)?

LAW

Section 367(a)(1)

Subject to certain exceptions, section 367(a)(1) generally provides that if a United States person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361, the foreign corporation is not considered a corporation for purposes of determining the extent to which the United States person recognizes gain on the transfer.

Section 1.367(a)-3(b)(1) provides two exceptions to the general rule of section 367(a)(1) for transfers by a United States person of stock or securities of a foreign corporation to a foreign corporation. The first exception applies if the United States person owns less than five percent (applying the attribution rules of section 318, as modified by section 958)) of both the total voting power and the total value of the stock of the transferee foreign corporation.[2] The second exception applies if the United States person enters into a five-year GRA with respect to the transferred stock or securities as provided in §1.367(a)-8.[3]

[2] §1.367(a)-3(b)(1)(i).

[3] §1.367(a)-3(b)(1)(ii).

Section 1.367(a)-8 (the GRA regulations) sets forth the requirements that must be satisfied for a United States person to enter into a GRA with respect to stock or securities of a foreign corporation transferred by the United States person to a foreign corporation pursuant to an exchange that would otherwise be subject to section 367(a)(1). In general, the GRA regulations provide, among other things, that the United States person must include the GRA and any other required documents with its timely filed return for the taxable year during which the transfer occurs.[4] However, if the United States person is a member but not the common parent of a consolidated group, then the common parent files the GRA and other documents on behalf of the US transferor;[5] in such a case, the GRA and other documents must thus be included with the timely filed return of the consolidated group for the taxable year during which the transfer occurs.

For purposes of this memorandum, the United States person, the transfer, the taxable year, and the stock or securities described in the previous paragraph are referred to at times as the “US transferor,” the “initial transfer,” the “initial transfer year,” and the “transferred stock,” respectively. In addition, for purposes of this memorandum, the gain realized but not recognized on an initial transfer by reason of entering into a GRA is referred to as “the GRA gain.”

Policies underlying the GRA regulations

In general, the GRA regulations are intended to establish an objective, administrable, and enforceable regime for identifying events that require a US transferor to include in income all or a portion of the GRA gain and, when such an event occurs, to place the US transferor in approximately the same position in which it would have been had the initial transfer or portion thereof been subject to section 367(a)(1).[6]

In particular, the terms and conditions of a GRA establish objective standards for identifying events that require a US transferor to include in income all or a portion of the GRA gain. Specifically, §1.367(a)-8(c)(1)(i) provides that the US transferor must recognize all or a portion of the GRA gain if a “gain recognition event” occurs during the “GRA term,” which that section defines as:

> [T]he period beginning on the date of the initial transfer and ending as of the close of the fifth full taxable year (not less than 60 months) following the close of the taxable year in which the initial transfer occurs.

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[4] §1.367(a)-8(d)(1)(i).

[5] §1.367(a)-8(d)(3).

[6] See H.R. REP. 98-432, Part 2, at 1321 (1984) (“The Committee believes that the [IRS] should set forth regulations whereby, where appropriate, the IRS would not impose tax on the transfer of [certain] stock . . . [But] [t]he transferor would be taxed on any income or gain from a [subsequent] disposition of the stock as if the disposition took place in the year of the original transfer at the fair market value of the stock at the time of the original transfer.”).

Section 1.367(a)-8(b)(1)(v) specifies the events that constitute "gain recognition events." One type of event that may constitute a gain recognition event is a "triggering event." Section 1.367(a)-8(j), in turn, specifies the list of events that constitute triggering events,[7] and §1.367(a)-8(k) provides that certain events are not treated as triggering events if certain conditions are met.[8]

To promote compliance with these rules, and consistent with the legislative history accompanying the 1984 amendments to section 367(a), the GRA regulations require a US transferor to, for certain periods following the initial transfer, supply information regarding whether a gain recognition event has occurred.[9] Specifically, under §1.367(a)-8(g), the US transferor must generally include annual certifications with its timely-filed return "for each of the five full taxable years following the taxable year of the initial transfer." Among other things, an annual certification must state whether a gain recognition event has or has not occurred during the taxable year. In certain cases, a new GRA filed by the US transferor is in lieu of the annual certification otherwise required for a taxable year.[10]

Further, the terms and conditions of a GRA ensure that, when a gain recognition event occurs, the US transferor is placed in approximately the same position in which it would have been had the initial transfer been subject to section 367(a)(1). Specifically, under §1.367(a)-8(c)(1)(v), the US transferor must pay and report interest on any additional tax due with respect to the GRA gain recognized, for the period between the due date of the US transferor's return for the year of the initial transfer and the date on which the additional tax due is paid.[11] In addition, under §1.367(a)-8(c)(4), the US transferor

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[7] In general, triggering events fall into two categories: one, direct or indirect dispositions of the transferred stock; and two, other events the result of which it would not be appropriate for a GRA to continue.

