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## *International Taxation:*

### U.S. Taxation of Outbound Property Transfers – New Regulations under Section 7874

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A number of particularly draconian U.S. tax provisions apply to transfers of property out of the United States into a foreign corporation.<sup>i</sup> Although the U.S. tax code (“the Code”)<sup>ii</sup> generally encourages U.S. business reorganizations, allowing many to occur on a tax-free basis, these more favorable rules generally do not apply to outbound transfers, where different policy considerations apply.<sup>iii</sup> Section 7874 has been one of the more difficult sets of rules to apply due to a lack of guidance regarding a key element, namely, the existence or non-existence of substantial business activity in the foreign jurisdiction post-acquisition. After years of uncertainty, the Internal Revenue Service has finally promulgated regulations which provide a bright-line test for determining whether the requisite activity exists.

If section 7874 applies, the acquisition is subject to U.S. taxation over a 10 year period with very limited availability of credits or deductions to offset gain. If the shareholder continuity is 80%, rather than 60% or more, section 7874 requires that the foreign corporation be treated as a U.S. corporation for *all* purposes of the Code, including estate and gift tax. This is an extremely harsh result, even by U.S. international tax standards.

Section 7874 applies to transfers of property to a foreign corporation where:

- substantially all of the properties held<sup>iv</sup> by a U.S. entity<sup>v</sup> are transferred;
- former owners of the US business own at least 60%<sup>vi</sup> of the foreign business after the transfer; and
- the resulting business group has “no substantial business activities” in the foreign country.

Treasury Regulation § 1.7874-3T(b)(1)<sup>vii</sup> replace the prior “facts and circumstances” test for substantial activity with a new bright-line test. Under the new rules, substantial business activity for the corporate group after acquisition will be deemed to exist only if a bright-line threshold (25%) requirement for three aspects of operations (employees, assets and income) is met.

- **Employees.** At least 25% of the total number of employees must be based in the foreign country<sup>viii</sup> and at least 25% of the total employee compensation must be paid to group employees based in the foreign country during the prior year;
- **Assets.** At least 25% of the value of the corporate group’s total assets must be located in the foreign country;<sup>ix</sup> and
- **Income.** At least 25% of the group's income (from transactions occurring in the ordinary course of business with unrelated customers) must be derived in the foreign country during

the prior year. Income is treated as derived in a foreign country only if the customer is located in such country.<sup>x</sup>

While the new regulation brings much needed certainty to a complex and potentially harsh Code provision, the existence of such a clear test also eliminates the possibility of relying on the facts and circumstances test to avoid application of section 7874 in transactions where the 25 percentage threshold might not have been met. It remains to be seen how these rules will impact U.S. business migration.

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<sup>i</sup> An article entitled *It's Not Just for Global Corporations Anymore*, by the author in the September issue of the KCBA Bulletin addressed these issues in some detail.

<sup>ii</sup> All references are to the Internal Revenue Code of 1986, as amended.

<sup>iii</sup> e.g., taxing appreciation considered to arise in the United States, or maintain jurisdiction to tax business operations essentially continuing in the United States.

<sup>iv</sup> This includes assets held directly and indirectly through equity ownership.

<sup>v</sup> The statute refers to a corporation or partnership.

<sup>vi</sup> If the shareholder continuity is 80%, rather than 60% or more, instead of taxing the acquisition, section 7874 will treat the foreign corporation as a U.S. corporation for *all* purposes of the Code, including estate and gift tax.

<sup>vii</sup> effective for acquisitions completed on or after June 7, 2012,

<sup>viii</sup> Measured on the last day of the month prior to acquisition

<sup>ix</sup> *Id.*

<sup>x</sup> See Preamble to Treasury Regulation § 1.7874-3T(b)(1))