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Killing Killer B's

By Robert W. Wood • Wood LLP • San Francisco

In what some may regard as a blast from the past, the IRS has put Killer B transactions back in the news. The cleverly named transaction dates back almost a decade. Notice 2006-85, IRB 2006-41, first put Killer B's in the spotlight when it announced that regulations would be issued, to be effective as of September 22, 2006.

What's the Fuss?

To follow their moniker, so-called Killer B transactions are usually structured as triangular B reorganizations. However, they can also end up as triangular C reorganizations. There is some variation in 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. In a triangular B reorganization, 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.

Taxpayers used to argue that P should recognize no gain or loss on the sale under Code Sec. 1032 and that FS should end up with a cost basis in the P shares. Plus, they claimed that FS should recognize no gain on the transfer of all the P shares. After all, the basis and fair market value of the shares should be the same.

Proponents of such deals have taken the position that FS's transfer of property to P should be treated as a stock purchase, not as 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 argued that the subsidiary should not recognize any gain upon the transfer of the shares of the parent. Indeed, the basis and fair market value of the shares are equal.

Furthermore, taxpayers did not include amounts under Code Sec. 951 in income. Finally, taxpayers argued 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

ALSO IN THIS ISSUE

amount attributable to the target stock that S1 exchanges.

Big Blue

Did any of these Killer B deals actually happen? They sure did. In 2007, IBM repurchased $12.5 billion of its stock by using a foreign subsidiary to buy back shares through foreign exchanges. IBM's subsidiary repurchased shares from public shareholders.

Then it 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. Two days after IBM's deal, the IRS issued Notice 2007-48, IRB 2007-25, to expand the impact of its new regulations to shut down such transactions.

In particular, the IRS expanded its new regulations to cover abusive triangular reorganizations under Code Sec. 368 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.

Temporary and Proposed Regulations

In May of 2008, the IRS issued temporary and proposed regulations applicable to triangular reorganizations where: (i) parent (P) or subsidiary (S), or both, are foreign; and (ii) in connection with the reorganization, S acquires, in exchange for property, all or a portion of the P stock that is used to acquire target's (T's) stock or assets. The "in connection with" standard included any transaction related to the reorganization, even if not part of the plan of reorganization.

These regulations were finalized, with certain modifications, in 2011. And now, in Notice 2014-32, IRB 2014-20, the IRS has outlined ways in which it will revise the final regulations released in 2011. Among other things, the Notice eliminates the deemed contribution model under the existing regulations.

It also notes a modification to the income and gain taken into account for purposes of applying the priority rules of Code Sec. 367. Finally, the notice clarifies the application of the anti-abuse rule.

Pesky Pesticide-Resistant B's

In Notice 2014-32, IRS states that it is aware that taxpayers are engaging in various types of transactions that the IRS sees as inconsistent with the policy concerns underlying the 2011 final regulations. Perceived abuses include taxpayers engaging in transactions designed to avoid U.S. tax by exploiting the deemed contribution rule provided under the final regulations.

Targeted abuses also include transactions facilitated by the priority rules in the 2011 final regulations that were designed to avoid recognizing gain under Reg. §1.367(a)-3(c). Finally, the IRS says that some taxpayers are taking an overly narrow interpretation of the anti-abuse rule. And that, says the IRS, is cause to revise the 2011 final regulations.

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Deemed Distributions and Contributions

In a triangular reorganization subject to Reg. §1.367(b)-10, the 2011 regulations provide that adjustments have to be made in a manner consistent with those that would have been made if S had distributed property to P under Code Sec. 301 (deemed distribution). The amount of the deemed distribution would normally equal the amount of property transferred by S to acquire the P stock. (*See* Reg. §1.367(b)-10(b)(1).)

In addition, adjustments would need to be made in a fashion that are consistent with those that would have been made if P had contributed that same property to S, *i.e.,* a deemed contribution. The effect is to increase P's basis in its S stock by the amount of the deemed distribution. (Reg. §1.367(b)-10(c)(2).)

Now, in Notice 2014-32, the IRS says that it will remove the rules in Reg. §1.367(b)-10(b)(2) and Reg. §1.367(b)-10(c)(2) regarding deemed contributions. It will make conforming changes in other parts of the final regulations.