[8] In general, §1.367(a)-8(k) provides exceptions for certain dispositions that constitute nonrecognition transactions but only if, immediately after the disposition, a US transferor retains, as applicable, a direct or indirect interest in the transferred stock, or in the assets of the transferred corporation, and a new GRA is entered into with respect to the initial transfer.

[9] See S. REP. 98-169, vol. 1, at 366 (1984) ("The committee understands that enforcement of such regulations could, in some cases, present problems. However, it believes that the burdens of enforcing compliance would not outweigh the benefits of regulations in many cases. To promote compliance, the IRS might require in the regulations, for example, the transferor to certify annually for some period (*e.g.*, 15 years) following the transfer that the transferred property is still held by the transferee and to file annually a waiver of the statute of limitations on assessment.").

[10] §1.367(a)-8(d)(2)(i).

[11] The legislative history accompanying the 1984 amendments to section 367(a) envisioned using an interest charge as a tool for placing the US transferor in approximately the same position in which it would have been had the initial transfer been subject to section 367(a)(1). See H.R. REP. 98-432, Part 2, at 1321 (1984) (explaining that upon a subsequent disposition, "[t]he transferor would be taxed on any income or gain from a disposition of the stock as if the disposition took place in the year of the original transfer at the fair market value of the stock at the time of the original transfer. Thus, interest would be added to the tax for the period from the initial transfer to the subsequent disposition.").

makes corresponding basis and other appropriate adjustments, as if the gain was recognized on the date of the initial transfer.

Finally, the GRA regulations ensure that the IRS may properly enforce these rules. For example, §1.367(a)-8(f) requires the US transferor to file Form 8838 to extend the period of limitations on assessments of tax with respect to the GRA gain "through the close of the eighth full taxable year following the taxable year during which the initial transfer occurs."[12] In addition, in part to ensure that a triggering event exception would not adversely impact the IRS' ability to enforce a GRA (e.g., as a result of a new person being treated as the US transferor), §1.367(a)-8(k) generally requires that, for an event to qualify as a triggering event exception, a new GRA be filed. Under §1.367(a)-8(c)(5), a new GRA replaces the existing GRA, the exiting GRA terminates without further effect, and the term of the new GRA is "the remaining term of the existing [GRA]." Similarly, when a new GRA is filed, §1.367(a)-8(f)(2) generally requires the US transferor to file a new Form 8838 to extend the period on assessments of tax on the initial transfer "through the close of the eighth full taxable year following the taxable year during which the initial transfer occurs . . . ."

ANALYSIS AND CONCLUSIONS

Issue 1: How to determine the GRA term (as defined in §1.367(a)-8(c)(1)(i)) for GRA1 and GRA2?

Under §1.367(a)-8(c)(1)(i), the GRA term begins on the date of the initial transfer and, absent any event that would otherwise terminate the GRA, ends on the date that is 60 months (that is, the number of months in five full taxable years) after the date on which the initial transfer year closes. The parenthetical language in §1.367(a)-8(c)(1)(i) stating that a GRA term is "not less than 60 months" simply describes how the date on which the GRA term would end is a date that is between 60 and 72 months following the date of the initial transfer, depending on how early during the initial transfer year the initial transfer occurs. Thus, the date on which the GRA term would end is fixed and is not affected by subsequent events, such as short taxable years of the US transferor.

Determining the GRA term in this manner—with the result that the GRA term is identifiable and fixed when the GRA is filed—is consistent with and best promotes the policies underlying the GRA regulations. In particular, by providing certainty about the length of the GRA term, it increases administrability. It also promotes objectivity by ensuring consistent treatment for US transferors without regard to whether a US transferor has a short taxable year following the initial transfer year.[13] Further, it is

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[12] The legislative history accompanying the 1984 amendments to section 367(a) envisioned using a waiver of the period of limitations on assessments of tax as a tool to enforce the terms and conditions of a GRA. See S. REP. 98-169, vol. 1, at 366 (1984) ("To promote compliance, the IRS might require . . . [the transferor] to file annually a waiver of the statute of limitations on assessment.").

[13] Alternative approaches to determining the GRA term—such as extending the GRA term by short taxable years subsequent to the initial transfer—would be inconsistent with the purposes underlying the GRA regulations. For example, alternative approaches could result in the GRA term not being fixed when

consistent with the 1998 amendments to the GRA rules, which, in response to comments that a transaction in year 8 should not trigger a GRA, provided that "the GRA term will be 5 years in all cases involving outbound transfers of foreign stock." See preamble to T.D. 8770 (emphasis added).

