

Part III - Administrative, Procedural, and Miscellaneous

Treatment Under Section 367(b) of Property Used to Purchase Parent Stock in Certain Triangular Reorganizations

Notice 2006-85

SECTION 1. OVERVIEW

This notice announces that the Internal Revenue Service (IRS) and the Treasury Department (Treasury) will issue regulations under section 367(b) of the Internal Revenue Code that address certain triangular reorganizations under section 368(a) involving one or more foreign corporations. This notice is issued in response to comments and specific requests for guidance regarding certain transactions that are designed to avoid U.S. income tax, including tax on the repatriation of a subsidiary's earnings. The transactions generally involve a subsidiary purchasing its parent's stock for property and then transferring the stock in exchange for the stock or assets of a corporation in a triangular reorganization under section 368(a). In general, and as described below, the regulations issued pursuant to this notice will apply to transactions occurring on or after September 22, 2006.

The IRS and Treasury recently finalized §1.367(b)-4(b)(1)(ii), which may apply to certain (but not all) of the triangular reorganizations described in this notice. That final regulation under section 367(b) appropriately addressed the treatment of the majority of

relevant triangular reorganizations. While the IRS and Treasury were aware of the transactions covered by this notice at that time, the decision was made to address these transactions comprehensively in separate guidance.

The following definitions apply for purposes of this notice. A “triangular reorganization” is a forward triangular merger, a triangular C reorganization, a reverse triangular merger, or a triangular B reorganization, as those terms are defined in §1.358-6(b)(2)(i) through (iv), respectively, or a reorganization described in section 368(a)(1)(G) and (a)(2)(D). In addition, P, S, and T are corporations described in §1.358-6(b)(1)(i) through (iii), respectively. Finally, the term “property” means money, securities, and any other property, except that the term does not include stock in S.

SECTION 2. TRANSACTIONS AT ISSUE

The IRS and Treasury are aware that certain taxpayers are engaging in triangular reorganizations involving foreign corporations that result in a tax-advantaged transfer of property from S to P. The transaction is often structured as a triangular B reorganization, but could also be structured as a triangular C reorganization or another type of triangular reorganization. For example, assume P, a domestic corporation, owns 100 percent of S, a foreign corporation, and S1, a domestic corporation. S1 owns 100 percent of T, a foreign corporation. S purchases P stock for either cash or a note, and provides the P stock to S1 in exchange for all the T stock in a triangular B reorganization.

Taxpayers take the position that (i) when P sells its stock to S for cash or a note, P recognizes no gain or loss on the sale under section 1032, (ii) S takes a cost basis in

the P shares under section 1012, and (iii) S recognizes no gain under §1.1032-2(c) upon the transfer of the P shares immediately thereafter because the basis and fair market value of the shares are equal. Thus, taxpayers take the position that the cash or note used by S to acquire the P stock does not result in a distribution under section 301. Furthermore, taxpayers do not include in income amounts under section 951(a)(1)(B) because S acquires and disposes of the P stock before the close of a quarter of the taxable year, which is the time at which to measure P's share of the average amount of United States property held by S. See section 956(a)(1)(A). Finally, under §1.367(b)-4(b)(1)(ii), S1 does not include in income as a deemed dividend the section 1248 amount attributable to the T stock that S1 exchanges.

The IRS and Treasury believe that the taxpayers' characterization of these transactions raises significant policy concerns, particularly when either P or S (or both) is a foreign corporation (regardless of whether T is related to P and S before the transaction). For example, when P is domestic and S is foreign, as in the example described above, the transaction could have the effect of repatriating foreign earnings of S to P without a corresponding dividend to P that would be subject to U.S. income tax. Similarly, where P is foreign and S is domestic, the transaction could have the effect of repatriating S's U.S. earnings to its foreign parent in a manner that is not subject to U.S. withholding tax. This variation of the transaction also raises U.S. earnings stripping issues where S uses a note to purchase all or a portion of the P stock. Moreover, where both P and S are foreign, the transactions may have the effect of avoiding income inclusions to certain U.S. shareholders of P that would be subject to U.S.

income tax under the subpart F provisions, absent the application of an exception, such as under section 954(c)(6). In addition, foreign-to-foreign transactions of this type can be used to facilitate the subsequent repatriation of foreign earnings to U.S. shareholders without U.S. income tax.

SECTION 3. BACKGROUND

.01 Triangular reorganizations

Section 368 defines the term “reorganization.” Sections 368(a)(1)(B), 368(a)(1)(C), 368(a)(1)(G), 368(a)(2)(D), and 368(a)(2)(E) describe certain reorganizations in which P stock may be used by S as the consideration issued in exchange for T’s stock or assets, as applicable.

Section 1032 provides that no gain or loss will be recognized to a corporation on the receipt of money or other property in exchange for stock of such corporation.

