
New proposed GRA regulations: Failures to file and deficiencies in GRAs and other documents

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In brief

US persons who either fail to timely file a gain recognition agreement (GRA) or related documents under the Section 367(a) regulations, or file such documents with material deficiencies, will face different rules for obtaining relief under proposed regulations released on January 30, 2013. The proposed regulations also address failures to file (and deficient filings of) certain documents required in the Section 6038B regulations concerning outbound transfers, as well as Form 926, and the Section 367(e)(2) regulations for liquidations into foreign corporations.

The current GRA regulations require taxpayers seeking relief to meet a 'reasonable cause' standard. By contrast, the proposed regulations would only require the US person to demonstrate that the failure was not 'willful'. On the other hand, the proposed regulations would continue to apply the current 'reasonable cause and not willful neglect' standard to US persons seeking relief from failure to report penalties under Section 6038B. Additional highlights include:

- The IRS directive put into place in 2010 (the 'GRA Directive'), which applies to timely filed but deficient GRAs and related documents, was not revoked in conjunction with the release of the proposed regulations (but likely will be revoked when the regulations are finalized, if not sooner);
- Whether the failure to file a GRA or to comply in all material respects with the GRA regulations was willful is to be determined based on all the relevant facts and circumstances;
- The proposed regulations illustrate the application of the 'willful' standard through a series of examples;
- The proposed regulations would eliminate the requirement that the IRS respond to requests for relief for missed and deficient GRA filings within 120 days of receipt of the request;
- The proposed regulations would extend the requirement to file a Form 926 to outbound stock transfers where the US transferor files a GRA; and
- The proposed regulations would provide relief rules similar to the proposed GRA relief rules for failures to file statements required by Treas. Reg. secs. 1.367(a)-3(c)(6), (c)(7), (d)(2)(vi)(B)(1)(ii), and 1.367(e)-2.

This newsalert describes the notable differences between the current regulations and the proposed regulations as well as actions that may be considered by taxpayers that have previously transferred or plan to transfer stock or securities to a foreign corporation.

In detail

Background

GRA overview and general filing requirements under Section 367(a)

In general, certain non-recognition transfers of stock by US persons to foreign corporations are taxable under Section 367(a), except to the extent the taxpayer files a GRA pursuant to Treas. Reg. secs. 1.367(a)-8.¹ In addition to filing a valid GRA, maintaining a GRA requires additional administrative procedures, including an extension of the assessment period of limitations as well as the filing of annual certifications.

GRAs are generally triggered (and thus US federal income tax must be paid on the gain realized but not recognized on the initial transfer) if certain events (such as a disposition of the stock of the transferred corporation) occur prior to the close of the fifth full taxable year following the year of the initial transfer. However, certain triggering events qualify for exceptions if the US transferor files a new GRA to account for the subsequent event (a 'Revised GRA').

Further, the Section 6038B regulations require US persons to

report property transfers to foreign corporations on Form 926 ('Return by a US Transferor of Property to a Foreign Corporation'). The penalty for failure to satisfy this requirement equals ten percent of the property's fair market value at the time of the exchange, not to exceed \$100,000 unless failure was due to intentional disregard. However, under the current regulations, relief from this penalty may be granted if the US transferor can demonstrate that the failure was due to reasonable cause and not willful neglect. Further, the current regulations under Section 6038B relieve a US person of the obligation to report a transfer of stock or securities on Form 926 if the US person has properly filed a GRA.

GRA reasonable cause relief and the GRA Directive

Current Treas. Reg. sec. 1.367(a)-8(p) requires a taxpayer to file a request for 'reasonable cause' relief in order to file a correct GRA or annual certification. The IRS generally will only grant such relief if the failure to comply with the regulations was due to 'reasonable cause and not willful neglect.' Determinations of 'reasonable cause' take into account all the relevant facts and circumstances, including the nature of the outbound transaction.

On July 26, 2010, Michael Danilack, Deputy Commissioner (International), IRS Large Business and International Division, issued the GRA Directive to IRS Revenue Agents. The GRA Directive offers taxpayers an unusual opportunity to fix defects in old GRAs and annual certifications without the need for a justification.

The GRA Directive applies to timely-filed but deficient GRAs and all subsequent related filings (including Revised GRAs accounting for later transfers) regardless of whether the subsequent related filing was timely

filed during open tax years. For example, the IRS would consider a timely-filed GRA that shows 'available upon request' for the basis and/or fair market value of the stock transferred as a deficient GRA. Such an improperly-filed GRA is eligible for the corrective procedures available under the GRA Directive.

The GRA Directive permits US transferors to amend defective GRAs and annual certifications by filing corrected GRAs and annual certifications with amended US federal income tax returns for the relevant years. The taxpayer does not need to obtain IRS approval to amend the documents or to provide an explanation for the failure to satisfy the GRA regulations' requirements.

