INBOUND §332 LIQUIDATIONS & INBOUND ASSET REORGANIZATIONS

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Tags
All Earnings and Profits Amount
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When a wholly-owned domestic subsidiary corporation liquidates into its domestic parent corporation, the transaction is generally non-taxable under Code §§332 and 337. In addition, when the assets of a domestic target corporation are transferred to a domestic acquiring corporation in an asset reorganization under Code §368(a)(1) (such as an A-, C-, D-, or F-reorganization), the transaction is generally non-taxable under Code §§354 and 361.

However, special rules under Treas. Reg. §1.367(b)-3 apply when a *foreign* subsidiary corporation liquidates into its domestic parent corporation (an "inbound 332 liquidation") and when the assets of a *foreign* target corporation are transferred to a domestic acquiring corporation in an asset reorganization (an "inbound asset reorganization").

INCOME INCLUSION REQUIREMENT

When a domestic corporation ("Domestic Acquiror") acquires the assets of a foreign corporation ("Foreign Target") in a liquidation described in Code §332 or an asset acquisition described in Code §368(a)(1), generally the "U.S. shareholder" must include in income as a dividend the "all earnings and profits amount" with respect to its stock in Foreign Target.[1]

The term U.S. shareholder means any U.S. person who owns, directly or indirectly, 10% or more of the total combined voting power of all classes of stock in Foreign Target that are entitled to vote.[2] The all earnings and profits amount means the shareholder's *pro rata* share of the earnings and profits of Foreign Target.[3]

Example 1 – Inbound 332 Liquidation

Domestic Acquiror owns all of the outstanding stock of Foreign Target. The stock of Foreign Target has a value of $100, and Domestic Acquiror has a basis of $30 in that stock. The all earnings and profits amount attributable to Foreign Target stock owned by Domestic Acquiror is $75. Foreign Target has a basis of $50 in its assets. In a liquidation described in Code §332, Foreign Target distributes all of its property to Domestic Acquiror, and the stock held by Domestic Acquiror is canceled.[4]

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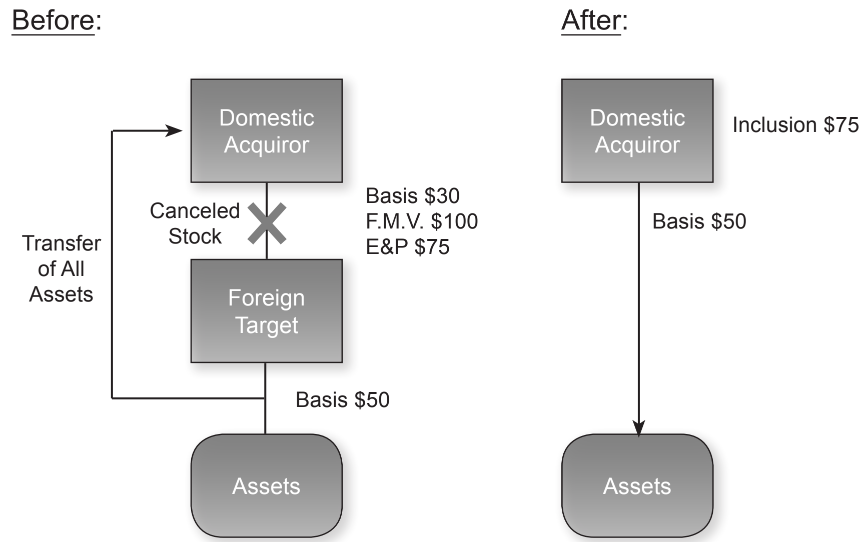
1 Treas. Reg. §1.367(b)-3(b)(3).

2 Treas. Reg. §1.367(b-3(b)(2) and Code §§951(b), 953(c)(1).

3 Treas. Reg. §1.367(b)-1(d).

4 Based on Example 2 of Treas. Reg. §1.367(b)-3(b).



Domestic Acquiror must include $75 in income as a deemed dividend from Foreign Target. Under Code §337(a) Foreign Target does not recognize gain or loss in the assets distributed to Domestic Acquiror, and under Code §334(b), Domestic Acquiror takes a basis of $50 in those assets. Because the requirements of Code §902 are met, Domestic Acquiror qualifies for a deemed paid foreign tax credit with respect to the deemed dividend that it receives from Foreign Target.

Example 2 – Inbound 332 Liquidation with a Minority Shareholder

Domestic Acquiror owns 80% of the outstanding stock of Foreign Target, and it has owned this 80% interest since Foreign Target was incorporated. The remaining 20% of the outstanding stock of Foreign Target is owned by a person unrelated to Domestic Acquiror (the "Minority Shareholder"). The Foreign Target stock owned by Domestic Acquiror is valued at $80, and Domestic Acquiror has a basis of $24 in that stock. The Foreign Target stock owned by the Minority Shareholder is valued at $20, and the Minority Shareholder has a basis of $18 in that stock.