Triangular Reorganizations

Under Reg. §1.367-10(a)(2), the 2011 final regulations do not apply to a triangular reorganization if:

- P and S are foreign corporations, and neither is a controlled foreign corporation immediately before or after the triangular reorganization;
- S is a domestic corporation, P's stock in S is not a U.S. real property interest, and P would not be subject to U.S. tax on a dividend from S under either Code Sec. 881 or Code Sec. 882; or
- In an exchange under Code Sec. 354 or Code Sec. 356, one or more U.S. persons exchanged stock or securities of T and the amount of gain in the T stock or securities recognized under Code Sec. 367(a)(1) is equal to or greater than the sum of the amount of the deemed distribution that would be treated by P as a dividend under Code Sec. 301(c)(1), and the amount of such deemed distribution that would be treated by P as gain from the sale or exchange of property under Code Sec. 301(c)(3) if Reg. §1.367(b)-10 would otherwise apply to the triangular reorganization.

The 2011 final regulations also provide a Code Sec. 367(b) priority rule that overrides the application of Code Sec. 367(a)(1) to an exchange under Code Sec. 354 or Code Sec. 356 that occurs in connection with certain triangular reorganizations, if the amount of gain otherwise to be recognized under Code Sec. 367(a)(1) is less than the amount of the Code Sec. 367(b) income recognized under Reg. §1.367(b)-10. (Reg. §1.367(a)-3(a)(2)(iv).)

In Notice 2014-32, IRS indicates that it will modify the Code Sec. 367(a) priority rule under Reg. §1.367(b)-10. Now, the amount of income or gain that is considered Code Sec. 367(b) income will be adjusted. The modified regulations will provide that Code Sec. 367(b) income includes a Code Sec. 301(c)(1) dividend or Code Sec. 301(c)(3) gain that would arise if Reg. §1.367(b)-10 applied to the triangular reorganization.

However, this inclusion is only to the extent that dividend income or gain would be subject to U.S. tax or would give rise to income under Code Sec. 951(a)(1)(A) that would be subject to U.S. tax. The IRS is making a conforming change to the Code Sec. 367(b) priority rule under Reg. §1.367(a)-3(a)(2)(iv).

No U.S. Tax?

The notice also says that the no-U.S.-tax exception will be modified to provide that the exception will not be available if P is a controlled foreign corporation. Furthermore, where (1) P is not a controlled foreign corporation, (2) S is a domestic corporation, and (3) P's stock in S is not a U.S. real property interest, the IRS says it will modify the regulations. They will clarify that the no-U.S.-tax exception will apply if the deemed distribution that would result from application of Reg. §1.367(b)-10 to the triangular reorganization would not be treated as a dividend.

Anti-Abuse Rule

The 2011 final regulations allow the IRS to make appropriate adjustments where a triangular reorganization is pursued with a view to avoid the purpose of Reg. §1.367(b)-10. (Reg. §1.367(b)-10(d).) The IRS says it will clarify this anti-abuse rule to provide that S's acquisition of P stock or securities in exchange for a note may invoke the anti-abuse rule.

In addition, the IRS plans to clarify that the E&P of a corporation may be taken into account for purposes of determining the consequences of the adjustments provided in the revised final regulations. That is so regardless of whether the corporation is related to P or S before the triangular reorganization. Finally,

the IRS says it will clarify Reg. §1.367(b)-10(d) to provide that a funding of S may occur after the triangular reorganization. Funding for this purpose would include capital contributions, loans or distributions.

Effective Date

Except for some special rules, the announced modifications to the 2011 final regulations are set to apply to a triangular reorganization completed on or after April 25, 2014. However, there are exceptions to the applicability of these revised final regulations. They will not apply if:

- T was not related to P or S (within the meaning of Code Sec. 267(b)) immediately before the triangular reorganization;
- the triangular reorganization was entered into either pursuant to a written agreement that was (subject to customary conditions) binding before April 25, 2014, and all times afterward, or pursuant to a tender offer announced before April 25, 2014, that is subject to section 14(d) of the Securities and Exchange Act of 1934 or that is subject to comparable foreign laws; and
- to the extent the P acquisition that occurs pursuant to the plan of reorganization is not completed before April 25, 2014, the P acquisition was included as part of the plan before April 25, 2014.

The IRS is shaking up the hive. It will be interesting to watch how these new regulations are applied, particularly if aggressive taxpayers attempt to morph their transactions into something testing the IRS' new standards.