IRS Expands Killer B Regulations

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On May 29, 2007, IBM repurchased $12.5 billion of its stock by using a foreign subsidiary to buy back shares through foreign exchanges. [*See* David Johnston, *IRS Moves to Close Tax Shelter Shortly After IBM Uses It to Save $1.6 Billion*, N.Y. Times, June 7, 2007.] IBM's subsidiary repurchased shares from public shareholders, and then used the shares to pay its U.S. corporate parent for goods and services. By engaging in this type of transaction, IBM essentially utilized its shares as a form of currency.

That may sound old hat, but the result was that IBM was able to bring profits into the United States tax-free. The savings were hardly chump change. In fact, the tax savings were reportedly nearly $1.6 billion. Yes, that's "billion" with a "B." A "Killer B," to be exact.

Not surprising, two days later, the IRS issued Notice 2007-48 to expand the impact of its new regulations to shut down transactions such as the one used by IBM. In particular, the IRS expanded its new regulations to cover abusive triangular reorganizations under Code Sec. 368, commonly referred to as "Killer B" reorganizations, involving foreign corporations and public shareholders. The IRS stated that it will disallow such transactions beginning on May 31, 2007.

IBM tax lawyers must have gulped a sigh of relief (plus, maybe something more celebratory) when they seemingly achieved this just-under-the-wire plan on the cusp of the kind of modern day New Deal. However, the IRS still contends that IBM's transaction would be vulnerable in audit because it lacks economic substance.

Regulatory Scope

The new regulations will address transactions in which a subsidiary buys the parent stock from someone other than the parent, such as from public shareholders. M&A Tax Report readers may recall that we covered the original notice, Notice 2006-85, IRB 2006-41, 677, in the November 2006 M&A Tax Report (*see* Wood, *B Reorganizations: A Time to Kill?* M&A Tax Report, Nov. 2006). Interestingly, that original notice did not address third party transactions and reorganizations involving one or more foreign corporations and public shareholders, because the IRS was uncertain whether taxpayers pursued reorganizations using public buybacks.

Notice 2007-48, IRB 2007-25, May 31, 2007 (and Notice 2006-85), announced that the forthcoming regulations under Code Sec. 367(b) will make adjustments in the case of the parent and the subsidiary so that there will be a deemed distribution of property under Code Sec. 301(c). The result of the adjustments may cause the parent to have a dividend inclusion or a reduction in the parent's basis in the subsidiary or the target's stock, and may cause the parent to recognize gain. Under Code Sec. 312, corresponding adjustments will also be made to the subsidiaries earnings and profit.

> **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 from one or more of P shareholders, and provides the P stock to S1 in exchange for all of the T stock in a triangular B reorganization.

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.

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.

Last Call

The IRS has announced that it will shut down any transactions like the one IBM used to save $1.6 billion. In fact, the IRS will shut down such transactions enunciated in Notice 2006-85 on September 22, 2006, and Killer B's involving public shareholders on May 31, 2007. The new regulations are expected to be released at the end of the year.