

Foreign Subsidiary's Acquisition of a Foreign Target with U.S. Parent Stock

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A U.S. multinational may acquire a foreign target using cash of its low-taxed foreign subsidiaries. Often a company in the target's country is formed and borrows from a foreign finance company within the group to make the acquisition. This structure permits the use of offshore cash without U.S. taxation and provides interest deductions in the target's country.

Alternatively, all or a portion of the consideration for the acquisition of the foreign target may be stock in the U.S. parent ("USP"). The foreign acquiring company may purchase such stock from the public (e.g., pursuant to a stock buyback program) or from the U.S. parent (e.g., treasury stock). Under recently issued Regs. §1.367(b)-14T, such an acquisition transaction may have significantly different U.S. tax consequences depending on whether the acquisition qualifies as a tax-free triangular reorganization.¹

For example, assume that USP owns all of the stock of a foreign holding company ("FH"). FH owns the stock of a number of foreign operating subsidiaries. USP has a basis in its FH stock of \$200, and FH has earnings and profits and cash of \$450, of which \$50 is previously taxed income under Subpart F. FH borrows \$550 from unrelated lenders and acquires \$1,000 of USP voting stock from the public shareholders. FH uses the USP stock to acquire all of the stock of a foreign target ("FT") from an unrelated seller (or sellers).²

FH's purchase of USP stock from the public shareholders is subject to §304(a)(2). The application of that provision should result in taxable capital gain to

¹ T.D. 9400, 73 Fed. Reg. 30301 (5/27/08). The temporary regulations implement the rules described in Notice 2006-85, 2006-41 I.R.B. 677, and Notice 2007-48, 2007-25 I.R.B. 1428.

² Subsequently, FH could sell the FT stock to a leveraged company organized in the target's country (the local company might elect to be disregarded to avoid any U.S. tax consequences).

the public shareholders, but should not result in any taxable income to USP.³

The transfer by FH of the USP voting stock to the FT shareholders in exchange for the stock of FT should qualify as a triangular reorganization under §368(a)(1)(B) and be tax-free to FT's shareholders, even though the parent stock was acquired in a taxable transaction.⁴ Nevertheless, FH ordinarily would recognize gain or loss on the transfer of the USP stock in exchange for the FT stock, but the consequences generally should be immaterial assuming FH holds the USP stock for only a short period.⁵

The §367 regulations, as modified in 2006, should not change the above results for the seller.⁶ Nevertheless, because the acquisition transaction qualifies as a tax-free reorganization, Regs. §1.367(b)-14T treats USP as receiving a distribution of \$1,000 from FH followed by a deemed contribution of the same amount from USP to FH.

More specifically, the temporary regulations provide that, under the facts set forth above, the amount of money and property transferred by the foreign subsidiary to the public shareholders for the U.S. parent stock used in the triangular reorganization is treated as a distribution of property by the foreign subsidiary to its U.S. parent under §301(c).⁷ The deemed distribution is treated as a distribution for all purposes of the Code, e.g., §§312, 902, and 959. In addition, to the extent the foreign subsidiary buys the U.S. parent stock from a person other than the U.S. parent, the U.S. parent is deemed to contribute to the foreign subsidiary the property deemed distributed, resulting in an adjustment to the basis of the foreign subsidiary

³ See *Virginia Materials Corp. v. Comr.*, 67 T.C. 372 (1976), *aff'd without opinion*, 577 F.2d 739 (4th Cir. 1978); *Webb v. Comr.*, 67 T.C. 293 (1976), *aff'd per curiam*, 572 F.2d 135 (5th Cir. 1978); *Broadview Lumber Co. v. U.S.*, 561 F.2d 698 (7th Cir. 1977); Rev. Rul. 80-189, 1980-2 C.B. 106, *modifying* Rev. Rul. 69-261, 1969-1 C.B. 94.

⁴ See Regs. §§1.1032-2(c) and 1.358-6(d) (explicitly recognize the use of parent stock purchased by the acquiring corporation in a triangular B reorganization).

⁵ FH's basis in the USP stock should be a cost basis under §1012. See Rev. Rul. 80-189, 1980-2 C.B. 106. The investment in U.S. property rules should not apply if the USP stock is not held by FH on the last day of a quarter. §956(a)(1).