Foreign Target's only asset is land valued at $100, of which Foreign Target's basis is $50. Gain on the land would not generate earnings and profits that qualify for an exclusion[5] from earnings and profits for purposes of Code §1248. Foreign Target has earnings and profits of $20, of which $16 is attributable to the stock owned by Domestic Acquiror.

Foreign Target subdivides and distributes the land. The Minority Shareholder receives land with a value of $20 and a basis of $10. As part of the same transaction, Foreign Target distributes the remainder of the land to Domestic Acquiror in a liquidation described in Code §332. The Foreign Target stock, which was previously held by Domestic Acquiror and the Minority Shareholder, is canceled.[6]

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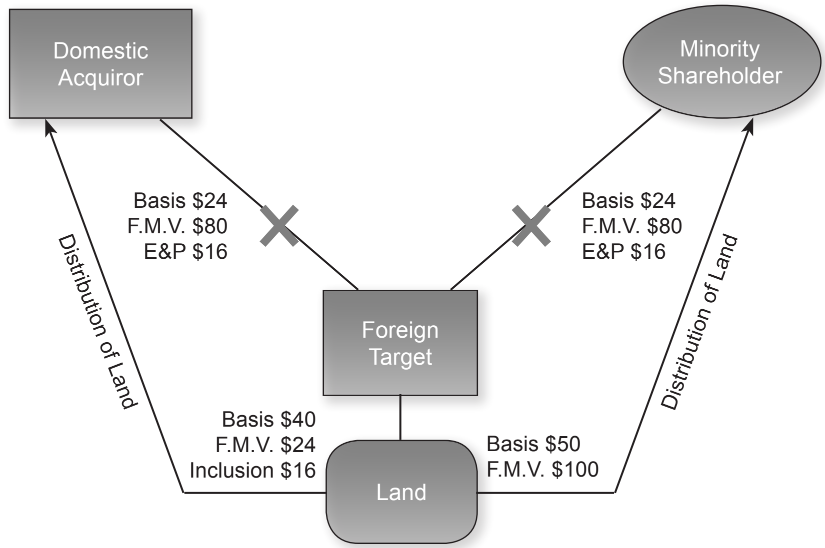
[5] Code §1248(d).

[6] Based on Example 3 of Treas. Reg. §1.367(b)-3(b).

“Gain on the land would not generate earnings and profits that qualify for an exclusion from earnings and profits for purposes of Code §1248.”

