New final GRA regulations: failures to file and deficiencies in GRAs and other documents

November 19, 2014

In brief

On November 18, 2014, in Treasury Decision 9704, the IRS and Treasury issued final and temporary regulations applicable to US persons who fail to file gain recognition agreements (GRAs) and related documents, or to satisfy other reporting obligations required for certain transfers of property to foreign corporations in nonrecognition exchanges. These regulations generally incorporate the provisions of proposed regulations issued on January 31, 2013, with certain modifications.

Under the final regulations, US persons who either fail to timely file a GRA or related documents under the Section 367(a) regulations, or file such documents with material deficiencies, will face rules for obtaining relief under final regulations that are similar to the 2013 proposed regulations. The final regulations also address failures to file (and deficient filings of) certain documents required in the Sections 367(a) and 6038B regulations concerning outbound transfers, as well as Form 926, and the Section 367(e)(2) regulations for liquidations into foreign corporations. The final regulations require the US person to demonstrate that any failure was not 'willful,' a less burdensome standard than withdrawn regulations' 'reasonable cause' standard. On the other hand, the final regulations continue to apply the '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into place in 2010 (the 'GRA Directive'), which applies to timely filed but deficient GRAs and related documents has been revoked effective November 19, 2014.
- 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 final regulations illustrate the application of the 'willful' standard through a series of examples.
- The final regulations 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 final regulations extend the requirement to file a Form 926 to outbound stock transfers where the US transferor files a GRA.
- The final regulations provide relief rules similar to the proposed GRA relief rules for failures to file statements required by Treas. Reg. secs. 1.367(a)-2T, 1.367(a)-3(c)(6), (c)(7), (d)(2)(vi)(B)(1)(ii), 1.367(a)-7, and 1.367(e)-2.

This *Tax Insight* describes the rules provided by the final regulations and discusses how the final regulations deviate from the 2013 proposed regulations and the withdrawn final regulations which they replaced. This Insight also describes actions that taxpayers may consider if they 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. sec. 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. Relief from this penalty can only be granted if the US transferor demonstrates that the failure was due to reasonable cause and not willful neglect. However, under the old final Section 6038B regulations, a US person had no obligation to report a transfer of stock or securities on Form 926 if the US person properly filed a GRA.

GRA reasonable cause relief and the GRA Directive

The withdrawn Treas. Reg. sec. 1.367(a)-8(p) required a taxpayer to file a request for 'reasonable cause' relief in order to file a correct GRA or annual certification retroactively. The IRS generally would 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' took into account all the relevant facts and circumstances, including the nature of the outbound transaction.

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

The GRA Directive applied 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 considered 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 a GRA was eligible for the corrective procedures available under the GRA Directive.

The GRA Directive permitted 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 did not need to obtain IRS approval to amend the documents or to provide an explanation for the failure to satisfy the GRA regulations' requirements.

The GRA Directive has now been revoked, effective November 19, 2014, pursuant to the issuance of the final regulations. Going forward, all new requests for relief related to GRAs and related documents filed under Section 367(a) will be subject to the willful failure standard, discussed below.

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 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 until now the regulations under Sections 367(e)(2) did 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. secs. 1.367(a)-2T, 1.367(a)-3, 1.367(a)-7, 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)-3T(d)(2)(vi)(B)(1)(ii).

Similar to the reporting obligations under the Section 367(e)(2) regulations mentioned above, until now Treas. Reg. sec. 1.367(a)-3 did 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.

In addition, in order to qualify for the foreign active trade or business exception of Treas. Reg. sec. 1.367(a)-2T (generally applicable to outbound transfers of property other than stock and intangible property) and to make basis adjustments under Treas. Reg. sec. 1.367(a)-7 (generally applicable to outbound reorganizations of domestic corporations), taxpayers must meet certain reporting obligations. Prior to the issuance of the new final regulations, the foreign active trade or business exception rules did not provide a relief mechanism with respect to reporting failures and the Treas. Reg. sec. 1.367(a)-7 rules required reasonable cause relief for failures to file.

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 has been revoked pursuant to the issuance of the final regulations. Consequently, taxpayers may no longer correct deficiencies without IRS scrutiny and must file for relief under the willful failure relief standard, as described in more detail below.

GRA relief provisions under the final regulations

With respect to failures to file GRAs, the final regulations, consistent with the proposed regulations, replace the reasonable cause relief standard and instead provide that a taxpayer must demonstrate that any failure to comply with the GRA rules 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].

While generally an intent-based standard, 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.

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

In a change from the withdrawn final regulations, the IRS is not required to respond to relief requests within 120 days of receipt of the request.

Further, taxpayers that have already submitted requests for relief with respect to GRAs and related documents under the reasonable cause relief standard (such as for a missed initial GRA, which did not qualify for the GRA Directive) may now resubmit such relief requests (even if the IRS previously denied the relief request) under the willful failure standard. However, two important conditions must be met and considered. First, the statute of limitations must be open for all relevant taxable years. Second, the taxpayer must agree to be subject to the new Section 6038B reporting requirements, which means that such taxpayers are also potentially subject to penalties for the failure to file a GRA under Section 6038B.

Examples of what constitutes a willful failure to file a GRA

Similar to the corresponding proposed regulations, the final regulations provide insight as to what constitutes acceptable diligence through the use of four examples. Of particular importance, in Example 1, largely unchanged from the proposed regulations, 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 and accidental oversight.' The term 'isolated and accidental oversight' replaces the term 'isolated oversight' in the proposed regulations' Example 1. The preamble does not explain this slight change in terminology.

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 makes binding 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 willfully fails to comply with the GRA regulations and is thus not entitled to relief under the final regulations. This rule is the same as in the proposed regulations.

Final GRA and Form 926 coordinating rule

As noted above, under the withdrawn final regulations a US transferor was relieved from its obligation to report the stock transfer on Form 926 and from the associated penalties under Section 6038B if it had timely filed a proper GRA.

Consistent with the proposed regulations, the final regulations explicitly fold the GRA into the Section 6038B reporting requirements. In addition, the final regulations expand these reporting requirements to include reporting the basis, fair market value, and realized gain in the transferred stock on the Form 926. Thus, the failure to file a GRA, or the filing of a GRA with a material deficiency, could (without appropriate relief) trigger both gain on the outbound stock transfer and a Section 6038B reporting penalty.

Similar to their proposed form, the new final regulations continue to apply the current 'reasonable cause and not willful neglect' standard to US persons seeking relief from the Section 6038B penalty for any failures to file the required documents. Therefore, although the GRA and Section 6038B requirements are combined, the standard of relief is different; failures and deficiencies with respect to GRAs are subject to the willful failure standard while failures and deficiencies with respect to the Section 6038B requirements (including both the GRA and the Form 926) are subject to the reasonable cause standard. Thus, a taxpayer will have to file for relief under two sets of standards if it fails to file a GRA—under the willful failure standard to prevent the recognition of gain under Section 367(a) and under the reasonable cause standard to prevent penalties under Section 6038B.

In addition, any taxpayer electing to refile a request for relief related to GRAs and related documents using the new willful failure standard must subject itself to the new Section 6038B rules, resulting in a potential penalty under Section 6038B for the failure to file the GRA (since the taxpayer may not have reasonable cause for the failure to file the GRA).

Final relief provisions for reporting obligations under Treas. Reg. secs. 1.367(a)-2T, 1.367(a)-3, 1.367(a)-7, Section 367(e), and related Section 6038B regulations

Whereas the withdrawn final regulations were silent, the final and temporary regulations apply the willful failure standard (as it applies to GRAs) to failures to file and deficiencies with respect to the required documents and statements under Treas. Reg. secs. 1.367(a)-3, 1.367(a)-3T, and 1.367(e)-2 discussed above. In addition, the new final regulations go beyond the proposed regulations by applying the willful failure standard to reporting under both the foreign active trade or business exception of Treas. Reg. sec. 1.367(a)-2T (which was previously silent in this regard) and basis adjustments under Treas. Reg. sec. 1.367(a)-7 (which previously applied the reasonable cause standard). The new final regulations apply the willful failure standard only to those filings outlined under the applicable statutory or regulatory provisions of Section 367. The new final regulations maintain the reasonable cause standard for failures and deficiencies in reporting under Section 6038B, such as the Form 926.

Effective Date

The regulations are effective for all requests for relief filed on or after November 19, 2014.

The takeaway

The new final regulations appear taxpayer friendly in that they replace the existing 'reasonable cause' standard in the withdrawn final GRA regulations with a less onerous 'willful failure' standard. However, the withdrawal of the GRA Directive removes the possibility of correcting deficient GRAs and related documents without IRS scrutiny of the reasons for the deficiency (or the failure to file, in the case of Revised GRAs, Forms 8838, and annual certifications).

Any taxpayers with outstanding GRAs which used 'available upon request' or similar language for the fair market value or basis of the transferred stock should alert their tax advisors as soon as possible. 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 benefit from demonstrating effective protocols for ensuring GRA compliance and that any future errors are an 'isolated and accidental oversight.'

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[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.

[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").

Let's talk

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