In December 2011, Deputy Commissioner Danilack first announced publicly that the IRS planned to revoke the GRA Directive at some point in the near future. In addition, Ronald Dabrowski, IRS Deputy Associate Chief Counsel (International-Technical), indicated that the government was considering guidance that would replace the GRA Directive.

Reporting obligations under Section 367(e) and related Section 6038B regulations

Section 367(e)(2) and the regulations thereunder generally override Section 337 non-recognition treatment with respect to certain liquidations qualifying under Section 332. For example, if a domestic liquidating corporation liquidates into a foreign parent corporation (an outbound liquidation), the liquidating corporation generally must recognize gain or loss on the distribution as if such property were sold to the distributee at its fair market value, except to the extent that it satisfies one of the exceptions provided under

¹ Generally, prior Treas. Reg. sec. 1.367(a)-8 was effective for transactions occurring on or after July 20, 1998, but before March 7, 2007; Treas. Reg. sec. 1.367(a)-8T was effective for transactions occurring on or after March 7, 2007, but before March 13, 2009; and current Treas. Reg. sec. 1.367(a)-8 is effective for transactions occurring on or after March 13, 2009.

Section 367(e)(2) regulations. Additionally, if a foreign liquidating corporation liquidates into a foreign parent corporation (a foreign-to-foreign liquidation) the liquidating corporation must generally recognize gain or loss on assets used in a US trade or business (other than US real property interests). Other than the exception for distributions of US real property interests by a domestic liquidating corporation, the exceptions to the general rule of Section 367(e)(2) require the timely filing of certain statements or schedules by the liquidating corporation and the distributee corporation. In certain respects, the documents required to be filed under the Section 367(e)(2) regulations are functionally the same as the reporting obligations under the GRA regulations, but the current regulations under Sections 367(e)(2) do not provide any detailed guidance regarding the consequences of failure to file or report the required information nor do they provide any mechanism to seek relief for such failures. Furthermore, a domestic liquidating corporation that distributes property to a foreign corporation in a transaction subject to Section 367(e)(2) must file a Form 926 with respect to the distribution.

Reporting obligations under Treas. Reg. sec. 1.367(a)-3 and related Section 6038B regulations

Beyond the requirements for filing a GRA, Treas. Reg. sec. 1.367(a)-3 also sets forth additional filing requirements in connection with certain transfers of stock. For example, under Treas. Reg. secs. 1.367(a)-3(c)(6) and (7), a US target must file certain statements upon the transfer of its stock to a foreign corporation. Another example is the statement that a US target must file in an outbound reorganization described in the indirect stock transfer rules of

Treas. Reg. sec. 1.367(a)-3(d)(2)(vi)(B)(1)(ii).

Similar to the reporting obligations under the Section 367(e)(2) regulations mentioned above, current Treas. Reg. sec. 1.367(a)-3 does not provide any detailed guidance regarding the consequences of failure to file or report the required information nor does it provide any mechanism to seek relief for such failures.

Key observations

Currently available GRA relief provisions

For GRAs that have been timely filed but are themselves deficient, or with respect to which there is a deficient subsequent filing, the GRA Directive remains in effect until otherwise revoked or withdrawn, and offers taxpayers a rare, temporary opportunity to correct deficiencies without IRS scrutiny. If the GRA Directive is revoked prior to the finalization of the proposed regulations, reasonable cause relief will be the only available relief procedure. The IRS has not announced when the GRA Directive will be revoked, though it is likely to be no later than the finalization of the proposed regulations (and could be sooner).

For GRAs that have not been timely filed, the only relief available to taxpayers is reasonable cause relief under current Treas. Reg. sec. 1.367(a)-8(p). The taxpayer must demonstrate to the IRS reasonable cause for the failure to file, and IRS must respond to such requests with 120 days of receipt.

Proposed GRA relief provisions

With respect to failures to file GRAs, the proposed regulations modify the current relief provisions under Treas. Reg. sec. 1.367(a)-8(p) whereby a taxpayer must prove reasonable cause,

and provide that a taxpayer must instead demonstrate that any failure to comply is not a 'willful failure' as defined in the context of other civil penalties. Whether a failure is 'willful' is determined based on all the facts and circumstances.

In civil contexts involving a requirement to report or disclose certain information to the IRS, 'willfulness' has been defined as conduct which is voluntary, rather than accidental or unconscious.² The Supreme Court has also stated that acting with 'willful blindness' to the obvious or known consequences of one's action also satisfies a willfulness requirement in the civil context.³

² *Lefcourt v. United States*, 125 F.3d 79, 83 (2d Cir.1997) (defining "willfulness" in the context of a civil penalty for willfully failing to disclose required information to the IRS as conduct that "requires only that a party act voluntarily in withholding requested information, rather than accidentally or unconsciously."); accord *Denbo v. United States*, 988 F.2d 1029, 1034–35 (10th Cir.1993) (defining "willful" conduct as a "voluntary, conscious and intentional decision"). Conduct that evidences "reckless disregard of a known or obvious risk" or a "failure to investigate ... after being notified [of the violation]" also satisfies the civil standard for willfulness in such contexts. *Id.* at 1033.