Section 1.1032-2(b) provides that in the case of a forward triangular merger, a triangular C reorganization, or a triangular B reorganization, P stock provided by P to S, or directly to T or T’s shareholders on behalf of S, pursuant to the plan of reorganization is treated as a disposition by P of shares of its own stock. However, §1.1032-2(c) provides that S must recognize gain or loss in the above transactions on its exchange of P stock for T stock or assets if S did not receive the P stock from P pursuant to the plan of reorganization. Section 361 provides that S does not recognize gain or loss on the P stock that it exchanges for T stock in a reverse triangular merger.

Section 361(a) provides that no gain or loss shall be recognized by T if it exchanges property in pursuance of the plan of reorganization solely for stock or

securities in P. Section 361(c) provides that no gain or loss shall be recognized to T on the distribution to its shareholders of P stock received from P in pursuance of the plan of reorganization.

Section 354 provides that no gain or loss shall be recognized by T shareholders if stock or securities in T are, in pursuance of the plan of reorganization, exchanged solely for stock or securities of P. Section 356 applies to T shareholders in cases where they receive other property in addition to the property permitted to be received under section 354.

Section 358 provides rules for determining the T shareholders' bases in their P stock following triangular reorganizations. Sections 1.358-6 and 1.367(b)-13 provide rules for determining P's basis in its S or T stock, as applicable. If P files a consolidated return with S or T, other basis rules apply. See Treas. Reg. §1.1502-30 or 1.1502-31.

.02 Section 367

Section 367(a)(1) provides that if, in connection with any exchange described in section 332, 351, 354, 356, or 361, a United States person transfers property to a foreign corporation, such foreign corporation shall not, for purposes of determining the extent to which gain shall be recognized on such transfer, be considered to be a corporation. The Secretary has broad authority under section 367(a)(2), (3), and (6) to provide that section 367(a)(1) will not apply to certain transfers described therein.

In the case of any exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), section 367(b)(1) provides that a foreign corporation shall be considered to be a

corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes.

Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing, among other things, the circumstances under which gain is recognized, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to basis of stock or securities.

.03 Distributions of property

Section 301(c)(1) provides that a distribution of property by a corporation to its shareholder with respect to its stock is included in the shareholder's gross income to the extent the distribution constitutes a dividend under section 316. Section 316 defines a dividend as a distribution out of a corporation's current and accumulated earnings and profits. To the extent the distribution is not a dividend, the shareholder reduces basis in the distributing corporation's stock, and any amount of the distribution in excess of the shareholder's basis is treated as gain from the sale or exchange of the corporation's stock. See section 301(c)(2) and (3).

Certain transactions that are exchanges in form can be treated as distributions for tax purposes. Section 304 generally provides that when a shareholder transfers stock of a controlled corporation to another controlled corporation in exchange for property, the two legs of the exchange are bifurcated and the receipt of the property by the shareholder is treated as a distribution. Section 304, by its terms, does not apply to

the transfer by a shareholder of its own stock to a controlled corporation in exchange for property, even though the economic effect of that transaction is essentially identical.

Other transactions may result in deemed distribution treatment in certain circumstances. For example, a shareholder that exchanges common stock of a corporation for common stock and property pursuant to a recapitalization will be treated as receiving a distribution of property with respect to its stock under section 301 if in substance the distribution is a separate transaction. See Treas. Reg. §1.301-1(l); see also, *Bazley v. Comm’r*, 331 U.S. 737 (1947).

.04 Distributions involving foreign corporations or foreign shareholders

The treatment of a distribution varies depending upon whether the corporation or shareholder is domestic or foreign. A distribution from a foreign corporation to a shareholder that is a U.S. person resulting in a dividend under sections 301(c)(1) and 316, or gain from the sale or exchange of property under section 301(c)(3), generally is subject to U.S. income tax, with potential offset by foreign tax credits.

A distribution from a domestic corporation to a shareholder that is not a U.S. person resulting in a dividend is generally taxable under section 871 or 881 at a rate of 30 percent, subject to reduction under an applicable treaty, and the domestic corporation is responsible for withholding tax under section 1441 or 1442. To the extent such a distribution results in gain from the sale or exchange of property to the foreign shareholder under section 301(c)(3), such amounts are subject to U.S. income tax under section 897(a) if the distributing corporation had been a United States real property holding corporation (as defined in section 897(c)(2)) within the past five years.

In such a case, the gain is subject to U.S. income tax as income effectively connected with the conduct of a trade or business within the United States.

Finally, a distribution from a foreign corporation to a shareholder that is a controlled foreign corporation, within the meaning of section 957, resulting in a dividend or gain from the sale or exchange of property to the foreign shareholder under section 301(c)(3) may also be subject to U.S. income tax. For example, such amounts may constitute subpart F income and therefore result in an income inclusion under section 951(a)(1)(A) to U.S. shareholders, within the meaning of section 951(b), of the controlled foreign corporation, subject to certain exceptions. See, e.g., section 954(c)(6).