⁶ Section 367(a) or (b) may apply under certain circumstances to the FT shareholders that are U.S. persons or controlled foreign corporations. Regs. §1.367(a)-3(d)(1)(iii)(B), §1.367(b)-4(b)(1)(ii). See Yoder, "A Bird's Eye View of §367's Application to Triangular Reorganizations Involving CFCs," 36 *Tax Mgmt. Int'l J.* 525 (10/12/07); Yoder, "Prop. Regs. §1.367(b)-4: Triangular Reorganization Rules Fixed," 34 *Tax Mgmt. Int'l J.* 389 (7/8/05).

⁷ This treatment appears to fall outside the purpose and scope of §367(b). See Yoder, "Notice 2007-48: IRS Takes a Shot at Public Triangular Reorganizations," 33 *Int'l Tax J.* 3 (Sept.-Oct. 2007).

stock held by the U.S. parent. These applications are considered as occurring immediately before the acquisition of the U.S. parent stock by the foreign subsidiary.

Applying the temporary regulations, the amount of money and property (\$1,000) transferred by FH to the public shareholders for the USP stock used in the triangular reorganization is treated as a distribution of property by FH to USP under §301(c). The fictional distribution of \$1,000 is a dividend to USP to the extent of FH's earnings and profits (\$450). Of that amount, \$50 would be excluded from USP's gross income as previously taxed income, and USP's basis in the FH stock would be reduced by \$50 to \$150.⁸ The next \$150 of the amount deemed distributed is treated as a non-taxable reduction of basis,⁹ and the remaining \$400 is capital gain.¹⁰ Any deemed-paid taxes associated with the \$400 of non-previously taxed earnings and profits should be available to USP as a foreign tax credit. In addition, USP should increase the basis in its stock of FH by the \$1,000 deemed contributed to FH,¹¹ and FH should have no earnings and profits.

If instead FH acquired the USP stock from USP, the above treatment generally applies, with several modifications. Section 1032 should apply to prevent USP from recognizing any gain on the sale of the USP stock to FH and prevent FH from recognizing any gain on the exchange of the USP stock for the FT stock.¹² In addition, while the deemed distribution provided by the temporary regulations should have the same consequences as described above, there would be no deemed contribution by USP to FH and accordingly no adjustment to the basis in the FH stock for the amount paid for the USP stock.

Under a second scenario, assume the above facts, but instead USP owns all of the stock of a domestic subsidiary ("DS"), which in turn owns all of the stock of FH with a basis of \$200. FH's purchase of the USP stock should be treated in the same manner as described above under §304(a)(2) or §1032. The

⁸ §§959(a), 961(b).

⁹ For issues that may arise with respect to a distribution that is treated as a return of basis, see Warnke, "Developments, Theories and Themes in Stock Basis," 86 *TAXES* 85 (March 2008); NYSBA Tax Section Comments on Basis Recovery in Dividend Equivalent Redemptions, 2006 *TNT* 116-12 (June 16, 2006); Zuckerman, "Aggregation of Bases Under Sections 301(c)(2) and (3)," 33 *Tax Law* 937 (1980).

¹⁰ This assumes that the increase in basis of the FH stock provided in the temporary regulations is not taken into account.

¹¹ The basis USP has in the FH stock also should be increased by the amount of basis the FT shareholders had in the FT stock exchanged. Regs. §1.358-6.

¹² Regs. §§1.1032-1(a), -2(c). FH might purchase some or all of the USP stock for a note.

acquisition by FH of the FT stock in exchange for the USP stock, however, does not qualify as a tax-free triangular reorganization because FH is not using stock of its parent (i.e., USP is a grandparent).¹³ A foreign holder of FT stock should be indifferent to any U.S. tax consequences, although such transaction would subject a U.S. holder to taxation on any gain (which may not be a material consideration under various circumstances).¹⁴ As under the first scenario, FH would recognize any gain on the transfer of the USP stock for the FT stock when the USP stock is purchased from the public, but would have a basis in the USP stock reflecting the amount paid for the shares.

Section 367(a) and (b) generally should not apply to the acquisition of the USP stock by FH and the use of the USP stock to acquire FT in a taxable transaction.¹⁵ In addition, since the acquisition of FT does not qualify as a tax-free reorganization, the temporary regulations do not apply.¹⁶ Accordingly, USP should not have any taxable income resulting from FH pur-

chasing its stock and using the USP stock to acquire the stock of FT in a taxable transaction.

