or more'' to ''more than 50 percent'' so that a U.S. transferor may qualify for an exception to section 367(a) in cases where U.S. transferors, in the aggregate, receive exactly 50 percent of the stock of the transferee foreign corporation in the exchange. The relaxation of the ownership threshold was intended to give 50–50 joint ventures involving unrelated U.S. and foreign corporations that are engaged in active businesses the option of using a foreign transferee corporation. Where a foreign corporation is smaller than a U.S. corporation that it acquires, the transaction will still generally be taxable; it would not be taxable if the U.S. participant were the acquiring corporation in the transaction (or if another U.S. holding company were the acquiring corporation). Second, although the regulation retains the presumption that shareholders of the U.S. target company are U.S. persons, it does not, in general, retain the cross-ownership presumption and no longer, as a general matter, takes cross-ownership into account. The regulation counts cross-ownership only in the limited circumstance where U.S. officers, directors, and 5-percent or greater shareholders of the U.S. target company own, in the aggregate, more than 50 percent of the total voting power or the total value of the transferee foreign corporation immediately after the transfer (a control group case). In such a case, the exchange is taxable to all U.S. transferors. The regulation allows taxpayers to rely on Schedule 13–D or 13–G filings made under the Securities Exchange Act of 1934 (15 U.S.C. 78m) to identify 5-percent shareholders of public companies for this purpose.

Although cross-ownership does not count toward the 50 percent ownership threshold (unless the control group case applies), it is still relevant in determining whether a U.S. transferor owns five percent or more of the transferee foreign corporation under the rules originally announced in Notice 87–85. Moreover, cross-ownership continues to be relevant for determining whether a 5-year or 10-year GRA is required under the rules originally announced in 87–85, and, for these purposes, there continues to be a rebuttable presumption.

In addition to the two modifications described above that were made in response to comments received with respect to Notice 94–46, these regulations contain a new active trade or business requirement not contained in Notice 94–46, which taxpayers must meet in order to qualify for an exception to the general rule of taxation under section 367(a). The IRS and the Treasury Department added the active trade or business requirement to address abuse potential, in particular, in a case in which a U.S. target company is smaller than a foreign acquirer that was formed and capitalized with a view to enabling the smaller U.S. company to move offshore. The IRS and the Treasury Department believe that this type of transaction presents an inappropriate opportunity for avoiding the anti-deferral regime without payment of the tax envisioned by Notice 94–46. The IRS and the Treasury Department believe that an exception to taxation is proper only in cases where a combination of two active businesses is contemplated and that the opportunity for tax avoidance is ameliorated when such businesses have been conducted for a period of at least 36 months prior to the exchange. Under the requirement contained in the regulations, no exception to taxation is available unless either the transferee foreign corporation or an affiliate of that corporation was engaged in the active conduct of a trade or business for the entire 36-month period prior to the exchange, and unless such business is substantial in relation to the business conducted by the U.S. target company. For this purpose, an affiliate is generally defined by reference to the rules in section 1504(a) (without the exclusion of foreign corporations), and generally includes a parent, subsidiary or brother-sister corporation of the transferee foreign corporation.

To summarize, under the temporary regulations, a U.S. person that exchanges stock or securities in a U.S. corporation for stock of a foreign corporation in an exchange described in section 367(a) will be taxable in cases where:

(i) The 50 percent ownership threshold is exceeded;

(ii) The control group case applies;

(iii) The active trade or business requirement is not met; or

(iv) The exchanging U.S. shareholder owns five percent or more of the stock of the transferee foreign corporation and fails to enter into a GRA and/or satisfy the requirements of section 6038B.

The duration of the GRA in case (iv) is 5 years if the transferor can demonstrate that all U.S. transferors in the aggregate own less than 50 percent of the total voting power or the total value of the stock of the transferee foreign corporation immediately after the transfer or 10 years if U.S. transferors own exactly 50 percent (or more than 50 percent as a result of cross-ownership) of the transferee foreign corporation immediately after the transfer. In all cases other than those enumerated in (i) through (iv) above, a U.S. person that transfers stock or securities of a domestic corporation in exchange for stock of a transferee foreign corporation will not be taxable under section 367(a) if certain reporting requirements described in the regulations are met.

Final regulations under section 367(a) are expected to address the transfer of stock or securities of foreign corporations and other matters contained in the 1991 proposed regulations that are not addressed herein.

Special Analyses

It has been determined that this temporary regulation is not a significant regulatory action as defined in Executive Order 12866. Therefore, a regulatory assessment is not required. It also has been determined that this regulation does not have a significant impact on a substantial number of small entities. Thus, the Regulatory Flexibility Act (5 U.S.C. chapter 6) does not apply to these regulations, and therefore, a Regulatory Flexibility Analysis is not required. Pursuant to section 7805(f) of the Internal Revenue Code, a copy of these temporary regulations will be submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on their impact on small business.

Drafting Information

The principal author of these regulations is Philip L. Tretiak of the Office of Associate Chief Counsel (International), within the Office of Chief Counsel, Internal Revenue Service. However, other personnel from the IRS and Treasury Department participated in their development.

List of Subjects

26 CFR Part 1

Income taxes, Reporting and Recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

Part 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *