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IMPACT OF CODE SECTION 367 AND THE EUROPEAN UNION'S 1990 COUNCIL DIRECTIVE ON TAX-FREE CROSS-BORDER MERGERS AND ACQUISITIONS

*Samuel C. Thompson, Jr.**

I. SCOPE

This Article examines the impact of (1) Internal Revenue Code section 367[1] and the regulations thereunder,[2] and (2) the European Union's (EU's) Council Directive on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares, Concerning Companies of Different Member States[3] on tax-free cross-border mergers and acquisitions.

This topic is immensely complex, and therefore, this Article focuses only on the impact of section 367 and the Council Directive on the seven standard forms of tax-free acquisitive reorganizations set forth in section 368 of the Code. This Article focuses only on the basic principles governing these acquisitive reorganizations. Further, from the perspective of section 367, the emphasis is only on cross-border acquisitions of publicly-held corporations in the following three situations:[4] (1)

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* Copyright 1998 Samuel C. Thompson, Jr., Dean, University of Miami School of Law. I would like to thank the following for their comments: Reuven S. Avi-Yonah, Harvard Law School; Michael Schler, Cravath, Swaine & Moore; and Willard B. Taylor, Sullivan & Cromwell. I would also like to thank my research assistant, Sholanda Wright, a graduate tax student at the University of Miami School of Law.

1. *See* I.R.C. § 367 (1994).

2. *See generally* Charles I. Kingson, *The Theory and Practice of section 367*, 37 INST. ON FED. TAX'N § 22 (1979); Charles I. Kingson, *The New Theory and Practice of section 367*, 1991 TAXES 1008 (Dec. 1991) [hereinafter Kingson, *New § 367 Theory*]; James M. Peaslee, *NYSBA Recommends Changes in Regs on Transfers to Foreign Corporations*, TAX NOTES TODAY, Jan. 30, 1992, *available in* LEXIS, Taxria Library, TNT File [hereinafter *NY State 1992 Report*]; William L. Bricker, Jr., et. al., *Report on the Proposed Regulations Under section 367*, 34 TAX L. REV. 79 (1978); Martin B. Amdur et al., *Report on the Examples Under section 367(b)*, 35 TAX L. REV. 317 (1979); JOEL D. KUNTZ & ROBERT J. PERONI, U.S. INTERNATIONAL TAXATION pt.B5 (1996); D. KEVIN DOLAN, U.S. TAXATION OF INTERNATIONAL MERGERS, ACQUISITIONS AND JOINT VENTURES chs. 8-13 (1997); BORIS I. BITTKER & JAMES S. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS ¶¶ 15.80-15.85 (6th ed. 1994); SAMUEL C. THOMPSON, JR., U.S. TAXATION OF INTERNATIONAL TRANSACTIONS 588-606 (1995). Some of the material in this Article is based on and is a modification of SAMUEL C. THOMPSON, JR. ET AL., FEDERAL TAXATION OF BUSINESS ENTITIES 4-1 to 4-44 (1988).

3. *See* Council Directive 90/434/EEC of 23 July 1990 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States, *infra* app. [hereinafter Council Directive]. *See also* David R. Tillinghast & Karina Haum, *A Primer on the Impact of the EC Directive on Mergers and Divisions of U.S. Companies with Interest in Europe*, 3 TAX NOTES INT'L 575 (1991).

4. This Article does not address transfers of U.S. real property interests, *see* I.R.C. § 897 (1994); transfers involving passive foreign investment companies, *see id.* § 1291; and transfers involving foreign investment companies, *see id.* § 1246. This Article also does not address the nondivisive or divisive (D)

the acquisition of a U.S. publicly-held target corporation (U.S. Target) by a foreign publicly-held acquiring corporation (Foreign Acquiror); (2) the acquisition of a foreign publicly-held target corporation (Foreign Target) by a publicly-held U.S. acquiring corporation (U.S. Acquiror); and (3) the acquisition of a foreign publicly-held target corporation (Foreign Target) by a foreign publicly-held acquiring corporation (Foreign Acquiror).

Generally, this Article first provides a rather detailed examination of section 367 and then briefly examines the manner in which the Council Directive would apply to the seven standard forms of reorganizations under section 368. Specifically, in Part II, this Article introduces section 367 and section 368, which defines the term "reorganization." Part II.B then discusses the seven forms of acquisitive reorganizations set out in section 368, four asset reorganizations, and three stock reorganizations. Part III contains a summary of the types of reorganization transactions governed by section 367.

Part IV then discusses outbound asset reorganizations, which involve the transfer of property of a U.S. target (including intangibles) to be used in the active conduct of a trade or business of a foreign acquiring corporation. Part V addresses the direct outbound transfer of the stock of a domestic target to a foreign acquiror in a stock-for-stock (B) reorganization.

Part VI reviews the treatment under section 367 of the acquisition by a foreign acquiring corporation of a U.S. target in a tax-free triangular reorganization involving a domestic subsidiary of the foreign acquiror. These are, in essence, outbound transfers (i.e., transfer by a U. S. person to a foreign corporation) of a controlling stock interest in a U.S. target. Parts VII through X examine non-outbound reorganizations governed by section 367(b). These transactions include both the acquisition of a foreign target by a domestic acquiror, and the acquisition of a foreign target by a foreign acquiror.

Part XI then outlines the impact of the EU's Council Directive on inbound and outbound acquisitions from the perspective of a Member of the EU that has adopted the Council Directive. Finally, Part XI provides a conclusion.

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reorganization under section 368(a)(1)(D); organization transactions under section 351; and the treatment of overlaps between section 351 and the (B) reorganization under section 368(a)(1)(B).

II. INTRODUCTION TO ACQUISITIVE REORGANIZATIONS UNDER CODE SECTION 368 AND THE GENERAL IMPACT OF SECTION 367

A. *Introduction to Section 368: Acquisitive Reorganizations*

1. In General

Section 368 defines seven types of acquisitive reorganization transactions.[5] Four of these reorganizations involve the acquisition of a target's assets and three involve the acquisition of a target's stock.

2. Asset Reorganizations

a. *The Direct Merger Under Section 368(a)(1)(A)*

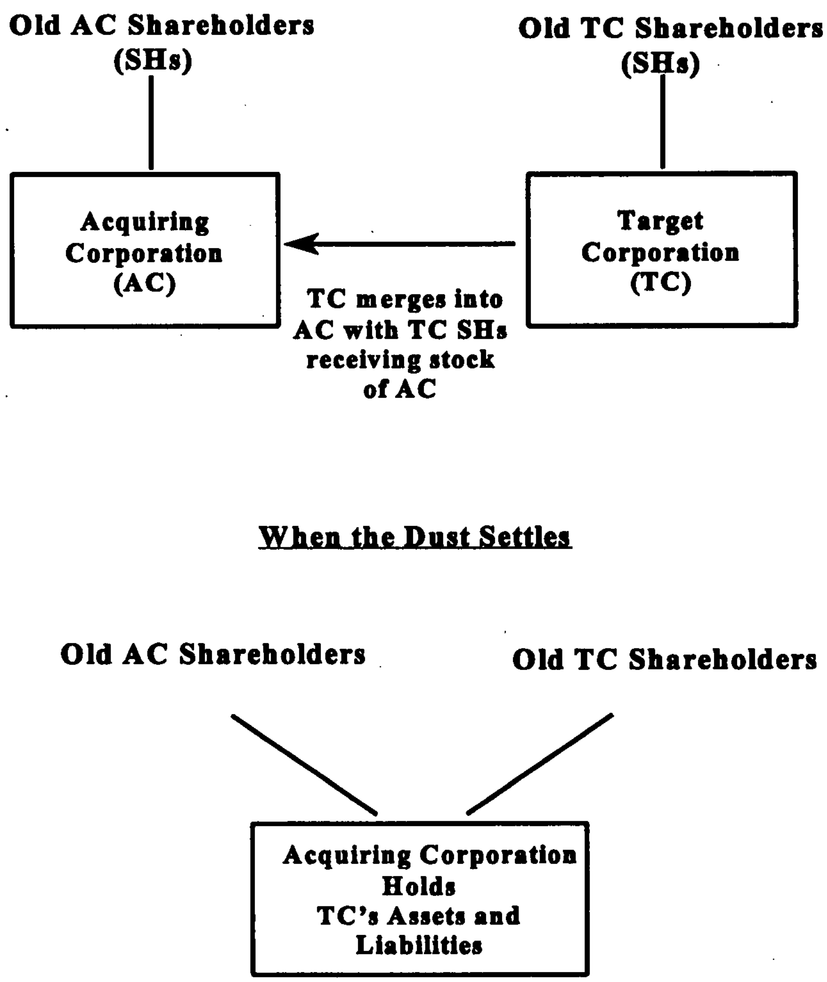
The "(A)" reorganization under section 368(a)(1)(A) is a merger of a target directly into an acquiror with the target's shareholders receiving stock in the acquiror. For private letter ruling purposes, to satisfy the continuity of interest requirement (i.e., that a substantial portion of the consideration be in stock), at least 50% of the consideration paid in an (A) reorganization must be stock of the acquiror.[6] Thus, up to 50% of the consideration paid can be non-stock consideration, i.e., boot. The transaction can be diagramed as follows:

5. *See generally* BITTKER & EUSTICE, *supra* note 2, at ¶¶ 12.01-12.67; SAMUEL C. THOMPSON, JR., TAXABLE AND TAX-FREE CORPORATE MERGERS, ACQUISITIONS AND LBOS 151-381 (1994).

6. *See* Rev. Proc. 77-37, 1977-2 C.B. 568, § 3.02.

GRAPH II-1

DIRECT "(A)" MERGER REORGANIZATION UNDER SECTION 368(a)(1)(A)



Under section 354, the target's shareholders have tax-free treatment on the receipt of the acquiror's common stock,[7] and under section 358, they take a substituted basis for the acquiror's stock, thereby deferring their gain. Any boot received is subject to tax under section 356 as either a dividend or capital gain.

The target has tax-free treatment under section 361, and the acquiror has tax-free treatment under section 1032 and takes a carryover basis for the target's assets under section 362(b). Under section 381, other tax attributes carry over to the acquiror.

The (A) reorganization is not available for cross-border acquisitions because both the target and the acquiror must be domestic corporations.[8] However, a merger may qualify as a (C) reorganization[9] if all the conditions of section 368(a)(1)(C) are satisfied.[10]

b. Forward Subsidiary Merger Under Section 368(a)(2)(D)

The section 368(a)(2)(D) reorganization is a merger of a target into a subsidiary (Acquiring Subsidiary) of the acquiring corporation (Acquiring Parent). Acquiring Subsidiary must acquire substantially all of the target's assets and for private letter ruling purposes, to satisfy the continuity of interest requirement, at least 50% of the consideration paid must be stock of Acquiring Parent. This transaction may be diagramed as follows:

7. As a result of an amendment to § 354 by the Taxpayer Relief Act of 1997, the target's shareholders will not receive tax-free treatment on the receipt of the acquiror's fixed rate preferred stock with a term of 20 years or less. This applies for all forms of reorganization transactions. *See* 26 U.S.C. § 354 (1997).

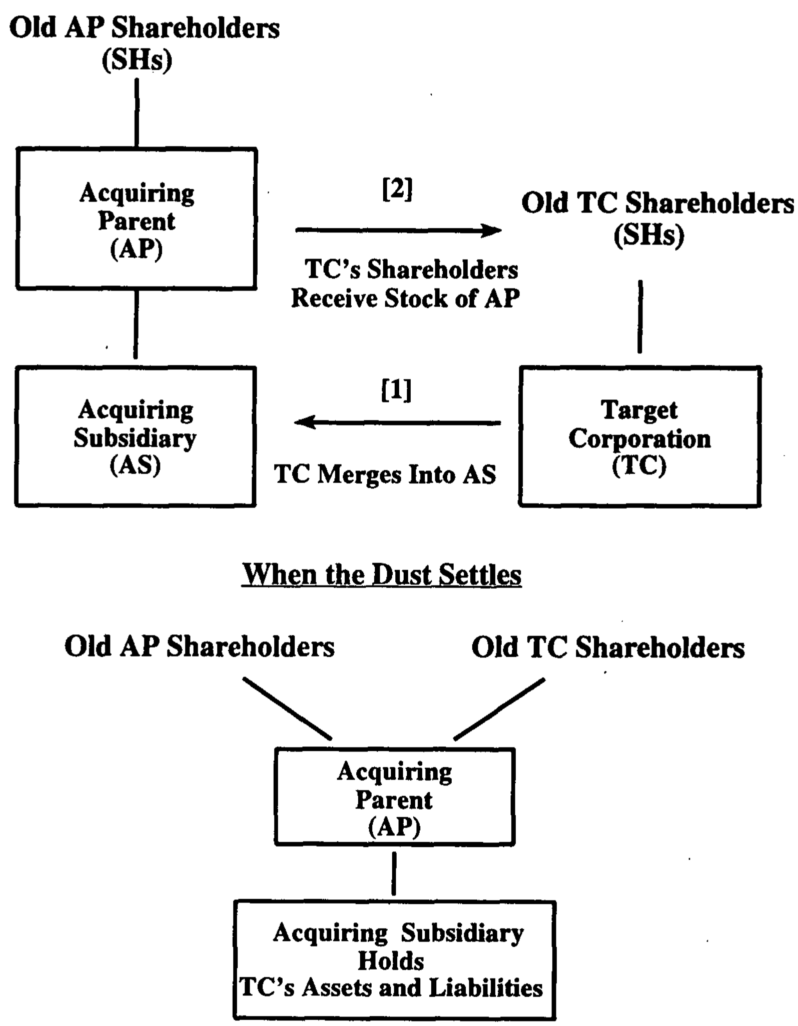
8. *See* Treas. Reg. § 1.368-2(b)(1) (1985). This provision provides that, to qualify as an (A), the merger must be "effected pursuant to the corporation laws of the United States or a State or Territory or the District of Columbia." *Id.*

9. *See infra* Part II.A.2.c.

10. *See, e.g.*, Rev. Rul. 67-326, 1967-2 C.B. 143.

GRAPH II-2

FORWARD SUBSIDIARY MERGER REORGANIZATION UNDER SECTION 368(a)(2)(D)



As will be seen in Part IV, a U.S. target may be acquired in a section 368(a)(2)(D) forward subsidiary reorganization by a domestic Acquiring Subsidiary that is owned by a foreign Acquiring Parent. However, a foreign target cannot be acquired in a forward subsidiary merger because both merging corporations must be domestic.

The target has tax-free treatment under section 361. The target's shareholders have tax-free treatment under section 354 on the receipt of stock of Acquiring Parent and take a substituted basis for the stock under section 358. Both Acquiring Sub and Acquiring Parent have tax-free treatment under section 1032 and the regulations thereunder, and under section 362(b), Acquiring Subsidiary takes a carryover basis for the target's assets. Also, under section 381, Acquiring Subsidiary carries over the target's other tax attributes.

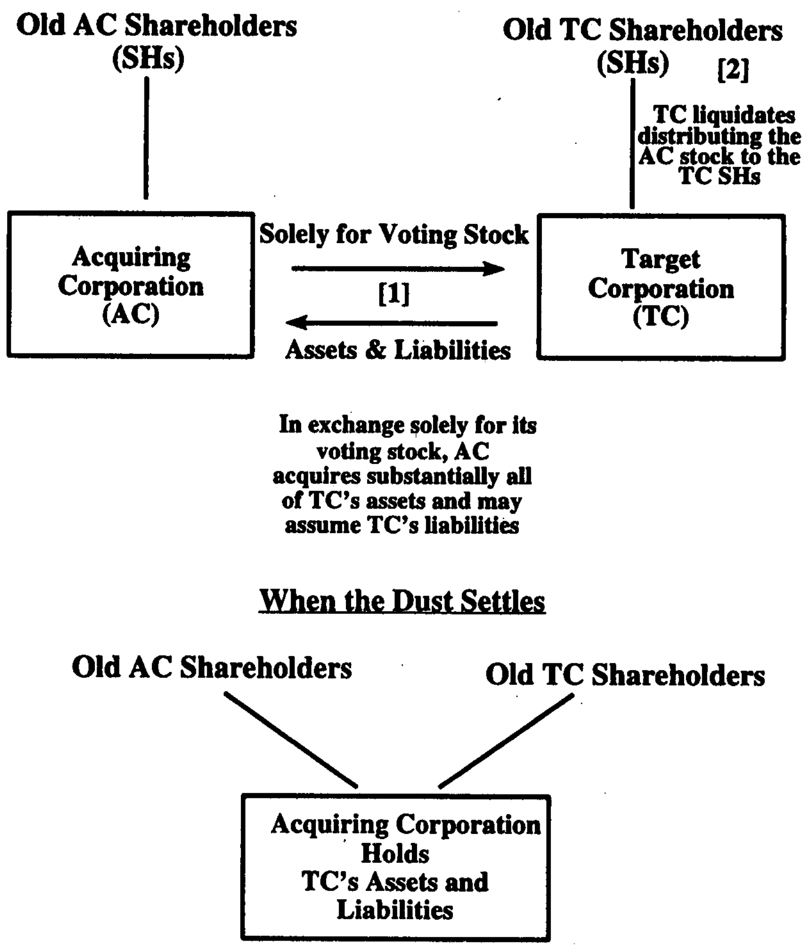
c. Direct Stock for Asset Reorganization Under Section 368(a)(1)(C)

In this "(C)" reorganization, an acquiring corporation acquires substantially all of a target's assets in exchange solely for voting stock of the acquiror. In certain limited circumstances the acquiror can pay up to 20% boot. The target must liquidate,[11] thereby distributing to the shareholders the stock received from the acquiror. The transaction can be diagramed as follows:

11. *See* I.R.C. § 368(a)(2)(H) (1994).