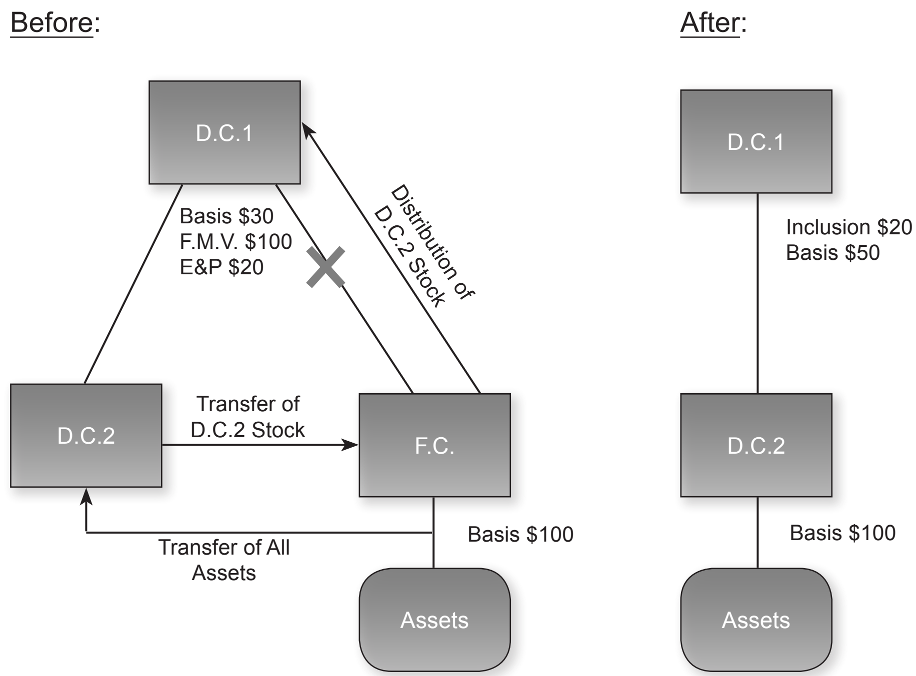


Under Code §336, Foreign Target recognizes $10 of gain on the land distributed to the Minority Shareholder. Under Code §331, the Minority Shareholder recognizes $2 of gain on the stock of Foreign Target. If the Minority Shareholder is a U.S. person described in Code §1248(a)(2), the latter amount is included in the income of the Minority Shareholder as a dividend, to the extent provided in Code §1248. The $10 of gain recognized by Foreign Target increases its earnings and profits for purposes of computing the all earnings and profits amount, and as a result, an additional $8 (*i.e.*, 80% of $10) is considered to be attributable to the Foreign Target stock owned by Domestic Acquiror. Domestic Acquiror’s all earnings and profits amount with respect to its stock in Foreign Target is $24 (*i.e.*, the initial all earnings and profits amount of $16 with respect to the Foreign Target stock held by Domestic Acquiror, plus the additional $8 resulting from Foreign Target’s recognition of gain on the distribution to the Minority Shareholder). Domestic Acquiror must include the $24 all earnings and profits amount in income as a deemed dividend from Foreign Target.

Example 3 – Inbound Asset Reorganization

A domestic corporation (“D.C.1”), owns all of the outstanding stock of another domesic corporation (“D.C.2”). D.C.1 also owns all of the outstanding stock of a foreign corporation (“F.C.”). The stock of F.C. has a value of $100, and D.C.1 has a basis of $30 in that stock. The assets of F.C. have a value of $100. The all earnings and profits amount with respect to the F.C. stock owned by D.C.1 is $20. In a reorganization described in Code §368(a)(1)(D), D.C.2 acquires all of the assets of F.C. solely in exchange for D.C.2 stock. F.C. distributes the D.C.2 stock to D.C.1, and the F.C. stock held by D.C.1 is canceled.[7]

[7] Based on Example 4 of Treas. Reg. §1.367(b)-3(b).



D.C.1's income must include a $20 deemed dividend from F.C. Under Code §361, F.C. does not recognize gain or loss in (i) the assets transfered to D.C.2 or (ii) the D.C.2 stock distributed to D.C.1. Under Code §362(b), D.C.2 takes a basis in the acquired assets equal to F.C.'s basis therein. D.C.1 takes a basis of $50 (*i.e.*, the $30 basis in the stock of F.C., plus the $20 treated as a deemed dividend to D.C.1) in the D.C.2 stock that it receives in exchange for the stock of F.C.[8] The earnings and profits of F.C. are reduced by the $20 deemed dividend.[9]

U.S. PERSON WHO IS NOT A U.S. SHAREHOLDER

General Rule

If the Foreign Target stock is owned by a U.S. person who is not a U.S. shareholder (*i.e.*, a less than 10% shareholder), the general rule is that the U.S. person must recognize realized gain (but not loss) with respect to the stock of Foreign Target.[10] However, in lieu of recognizing gain, the U.S. person may elect to include a deemed dividend in its income, the amount of which reflects the all earnings and profits amount with respect to the stock in Foreign Target.[11] The election is available only if Foreign Target provides the U.S. person with the information needed to compute

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8 Treas. Reg. §1.367(b)-2(e)(3)(ii) and Code §358(a)(1).

9 Treas. Reg. §1.367(b)-2(e)(3)(iii) and Code §312(a).

10 Treas. Reg. §1.367(b)-3(c)(2).

11 Treas. Reg. §1.367(b)-3(c)(3).

the shareholder's all earnings and profits amount and the shareholder complies with the notice requirements in Treas. Reg. §1.367(b)-1(c).[12]

De Minimis Exception

U.S. persons who are not U.S. shareholders are not subject to the gain or income inclusion requirements if they own stock in Foreign Target that has a fair market value of less than $50,000.[13]

CARRYOVER OF FOREIGN TARGET EARNINGS AND PROFITS TO DOMESTIC ACQUIROR

"Special rules apply when a foreign subsidiary corporation liquidates into its domestic parent and when the assets of a foreign target corporation are transferred to a domestic acquiring corporation in an asset reorganization."

Earnings and profits of Foreign Target that are not included in income as a deemed dividend under the Code §367(b) regulations are carried over from Foreign Target to Domestic Acquiror,[14] but only to the extent that such earnings and profits are effectively connected with the conduct of a U.S. trade or business.[15] Other earnings and profits (or deficits in earnings and profits) of Foreign Target do not carry over to Domestic Acquiror, and as a result, they are eliminated.

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12 *Id.*

13 Treas. Reg. §1.367(b)-3(c)(4).

14 Code §381(c)(2).

15 Treas. Reg. §1.367(b)-3(f).