SECTION 4. APPLICATION OF SECTION 367(b)

Congress enacted section 367(b) to ensure that international tax considerations are adequately addressed when the subchapter C provisions apply to certain nonrecognition exchanges involving foreign corporations. This provision was necessary because the subchapter C provisions were enacted largely to address transactions involving domestic corporations and shareholders that are United States persons. As a result, the subchapter C provisions do not fully account for international tax concerns that arise when the provisions apply to transactions involving foreign corporations or shareholders that are not U.S. persons.

In enacting section 367(b), Congress noted that “it is essential to protect against tax avoidance in transfers to foreign corporations and upon the repatriation of previously untaxed foreign earnings....” H.R. Rep. No. 658, 94th Cong., 1st Sess. 241 (1975). In

addition, because determining the proper interaction of the Code's international and subchapter C provisions is "necessarily highly technical," Congress granted the Secretary broad regulatory authority to provide the "necessary or appropriate" rules to prevent the avoidance of Federal income taxes, rather than enacting a more comprehensive statutory regime. *Id.* This broad grant of authority has been exercised on numerous occasions to address a wide range of international policy concerns. See, e.g., Treas. Reg. §§1.367(b)-4(b)(1) (preserving section 1248 amounts), (b)(2) (addressing trafficking in foreign tax credits by use of preferred stock), -5(b)(1)(ii) (ensuring section 311(b) gain is recognized by a domestic corporation when it distributes stock of a controlled foreign corporation to an individual distributee under section 355), and -7 (addressing the carryover of tax attributes in a foreign-to-foreign section 381 transaction).

In a triangular reorganization, the exchange by the T shareholders of their T stock for P stock is described in section 354 or 356. As a result, a triangular reorganization involving a foreign corporation is described in section 367(b) and, therefore, may be subject to regulations issued under the broad regulatory authority granted therein. It is on this basis that regulations will be issued to address the triangular reorganizations covered by this notice.

SECTION 5. REGULATIONS TO BE ISSUED UNDER SECTION 367(b)

The IRS and Treasury will issue regulations under section 367(b) to address certain triangular reorganizations involving foreign corporations. The regulations will apply to triangular reorganizations where P or S (or both) is foreign and, pursuant to the

reorganization, S acquires from P, in exchange for property, all or a portion of the P stock that is used to acquire the stock or assets of T (T could be either related or unrelated to P and S before the transaction). In such a case, the regulations under section 367(b) will make adjustments with respect to P and S such that the property transferred from S to P in exchange for P stock will have the effect of a distribution of property from S to P under section 301(c) that is treated as separate from the transfer by P of the P stock to S pursuant to the reorganization. The adjustments will be made notwithstanding the fact that section 1032 otherwise applies to the reorganization. Therefore, the regulations will require, as appropriate, an inclusion in P's gross income as a dividend, a reduction in P's basis in its S or T stock, and the recognition of gain by P from the sale or exchange of property. The regulations will also provide for appropriate corresponding adjustments to be made, such as a reduction of S's earnings and profits as a result of the distribution (consistent with the principles of section 312). The regulations will also address similar transactions in which S acquires the P stock used in the reorganization from a related party that purchased the P stock in a related transaction.

SECTION 6. EFFECTIVE DATE

In general, the regulations to be issued under section 367(b) that are described in section 5 of this notice will apply to transactions occurring on or after September 22, 2006. The regulations described in this notice will not, however, apply to a transaction that was completed on or after September 22, 2006, provided the transaction was entered into pursuant to a written agreement which was (subject to customary

conditions) binding before September 22, 2006 and all times thereafter.

No inference is intended as to the treatment of transactions described herein under current law, and the IRS may, where appropriate, challenge such transactions under applicable provisions or judicial doctrines.

SECTION 7. COMMENTS

The IRS and Treasury request comments on the regulations to be issued under this notice. Specifically, comments are requested as to whether in certain cases it is appropriate to provide an exception from the treatment described in this notice. In addition, comments are requested as to the source and timing of the adjustments to be made with respect to P and S under the regulations to be issued.

The IRS and Treasury also request comments regarding transactions that are not described in section 5 of this notice. For example, comments are requested on transactions where S or P is foreign and S purchases P stock from a person unrelated to P (for example, from the public on the open market), or where S acquires the P stock in a transaction that is unrelated to the triangular reorganization. Finally, the IRS and Treasury request comments on the treatment of transactions similar to those described in this notice that do not qualify as reorganizations (for example, because S issues minimal consideration to T in a transaction that would otherwise qualify as a reorganization under section 368(a)(1)(B)). Any regulations issued to address transactions that are not described in section 5 of this notice will apply prospectively.

SECTION 8. DRAFTING INFORMATION

The principal authors of this notice are Daniel McCall of the Office of Associate

Chief Counsel (International) and Sean McKeever of the Office of Associate Chief Counsel (Corporate). However, other personnel from the IRS and Treasury participated in its development. For further information regarding this notice contact Mr. McCall at (202) 622-3860 (not a toll-free call). For comments or questions regarding subchapter C issues, contact Mr. McKeever at (202) 622-7750.