GRAPH II-3

DIRECT "(C)" STOCK FOR ASSET REORGANIZATION
UNDER SECTION 368(a)(1)(C)



The target has tax-free treatment under section 361. The target's shareholders have tax-free treatment under section 354 and take a substituted basis under section 358 for the acquiror's stock they receive. The acquiror has tax-free treatment under section 1032 and takes a carryover basis for the target's assets under section 362(b). Also, under section 381, the acquiror carries over the target's other tax attributes.

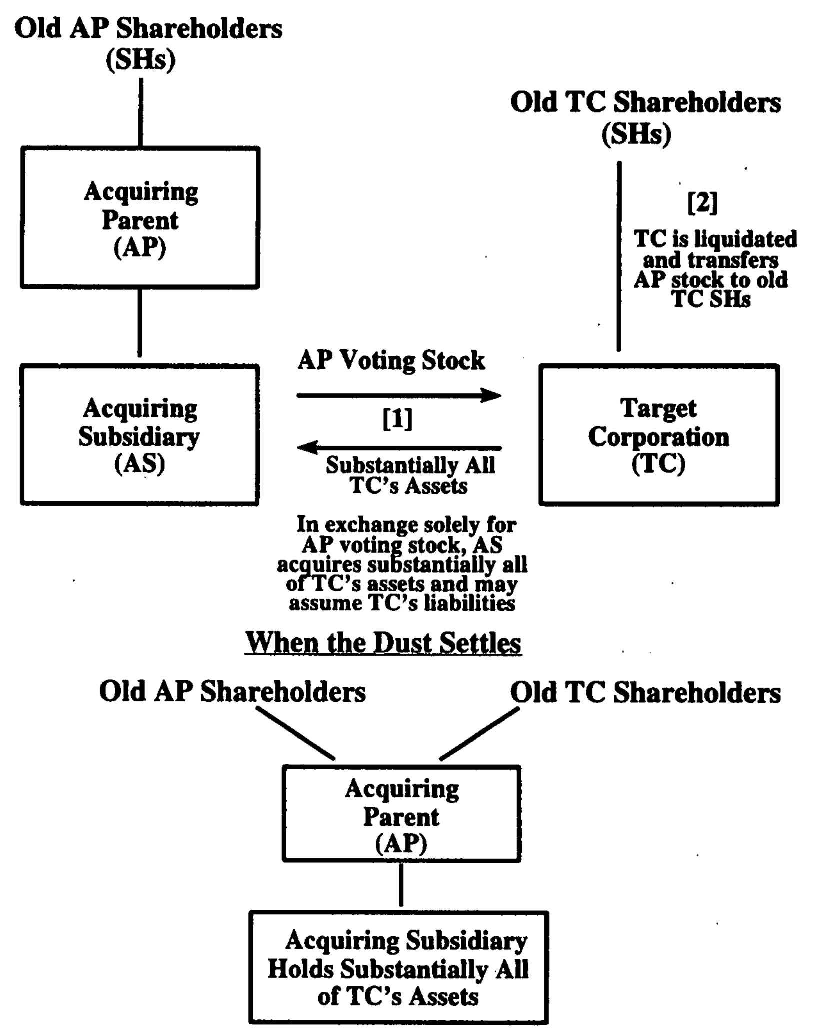
A U.S. target could be acquired by a foreign acquiror in a (C) reorganization, and also a foreign target could be acquired by a U.S. acquiror in a (C) reorganization.

d. Triangular Stock for Asset Reorganization Under Section 368(a)(1)(C)

The triangular (C) reorganization is essentially the same as the direct (C) reorganization described in Part II.B.2.c above, except the acquisition is made by an acquiring subsidiary and the consideration paid is voting stock of the acquiring parent. The transaction can be diagramed as follows:

GRAPH II-4

TRIANGULAR "(C)" STOCK FOR ASSET REORGANIZATION UNDER SECTION 368(a)(1)(C)



The tax treatment to the target and the target's shareholders is the same as in the (C) reorganization. Both Acquiring Parent and Acquiring Subsidiary have tax-free treatment. Under section 362(b), Acquiring Subsidiary takes a carryover basis for the target's assets, and under section 381, Acquiring Subsidiary carries over the target's other tax attributes.

A domestic target could be acquired in a triangular (C) by a foreign or domestic Acquiring Subsidiary of a foreign Acquiring Parent, and also a foreign target could be acquired by a domestic or foreign Acquiring Subsidiary of a domestic Acquiring Parent.

e. Summary of Asset Reorganizations

The four asset reorganizations are as follows: (1) the direct (A) merger; (2) the forward triangular merger; (3) the stock for asset (C) reorganization; and (4) the triangular stock for asset (C) reorganization. In each of these transactions the target's assets are transferred to the acquiror or an acquiring subsidiary.

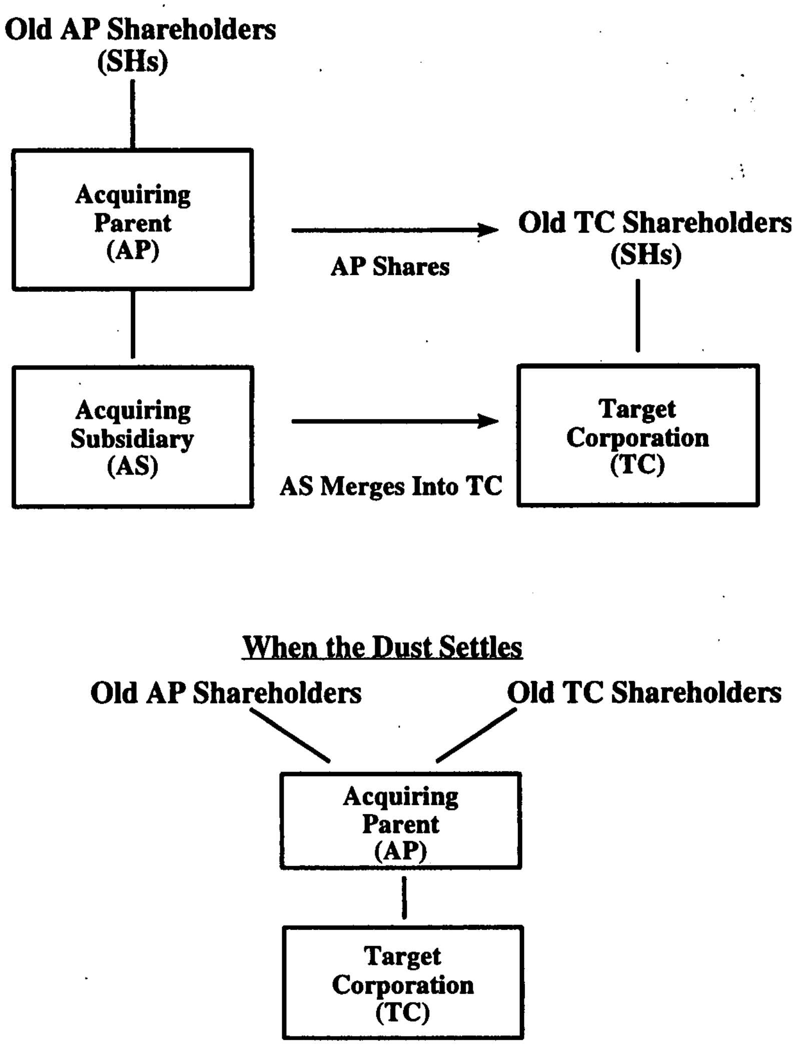
3. Stock Reorganizations

a. Reverse Subsidiary Merger Under Section 368(a)(2)(E)

In the reverse triangular merger under section 368 (a)(2)(E), Acquiring Subsidiary merges into the target, with the target's shareholders receiving voting stock of Acquiring Parent in exchange for at least 80% of the target's stock. The balance of the target's stock may be acquired for boot. When the dust settles, the target has become a wholly-owned subsidiary of Acquiring Parent. The transaction can be diagramed as follows:

GRAPH II-5

REVERSE SUBSIDIARY MERGER UNDER SECTION 368(a)(2)(E)



In this transaction, the target's shareholders receive tax-free treatment under section 354 on receipt of stock of the acquiror, and Acquiring Subsidiary, the target, and Acquiring Parent also have nonrecognition treatment. In general, Acquiring Parent increases its basis for the target's stock by an amount equal to the difference between the aggregate basis of the target's assets and the amount of the target's liabilities.[12] This is generally known as a net basis adjustment.

A domestic target could be acquired by a foreign Acquiring Parent in a reverse triangular merger as long as Acquiring Subsidiary is a domestic corporation. A foreign target could not be acquired in a reverse subsidiary merger by a domestic Acquiring Parent because the merger must be between two domestic corporations.

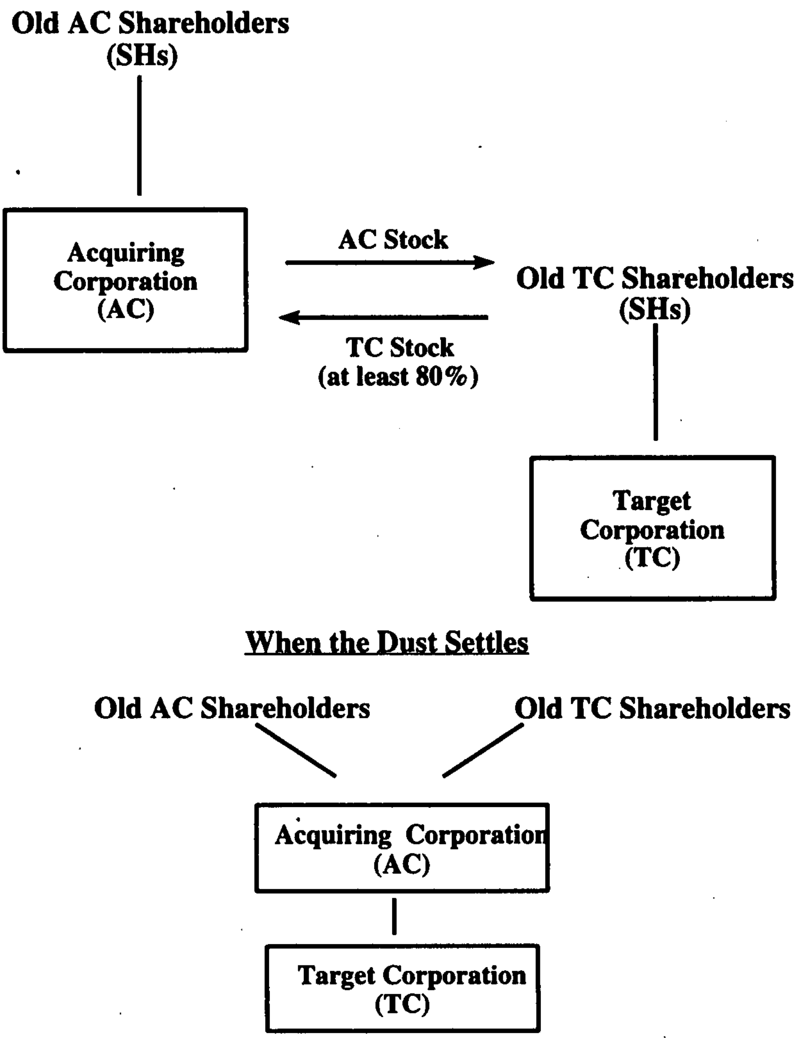
b. Stock-for-Stock Reorganization Under Section 368(a)(1)(B)

In this "(B)" reorganization, an acquiring corporation acquires, in exchange solely for its voting stock, at least 80% of the stock of a target. No boot can be used in the transaction. After the exchange, the target is a subsidiary of the acquiror. The transaction may be diagramed as follows:

12. Treas. Reg. § 1.358-6(c)(2) (1985).

GRAPH II-6

STOCK FOR STOCK "(B)" REORGANIZATION UNDER SECTION 368(a)(1)(B)



Under section 354, the target's shareholders have tax-free treatment. Under section 1032, the acquiror has tax-free treatment, and under section 362(b), the acquiror takes a carryover basis for the target's stock.

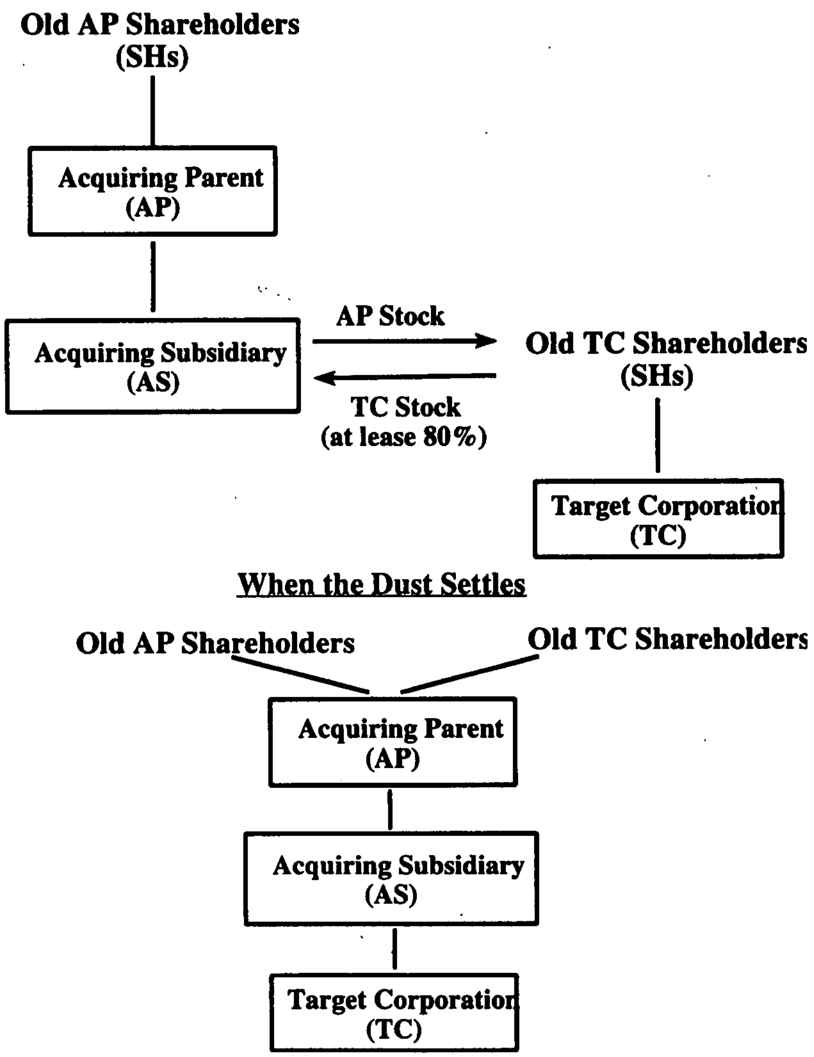
A domestic target could be acquired by a foreign acquiror in a (B) reorganization, and a foreign target could be acquired by a domestic acquiror.

c. Triangular (B) Reorganization Under Section 368(a)(1)(B)

This triangular (B) reorganization is the same as the direct (B), except Acquiring Subsidiary acquires the target's stock in exchange for stock of Acquiring Parent. This transaction can be diagramed as follows:

GRAPH II-7

TRIANGULAR (B) REORGANIZATION UNDER SECTION 368(a)(1)(B)



d. Summary of Stock Reorganizations

The three stock reorganizations are: (1) the reverse subsidiary merger under sections 368(a)(2)(E); (2) the stock-for-stock (B) reorganization under section 368(a)(1)(B); and (3) the triangular stock-for-stock (B) reorganization. In each of these transactions, the target ends up as a subsidiary of the acquiror or acquiring subsidiary, and assuming only voting stock consideration is paid, the target's shareholders have tax-free treatment under section 354.

B. Introduction to the Impact of Section 367 on Acquisitive Reorganizations

1. In General

If a foreign corporation is involved in a reorganization transaction described in section 368, the effect of section 367 must be considered.[13] Section 367 can cause gain to be recognized even if the exchange is otherwise a nonrecognition transaction under either: (1) section 354, which relates to the tax-free exchange of stock or securities of a target corporation for stock or securities of an acquiring corporation pursuant to a reorganization defined in section 368; or (2) section 361 on a tax-free transfer of the assets of a target corporation to an acquiring corporation in exchange for stock or securities of the acquiror pursuant to a reorganization defined in section 368.

2. Purpose of Section 367 and Controlled Foreign Corporation and Related Provisions

a. Section 367

The United States taxes nonresident aliens and foreign corporations only on certain "fixed or determinable" items of passive income (e.g., interest) from sources within the United States,[14] and income that is "effectively connected" with the conduct of a trade or business within

13. Section 367 also applies to: (1) section 351 exchanges in which property can be transferred tax-free to a controlled corporation in exchange for stock, *see* I.R.C. § 351; (2) section 355 distributions in which stock of a subsidiary may be spun off tax-free, *see id.* § 355; and (3) section 332 in which a controlled subsidiary can be liquidated tax-free, *see id.* § 332. These provisions are not examined here except to the extent that they are relevant to an acquisitive reorganization under section 368. *See id.* § 368.

14. *See id.* §§ 871, 881.

the United States.[15] This system of taxation, combined with certain provisions of the Code, including sections 354 and 361, which provide nonrecognition treatment to a target's shareholders and the target in acquisitive reorganizations under section 368, could allow a U.S. resident to avoid U.S. taxation on the sale of appreciated property.

By way of example, U.S. Target could transfer its assets to Foreign Acquiror in a (C) reorganization under section 368(a)(1)(C), and the assets would thereby be removed from the taxing jurisdiction of the United States without a tax on the transfer either at the U.S. Target level or the U.S. shareholder level. Section 361 would give U.S. Target nonrecognition treatment, and section 354 would give the shareholders of U.S. Target nonrecognition treatment on receipt of stock of Foreign Acquiror.

A myriad of transactions involving foreign corporations could give rise to potential avoidance of U.S. taxation. Many of these transactions involve a nonrecognition transaction under: (1) sections 354 and 361, which provide for nonrecognition treatment for corporate reorganizations under section 368; (2) section 351, which provides for nonrecognition on the transfers of property to a controlled corporation; and (3) section 332, which allows nonrecognition treatment on the liquidation of controlled subsidiaries. To deter tax-avoidance schemes involving international corporate transactions that are otherwise accorded nonrecognition treatment, Congress enacted the predecessor to section 367 in 1932. Section 367 has been substantially amended on numerous occasions since its enactment.

The General Explanation of the Tax Reform Act of 1984 gives the following general overview of the operation of the present section 367(a), which governs outbound transactions (i.e., transfers of stock or property outside the taxing jurisdiction of the United States):

> The Act restructures the rules governing outbound transfers.[16] Under the general rule,[17] a foreign corporation is not considered a corporation for purposes of determining the extent to which gain is recognized on an outbound transfer. A general exception is provided for transfers of property for use in the active conduct of a trade or business outside of the United States.[18] Transfers of stock, securities, or partnership interests may qualify for the exception.[19] The Secretary of the Treasury, however, by regulations, may provide for

15. *See id.* §§ 872, 882.
16. *See id.* § 367(a) (citation added).
17. *See id.* § 367(a)(1) (citation added).
18. *See id.* § 367(a)(3) (citation added).
19. *See id.* § 367(a)(2), (4) (citation added).

> recognition of gain in cases of transfers of property for use in the active conduct of a trade or business outside the United States.[20] It was intended that the Secretary use this regulatory authority to provide for recognition in cases of transfers involving potential tax avoidance. The Act also authorizes the Secretary to designate other transfers[21] that are excepted from the general rule of recognition.[22]

The General Explanation of the Tax Reform Act of 1976 gives the following description of section 367(b), which governs non-outbound transactions:

> [The Act] establishes separate treatment under section 367(b) for a second group of transfers which consists of exchanges described in sections 332, 351, 354, 355, 356, and 361, that are not treated as transfers out of the United States . . . . With respect to these other transactions, . . . a foreign corporation will not be treated as a corporation to the extent that the Secretary of the Treasury provides in regulations that are necessary or appropriate to prevent the avoidance of Federal income taxes. Transfers covered in these regulations are to include transfers constituting a repatriation of foreign earnings. Also included are transfers that involve solely foreign corporations and shareholders (and involve a U.S. tax liability of U.S. shareholders only to the extent of determining the amount of any deemed distribution under the subpart F rules). It is anticipated that in this latter group of exchanges, the regulations will not provide for any immediate U.S. tax liability due but will maintain the potential tax liability of the U.S. shareholder.[23]

b. Controlled Foreign Corporation and Related Provisions

In addition to section 367, the Code also contains other provisions designed to prevent the avoidance of U.S. tax through the use of foreign corporations. Because a foreign corporation is only subject to U.S. taxation on its U.S. source income, it would be possible for U.S. shareholders to avoid U.S. taxation by conducting business or investments through a foreign corporation. Also, little or no tax would be paid if the foreign corporation operated in a tax haven country.

For example, an individual, Sam, could transfer $100,000 of cash to Tax Haven, Inc., a newly formed corporation organized in a tax haven

20. *See id.* § 367(a)(3)(A) (citation added).

21. *See id.* § 367(a)(6) (citation added).

22. STAFF OF THE JOINT COMM. ON TAXATION, 98TH CONG., 2D SESS., GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, at 429 (Comm. Print 1984).

23. STAFF OF THE COMM. ON WAYS AND MEANS, 94TH CONG., 2D SESS., GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1976, at 263 (Comm. Print 1976).

country, and Tax Haven, Inc. could invest in non-U.S. investments. Under the general rules governing foreign corporations, neither Sam nor Tax Haven, Inc. would be subject to U.S. tax on the foreign income earned by Tax Haven, Inc.

The Code, however, contains several provisions to prevent this type of avoidance of U.S. tax. These include: (1) the foreign personal holding company provisions,[24] which impute the income of a foreign corporation to the U.S. shareholders if a corporation is a foreign personal holding company (i.e., a foreign corporation that is controlled, i.e., 50% ownership, by individual U.S. shareholders and that has substantial passive income); (2) the controlled foreign corporation provisions,[25] which impute certain types of tax haven income, known as subpart F income, to the 10% or more U.S. shareholders of a foreign corporation that is controlled (i.e., 50% ownership) by five or fewer 10% U.S. shareholders (a CFC); (3) the passive foreign investment company provisions, [26] which can, *inter alia*, impose a tax that includes an interest charge based on the value of the tax deferral on income realized by a U.S. person from a passive foreign investment company, which is a foreign corporation with a significant amount of passive income or assets; and (4) section 1248,[27] which treats the gain recognized by a 10% U.S. shareholder on the sale of the stock of a CFC as dividend income to the extent the gain is attributable to earnings of the CFC that have not been subject to U.S. taxation.

Each of these four provisions, the foreign personal holding company provisions, the controlled foreign corporation provisions, the passive foreign investment company provisions, and section 1248, is designed to eliminate or mitigate the benefits of deferral from U.S. taxation that otherwise are available for the foreign operations of a foreign corporation.

3. Elaboration on Structure of Section 367 as Applicable to Acquisitive Reorganizations

a. Section 367(a)(1) Gain Recognition Rule for Outbound Transfers

Section 367(a)(1) provides:

24. *See* I.R.C. §§ 551-555.
25. *See id.* §§ 951-960.
26. *See id.* §§ 1291-1297.
27. *See id.*

> If, in connection with any exchange described in section . . . 354 [relating to tax-free treatment for a shareholder of a target that exchanges target stock for stock of an acquiror pursuant to a reorganization as defined in section 368] . . . or 361 [relating to tax-free treatment for a target that exchanges its assets for stock of an acquiror pursuant to a reorganization as defined in section 368], 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.[28]

If section 367(a) applies to a transfer of property to a foreign corporation in what would otherwise be a reorganization, the foreign corporation is not treated as a corporation, and consequently, the transaction will not give rise to tax-free treatment of gain under section 354 or section 361, both of which require that the transferor receive stock in a corporation. This is referred to here as the gain recognition rule.[29]

b. Section 367(a)(6) Exceptions to Gain Recognition Rule for Outbound Transactions Described in Regulations

Notwithstanding the broad sweep of the gain recognition rule of section 367(a)(1), under section 367(a)(6), the Treasury may promulgate regulations making section 367(a)(1) inapplicable to certain transfers of property to foreign corporations.

c. Section 367(a)(2) Exception to Gain Recognition Rule for Transfer of Stock or Security of Foreign Corporations

Section 367(a)(2) provides that the gain recognition rule of section 367(a)(1) does not apply, except as provided in regulations, to "the transfer of stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization."[30] This provision is not examined further here.

28. *Id.* § 367(a)(1).

29. Section 367 provides recognition treatment for only gains, not losses. *See id.* § 367.

30. *Id.* § 367(a)(2).

d. Section 367(a)(3) Exception to Gain Recognition Rule for Certain Outbound Incorporations

Section 367(a)(3) provides an exception to the gain recognition rule of section 367(a)(1) for certain transfers of property to a foreign corporation to be used in the active conduct by the corporation of a trade or business. This exception principally applies to incorporation transactions under section 351, in which property is transferred to a controlled foreign corporation in exchange for stock.

e. Section 367(a)(5) Exception to the Section 367(a)(2) and (3) Exceptions

Section 367(a)(5) provides that neither section 367(a)(2), relating to the exception for the transfer of stock or securities of a foreign corporation, nor section 367(a)(3), relating to the transfer of an active trade or business, shall "apply in the case of an exchange described in subsection (a) or (b) of section 361."[31] Section 361 would apply, for example, to the transfer by U.S. Target of its assets to Foreign Acquiror in exchange for stock of Foreign Acquiror pursuant to a (C) reorganization under section 368(a)(1)(C). Thus, section 367(a)(5) provides for gain recognition for this type of transaction. However, section 367(a)(5) also provides an exception to this gain recognition exception "if the transferor corporation [i.e., U.S. Target] is controlled (within the meaning of section 368(c) [i.e., at least 80%]) by 5 or fewer domestic corporations."[32] Because this Article deals only with acquisitive reorganizations involving publicly-held targets and acquirors, this rule is not addressed further.

f. Section 367(b) Rules for Non-outbound Transfers

Section 367(b) governs exchanges described in sections 354 and 361 in connection with which there is a non-outbound transfer of property. In these non-outbound cases, which involve both the acquisition of Foreign Target by U.S. Acquiror, and foreign-to-foreign acquisitions, section 367(b)(1) provides that "a foreign corporation shall be considered to be a corporation except to the extent provided in regulations . . . which are necessary or appropriate to prevent the avoidance of federal income taxes."[33] Elaborating on the scope of these regulations, section 367(b)(2) provides:

31. *Id.* § 367(a)(5).
32. *Id.*
33. *Id.* § 367(b)(1).

> 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—
>
> (A) the circumstances under which -
>
> (i) gain shall be recognized currently, or amounts included in gross income currently as a dividend, or both, or
>
> (ii) gain or other amounts may be deferred for inclusion in the gross income of a shareholder (or his successor in interest) at a later date, and
>
> (B) the extent to which adjustments shall be made to earnings and profits, basis of stock or securities, and basis of assets.[34]

III. REORGANIZATION TRANSACTIONS GOVERNED BY SECTION 367

A. Applicability of Section 367 to Outbound, Inbound, and Foreign-to-Foreign Reorganizations[35]

A reorganization governed by section 367 can take the form of an outbound transfer, an inbound transfer, or a completely foreign-to-foreign transfer. Examples of outbound reorganization transfers are the transfer by a U.S. person of stock of U.S. Target to Foreign Acquiror in a stock-for-stock reorganization under section 368(a)(1)(B), or the acquisition by Foreign Acquiror of the assets of U.S. Target in exchange solely for voting stock of Foreign Acquiror in a transaction that qualifies as a reorganization under section 368(a)(1)(C).

Inbound reorganization transfers include, for example, the acquisition by U.S. Acquiror of the assets of Foreign Target in a transaction that qualifies as a section 368(a)(1)(C) reorganization. Completely foreign reorganization transactions include, for example, the acquisition by Foreign Acquiror of the assets of Foreign Target in a section 368(a)(1)(C) reorganization. Outbound transfers are governed by section 367(a), and inbound and foreign-to-foreign transactions are governed by section 367(b).

34. *Id.* § 367(b)(2).

35. *See generally* Kingson, *New § 367 Theory*, *supra* note 2.

B. Direct Outbound Transfers of Stock or Assets

The principal types of acquisitive reorganization transactions involving direct outbound transfers that could be subject to section 367(a) are as follows: (1) The acquisition by Foreign Acquiror (or its foreign subsidiary) of substantially all of the assets of U.S. Target in exchange for voting stock of Foreign Acquiror in a transaction that qualifies as a reorganization under section 368(a)(1)(C) (i.e., an outbound (C) reorganization). This type of transaction is examined in Part IV. (2) The acquisition by Foreign Acquiror (or its foreign subsidiary) of the stock of U.S. Target in exchange solely for voting stock of Foreign Acquiror in a transaction that qualifies as a stock-for-stock reorganization under section 368(a)(1)(B) (i.e., an outbound (B) reorganization). This type of transaction is explored in Part V.

C. Indirect Outbound Transfers of Stock of a Domestic Target

In addition to the above forms of outbound acquisitive reorganizations, the regulations under section 367(a) treat certain acquisitive triangular reorganizations involving domestic subsidiaries as indirect outbound transfers.[36] In these transactions, the stock or assets of U.S. Target are acquired in a triangular reorganization in which U.S. Acquiring Subsidiary is a domestic subsidiary of Foreign Acquiring Parent. Thus, U.S. Target enters into a triangular reorganization with a U.S. Acquiring Subsidiary of Foreign Acquiror, and the shareholders of U.S. Target end up with stock of Foreign Acquiror. This type of transaction is addressed in Part VI.

D. Inbound Transfers of Stock or Assets

The principal types of acquisitive inbound reorganizations that could be subject to section 367(b) are as follows: (1) The acquisition by U.S. Acquiror (or its subsidiary) of the assets of Foreign Target in a stock-for-asset reorganization under section 368(a)(1)(C) (i.e., an inbound (C) reorganization). This type of transaction is examined in Part VIII. (2) The acquisition by U.S. Acquiror (or its subsidiary) of the stock of Foreign Target in a transaction that qualifies as a stock-for-stock reorganization under section 368(a)(1)(B) (i.e., an inbound (B) reorganization). This type of transaction is examined in Part IX.

36. *See* Temp. Treas. Reg. § 1.367(a)-3T(g)(8) (1995).

E. Foreign-to-Foreign Transfers of Stock or Assets

The principal types of acquisitive foreign-to-foreign reorganizations that could be subject to section 367(b) are as follows: (1) The acquisition by Foreign Acquiror (or its foreign subsidiary) of the stock of Foreign Target in an exchange that qualifies as a stock-for-stock reorganization under section 368(a)(1)(B) (i.e., a foreign (B) reorganization). This type of transaction is examined in Part X. (2) The acquisition by Foreign Acquiror (or its foreign subsidiary) of the assets of Foreign Target in a stock for asset reorganization under section 368(a)(1)(C) (i.e., a foreign (C) reorganization). This type of transaction is examined in Part X.

F. Summary of Outbound, Inbound, and Foreign-to-Foreign Acquisitive Reorganizations Governed by Section 367

For purposes of analyzing the above types of reorganizations under section 367, the transactions can be separated into the following categories:

(1) *Outbound asset reorganizations.* These transactions encompass direct and triangular outbound (C) reorganizations in which U.S. Target transfers its assets to Foreign Acquiror or Foreign Acquiror subsidiary in exchange for stock of Foreign Acquiror. These transactions are subject to the rules of section 367(a).[37]

(2) *Outbound stock reorganizations.* These transactions involve direct and triangular outbound stock-for-stock (B) reorganizations, in which U.S. persons transfer stock of U.S. Target to Foreign Acquiror or Foreign Acquiror subsidiary in exchange solely for voting stock of the Foreign Acquiror. These transactions are subject to the rules of section 367(a).[38]

(3) *Indirect outbound triangular reorganizations.* These transactions involve the acquisition of U.S. Target by the domestic subsidiary of Foreign Acquiror in a triangular reorganization. These transactions are subject to the rules of section 367(a).[39]

(4) *Inbound asset reorganizations.* These transactions encompass direct and triangular inbound (C) reorganizations, in which the assets of Foreign Target are acquired by U.S. Acquiror solely in exchange for U.S. Acquiror's voting stock. These transactions are subject to the rules of section 367(b).[40]

37. *See infra* Part IV.
38. *See infra* Part V.
39. *See infra* Part VI.
40. *See infra* Part VIII.

(5) *Inbound stock reorganizations.* These transactions involve direct and triangular inbound (B) reorganizations, in which the stock of Foreign Target is acquired by U.S. Acquiror. These transactions are subject to the rules of section 367(b).[41]

(6) *Foreign-to-foreign asset and stock reorganizations.* These transactions encompass (1) direct and triangular foreign (B) reorganizations, and (2) direct and triangular foreign (C) reorganizations. These transactions are subject to the rules of section 367(b).[42]

The direct merger reorganization under section 368(a)(1)(A) is generally not of any significance for purposes of section 367 because a reorganization under section 368(a)(1)(A) requires a merger of two domestic corporations.[43] However, a merger between a domestic and a foreign corporation or between two foreign corporations may be treated as a (C) reorganization if all the conditions under section 368(a)(1)(C) are satisfied.[44]

IV. DIRECT OUTBOUND TRANSFER OF DOMESTIC TARGET'S ASSETS TO FOREIGN ACQUIROR IN AN OUTBOUND (C) REORGANIZATION

A. General Principles

The transactions discussed in this Part involve the transfer by U.S. Target of its assets to Foreign Acquiror in an outbound stock for asset (C) reorganization under section 368(a)(1)(C). Subject to the rules of section 367, U.S. Target has nonrecognition treatment under section 361 upon the receipt and distribution of the stock of Foreign Acquiror. The shareholders of U.S. Target have nonrecognition under section 354 on the exchange of their stock in the Target for stock of Foreign Acquiror. These transactions encompass both direct and triangular outbound (C) reorganizations.

Prior to 1988, these outbound asset reorganizations qualified for the active business exception of section 367(a)(3) and the stock and security exception of section 367(a)(2) to the gain recognition rule of section 367(a)(1). Thus, the rules that applied to outbound section 351 transactions also applied to outbound asset reorganizations. As a result of the repeal of the "general utilities" doctrine by the Tax Reform Act

41. *See infra* Part IX.
42. *See infra* Part X.
43. *See* Treas. Reg. § 1.368-2(b)(1) (1985).
44. *See, e.g.*, Rev. Rul. 67-326, 1967-2 C.B. 143.

of 1986, these results were changed by the Technical and Miscellaneous Revenue Act of 1988 (TAMRA 1988),[45] which added section 368(a)(5). This section provides that the exception in section 367(a)(2) for certain transfers of stock or securities of a foreign corporation and the exception in section 367(a)(3) for transfers of property used in the active conduct of a trade or business do not apply to a transfer of assets described in section 361, which applies to an outbound (C) reorganization. Thus, outbound (C) reorganizations no longer qualify for these exceptions. However, subject to such basis adjustments as are provided in the regulations, the exceptions in section 367(a)(2) and (a)(3) are to apply if the transferee foreign corporation is controlled by five or fewer domestic corporations.[46] This provision is not examined here because it will not apply when U.S. Target is publicly held.

The 1988 House Report says that new section 367(a)(5) "clarifies that a transfer of property to a foreign corporation in a transaction that would otherwise qualify as a tax-free reorganization is treated in the same manner as a liquidating transfer [under section 367(e)(2)] of such property to an 80 percent foreign corporate distributee."[47] Section 367(e)(2) provides that, except as provided in regulations, a U.S. subsidiary has full recognition of gain on the distribution of its property to a controlling foreign parent corporation. The regulations under section 367(e)(2) provide an exception to the general gain recognition rule of that section if the property distributed is used in a U. S. trade or business, and (1) the distributee foreign parent corporation is not a controlled foreign corporation, (2) the distributee foreign parent corporation uses the property in the conduct of a U.S. trade or business for the ten-year period beginning on the date of the distribution, and (3) both the U.S. subsidiary and the foreign parent corporation file a statement requiring recognition of the gain on the distribution by the U.S. subsidiary as of the date of the initial distribution if the property is not used in a U.S. trade or business for the ten-year period.[48] The

45. *See* 26 U.S.C. § 367(a)(5); Technical and Miscellaneous Revenue Act of 1988, Pub. L. 100-647, § 1006(e)(13)(A), 102 Stat. 3342 (1988).

46. *See* I.R.C. § 367(a)(5) (1994). This provision contemplates that the controlling corporate shareholder or shareholders will take as the basis for the stock of Foreign Acquiror received, the basis that U.S. Target had for its assets. *See id.* Thus, the gain inherent in U.S. Target's assets is locked into the stock of Foreign Acquiror held by the controlling shareholder or shareholders. *See id.* In the absence of this rule, the basis to the controlling shareholder or shareholders for the stock of Foreign Acquiror would be a substituted basis under section 358 (i.e., the basis of U.S. Target stock surrendered), and, thus, the built-in-gain inherent in the assets of U.S. Target may or may not be locked into the stock of U.S. Acquiror held by the controlling shareholder or shareholders. *See id.*; *id.* § 358. *See generally* DOLAN, *supra* note 2, at 10-25 to -26.

47. *See* H.R. Rep. No. 100-795, at 60 (1988).

48. *See* Treas. Reg. § 1.367(e)-2T(b)(2) (1985).

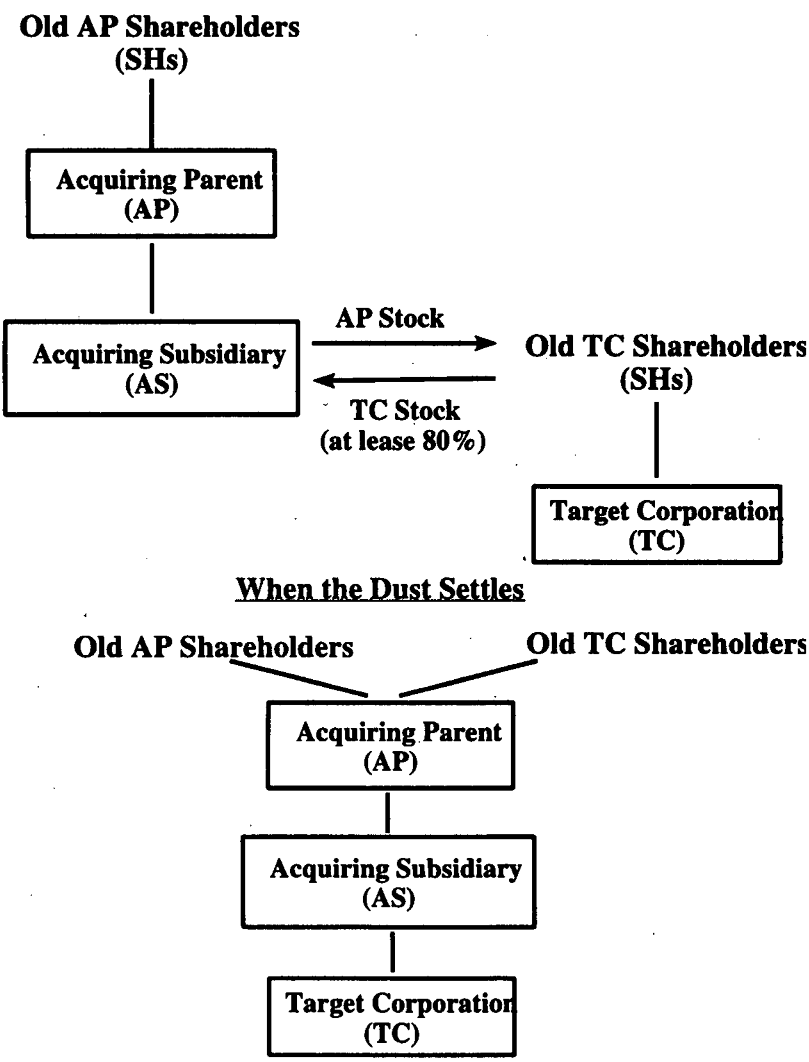
Treasury has not promulgated regulations under section 367(a)(5), and therefore, there is no similar exception for outbound (C) reorganizations.

To summarize, in the outbound (C), U.S. Target would be subject to full recognition of gain on the transfer of its assets to Foreign Acquiror, because section 367(a)(5) would override the nonrecognition treatment that would otherwise have been provided under section 361. Although section 367(a)(5) gives U.S. Target recognition in an outbound (C), the shareholders of U.S. Target have nonrecognition under section 354. This is because section 367(a)(5) only overrides section 361, not section 354.

A prototype outbound direct (C) reorganization is diagramed below, followed by a summary of the tax results:

GRAPH IV-1

OUTBOUND (C) REORGANIZATION UNDER SECTION 368(a)(1)(C)



B. Summary of Tax Results

(1) Because of section 367(a)(5), section 361 does not apply to U.S. Target, and therefore, U.S. Target has full gain recognition. If, however, Foreign Acquiror uses U.S. Target's assets in a U.S. trade or business for a period of ten years, U.S. Target should have nonrecognition treatment in the same manner that applies under the regulations under section 367(e)(2) for liquidation of a U.S. subsidiary into a foreign parent corporation.

(2) The shareholders of U.S. Target receive tax-free treatment under section 354 upon the exchange of their stock in U.S. Target for voting stock in Foreign Acquiror.

(3) The results to U.S. Target and its shareholders would be the same in a triangular outbound (C) reorganization.

C. Critique of General Principles

The gain recognition rule of section 367(a)(5) makes sense for outbound (C) reorganizations in which the assets of U.S. Target are actually being transferred outside of the taxing jurisdiction of the United States. However, if Foreign Acquiror continues to operate U.S. Target's assets within the United States, then it seems sensible to provide for an exception to the gain recognition rule along the line of the exception that applies to outbound subsidiary liquidations under the regulations under section 367(e)(2).[49] An amendment to section 367(a)(5) may be necessary to authorize such a regulatory exception; however, it is possible that the regulatory authority in section 367(a)(6) may be broad enough to permit this change by regulations.

V. DIRECT OUTBOUND TRANSFER OF STOCK OF DOMESTIC TARGET TO FOREIGN ACQUIROR IN A (B) REORGANIZATION

A. General Principles

Treasury Regulation section 1.367(a)-3 deals with, *inter alia*, the treatment under section 367 of the transfer by a U.S. person of the stock

49. *See supra* Part IV.A.

of U.S. Target to Foreign Acquiror in an outbound (B) reorganization.[50] Treasury Regulation section 1.367(a)-3(c)(1) provides that a transfer of stock of U.S. Target by a U.S. person to Foreign Acquiror in an outbound (B) reorganization under section 368(a)(1)(B) is not subject to the gain recognition rule of section 367(a)(1) if the following five conditions are satisfied.

First, the stock of Foreign Acquiror received by the U.S. shareholders of U.S. Target does not exceed, in the aggregate, 50% of the total voting power or the total value of the stock of Foreign Acquiror.[51] Thus, the amount of stock received by the shareholders of U.S. Target cannot exceed this 50%-ownership threshold.[52] The rationale for this limitation is set out in Notice 94-46:[53]

> The Internal Revenue Service and Treasury Department are concerned that widely-held U.S. companies with foreign subsidiaries recently have undertaken certain restructurings for tax-motivated purposes. These restructurings typically involve a transfer of the stock of the domestic parent corporation to an existing foreign subsidiary or a newly-formed foreign corporation in exchange for shares of the foreign corporation in a transaction intended to qualify for nonrecognition treatment under the Code. Following the transaction, the former shareholders of the domestic corporation own stock of a Foreign corporation that typically is not a controlled foreign corporation ("CFC") within the meaning of section 957 of the Code.
>
> The Internal Revenue Service and Treasury Department are concerned that these transactions, or related transactions undertaken pursuant to the restructurings, present opportunities for avoidance of U.S. tax. The regulations under section 367(a), therefore, will be modified to provide that the transfer of stock or securities of a domestic corporation by a U.S. person to a foreign corporation is taxable under section 367(a)(1) if all U.S. transferors own in the aggregate 50 percent or more of either the total voting power or the total value of the stock of the transferee corporation immediately after the exchange.[54]

---

50. Treas. Reg. § 1.367(a)-3 also deals with transfers of stock to a foreign corporation under section 351 (relating to incorporation transactions) and section 361 (relating to a transfer of a target's assets in a reorganization). The applicability of the regulations in these contexts is not addressed here.

51. *See* Treas. Reg. § 1.367(a)-3(c)(1)(i) (1996).

52. *See id.*

53. T.D. 8533 1994-1 C.B. 356. This notice was adopted in response to the Helen of Troy transaction in which the stock of a publicly-held domestic corporation was transferred to a newly-formed foreign corporation, which provided tax benefits. *See* DOLAN, *supra* note 2, at 59-3.

54. *Id.*

Second, not more than 50% of the total voting power and total value of the stock of Foreign Acquiror is owned, in the aggregate, immediately after the transfer by U.S. persons who are either officers or directors of U.S. Target, or 5% or more shareholders of U.S. Target.[55] Thus, the officers, directors and 5% or more shareholders of U.S. Target cannot constitute a "control group" with respect to Foreign Acquiror immediately after the (B) reorganization.[56] In applying this rule all stock of Foreign Acquiror held by U.S. insiders is counted, not just the stock of Foreign Acquiror received in the transaction.

Third, with respect to each individual shareholder of U.S. Target, either such shareholder does not become a 5% or more shareholder of Foreign Acquiror, or such shareholder becomes a 5% or more shareholder and enters into a five-year gain recognition agreement (GRA) with respect to the stock of U.S. Target.[57] Both the stock of Foreign Acquiror received in the transaction and such stock held before the transaction are counted for purposes of determining whether the 5% threshold is satisfied.[58] A GRA is a binding agreement pursuant to which a former shareholder of U.S. Target who becomes a 5% or more shareholder of Foreign Acquiror agrees to recognize gain upon Foreign Acquiror's later disposition of the stock of U.S. Target.[59] Under this agreement, if prior to the close of the fifth taxable year following the taxable year of the (B) reorganization, Foreign Acquiror disposes of the stock of U.S. Target (or U.S. Target disposes of a substantial portion of its assets), then the transferor shareholder must file an amended return for the year of the (B) reorganization and recognize thereon the gain realized, but not recognized, in the reorganization.[60]

The purpose of this provision is to force certain substantial shareholders of U.S. Target who, as a result of the (B) reorganization, become substantial shareholders of Foreign Acquiror to recognize the gain they realized in the reorganization but did not recognize because of section 354, provided Foreign Acquiror disposes of the stock of U.S. Target within five years of the reorganization. The preamble to the regulations explains that "[w]ithout such GRA, the transfer by the 5-percent transferee shareholder will not qualify for nonrecognition treatment;

55. *See* Temp. Treas. Reg. § 1.367(a)-3T(c)(1)(ii) (1996).
56. *See id.*
57. *See id.* § 1.367(a)-3T(c)(1)(iii).
58. *See id.* § 1.367(a)-3T(c)(5)(ii).
59. *See id.* § 1.367(a)-3T(g).
60. *See id.* § 1.367-3T(g)(3).

however, transfers by other U.S. transferors not subject to the GRA requirement may qualify if all other requirements are met."[61]

Fourth, the trade or business test must be satisfied.[62] Under this three-part test, (1) Foreign Acquiror must have been engaged, directly or indirectly, in an active trade or business outside the U.S. for the entire 36-month period immediately before the reorganization;[63] (2) the shareholders of neither U.S. Target nor Foreign Acquiror must have an intention to "substantially dispose of or discontinue such trade or business";[64] and (3) at the time of the (B) reorganization, the fair market value of Foreign Acquiror must be at least equal to the fair market value of U.S. Target.[65]

Fifth, U.S. Target must comply with certain reporting requirements designed to police compliance with the above four conditions.[66]

If the following requirements are met, the shareholders of U.S. Target will receive nonrecognition treatment under section 354 upon the exchange of their stock in U.S. Target for stock in Foreign Acquiror: (1) the shareholders of U.S. Target end up owning, in the aggregate, less than 50% of the stock of Foreign Acquiror; (2) none of the shareholders of U.S. Target end up being 5% or more shareholders of Foreign Acquiror; (3) the active trade or business test is satisfied; and (4) U.S. Target complies with the reporting requirements. This type of tax-free (B) reorganization can be diagramed as follows:

61. Certain Transfers of Domestic Stock or Securities by U.S. Persons to Foreign Corporations, 61 Fed. Reg. 68633, 68634 (1996) (to be codified at 26 C.F.R. pts. 1, 602).

62. *See* Temp. Treas. Reg. § 1.367(a)-3T(c)(1)(iv).

63. *See id.* § 1.367(a)-3T(c)(3)(i)(A).

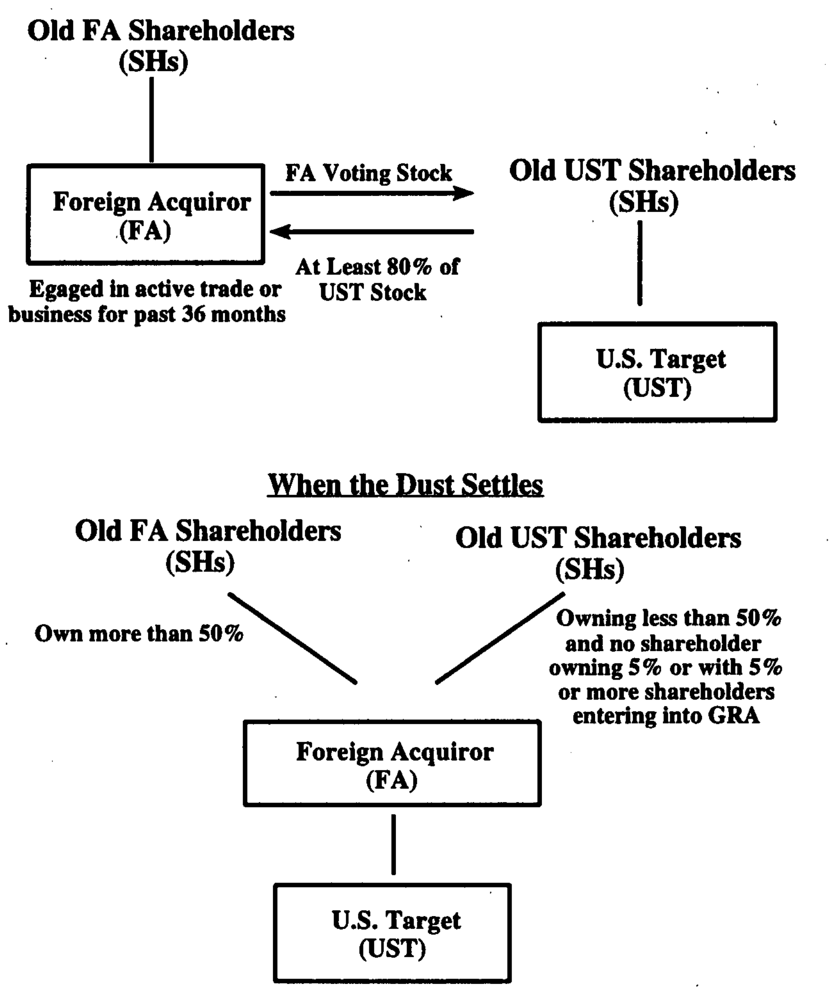
64. *See id.* § 1.367(a)-3T(c)3(i)(B).

65. *See id.* §§ 1.367(a)-3(c)(3)(i)(c), 1.367(a)-3(c)(3)(iii).

66. *See id.* §§ 1.367(a)-3T(c)(1), 1.367(a)-3(c)(6).

GRAPH V-1

TAX-FREE OUTBOUND (B) REORGANIZATION UNDER SECTION 368(a)(1)(B)



B. *Summary of Tax Results*

(1) The transaction constitutes a (B) reorganization under section 368(a)(1)(B).

(2) Because all of the conditions of Treasury Regulation section 1.367(a)-3(c) are satisfied, the gain recognition rule of section 367(a)(1) does not apply to the transfer, and consequently, under section 354, the shareholders of U.S. Target receive nonrecognition treatment on the exchange of their stock of U.S. Target for stock of Foreign Acquiror.

(3) Under section 358, the shareholders of U.S. Target take a substituted basis for the shares of Foreign Acquiror received.

(4) Because none of the shareholders of U.S. Target becomes a 5% or more shareholder of Foreign Acquiror, a GRA is not required, and therefore, there are no limitations on the period during which Foreign Acquiror must hold the shares of U.S. Target or U.S. Target must conduct its business.

(5) If the shareholders of U.S. Target end up owning, in the aggregate, more than 50% of the stock of Foreign Acquiror, the transaction is completely taxable to such shareholders.

(6) The same results would follow for the shareholders of U.S. Target if the stock of U.S. Target were acquired by a subsidiary of Foreign Acquiror in a triangular (B) reorganization.

C. *Critique of General Principles*

The above rules seem basically sensible. However, the conditions of a gain recognition agreement for more than 5% shareholders appear overly restrictive. What purpose is being served by this requirement? Also, consideration should be given to basing the 50% test on the value of the stock of Foreign Acquiror at the time the deal is struck, rather than the time the deal closes.

VI. INDIRECT OUTBOUND TRANSACTIONS: REORGANIZATIONS INVOLVING THE ACQUISITION OF A DOMESTIC TARGET BY A FOREIGN ACQUIROR IN A TRIANGULAR REORGANIZATION INVOLVING A DOMESTIC SUBSIDIARY OF THE FOREIGN ACQUIROR

A. *General Principles*

1. Introduction

Certain triangular reorganizations in which the stock or assets of a U.S. Target are acquired by a domestic subsidiary (U.S. Sub) of Foreign Acquiror are treated as indirect outbound transfers of property by U.S. persons to a foreign corporation and are, therefore, subject to section 367(a).[67] Each of these indirect outbound transactions is a reorganization that involves the issuance of stock of Foreign Acquiror to U.S. persons.[68] The following four triangular reorganizations are treated as indirect outbound transactions under this regulation.

2. Indirect Outbound Forward Subsidiary Merger

An indirect outbound transaction includes a merger of U.S. Target into U.S. Sub of Foreign Acquiror in a transaction that qualifies as a forward subsidiary merger under section 368(a)(2)(D).[69] The shareholders of U.S. Target receive stock of Foreign Acquiror. In this transaction, the merger takes place between two domestic corporations, although the stock of U.S. Sub is wholly owned by Foreign Acquiror. The transaction may be diagramed as follows:

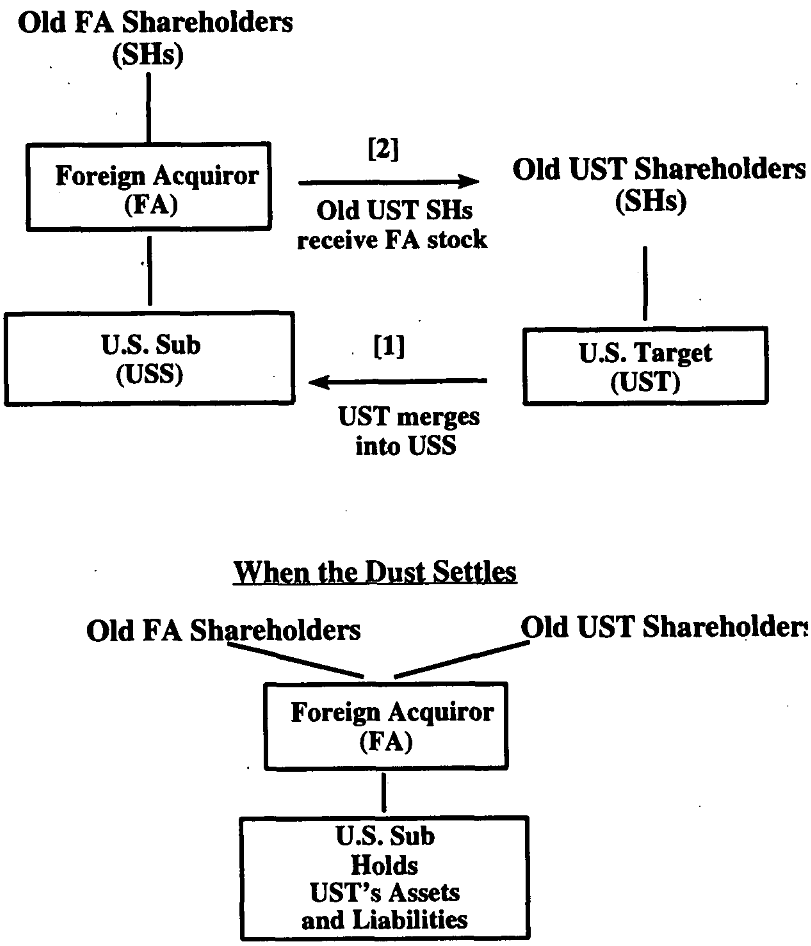
67. *See id.* § 1.367(a)-1T(c).

68. *See id.* § 1.367(a)-1T(c)(2).

69. *See id.* § 1.367(a)-1T(c)(2)(i)(B). *See also* Rev. Rul. 74-297, 1974-1 C.B. 84 (holding that this type of transaction qualifies as a reorganization under section 368(a)(2)(D) even though the parent of the acquiring subsidiary is a foreign corporation). For a general discussion of forward subsidiary mergers under section 368(a)(2)(D), see *supra* Part II.A.2.b.

GRAPH VI-1

INDIRECT OUTBOUND FORWARD SUBSIDIARY MERGER UNDER SECTION 368(a)(2)(D)



This is the type of transaction pursuant to which British Telecommunications, a publicly-held U.S. corporation, was going to acquire MCI Communications Corporation, a Delaware corporation. In the transaction, MCI was going to merge into a wholly-owned Delaware subsidiary of British Telecommunications, with the shareholders of MCI receiving both stock in British Telecommunications represented by American Depository Receipts (ADRs), which were to be traded on the New York Stock Exchange (NYSE), and cash.[70] Although the transaction was aborted, the forward subsidiary merger under section 368(a)(2)(D) is a common structure for effectuating such an acquisition. Another, and possibly even more common method, is the reverse subsidiary merger under section 368(a)(2)(E) as discussed in the next Part of this Article. One major difference between the forward subsidiary merger under section 368(a)(2)(D) and the reverse subsidiary merger under section 368(a)(2)(E) is that only 20% boot can be used in the reverse subsidiary, whereas up to 50% (and possibly more) boot can be used in a forward subsidiary merger.

In the MCI acquisition, the cash to be paid by British Telecommunications could have exceeded 20% of the consideration, depending upon the trading price of British Telecommunications on the date of the merger. This may have been the reason the transaction was structured as a forward, rather than as a reverse, subsidiary merger.

3. Indirect Outbound Reverse Subsidiary Merger

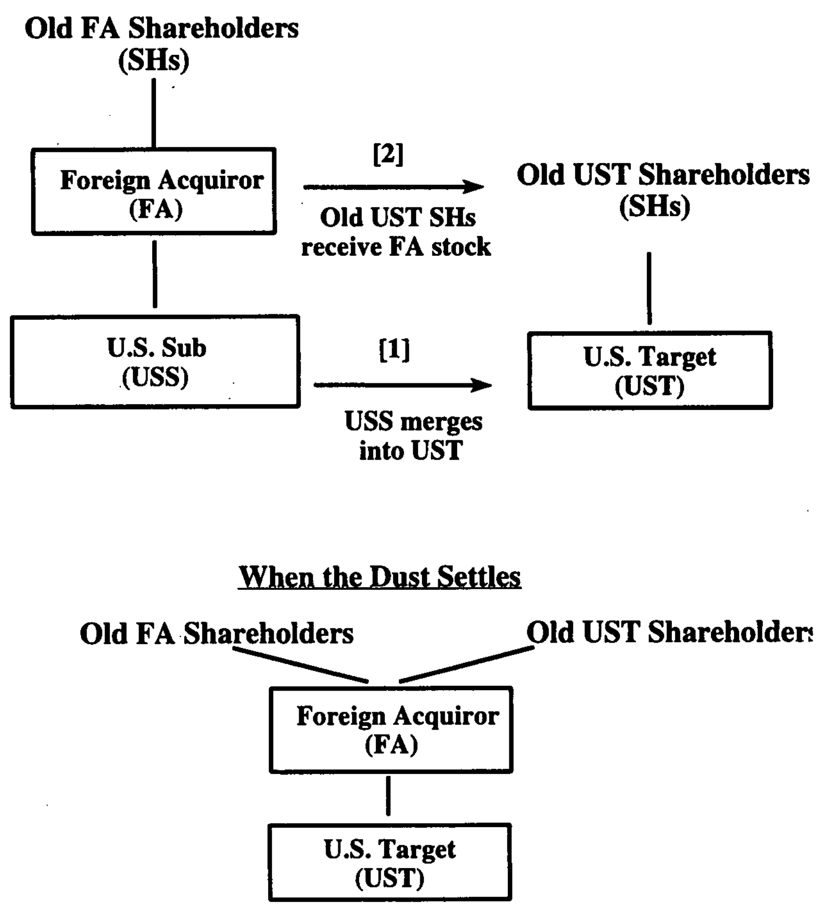
An indirect outbound transfer includes the merger of a U.S. sub of Foreign Acquiror into U.S. Target in a reverse subsidiary merger under section 368(a)(2)(E).[71] The shareholders of U.S. Target receive stock of Foreign Acquiror. The transaction may be diagramed as follows:

70. *See* MCI Communications Corp. Proxy Statement/Prospectus, Certain Tax Consequences (Mar. 3, 1997).

71. *See* Temp. Treas. Reg. § 1.367(a)-1T(c)(2)(i)(C). For a general discussion of reverse subsidiary mergers under section 368(a)(2)(E), see *supra* Part II.A.3.a.

GRAPH VI-2

INDIRECT OUTBOUND REVERSE SUBSIDIARY MERGER UNDER SECTION 368(a)(2)(E)



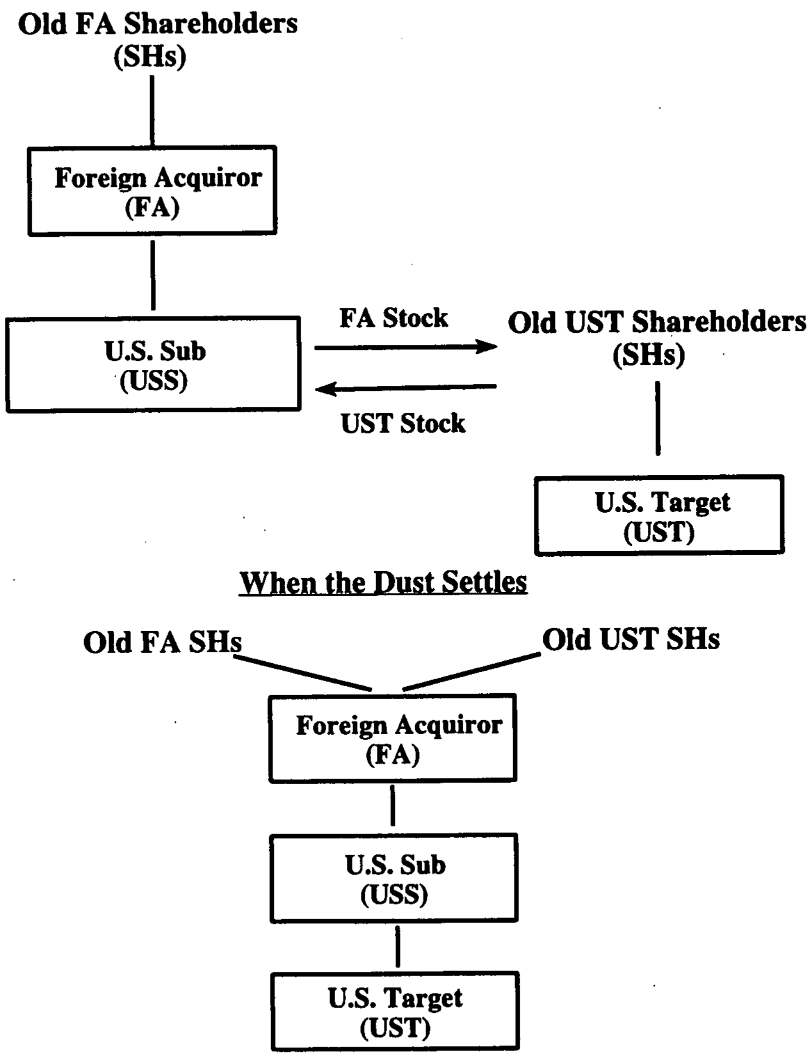
4. Indirect Outbound Triangular (B) Reorganization

An indirect outbound transaction includes an acquisition by a U.S. sub of Foreign Acquiror of a controlling stock interest (i.e., at least 80%) in U.S. Target in exchange solely for voting stock of Foreign Acquiror in a (B) reorganization under section 368(a)(1)(B).[72] The transaction may be diagramed as follows:

72. *See* Temp. Treas. Reg. § 1.367(a)-1T(c)(2)(ii). For a general discussion of triangular stock for stock reorganizations under section 368(a)(1)(B), see *supra* Part II.A.3.c.

GRAPH VI-3

INDIRECT OUTBOUND TRIANGULAR (B)
REORGANIZATION UNDER SECTION 368(a)(1)(B)



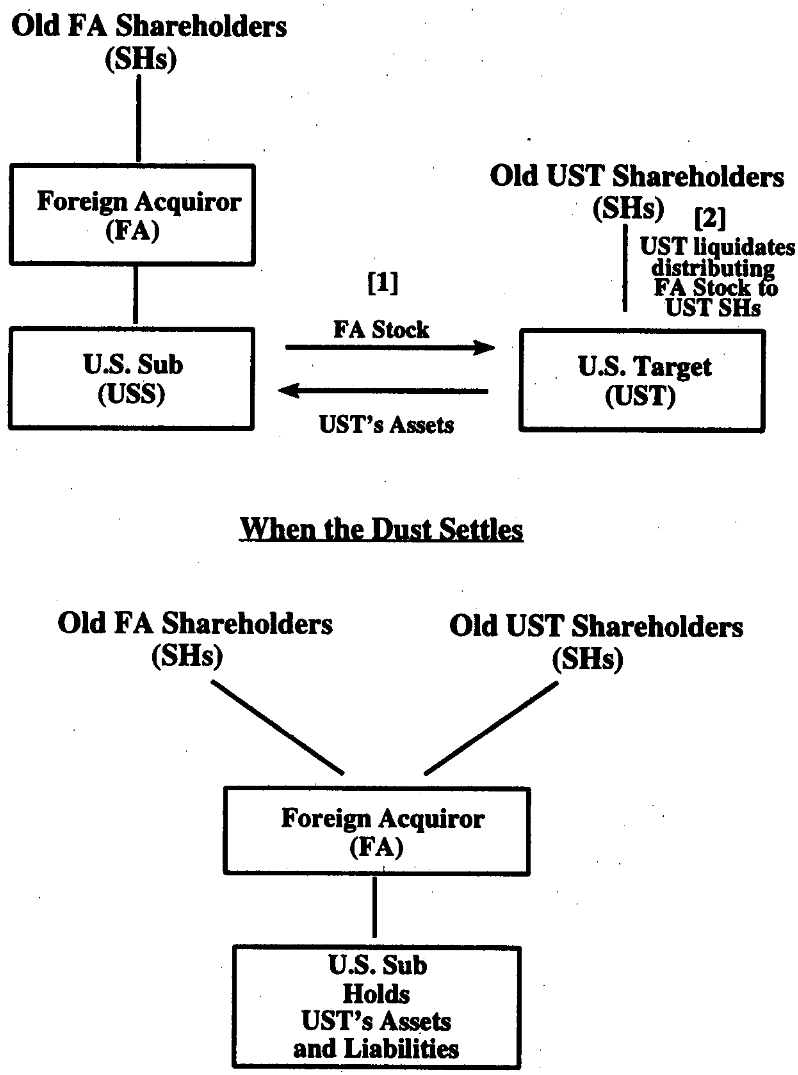
5. Indirect Outbound Triangular (C) Reorganization

The final indirect outbound reorganization is the triangular (C) under section 368(a)(1)(C) in which a U.S. sub of Foreign Acquiror acquires substantially all of the assets of U.S. Target in exchange solely for voting stock of Foreign Acquiror, and U.S. Target liquidates, distributing the stock to its shareholders.[73] The transaction may be diagramed as follows:

73. *See* Temp. Treas. Reg. § 1.367(a)-1T(c)(2)(iii). For a general discussion of triangular stock for asset reorganizations under section 368(a)(1)(C), see *supra* Part II.A.2.d.

GRAPH VI-4

INDIRECT OUTBOUND TRIANGULAR (C)
REORGANIZATION UNDER SECTION 368(a)(1)(C)



6. Economic Effect of Indirect Outbound Triangular Reorganization

The economic effect of each of the above triangular reorganizations is essentially the same. First, after completion of the transaction, the assets of U.S. Target continue to be held by a domestic corporation, either by U.S. Target itself in a reverse subsidiary merger and in a triangular (B), or by U.S. Sub in a forward subsidiary merger and in a triangular (C). Thus, the assets of U.S. Target continue to be subject to U.S. taxation. Second, the shareholders of U.S. Target end up as shareholders of Foreign Acquiror; as a consequence, the transaction is the substantial economic equivalent of a direct outbound transfer of stock of U.S. Target in a direct (B) reorganization as addressed in Part V.

7. Impact of Section 367

Because the economic impact of these indirect outbound triangular reorganizations is essentially the same as the economic impact of a direct outbound (B) reorganization, the tax treatment of these transactions under section 367 should be the same. Although the current regulations do not appear to be perfectly clear on the point, a fair reading of the regulations leads to the conclusion that the shareholders of U.S. Target who receive only voting stock of Foreign Acquiror will receive nonrecognition treatment under section 354 provided: (1) the 50% ownership threshold is not exceeded; (2) there is no control group; (3) the particular shareholder owns less than 5% of the stock of Foreign Acquiror, or owns 5% or more of such stock and enters a five-year gain recognition agreement;[74] (4) Foreign Acquiror satisfies the active business test; and (5) U.S. Target complies with the reporting requirements.[75] These are the same five conditions that apply to the direct outbound (B) reorganization.[76]

74. *See* Temp. Treas. Reg. § 1.367(a)-3T(g).

75. *See* Treas. Reg. § 1.368(a)-3(c)(1) (1996). *See supra* Part V. It is not certain that the conditions of this regulation apply to indirect outbound transfers, but it is clear from Temp. Treas. Reg. § 1.367(a)-3T(g) that the shareholders of U.S. Target who become 5% shareholders of Foreign Acquiror must file a gain recognition agreement. *See* Temp. Treas. Reg. § 1.367(a)-3T(g).

76. *See supra* Part V.

B. Critique of General Principles

The economic effect of each of these triangular reorganizations can be summarized as follows: (1) The assets and liabilities of U.S. Target continue to he held by either U.S. Target or a U.S. sub of Foreign Acquiror. Thus, these assets continue to be subject to U.S. taxation on a world-wide basis. (2) The shareholders of U.S. Target have swapped their stock in U.S. Target for stock in Foreign Acquiror. Consequently, this part of the transaction is the equivalent of an outbound transfer of stock. The section 367 regulations correctly treat each of these transactions as an outbound transfer of the stock of U.S. Target.

VII. INTRODUCTION TO THE IMPACT OF SECTION 367(B) ON NON-OUTBOUND ACQUISITIVE REORGANIZATIONS[77]

As indicated in section II.B.3.f, section 367(b) applies to, *inter alia*, inbound acquisitive reorganizations in which the stock or assets of Foreign Target are acquired by U.S. Acquiror and to foreign-to-foreign reorganizations in which the stock or assets of Foreign Target are acquired by Foreign Acquiror. The discussion here focuses on the proposed regulations under section 367(b) that were issued on August 26, 1991[78] and examines the impact of these proposed regulations on non-outbound reorganizations.

The preamble to the proposed regulations specifies several basic principles that guided the drafting of the regulations.[79] The first principle is the prevention of the repatriation of earnings or basis without tax. The preamble to the proposed regulations explains:

> The United States generally does not tax a foreign corporation on its foreign source earnings and profits if the foreign corporation is owned in whole or in part, directly or indirectly, by a United States person. In certain circumstances the United States does not tax the United States person on the foreign corporation's earnings and profits until those earnings and profits are repatriated (for example, through the payment of dividends) or the United States person disposes of an interest in the foreign corporation. One of the principles of the proposed regulations under section 367(b) is that the repatriation of a United States person's share of earnings and profits of a foreign

77. *See generally* Kingson, *New § 367 Theory*, *supra* note 2.

78. Transfers of Stock on Securities by U.S. Persons to Foreign Corporations, and Foreign Liquidations and Reorganizations; Hearing, 56 Reg. 41992 (1991) (to be codified at 26 C.F.R. pt. 1) (proposed Aug. 26, 1991) [hereinafter *Preamble to section 367(b) Proposed Regulations*].

79. *See id.*

> corporation through what would otherwise be a nonrecognition transaction (for example, . . . an acquisition by a domestic corporation of the assets of a foreign corporation in a reorganization described in section 368) should generally cause recognition of income by the foreign corporation's shareholders. A domestic acquiror of the foreign corporation's assets should not succeed to the basis or other tax attributes of the foreign corporation except to the extent that the United States tax jurisdiction has taken account of the United States person's share of the earnings and profits that gave rise to those tax attributes.[80]

The second principle is the prevention of a material distortion of income. The preamble explains:

> Another objective of the regulations under section 367(b) is to prevent the occurrence of a material distortion in income. For this purpose, a material distortion in income includes a distortion relating to the source, character, amount or timing of any item, if such distortion may materially affect the United States tax liability of any person for any year. Thus, for example, the regulations generally operate to prevent the avoidance of provisions such as section 1248 (which requires inclusion of certain gain on the disposition of stock as a dividend). For this purpose, the concept of "avoidance" includes a transaction that results in a material distortion in income even if such distortion was not a purpose of the transaction.[81]

The third principle is the minimization of complexity, which the preamble explains as follows:

> The regulations under section 367(b) also generally attempt to minimize complexity to the extent not inconsistent with principles (1) and (2) described above, in order to reduce taxpayer compliance burdens and the Treasury's administrative costs, and to improve enforcement of the tax laws. In addition, in some cases the regulations adopt a rule that has the effect of minimizing complexity even though the rule is to some extent a departure from principles (1) and (2) described above. In those instances in which minimizing complexity results in a departure from principles (1) and (2), the taxpayer is sometimes treated more favorably and sometimes less favorably than if the regulations had not taken complexity into account.[82]

Finally, the fourth principle is the permissibility of deferral, which the preamble explains as follows:

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80. *Id.*
81. *Id.*
82. *Id.*

> To the extent not inconsistent with principles (1), (2) and (3) described above, the regulations under section 367(b) generally do not operate to accelerate the recognition of income that is realized but which would not otherwise be recognized by reason of a nonrecognition provision of the Internal Revenue Code.[83]

Proposed Regulation section 1.367(b)-1(a) provides that Proposed Regulation sections 1.367(b)-1 through 1.357(b)-6 apply to any exchange governed by section 367(b). Such transaction is defined as a "section 367(b) exchange."[84] A section 367(b) exchange includes a non-outbound acquisitive reorganization, for which the status of a foreign corporation as a corporation is relevant to determine the extent to which income shall be recognized, or to determine the effect of the transaction on earnings and profits, basis of stock or securities, or basis of assets.[85]

The general rule for a section 367(b) exchange is that a "foreign corporation engaged in [such an] exchange is considered to be a corporation except to the extent provided in §§ 1.367(b)-2 through 1.367(b)-6."[86] A person realizing income in a section 367(b) exchange must file a notice of such exchange, setting forth certain required information on the exchange such as a description of the exchange and a statement describing the amounts required to be recognized under the section 367(b) regulations.[87]

Proposed Regulation section 1.367(b)-2 sets forth several definitions relating to section 367(b) exchanges. The term "controlled foreign corporation" (CFC) is defined as a foreign corporation that is owned to the extent of 50% or more by five or fewer 10% U.S. shareholders, all as specified in section 957.[88] A "section 1248 shareholder" is defined as a 10% or more U.S. shareholder of a foreign corporation as specified in section 1248(a)(2) or (c)(2).[89] The term "section 1248 amount" is defined as the "net positive earnings and profits (if any) that would have been attributable to such stock and includible in income as a dividend under section 1248 . . . if the stock were sold by the shareholder."[90] Thus, the section 1248 amount is essentially the foreign income of the CFC that has been deferred from U.S. taxation and that would be recognized as dividend income on the sale of the stock of the CFC by a 10% or more

83. *Id.*
84. *See* Prop. Treas. Reg. § 1.367(b)-1(a), 56 Fed. Reg. 41993 (1991).
85. *See id.*
86. *See id.* § 1.367(b)-1(b).
87. *See id.* § 1.367(b)-1(c).
88. *See id.* § 1.367(b)-2(a).
89. *See id.* § 1.367(b)-2(b).
90. *See id.* § 1.367(b)-2(c).

U.S. shareholder. This is the earnings and profits attributable to the period the U.S. person was a 10% shareholder.

The impact of section 1248 may be illustrated by the following example. Suppose that Domestic Parent Corporation contributes $1 million to Foreign Sub and, over several years, Foreign Sub engages in foreign operations that generate $5 million of earnings and profits (E&P). All the E&P is retained by Foreign Sub and none of the E&P is required to be imputed to Domestic Parent Corporation under any of the Code's anti-deferral provisions. Domestic Parent Corporation sells the stock of Foreign Sub for $10 million for a gain of $9 million. Section 1248 treats $5 million of the gain (i.e., the portion attributable to Foreign Sub's E&P) as a dividend. Section 1248 only applies to sales by 10% or more shareholders of CFCs and only to the E&P that accrued while the stockholder was a 10% or more shareholder.

The "all earnings and profits amount" is defined, essentially, as the net positive and negative adjustments to E&P determined pursuant to certain specified rules and "without regard to the amount of gain that would be realized on a sale or exchange of the stock of the foreign corporation."[91] This appears to be all of a corporation's E&P, not just the E&P that accrued while a U.S. person was a 10% shareholder.

The proposed regulations also set out certain rules governing the treatment of deemed dividends, which a shareholder may be required to include in income under the rules governing section 367(b) exchanges.[92]

Next, this Article focuses on the treatment of the following types of section 367(b) exchanges: (1) inbound asset reorganizations, which encompass the direct and triangular (C) reorganizations in which the assets of Foreign Target are acquired by U.S. Acquiror or its U.S. sub solely in exchange for the voting stock of U.S. Acquiror; (2) inbound direct and triangular (B) reorganizations in which the stock of Foreign Target is acquired by U.S. Acquiror or its U.S. sub in exchange solely for voting stock of U.S. Acquiror; and (3) foreign-to-foreign asset or stock reorganizations in which the stock or assets of Foreign Target are acquired by Foreign Acquiror or its foreign sub in a direct or triangular (B) or (C) reorganization in exchange solely for voting stock of Foreign Acquiror.

91. *See id.* § 1.367(b)-2(d).

92. *See id.* § 1.367(b)-2(e).

VIII. ACQUISITION BY U.S. ACQUIROR OR ITS U.S. SUBSIDIARY OF ASSETS OF FOREIGN TARGET IN AN INBOUND (C) REORGANIZATION

A. *General Principles*[93]

In this transaction, U.S. Acquiror or its U.S. sub acquires substantially all of the assets of Foreign Target solely in exchange for voting stock of U.S. Acquiror. Foreign Target is liquidated distributing to its shareholders the stock of U.S. Target received in the exchange. The transaction may be structured as a merger of Foreign Target into U.S. Acquiror or U.S. Sub. Such a merger cannot, however, qualify as an (A) reorganization under section 368(a)(1)(A), because to qualify as an (A) merger reorganization both corporations must be domestic.[94] The transaction may qualify as a (C) reorganization under section 368(a)(1)(C) assuming all the conditions of the (C), principally the solely for voting stock requirement, are satisfied.[95]

It is assumed that both Foreign Target and U.S. Acquiror are publicly-held corporations and that some of the shareholders of Foreign Target are U.S. persons. This could easily be the case because many foreign corporations have their shares listed on a U.S. exchange, such as the NYSE, in the form of ADRs.

This type of transaction is governed by Proposed Regulation section 1.367(b)-3, which deals with the repatriation of foreign corporate assets in certain nonrecognition transactions. This regulation applies, *inter alia*, to an acquisition by U.S. Acquiror of the assets of Foreign Target in a (C) reorganization under section 368(a)(1)(C).

In considering this proposed regulation it is helpful to first focus on what the regulation does not do. The proposed regulation does not impose a tax either on U.S. Acquiror, which is protected from recognition on the issuance of its stock by section 1032, or Foreign Target, which receives nonrecognition under section 361.[96] Also, the regulations do not address the tax treatment of the foreign shareholders of Foreign Target, because they are generally not subject to U.S. taxation on gains realized on the exchange of their stock in Foreign Target for stock in U.S. Acquiror.

The regulations apply to an exchanging U.S. shareholder of Foreign Target that is a 10% or more shareholder of Foreign Target, without

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93. *See* KUNTZ & PERONI, *supra* note 2, at pt. B 5-45; *NY State 1992 Report*, *supra* note 2, § III.E.

94. *See* Treas. Reg. § 1.368-2(b)(1) (1998).

95. *See, e.g.*, Rev. Rul. 67-326, 1967-2 C.B. 143.

96. Under general principles, Foreign Target is not subject to U.S. taxation, except with respect to certain U.S. source passive and business income.

regard to whether Foreign Target is a controlled foreign corporation.[97] For these 10% U.S. shareholders of Foreign Target, the proposed regulations require that they "include in income as a deemed dividend the all earnings and profits amount with respect to its stock in [Foreign Target]."[98] The preamble to the Proposed Regulations explains the rationale of this dividend rule as follows:

> One of the principles of the section 367(b) regulations is to prevent the repatriation of earnings and profits without tax. The proper measure of the earnings and profits that should be subject to tax is the all earnings and profits amount. Thus, the proposed regulations generally require that the exchanging shareholder of the foreign acquired corporation include in income as a deemed dividend the all earnings and profits amount with respect to the stock of the foreign acquired corporation.[99]

This deemed dividend rule does not apply if the 10% U.S. shareholder makes an election to treat the transaction as a taxable exchange.[100] The preamble to the Proposed Regulations gives the following explanation of the rationale for the taxable exchange election:

> Notwithstanding the above-stated principles, the regulations make certain departures from the requirement to include in income the all earnings and profits amount and to recognize exchange gain or loss with respect to capital [discussed below]. In lieu of such treatment, an exchanging shareholder may elect to recognize the gain that it realizes in the exchange, as if it sold the stock for its fair market value. If such an election is made, the regulations require a reduction in basis (or other tax attributes) that corresponds to the difference between the all earnings and profits amount as compared to the gain actually recognized by the electing shareholder. Because the foreign acquired corporation's earnings and profits to the extent of such difference are not taken into account by the United States tax jurisdiction as income, the United States tax jurisdiction does not take into account of the corresponding basis (or other tax attributes) to which those earnings and profits gave rise.[101]

In addition to the deemed dividend, unless the taxable exchange election is made, the 10% U.S. shareholders of Foreign Target are

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97. *See* Prop. Treas. Reg. § 1.367(b)-3(b), 56 Fed. Reg. 41993 (1991). This regulation also applies to foreign corporate shareholders of Foreign Target, provided that there are 10% U.S. shareholders of such foreign corporate shareholder. *See id.* This provision is not examined further here.

98. *See id.* § 1.367(b)-3(b)(2).

99. *Preamble to section 367(b) Proposed Regulations*, *supra* note 78, at 41996.

100. *See* Prop. Treas. Reg. § 1.367(b)-3(b)(2)(iii), 56 Fed. Reg. 41993.

101. *Preamble to section 367(b) Proposed Regulations*, *supra* note 78, at 41997.

required to "realize and recognize exchange gain (or loss) to the extent that its share of the [Foreign Target's] capital account . . . has appreciated (or depreciated) by reason of changes in the relative exchange rates of [Foreign Target's] functional currency and the exchanging shareholder's functional currency during the exchanging shareholder's holding period."[102] The amount of exchange loss cannot, however, exceed the amount of the deemed dividend.[103] The preamble to the Proposed Regulations gives the following explanation of the rationale for this exchange gain or loss rule:

> Another principle of the section 367(b) regulations is to prevent the repatriation of basis without tax. In implementing this principle, the regulations generally require the recognition of exchange gain (or loss) to the extent that the shareholder's capital account in the foreign acquired corporation has appreciated (or depreciated) as a result of changes in currency exchange rates. Such appreciation in effect becomes basis when the foreign corporation's functional currency asset bases are translated into dollar bases at the spot rate on the date of the transaction, pursuant to section 985.[104]

The regulations also apply to U.S. persons who are less than 10% shareholders of Foreign Target. These U.S. shareholders are required to recognize gain on the exchange of their stock in Foreign Target for stock in U.S. Acquiror and, therefore, are denied the benefit of section 354.[105] The preamble to the Proposed Regulations gives the following rationale for this gain recognition rule for non-10% shareholders of Foreign Target:

> As another departure from the requirement to include in income the all earnings and profits amount and to recognize exchange gain or loss with respect to capital, the regulation instead simply requires full recognition of gain in the stock of the foreign acquired corporation if the exchanging person may not own a sufficient interest in the foreign acquired corporation [i.e., a 10% shareholder]. Such a United States person may not own a sufficient interest in the foreign acquired corporation to obtain the relevant earnings and profits information needed to compute the all earnings and profits amount with respect to the stock that it exchanges. Similarly, the foreign acquired corporation may not have adequate information about such a shareholder's realized gain to compute the proper attribute reduction. Thus, the asset bases (or other tax attributes) of the foreign acquired

102. *See* Prop. Treas. Reg. § 1.367(b)-3(b)(2)(ii), 56 Fed. Reg. 41993.

103. *See id.*

104. *Preamble to section 367(b) Proposed Regulations*, *supra* note 78, at 41996.

105. *See* Prop. Treas. Reg. § 1.357(b)-3(c), 56 Fed. Reg. 41993 (1991).

> corporation are not reduced, even if the gain recognized by the exchanging United States person is less than the all earnings and profits amount with respect to the stock exchanged by the United States person.[106]

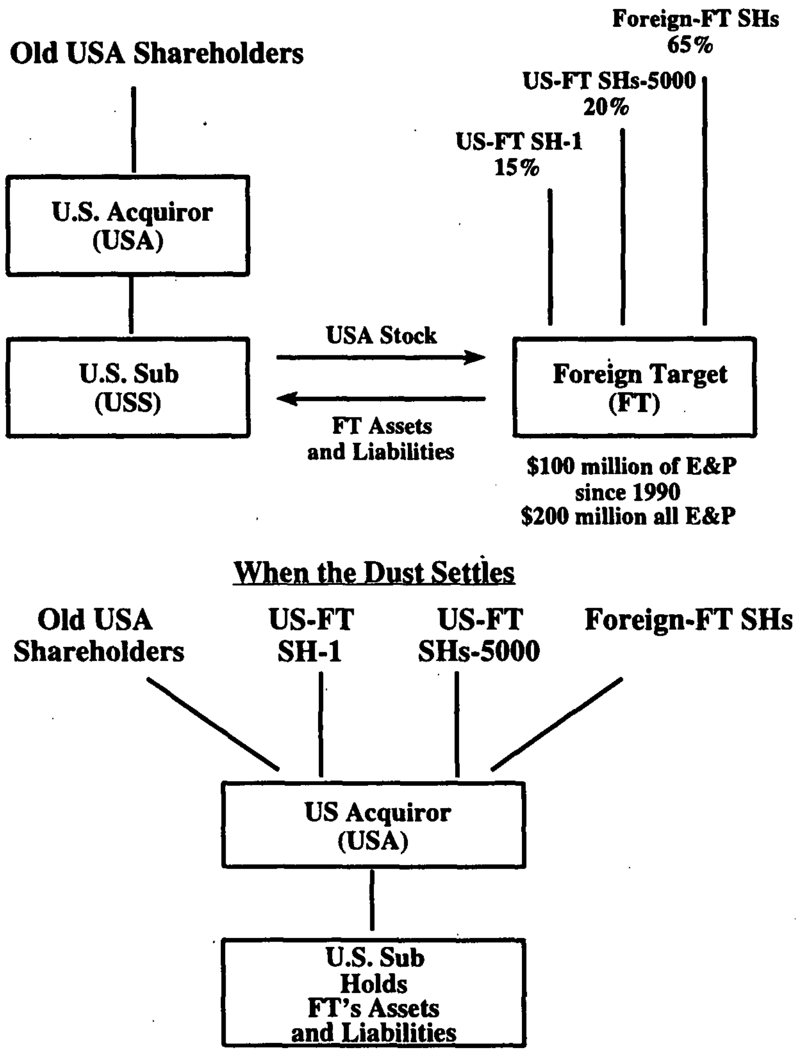
The above principles can be illustrated by the following example. Foreign Target is a publicly-held corporation whose shares are traded on the NYSE through ADRs. U.S. shareholder #1 (US-FT SH-1) owns 15% of Foreign Target's stock through its ownership of ADRs. Approximately 5,000 other U.S. persons (US-FT SHs-5000) hold varying amounts of the stock of Foreign Target through ADRs, but none of these shareholders holds more than 2% of such stock. In the aggregate, U.S. shareholders own 20% of the stock of Foreign Target.

US-FT SH-1 purchased its 15% of the stock of Foreign Target in 1990 for $5 million and such shares are now worth $30 million. During this period, Foreign Target has retained $100 million of E&P, and Foreign Target's total E&P for all years is $200 million. Foreign Target is acquired by U.S. Sub of U.S. Acquiror in a triangular (C) reorganization in exchange for $300 million of the voting stock of U.S. Acquiror. The transaction can be diagramed as follows, with the summary tax results then provided:

106. *Preamble to section 367(b) Proposed Regulations*, *supra* note 78, at 41997.

GRAPH VIII-1

INBOUND TRIANGULAR (C) REORGANIZATION UNDER SECTION 368(a)(1)(C)



B. Summary of Tax Results

(1) The transaction qualifies as a (C) reorganization.

(2) Under section 361, Foreign Target has nonrecognition on the transfer of its U.S. property and under general principles Foreign Target is not subject to tax on the transfer of its foreign assets.

(3) U.S. Sub takes a carryover basis under section 362(b) for the assets received from Foreign Target.

(4) US-FT SH-1 is required to include in its income as a deemed dividend the all E&P amount with respect to its stock of Foreign Target. Because Foreign Target's all E&P amount is $200 million, US-FT SH-1 is required to include $30 million in its income as a deemed dividend (i.e., 15% of $200 million).[107] This is so even though the aggregate amount of stock received by US-FT SH-1 is only $30 million. US-FT SH-1, therefore, has a deemed dividend that exceeds its $25 million gain realized on the transaction (i.e., $30 million minus $5 million) by $5 million. This is so even though Foreign Target is not a CFC.

(5) US-FT SH-1's basis for the U.S. Target stock received would be $35 million (i.e., $5 million basis plus $30 million deemed dividend, which is deemed to be contributed to capital).[108]

(6) Presumably the US-FT SH-1 would make the taxable exchange election to avoid the excess deemed dividend.

(7) US-FT SHs-5000 receive taxable gain, but not loss, on the exchange of their stock in Foreign Target for stock in U.S. Acquiror.[109]

(8) The foreign shareholders generally are not subject to U.S. taxation, but in any event, section 354 would give them nonrecognition treatment.

(9) If Foreign Target's all E&P amount were $100 million rather than $200 million, US-FT SH-1 would have a deemed dividend of $15 million (i.e., 15% of $100 million). This would increase US-FT SH-1's basis in its FT stock from $5 million to $20 million.[110] Section 354 would then apply to give US-FT SH-1 tax-free treatment on the $10 million balance of its gain (i.e., $30 million - $20 million), and under section 358, US-FT SH-1 would take a basis of $20 million for the stock of U.S. Acquiror.

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107. *See* Prop. Treas. Reg. § 1.367(b)-3(b)(2), 56 Fed. Reg. 41993.
108. *See id.* § 1.367(b)-2(e)(3)(ii).
109. *See id.* § 1.367(b)-3(c).
110. *See id.* § 1.367(b)-2(e)(ii).

(10) Unless the taxable exchange election is made, US-FT SH-1 is also required to recognize foreign currency gain or loss with respect to its capital account in Foreign Target.[111]

C. Critique of General Principles

The denial of nonrecognition treatment under section 354 for non-10% shareholders of Foreign Target is extremely harsh, and the articulated reason for this treatment does not seem to be compelling. This rule could lead to bizarre results.

For example, assume that the all earnings and profits amount for Foreign Target is $1 million and two U.S. persons are shareholders of Foreign Target. U.S. person A owns 15% of Foreign Target's stock for which it has a basis of $1.5 million, and U.S. person B owns 5% of Foreign Target's stock for which it has a basis of $500,000. Foreign Target is acquired by U.S. Acquiror in an inbound (C) reorganization with U.S. Acquiror issuing its stock with a fair market value of $100 million. Therefore, shareholder A receives $15 million of stock of U.S. Acquiror and shareholder B receives $ 5 million. Assume that there is no exchange gain or loss.

The tax results to shareholders A and B are set out below:

111. *See id.* § 1.367(b)-3(b)(2)(ii).

TABLE VIII-1

ILLUSTRATION OF DIFFERENT TREATMENT OF 10% AND NON-10% SHAREHOLDERS IN INBOUND (C) REORGANIZATIONS

	Shareholder A (15% Shareholder of Foreign Target)	Shareholder B (5% Shareholder of Foreign Target)
Amount Realized (Stock of U.S. Acquiror)	$ 15 million	$ 5 million
(minus)		
Adjusted Basis (Stock of Foreign Target)	$ 1.5 million	$ .5 million
Gain Realized	$ 13.5 million	$ 4.5 million
(minus)		
Dividend, Share of all E&P Amount (15% of $ 1 million)	$ .15 million	—
Balance of Gain Realized	$ 13.35 million	—
Nonrecognition Under section 354	$ 13.35 million	—
Gain Recognized	—	$ 4.5 million
Basis Under section 358	$ 1.65 million ($ 1.5 million + $ .15 million dividend)	—
Basis Under section 1012	—	$ 4.5 million

As the illustration demonstrates, shareholder A, a 15% shareholder of Foreign Target, gets nonrecognition treatment under section 354 for $13.35 million of its gain realized. On the other hand, shareholder B, who is only a 5% shareholder, has complete gain recognition. What policy rationale could justify this result? Presumably, the concern is that the untaxed E&P of Foreign Target will be coming into the United States without a corporate or shareholder level tax. However, the United States does not tax Foreign Target or its shareholders on the foreign earnings of Foreign Target, unless one of the special anti-deferral rules, such as the CFC provisions, apply. In the cases addressed here, none of these anti-deferral rules apply.

I suggest that strong consideration be given to giving non-10% shareholders of Foreign Target the full benefit of section 354.

IX. ACQUISITION BY U.S. ACQUIROR OF ITS U.S. SUBSIDIARY OF FOREIGN TARGET IN AN INBOUND (B) REORGANIZATION

A. *General Principles*

In this transaction, U.S. Acquiror or its U.S. subsidiary acquires a controlling interest (i.e., at least 80%) in the stock of Foreign Target in exchange solely for voting stock of U.S. Acquiror in a (B) reorganization under section 368(a)(1)(B). As long as the consideration paid is solely voting stock of U.S. Acquiror, the transaction could be effectuated by a reverse subsidiary merger in which the U.S. sub (or even a foreign sub of U.S. Acquiror) merged into Foreign Target with the shareholders of Foreign Target receiving solely voting stock of U.S. Acquiror. This transaction cannot qualify as a reverse subsidiary merger reorganization under section 368(a)(2)(E) because under that section, the merger must be between two domestic corporations.[112] However, the Service has ruled that, as long as the solely for voting stock requirement is satisfied, a transaction otherwise qualifying as a (B) a reorganization will be treated as a (B) even though the transaction is effectuated by a reverse subsidiary merger.[113] In structuring the reverse subsidiary merger as a (B) rather than under section 368(a)(2)(E), the 20% boot permitted under section 368(a)(2)(E) is not available; thus, the consideration paid by U.S. Acquiror must be solely its voting stock.

To summarize, Foreign Target could be acquired in the following three types of (B) reorganizations. First, U.S. Acquiror could issue solely

112. *See* Treas. Reg. § 1.368-2(b)(1) (1998).

113. *See* Rev. Rul. 67-448, 1967-2 C.B. 144.

its voting stock in exchange for at least 80% of Foreign Target's stock. Second, U.S. Sub (or a foreign sub of U.S. Acquiror) could issue solely U.S. Acquiror's voting stock in exchange for at least 80% of Foreign Target's stock. Third, U.S. Sub (or a foreign sub of U.S. Acquiror) could merge into Foreign Target in a reverse subsidiary merger in which all of the shareholders of Foreign Target receive solely voting stock of U.S. Acquiror in exchange for their stock in Foreign Target. The advantage of the reverse subsidiary merger (B) reorganization is that all the shareholders of Foreign Target could presumably be forced under the corporate law governing Foreign Target to either exchange their shares, or dissent from the transaction and receive the appraised value of their shares.

The Proposed Regulations do not have an impact on this type of transaction,[114] and consequently, all the shareholders of Foreign Target, including U.S. shareholders, receive nonrecognition treatment under section 354 upon the exchange of their shares in Foreign Target solely for voting stock of U.S. Acquiror.

Under the Temporary Regulations, if the Foreign Target is a CFC (i.e., is owned to the extent of 50% or more by 5 or fewer 10% U.S. shareholders), the 10% U.S. shareholders of Foreign Target are required to recognize as a dividend the section 1248 amount attributable to their shares in Foreign Target.[115]

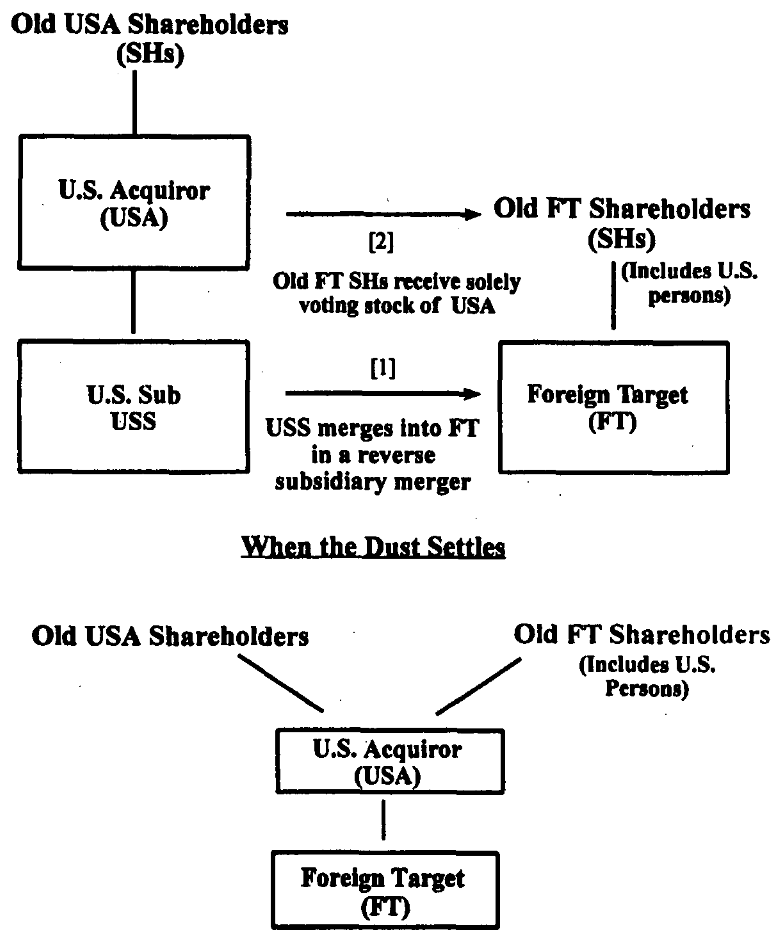
The reverse subsidiary merger (B) reorganization can be diagramed as follows, with the summary tax results also set out:

114. *See, e.g.*, DOLAN, *supra* note 2, at 13-31.

115. Temp. Reg. § 7.367(b)-7(c)(2)(L). *See generally* DOLAN, *supra* note 2, at 13-30 to -31.

GRAPH IX-1

INBOUND (B) REORGANIZATION UNDER SECTION 368(a)(1)(B)



B. Summary of Tax Results

(1) Provided solely voting stock of U.S. Acquiror is the consideration paid, then the transaction qualifies as a (B) reorganization under section 368(a)(1)(B).

(2) Under section 354, the shareholders of Foreign Target, including U.S. shareholders of Foreign Target, receive nonrecognition treatment. This is the result even if Foreign Target is a CFC. The foreign shareholders of Foreign Target also get nonrecognition treatment under section 354, but in any event, they generally would not be subject to U.S. tax on the exchange.

C. Critique of General Principles

The availability of nonrecognition treatment under section 354 is the correct result for inbound (B) reorganizations. As indicated in Part VIII.B, this should also generally be the rule for inbound (C) reorganizations.