³ See *Global/Tech Appliances, Inc. v. SEB S.A.*, -- U.S. --, 131 S.Ct. 2060, 2068, 69 (2011) ("persons who know enough to blind themselves to direct proof of critical facts in effect have actual knowledge of those facts").

As compared to the reasonable cause standard currently applicable to those taxpayers who have failed to timely file an initial GRA (and for whom relief under the GRA Directive is, therefore, currently not available), the proposed regulations' willful failure standard provides taxpayers a more favorable standard for obtaining relief.

While generally an intent-based standard, as discussed above there are times where (based on all the relevant facts and circumstances) conduct that is not willful itself, but demonstrates a taxpayer's disregard of the rules and/or lack of diligence, may be considered willful. When finalized, the proposed regulations may expand on what constitutes this type of conduct and/or may provide more illustrative examples.

Generally, under the reasonable cause standard reasonable reliance upon competent tax advisors provided taxpayers with reasonable cause for failures to comply. Such reasonable reliance appears to be acceptable under the new 'willful' standard.

In a change from the current regulations, the IRS will not be required to respond to relief requests within 120 days of receipt of the request.

Examples of what constitutes a willful failure to file a GRA

Further, the proposed regulations provide additional insight as to what constitutes a valid GRA (i.e., a GRA that is 'timely filed' and 'completed in all material respects') through the use of four examples. Of particular importance, in Example 1, a taxpayer with a history of timely filing valid GRAs is determined not to have a willful failure to file because the failure to timely file the GRA was an 'isolated oversight.' When juxtaposed with Example 2, in which a taxpayer was determined to have a willful

failure in part because of its 'history of failing to file required tax and information returns in general and GRAs in particular,' it appears that the IRS will give particular importance to a taxpayer's prior GRA filing experience, diligence, and protocols in determining whether the failure to file was a willful failure.

The examples establish two poles of taxpayers that fail to file initial GRAs. Taxpayers that fail to file an initial GRA should assess where their failure fits between the poles established by Examples 1 and 2.

Example of what constitutes a willful failure to comply with the GRA regulations

Example 3 confirms the government's position that a failure to provide either the fair market value or the basis of the transferred stock invalidates a GRA. The example provides that a taxpayer providing 'available upon request' for either the fair market value or the basis on a GRA wilfully fails to comply with the GRA regulations and is thus not entitled to relief under the proposed regulations.

Proposed GRA and Form 926 coordinating rule

As noted above, under the current regulations a US transferor is relieved from its obligation to report the stock transfer on Form 926 and from the associated penalties under Section 6038B if it has timely filed a proper GRA. The proposed regulations require that a Form 926 be filed in all cases in which a GRA is filed. Specifically, the US transferor must include on Form 926 the basis and fair market value of the property transferred. However, if the only asset being transferred is stock, the taxpayer need only fill out Part I (US Transferor Corporation Information) and Part II (Transferee Foreign

Corporation Information) of Form 926.

The proposed GRA regulations continue to apply the current 'reasonable cause and not willful neglect' standard to US persons seeking relief from the Section 6038B penalty.

The proposed regulations also explicitly fold the GRA into the Section 6038B reporting requirements. Thus, the failure to file a GRA, or the filing of a GRA with a material deficiency, could (without the appropriate relief) trigger both gain on the outbound stock transfer and a Section 6038B reporting penalty.

Proposed relief provisions for reporting obligations under Treas. Reg. sec. 1.367(a)-3, Section 367(e), and related Section 6038B regulations

Whereas the current regulations are silent, the proposed regulations apply the willful failure standard (as it applies to GRAs) to failures to file the required documents and statements under Treas. Reg. secs. 1.367(a)-3 and 1.367(e)-2 discussed above.

The proposed regulations apply the willful failure standard only to those filings outlined under the applicable statutory or regulatory provisions of Section 367. The proposed regulations maintain the reasonable cause standard for failures and deficiencies in reporting under Section 6038B, such as the Form 926.

The takeaway

The proposed regulations appear taxpayer friendly in that they replace the existing 'reasonable cause' standard in the current GRA relief regulations with a less onerous 'willful failure' standard. Furthermore, the proposed regulations do not revoke and replace the temporary GRA Directive that applies to timely-filed but deficient GRAs and related

documents. In light of the temporary nature of the GRA Directive, US persons that have entered into GRAs should carefully review all GRAs and related statements, and perfect such filings as appropriate. In particular, taxpayers should determine if any of their GRAs used 'available upon request' or similar language for either

the fair market value or basis of the transferred stock. The proposed regulations make clear that the IRS considers such GRAs materially deficient and will only provide relief to correct them under the temporary GRA Directive. Additionally, taxpayers should consider their current and future protocols for

ensuring GRA compliance, as it appears the IRS will assess the taxpayer's protocols in making future relief determinations. Taxpayers may benefit from demonstrating effective protocols for ensuring GRA compliance and that any future errors are an 'isolated oversight.'

Let's talk

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