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B Reorganizations: A Time to Kill?

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I've never done a B reorganization. Perhaps my experience is unusual, although I'm suspicious that many others have also not participated in a B reorganization. For one thing, the "solely for voting stock" requirement is awfully unforgiving. Despite such limitations, I should arguably gravitate toward B reorganizations, since my wife is named Bea. Of course, triangular B reorganizations are less unforgiving (if that isn't an oxymoron), though maybe that will change.

Regardless of my own circumstances, it is safe to assume that even fewer B reorganizations will be contemplated in the future. On September 22, 2006, the IRS released Notice 2006-85 [IRB 2006-41, 1], announcing that the IRS will issue regulations impacting some of these transactions. The target is not the plain old vanilla B reorganization, but rather certain triangular reorganizations that involve one or more foreign corporations. The regulations are to come under Code Sec. 367(b) and are to address situations designed to avoid U.S. income tax, including tax on the repatriation of a subsidiary's earnings.

Fumigation

The type of transaction targeted by this notice generally involves a subsidiary that purchases the stock of its parent in exchange for property, with a subsequent transfer of the parent's stock in exchange for the stock (or assets) of a corporation in a triangular reorganization. These regulations may take a while to develop. Still, Notice 2006-85 tells the tax world that the regulations (when they are eventually issued) will hearken back to the September 22, 2006, effective date of the notice.

This kind of retroactive effective date is something we've seen much more frequently in recent years. Sometimes such dates are a stretch and a surprise. Yet in this case, there is plainly no surprise. Besides, there's a binding contract provision, allowing that the new rules won't apply to transactions occurring on or after September 21, 2006, if they were entered into under a written agreement that

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was binding before September 22, 2006, and at all times thereafter.

In any case, whether you regard this is as a bootstrap effective date or not, the tax world has been on notice for some time that these triangular B reorganizations were suspect. To follow their clever moniker, the so-called killer bee transactions are usually structured as triangular B reorganizations. However, they can also metamorphize as triangular C reorganizations. There is some variation in the fact patterns.

For example, assume that P, a domestic parent corporation, owns 100 percent of FS, a foreign corporation, and S1, a domestic corporation. Assume that S1 owns 100 percent of T, a foreign corporation. FS purchases P stock for either cash or a note, and provides the P stock to S1 in exchange for all of the T stock in a triangular B reorganization.

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The taxpayers will argue that P should recognize no gain or loss on the sale under Code Sec. 1032, and that FS ends up with a cost basis in the P shares. Plus, they say FS will recognize no gain on the transfer of all the P shares, since the basis and fair market value of those shares are the same.

Bee proponents take the position that FS's transfer of property to P should be treated as a stock purchase, rather than a distribution from FS to P. Because FS is foreign, this admitted repatriation might be tested as a distribution under Code Sec. 301. Taxpayers, though, generally argue that the subsidiary does not recognize any gain upon the transfer of the shares of the parent (again, because the basis and fair market value of the shares are equal).

Furthermore, the taxpayers will not include in income amounts under Code Sec. 951, because the foreign subsidiary is merely acquiring and disposing of the parent's stock before the close of a quarter of the tax year (the time at which one measures the parent's share of the average amount of U.S. property held by the subsidiary). [*See* Code Sec. 956(a)(1)(A).] Finally, the taxpayers argue that under the Code Sec. 367 regulations, the domestic subsidiary S1 does not have to include in income (as a deemed dividend) the Code Sec. 1248 amount attributable to the target stock that S1 exchanges.

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These "killer bee" transactions raise a host of concerns to the IRS. If (as in the above example) the parent is domestic and the subsidiary is foreign, the transaction has the effect of repatriating foreign earnings without a corresponding dividend to the parent that would be subject to U.S. tax. On the other hand, if the parent is foreign and the subsidiary is domestic, the subsidiary's U.S. earnings could be repatriated to the foreign parent in a manner not subject to U.S. withholding tax. This latter scenario can also raise earnings strippings issues, since the subsidiary may use a note to purchase all or a portion of the parent's stock.

Subpart F issues can also be raised. Foreign-to-foreign transactions may also be used. There, the object is a subsequent repatriation of foreign earnings to U.S. shareholders without U.S. income tax.

One interesting (though perhaps academic) point concerns the specific manner in which the IRS chose to attack these transactions. With several Code provisions in the offing, the IRS presumably picked Code Sec. 367(b) as the fumigation vehicle for this hornet's nest precisely because of the broad reach that section has.