

NEW REGULATIONS IMMINENT FOR TRIANGULAR REORGANIZATIONS AND INBOUND NONRECOGNITION TRANSACTIONS

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Tags

Nonrecognition Transaction
Tax Avoidance
Triangular Reorganization

INTRODUCTION

On December 2, 2016, the Internal Revenue Service (“I.R.S.”) published Notice 2016-73, announcing that it intends to issue regulations preventing certain taxpayer abuses incident to triangular reorganizations involving foreign corporations. These are transactions in which a subsidiary is the acquisition vehicle, and the shares used to acquire the target are shares of the parent company, hence the reference to a triangle.

The notice is designed to address triangular “Killer B” transactions, which use the interplay of the outbound Code §367(a) regulations and the non-outbound Code §367(b) regulations to facilitate tax-free repatriation of property from controlled foreign corporations. A U.S. corporation receives shares of a foreign target at a stepped-up basis without a significant amount of income being generated. The I.R.S. believes that taxpayers are engaging in transactions designed to repatriate earnings and basis of foreign corporations, while avoiding U.S. Federal income tax.

The forthcoming final regulations will modify

- the rules applicable to property used to acquire parent stock or securities in certain triangular reorganizations involving one or more foreign corporations,
- the consequences to persons receiving parent stock or securities in the targeted types of triangular reorganizations, and
- the amount of the income inclusion that will be required in certain inbound nonrecognition transactions.

The notice provides several examples.

CONTEXT

Code §367(a)(1) applies rules regarding the recognition of gain incident to outbound transfers of property in a rollover transaction. It provides that if, in connection with any rollover exchange described in Code §332 (liquidations), Code §351 (corporate formations), Code §354 (exchanges of stock in a reorganization), Code §356 (certain reorganizations involving boot), or Code §361 (reorganizations in which property is transferred for stock), a U.S. person transfers property to a foreign corporation, the foreign corporation will not be considered to be a corporation, and therefore, gain must be recognized. Code §§367(a)(2), (3), and (6) provide exceptions to the foregoing general rule and, *inter alia*, grant regulatory authority to the I.R.S. to provide additional exceptions and limitations.

“Triangular reorganizations . . . are transactions in which a subsidiary is the acquisition vehicle, and the shares used to acquire the target are shares of the parent company, hence the reference to a triangle.”

Code §367(b)(1) applies rules regarding the required income inclusion by persons considered to be “U.S. Shareholders” for purposes of Subpart F, in connection with certain rollover transactions involving controlled foreign corporations. It provides that in the case of any rollover exchange described in Code §§332, 351, 354, 356, or 361, where no outbound transfer of property by a U.S. person takes place, a foreign corporation is considered to be a corporation, except to the extent provided in regulations that are necessary or appropriate to prevent the avoidance of U.S. Federal income tax. Thus, that no gain is recognized on the transaction that would give rise to tax under Subpart F for a U.S. Shareholder. Code §367(b)(2) provides that the regulations cover, *inter alia*, the sale or exchange of stock or securities in a foreign corporation by a U.S. person, the circumstances under which gain is recognized or deferred, the amounts that are included in gross income as a dividend, the adjustments that are made to earnings and profits, and the adjustments that are made to the basis of stock or securities.

Treas. Reg. §1.367(b)-10 applies to certain triangular reorganizations. The regulation deals with a fact pattern in which a subsidiary (“S”) acquires stock or securities of its parent corporation (“P”) in exchange for property (the “P acquisition”), and S exchanges the acquired P stock or securities for stock, securities, or property of a target corporation (“T”). The final regulations do not apply unless P or S or both are foreign corporations. The application of the final regulations is also subject to a priority rule, described below.

ANNOUNCED REVISIONS

When applicable to a triangular reorganization, the final regulations will require that adjustments be made that have the effect of a distribution of property from S to P under Code §301 (deemed distribution).¹ For this purpose, the amount of the deemed distribution generally is the amount of property that was transferred by S to acquire the P stock and securities in the P acquisition.² For purposes of making the required adjustments, the final regulations treat the deemed distribution as a separate transaction that occurs before the P acquisition or, if P does not control S at the time of the P acquisition, immediately after P acquires control of S, but before the triangular reorganization.³ The term “property” for purposes of the final regulations has the meaning set forth in Code §317(a) (*i.e.*, money, securities, and any other property, other than stock in the corporation making the distribution), as modified to take into account certain assumed liabilities and S stock or rights used by S to acquire P stock or securities from a person other than P.⁴

PRIORITY RULES

Treas. Reg. §1.367(b)-10(a)(2)(iii) provides that the final regulations do not apply to a triangular reorganization if, in an exchange under Code §§354 or 356,

- one or more U.S. persons exchange stock or securities of T,

¹ Treas. Reg §1.367(b)-10(b)(1)

² *Id.*

³ Treas. Reg §1.367(b)-10(b)(3).

⁴ Treas. Reg §1.367(b)-10(a)(3)(ii).

- the amount of gain in the T stock or securities recognized by such U.S. persons under Code §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 §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 §301(c)(3) (together, “Code §367(b) Income”), and
- the final regulations would otherwise apply to the triangular reorganization (the “Code §367(a) Priority Rule”).

Treas. Reg. §1.367(a)-3(a)(2)(iv) provides a similar priority rule that turns off the application of Code §367(a)(1) for an exchange under Code §§354 or 356 that occurs in connection with a triangular reorganization described in the final regulations. In order for the rule to apply, the amount of gain that otherwise would be recognized under Code §367(a)(1) (without regard to any exceptions thereto) must be less than the amount of the Code §367(b) Income recognized under the final regulations (the “Code §367(b) Priority Rule”).

CONCLUSION

The regulations described in the notice apply to transactions completed on or after December 2, 2016, and to inbound transactions treated as completed before December 2, 2016, as a result of an entity classification election that is filed on or after December 2, 2016. The regulations have been widely attacked as an overly broad exercise of discretion because the purpose for the transaction, and not the transaction itself, triggers the determination that a transaction is abusive. While U.S. tax law does not have a general anti-abuse rule, it does contain an economic substance test. This test is intended to be applied when tax reduction, rather than economic benefit, is the principal result of the transaction. As drafted, Notice 2016-73 attacks many common transactions that are far from being abusive. Comments have been requested by the I.R.S. and the Treasury Department and must be received by March 2, 2017.