



International Tax

United States Tax Alert

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Cross-Border Triangular Reorganizations Notice

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On April 25, 2014, the Internal Revenue Service and Treasury Department issued Notice 2014-32 to notify taxpayers that they will issue regulations to modify Treas. Reg. §1.367(b)-10's treatment of cross-border triangular reorganizations. Such reorganizations involve the purchase of some of the shares used to effect the acquisition (generally, a reorganization where a subsidiary (S) purchases shares of its parent (P), either P or S is a foreign corporation, and S uses the shares to acquire a target (T) in a section 368 reorganization). As discussed below, the changes would tend to:

- (1) Reduce the ability to rely on the Priority Rule in Treas. Reg. §1.367(b)-10(b)(2)(iii) to allow §1.367(b)-10 to trump the application of section 367(a)(1) for certain so-called expatriation transactions,
- (2) Increase the U.S. tax cost of the deemed distribution under §1.367(b)-10 (when applicable), and
- (3) Reduce P's basis in the stock of S after the reorganization (i.e., prevent preservation of basis in S stock to the extent there is a section 301(c)(2) component to the deemed distribution).

The changes will apply to a reorganization that is completed on or after April 25, 2014, unless it occurs in relation to an acquisition of an unrelated target pursuant to a binding agreement entered into, or tender offer announced, before April 25, 2014. Although the new rules reflected in items (1) and (3) above are clearly changes to the current regulations, the Notice includes language describing the changes it announces (primarily addressing item (2) above) as *clarifications* to the regulations, and disagrees with various interpretations to the contrary. Thus, although the regulations are effective on April 25, 2014, the Notice states that no inference is intended with respect to transactions under current law and that the IRS may challenge such transactions under current law and judicial doctrines.

Current Treas. Reg. §1.367(b)-10

As noted, Treas. Reg. §1.367(b)-10 applies to certain cross-border triangular reorganizations described in section 368, in which S purchases part or all of the P stock used to effect the acquisition. The regulation does not apply pursuant to

§1.367(b)-10(b)(2) if:

- (1) P and S are both foreign corporations and neither is a controlled foreign corporation immediately before or after the reorganization,
- (2) S is a domestic corporation, P's stock in S is not an interest in U.S. real property, and P would not be subject to U.S. tax on a dividend from S, or
- (3) In an exchange under section 354 or 356 U.S. shareholders of T recognize gain under section 367(a)(1) that is equal to or greater than the sum of the amount of the deemed distribution that would occur under the regulations (if they applied) that would be treated as a section 301(c)(1) or 301(c)(3) distribution (i.e., dividend or gain) (the Priority Rule).

Please note that under the Priority Rule in Treas. Reg. §1.367(b)-10(b)(2)(iii) (described in exception (3) above) and as mimicked in §1.367(a)-3(a)(2)(iv), if §1.367(b)-10 *is not applicable*, then section 367(a) *would apply* to T's U.S. shareholders in the cross-border triangular reorganization. On the other hand, if §1.367(b)-10 *is applicable*, then section 367(a) *would not apply* to T's U.S. shareholders in the cross-border triangular reorganization.

If Treas. Reg. §1.367(b)-10 applies, it recasts S's purchase of the P stock to deem a distribution subject to section 301 from S to P in an amount equal to the purchase price, and then a contribution in that amount from P to the equity of S with appropriate adjustments made to P's basis in S stock. If P controls S (under section 368(c)) at the time the stock of P is acquired, then the deemed distribution and contribution occur immediately before the P stock is acquired. If P lacks control of S immediately beforehand, then the deemed distribution and contribution occur immediately after P acquires control of S, but prior to the reorganization.

Treas. Reg. §1.367(b)-10 includes an anti-abuse rule that requires appropriate adjustments if in connection with a triangular reorganization a transaction is engaged in with a view to avoiding the purposes of the regulation. In this regard, the following example is provided:

For example, if S is created, organized, or funded to avoid the application of this section with respect to the earnings and profits of a corporation related (within the meaning of section 267(b)) to P or S, the earnings and profits of S will be deemed to include the earnings and profits of such related corporation for purposes of determining the consequences of the adjustments provided in this section, and appropriate corresponding adjustments will be made to account for the application of this section to the earnings and profits of such related corporation.

As presently written, it is unclear whether or when T's earnings and profits could be treated as part of S's earnings and profits for purposes of the section 301(c)(1) component of the deemed distribution under Reg. §1.367(b)-10 when T is a target and not a member of the P-S group, as defined by section 267(b).

Announced Changes to Reg. §1.367(b)-10

Deletion of the Recontribution Rule

The Notice announces that Reg. §1.367(b)-10 will be modified to eliminate the deemed contribution treatment. In other words, if the regulation applies, S would be deemed to make a distribution to P in the amount of the relevant purchase price, but there would not be a corresponding deemed contribution of that amount from P to S. As a result, P's basis in S could be used once in the section 301(c)(2) component of the deemed distribution, but then that basis would not be preserved in the shares of S.

However, the Notice also announced that the basis adjustment rules for triangular reorganizations under §1.358-6 will be applied as if P provided the P stock or securities pursuant to the plan of reorganization, notwithstanding that S in fact purchased that stock or securities. Taxpayers will apply the appropriate rule of Treas. Reg. §1.358-6(c) to increase the basis P has in its S stock, without the limitation of §1.358-6(d). This should, should, therefore, avoid the basis "grind" in the S stock pursuant to §1.358-6 for the portion of the consideration paid by S to P.

Change in the Priority Rule

The Notice also announced that the Priority Rule in Treas. Reg. §1.367(b)-10(b)(2)(iii) and §1.367(a)-3(a)(2)(iv) would be modified. The new rule would compare the U.S. shareholders of T's recognized gain under section 367(a)(1) to the amount of the deemed distribution under §1.367(b)-10 that would occur under the regulations (if they applied) that would be treated as a section 301(c)(1) or 301(c)(3) distribution (i.e., dividend or gain). However, the dividend income or gain would be counted only to the extent such amounts would be subject to U.S. tax or give rise to an income inclusion under section 951(a)(1)(A) that would be subject to U.S. tax. Thus, for purposes of determining the application of the Priority Rule, the §1.367(b)-10 income amount would not include that portion of the deemed distribution that was not subject to U.S. income or withholding tax.

It is noted that for purposes of the Priority Rule, no comparable adjustment was provided within the Notice to reduce the section 367(a)(1) U.S. shareholder gain amount by the portion of that gain that is not, or will not be, otherwise subject to U.S. income tax.

Modifications to the Anti-Abuse Rule

The Notice further announced that the anti-abuse rule will be clarified to state that it may be implicated by S's purchase of P stock with a note, and may take into account earnings and profits of a corporation (or successor) regardless of whether related to P or S before the reorganization, including T or a subsidiary of S or T.

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