Accordingly, in UST's case, the GRA term for GRA1 begins on June 30 of Year 0, the date of the TFD transfer. In addition, the date on which GRA 1 would end, absent any event that would otherwise terminate the GRA, is December 31 of Year 5, the date that is 60 months after the date on which UST's taxable year for the year of the TFD transfer closes. However, pursuant to §1.367(a)-8(c)(5), GRA1 terminates on June 30, Year 3, and the GRA term for GRA 2 then begins on July 1, Year 3. Absent any event that would otherwise terminate GRA 2, the GRA term for GRA 2 will end on December 31 of Year 5.

Issue 2: For which taxable years must an annual certification (as described in §1.367(a)-8(g)) be filed?

Under §1.367(a)-8(g), a US transferor must include an annual certification—or, if applicable, a new GRA in lieu of an annual certification—with the timely-filed return for each taxable year (other than the initial transfer year) covering a period within the GRA term. Thus, if the US transferor has a short taxable year during the GRA term, the US transferor must include an annual certification or new GRA, as applicable, with its timely-filed return for that year. Consistent with the legislative history to section 367(a), this approach best promotes compliance with the GRA rules by ensuring that, for each tax return covering a period within the GRA term, the US transferor supplies information regarding whether a gain recognition event has occurred during the GRA term.[14]

Thus, for GRA1 and GRA 2, an annual certification (or new GRA in lieu of an annual certification, if applicable) must be included with the timely-filed return of UST or the USP group, as applicable, for each taxable year (other than the initial transfer year) covering a period within the GRA term for GRA 1 and GRA 2. Accordingly, UST must include an annual certification with its timely-filed returns for the following taxable years: January 1 through December 31 of Year 1, January 1 through December 31 of Year 2, and January 1 through June 30 of Year 3.[15]

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the GRA is filed and could result in disparate treatment between US transferors depending on whether a US transferor has a short taxable year following the initial transfer year.

[14] See note 9 and related discussion, supra.

[15] If UST were not required to include an annual certification with its return for the period from January 1 through June 30 of Year 3, no annual certification would be filed with respect to the early part of Year 3. This would create a "gap" in the certification period, which would be inconsistent with the underlying purpose of promoting compliance for the entirety of the GRA term, see note 9 and related discussion, supra.

In addition, for the May 1 of Year 3 through April 30 of Year 4 taxable year of the USP group, USP must file, on behalf of UST, GRA 2 in lieu of the annual certification otherwise required for that period.

Further, absent an event that would terminate GRA 2 before December 31 of Year 5, USP must include, on behalf of UST, an annual certification with the USP group's timely-filed return for the taxable years of May 1 of Year 4 through April 30 of Year 5 and May 1 of Year 5 through April 30 of Year 6. With respect to the annual certification included with the return for the taxable year ending on April 30 of Year 6, the annual certification need only supply information with respect to events that occur through December 31 of Year 5, the end of the GRA term. This is because §1.367(a)-8(g)(1) provides that an annual certification must state whether a gain recognition event occurred within the taxable year, and events occurring outside the GRA term cannot be gain recognition events. See §1.367(a)-8(b)(1)(v) (defining gain recognition event as "an event . . . that requires gain to be recognized under a [GRA]") and (c)(1)(i) (establishing a general rule that requires gain recognition only with respect to an event that occurs within the GRA term).

Issue 3: Through which date must UST extend the period of limitations on assessments of tax pursuant to §1.367(a)-8(f)

Under §1.367(a)-8(f)(1), a US transferor must file a Form 8838 extending the period of limitations on assessments of the tax with respect to the GRA gain through the date that is 96 months (that is, the number of months in eight full taxable years) after the date on which the initial transfer year closes. Thus, the date through which the extension must be made is fixed and is not affected by subsequent events.

Providing certainty when the GRA is entered into is consistent with the policies underlying the GRA regulations, as well as consistent with the determination of the GRA term. See *Issue 1* and related discussion, earlier. Further, to enforce a GRA, it is not necessary to require an extension of the period of limitations on assessments of tax beyond the date that is 36 months after the date on which events cease to be events occurring within the GRA term.[16]

Accordingly, in UST's case, the date through which UST must extend the period of limitations on assessments of tax is December 31 of Year 8, the date that is 96 months after the date on which UST's taxable year for the year of the TFD transfer closes.

Please call (202) 317-6937 if you have any further questions.

cc: Area Counsel

[16] Alternative approaches to determining the date through which the extension must be made could result in a date that is more than 96 months after the date on which the initial transfer year closes, depending on whether a US transferor has one or more short taxable years. Such an approach would be inconsistent with the purposes of the GRA regulations, which are intended to promote consistent treatment for US transferors without regard to short taxable years following the initial transfer.