The results in the above two scenarios should be the same if FH used the USP stock it purchased to acquire the assets of FT. The assets might actually be acquired or deemed acquired as a result of liquidating the target into FH (or FT might be deemed liquidated into FH as a result of a disregarded entity election for FT).¹⁷ In the first scenario where USP is the parent of FH, the acquisition transaction should qualify as a tax-free triangular reorganization described in §368(a)(1)(C), and Regs. §1.367(b)-14T should apply with the tax consequences described above. On the other hand, under the second scenario where DS owns FH, the acquisition transaction does not qualify as a tax-free reorganization (i.e., USP is a grandparent of FH), and accordingly there should be no U.S. tax consequences to USP.

In sum, the utilization of low-taxed earnings of foreign subsidiaries to purchase USP stock to use as consideration for the acquisition of a foreign target may be accomplished in a tax-efficient manner if the acquisition transaction is a taxable transaction. On the other hand, under temporary regulations, the purchase of USP stock would result in a deemed distribution from FH to USP if the acquisition transaction qualifies as a tax-free triangular reorganization.¹⁸

¹³ The only permitted consideration in a §368(a)(1)(B) reorganization is voting stock of the acquiring corporation or voting stock of the corporation which is in "control" of the acquiring corporation. Control is defined under §368(c) as ownership of stock possessing at least 80% of the voting stock and 80% of all other classes of the corporation's stock, and indirect control is not taken into account for this purpose. Note that, under the ownership structure of scenario one, the requirements of §368(a)(1)(B) should not be met if a portion of the consideration for the FT shares consisted of something other than USP voting stock (e.g., cash, obligations, or FH stock).

¹⁴ A taxable acquisition would allow a §338 election to be made for FT. See Yoder, "CFC Target: To Make or Not to Make a Code Sec. 338 Election," 3 *J. of Tax'n of Global Trans.* 3 (Winter 2004); Yoder, "Code Sec. 338(g) Election Applied to Foreign Targets: Permissible Tax Arbitrage," 33 *Int'l Tax J.* 3 (May-June 2007).

¹⁵ Section 367 only applies to exchanges described in §§332, 351, 354, 356, or 361.

¹⁶ Cf. Regs. §1.367(b)-14T(d) (under certain circumstances, appropriate adjustments shall be made if, in connection with a triangular reorganization, a transaction is engaged in to avoid the pur-

poses of the rules).

¹⁷ Regs. §301.7701-3(g)(1)(iii). See, e.g., *King Enterprises, Inc. v. Comr.*, 418 F.2d 511 (Ct. Cl. 1969); Rev. Rul. 67-274, 1967-2 C.B. 141; Rev. Rul. 2004-83, 2004-32 I.R.B. 157; PLR 200706007.

¹⁸ Rather than FH purchasing the USP stock, USP may contribute its stock to FH (or transfer the USP stock directly to the FT shareholders), which should not result in any taxation to USP or FH. See §§351 and 1032(a). Under these circumstances, Regs. §1.367(b)-14T should not apply. In addition, no gain or loss should be recognized by FH on the transfer of the USP stock in exchange for the stock of FT pursuant to a tax-free triangular reorganization. Regs. §1.1032-2.

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Tax Management

International Journal

BNATAX
Management
America's Tax Authority

Vol. 37, No. 10

October 10, 2008

ARTICLES

- 575 Temporary Regulations Deny Foreign Tax Credits for Amounts Paid Pursuant to "Structured Passive Investment Arrangements"**
by Caren S. Shein, Esq.
- 584 Addressing Foreign Plan Issues Under §409A**
by Sandra W. Cohen, Esq.

CANADA-U.S. INVESTMENT: CANADIAN TAX PERSPECTIVE

- 591 Cross-Border Reimbursement of Stock Option Benefits**
by Tania W. Ng, Esq.

LEADING PRACTITIONER COMMENTARY

- 599 Section 956 Relief for Certain Partnerships**
by Philip D. Morrison, Esq.
- 600 The New Expatiation Tax Regime — §877A**
by Edward Tanenbaum, Esq.
- 602 The Protocol to the U.S.-Canada Income Tax Treaty**
by Willard B. Taylor, Esq.
- 604 Foreign Subsidiary's Acquisition of a Foreign Target with U.S. Parent Stock**
by Lowell D. Yoder, Esq.

TAX TREATIES AND INTERNATIONAL TAX AGREEMENTS

- 607 Current Status of U.S. Tax Treaties and International Tax Agreements**
by John Venuti, Manal S. Corwin, and Steven R. Lainoff

LEGISLATION

- 615 Current Status of Legislation Relating to U.S. International Tax Rules**
by David Benson, Esq., Marjorie A. Rollinson, Esq., Peg O'Connor, Esq., Eric Oman, CPA, and Carlos R. Probus, Esq.

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