X. FOREIGN-TO-FOREIGN STOCK AND ASSET REORGANIZATIONS

A. *General Principles*[116]

This section addresses two types of transactions: (1) the acquisition by Foreign Acquiror (or its foreign sub) in exchange solely for Foreign Acquiror's voting stock of the assets of Foreign Target in a transaction that qualifies as a direct or triangular (C) reorganization under section 368(a)(1)(C); and (2) the acquisition by Foreign Acquiror (or its foreign sub) in exchange solely for Foreign Acquiror's voting stock of a controlling interest (i.e., at least 80%) in the stock of Foreign Target in a transaction that qualifies as a direct or triangular (B) reorganization under section 368(a)(1)(B).

The section 368(a)(1)(A) merger, the section 368(a)(2)(D) forward subsidiary merger, and the section 368(a)(2)(E) reverse subsidiary merger cannot be used in these foreign-to-foreign reorganizations because both merging corporations in such transactions must be domestic.[117] However, a merger of Foreign Target into Foreign Acquiror (or its foreign sub) may constitute a direct or triangular (C) reorganization, provided the solely for voting stock and other requirements are satisfied.[118] Also, if Foreign Target is acquired by Foreign Acquiror in a reverse subsidiary merger and the solely for voting stock and other requirements for a (B) reorganization are satisfied, the transaction will be treated as a (B) reorganization.[119]

These types of foreign-to-foreign reorganizations are governed by Proposed Regulation section 1.367(b)-4, which is entitled "[a]cquisition of foreign corporate stock or assets by a foreign corporation in certain nonrecognition transactions." This Proposed Regulation applies only to "section 1248 shareholders," which are at least 10% shareholders of a foreign target that is a CFC (i.e., a foreign corporation of which more than 50% of the stock is owned by 10% U.S. shareholders).[120] Under this Proposed Regulation, a section 1248 shareholder of such a foreign target (FT § 1248 Shareholder) is required to recognize as a deemed dividend the section 1248 amount attributable to the stock it exchanges, provided that, immediately after the exchange, the foreign acquiror is not a CFC as to which the FT § 1248 Shareholder is a section 1248

116. *See NY State 1992 Report*, *supra* note 2, § III.F.

117. *See* Treas. Reg. § 1.368-2(b)(1) (1998).

118. *See, e.g.*, Rev. Rul. 67-326, 1967-2 C.B. 143.

119. *See, e.g.*, Rev. Rul. 67-448, 1967-2 C.B. 144; *see also supra* Part IX.A.

120. *See* Prop. Treas. Reg. § 1.367(b)-4(b), 56 Fed. Reg. 41993 (1991); *id.* § 1.367(b)-2(b).

shareholder.[121] Thus, if in a direct or triangular (C) or (B) reorganization involving the acquisition of Foreign Target by Foreign Acquiror, a section 1248 shareholder with respect to Foreign Target does not become a section 1248 shareholder with respect to Foreign Acquiror (either because Foreign Acquiror is not a CFC or Foreign Acquiror is a CFC but the shareholder is not a 10% shareholder), then the shareholder must recognize as a deemed dividend the attributable E&P of Foreign Target that was deferred from U.S. tax during the period the shareholder held the stock of Foreign Target.[122] Because this Article does not deal with acquisitions involving CFCs, it is not necessary to examine this deemed dividend rule further.

In addition, the transfer by U.S. shareholders of the stock of Foreign Target could be subject to the rules of section 367(a)(1). However, as long as the U.S. transferor owns less than 5% of the stock of Foreign Acquiror, the transfer will not be subject to section 367(a)(1).[123]

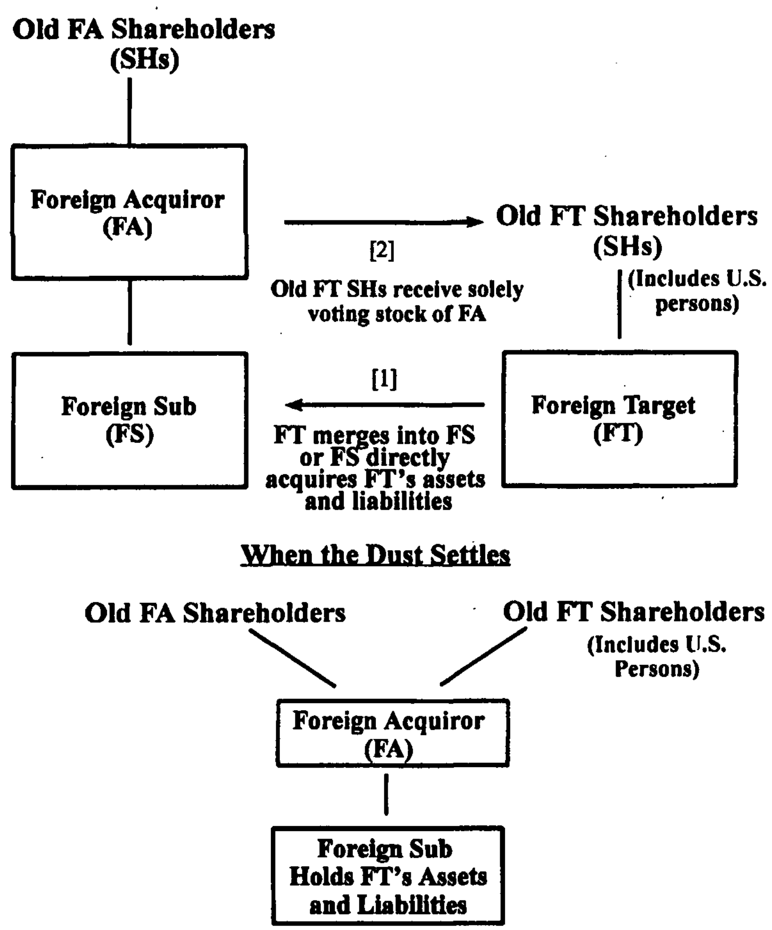
Thus, in a foreign-to-foreign direct or indirect (B) or (C) reorganization not involving the acquisition of Foreign Target, which is a CFC, all the shareholders of Foreign Target, including U.S. persons that are 10% shareholders, receive nonrecognition treatment under section 354 on the exchange of their stock in Foreign Target for stock in Foreign Acquiror. In a (C) reorganization, Foreign Target has tax-free treatment under section 361, and under section 362(b), Foreign Acquiror (or Foreign Sub, as the case may be) gets a carryover basis in the assets of Foreign Target. In a (B) reorganization, Foreign Acquiror gets a carryover basis under section 362(b) for the stock of Foreign Target it receives. The results in these four reorganizations can be illustrated by the following diagram of a merger of Foreign Target into Foreign Sub of Foreign Acquiror in a transaction that qualifies as a triangular (C). The tax results are also set out.

121. *See id.* § 1.367(b)-4(b)(1). This Proposed Regulation also requires recognition in other contexts not discussed here.

122. *See id.* § 1.367(b)-4(b).

123. *See* Treas. Reg. § 1.367(a)(3) (1996); Notice 87-85, 1987-2 C.B.395.

GRAPH X-1
FOREIGN-TO-FOREIGN TRIANGULAR (C)
REORGANIZATION UNDER SECTION 368(a)(1)(C)



B. Summary of Tax Results

(1) The merger of Foreign Target into Foreign Sub qualifies as a triangular (C) reorganization,[124] even though it does not qualify as an (A) reorganization because the merger is not between domestic corporations.[125]

(2) Foreign Target has nonrecognition under section 361.

(3) Under section 362(b), Foreign Sub takes a carryover basis for the assets of Foreign Target.

(4) Under section 354, the shareholders of Foreign Target, including the U.S. shareholders, receive nonrecognition treatment.

C. Critique of General Principles

The results above are clearly correct.

XI. THE IMPACT OF THE EUROPEAN UNION'S COUNCIL DIRECTIVE ON CROSS-BORDER MERGERS AND ACQUISITION

A. In General

In 1990, the Commission of the European Communities issued the Council Directive dealing with a "common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States." [126] Thus, the Council Directive sets forth guidance on the rules the countries of the EU (that is, the Member States) should adopt governing, *inter alia*, cross-border mergers and acquisitions between companies of different Member States. The Member States were to have implemented the Council Directive by January 1, 1992, and most have done so.

This Part first outlines the basic principles reflected in the Council Directive. It then illustrates the treatment under both the Council Directive and the Code of the two following cross-border tax-free acquisitions: (1) the acquisition of the stock of a publicly-held U.S. target by a publicly-held acquiror organized in a country that has adopted the Council Directive (Council Directive Acquiror); and (2) the acquisition by a publicly-held U.S. acquiror of the stock of a publicly-

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124. *See* Rev. Rul. 67-326, 1967-2 C.B. 143.

125. *See* Treas. Reg. § 1.368-2(b)(1) (1985).

126. Council Directive, *supra* note 3.

held target organized in a country that has adopted the Council Directive (Council Directive Target). Although the Council Directive only applies to companies organized in the Member States, for illustrative purposes, it is assumed here that the country under which the Council Directive Target and Acquiror are organized applies the principles of the Directive to a cross-border acquisition involving a U.S. Target or Acquiror.

B. Outline of the Basic Rules Reflected in the Council Directive

Article 2(a) of the Council Directive defines the terms "merger," "transfer of assets," and "exchange of shares." A "merger" is defined, *inter alia*, as:

> an operation whereby:
> - one or more companies, . . . transfer all their assets and liabilities to another existing company in exchange for the issue to their shareholders of securities representing the capital of that other company, and, if applicable, a cash payment not exceeding 10% of the nominal value . . . of those securities.[127]

This is the analogue to the (A) merger under section 368(a)(1)(A). In a merger under the Council Directive, the boot cannot exceed 10% of the stock of the acquiror paid in the exchange, whereas under the (A) reorganization, there can be up to 50% (and possibly more) boot.[128] The Council Directive does not provide for triangular mergers like the forward subsidiary merger under section 368(a)(2)(D) or the reverse subsidiary merger under section 368(a)(2)(E). As is discussed below, this is one of the major defects in the Council Directive.

A "transfer of assets" is defined in the Article 2(c) of the Council Directive as "an operation whereby a company transfers without being dissolved all of one or more branches of its activity to another company in exchange for the transfer of securities representing the capital of the receiving company."[129] This is similar to the (C) reorganization under section 368(a)(1)(C); however, the target does not liquidate and there is no "substantially all the assets" requirement. No boot is permitted in the transfer of assets under the Council Directive, whereas under certain circumstances up to 20% boot can be paid in a (C) reorganization.[130] This transfer of assets is not considered here further.

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127. *Id.* art. 2(a).
128. *See supra* Part II.A.2.a.
129. Council Directive, *supra* note 3, art. 2(c).
130. *See* I.R.C. § 368(a)(2)(C) (1994).

Under Article 2(d) of the Council Directive, an "exchange of shares" is defined as:

> an operation whereby a company acquires a holding in the capital of another company such that it obtains a majority of the voting rights in that company in exchange for the issue to the shareholders of the latter company, in exchange for their securities, of securities representing the capital of the former company, and, if applicable, a cash payment not exceeding 10% of the nominal value . . . of the securities issued in exchange.[131]

This is the analogue to the (B) reorganization under section 368(a)(1)(B). To qualify as a (B) reorganization, the acquiror must acquire at least 80% of the stock of the target, whereas under the exchange of shares in the Council Directive, the acquiror need acquire only a majority of the target's stock. Also, the (B) reorganization has a solely for voting stock requirement, whereas an exchange of shares under the Council Directive allows boot equal to 10% of the value of the shares paid by the acquiror.

The tax consequences to the parties in a merger and exchange of shares under the Council Directive is similar to the treatment of the parties in a reorganization under the Code. Under Article 4(1), the target in a merger does not recognize gain or loss with respect to its "transferred assets and liabilities."[132] This term is defined as "those assets and liabilities of the transferring company which . . . are effectively connected with a permanent establishment of the [acquiror] in the Member State of the [target] and plays a part in generating the profits or losses taken into account for tax purposes."[133] Thus, the nonrecognition treatment is available only with respect to assets of the target that remain within the target's country of incorporation. For the target to qualify for the tax-free treatment, Article 4(2) requires that the acquiror take a carryover basis for the assets acquired.[134]

The nonrecognition treatment for the target is the analogue to the nonrecognition treatment that applies under section 361 to a target in a reorganization. Also, the carryover basis rule for the acquiror is the analogue to the carryover basis rule that applies under section 362(b) to an acquiror in a reorganization.

Article 8 (1) provides that the shareholders of a target who, pursuant to a merger or exchange of shares, exchange their shares in the target

131. Council Directive, *supra* note 3, art. 2(d).
132. *See id.* art. 4(1).
133. *Id.*
134. *See id.* art. 4(2).

for shares in an acquiror receive nonrecognition treatment on the exchange. This is the analogue to section 354.[135] Under Article 8(2), the exchanging shareholders take a substituted basis for the shares of the acquiror received.[136] This is the analogue to section 358.

A special rule applies where the assets transferred in a merger include a permanent establishment of a target that is situated in a Member State other than the target's Member State. This rule would apply, for example, where a French target had business operations in another country and the assets of the French target were acquired by a non-French acquiror.[137] This exception is not explored here; thus, it is assumed that any Council Directive target discussed below does not directly have business operations outside of its home country.

Article 11 of the Council Directive provides that a Member State may deny the benefits of nonrecognition provided above where "it appears [, *inter alia,*] that the merger . . . or exchange of shares: (a) has as its principal objective or as one of its principal objectives tax evasion or tax avoidance."[138] Thus, Member States may enact provisions like section 367 to prevent the erosion of their tax base through tax-free cross-border mergers and acquisitions.

C. Acquisition by a Council Directive Acquiror of a U.S. Target

The most likely manner in which Council Directive Acquiror would acquire U.S. Target in a tax-free reorganization is by way of either a forward or reverse subsidiary merger. In this transaction, Council Directive Acquiror would form U.S. Sub and either U.S. Sub would merge into U.S. Target in a reverse subsidiary merger,[139] or U.S. Target would merge into U.S. Sub in a forward subsidiary merger.[140] The shareholders of U.S. Target would receive stock in Council Directive Acquiror. In the forward subsidiary merger, up to 50% of the consideration could be boot,[141] and in the reverse subsidiary merger, up to 20% of the consideration could be boot.[142]

The transactions would constitute a reorganization under the Code, and the shareholders of U.S. Target would qualify for tax-free treatment under section 354, provided the shareholders of U.S. Target in the

135. *See id.* art. 8(1).
136. *See id.* art. 8(2).
137. *See id.* art. 10.
138. *Id.* art. 11(1).
139. *See* Graph VI-2, *supra* Part VI.A.3.
140. *See* Graph VI-1, *supra* Part VI.A.2.
141. *See* I.R.C. § 368 (a)(2)(B) (1994).
142. *See id.* § 368 (a)(2)(E).

aggregate did not receive more than 50% of the stock of Council Directive Acquiror and any such shareholder who received 5% of the stock of Council Directive Acquiror entered into a gain recognition agreement.[143]

The transaction would not qualify for tax-free treatment under the Council Directive, however, because the Council Directive does not contemplate triangular mergers. Thus, any shareholders of U.S. Target who were citizens of the country in which Council Directive Acquiror was organized would not qualify for tax-free treatment under the Council Directive.

To structure the acquisition of U.S. Target in a form that would be tax-free under both the Code and the Council Directive, Council Directive Acquiror would have to acquire solely in exchange for its voting stock at least 80% of the stock of U.S. Target.[144] For federal income tax purposes, the transaction could be structured as a reverse subsidiary merger in which the only consideration paid is voting stock of Council Directive Acquiror,[145] but it is not clear whether this transaction would be treated as an "exchange of shares" under the Council Directive.

D. *Tax-Free Acquisition by a U.S. Acquiror of a Council Directive Target*

If U.S. Acquiror is acquiring Council Directive Target, it could be desirable to have the transaction treated as tax-free in both the United States and the country in which Council Directive Target is incorporated. This would ensure that the shareholders of Council Directive Target located in both the United States and the country in which Council Directive Target is located, receive tax-free treatment on the transaction.

Because U.S. Acquiror would not likely want to acquire Council Directive Target in a direct merger of Council Directive Target into U.S. Acquiror, which would be treated as a (C) reorganization under the Code and a merger under the Council Directive, to accomplish this tax-free treatment, the transaction would have to be structured as an exchange of shares under the Council Directive and as a (B) reorganization under the Code. Therefore, U.S. Acquiror would have to acquire in exchange solely for its voting stock at least 80% of Council Directive Target's stock. For U.S. tax purposes, the transaction could be

143. *See supra* Part V.A.

144. *See* Graph V-1, *supra* Part V.A.

145. *See* Rev. Rul. 67-448, 1967-2 C.B. 144; *supra* Part IX.A.

structured as a reverse subsidiary merger that qualifies as a (B) reorganization because the only consideration paid is solely voting stock of U.S. Acquiror.[146] It appears uncertain whether this transaction would be treated as an exchange of shares under the Council Directive.

E. Critique of the Council Directive

Although the Council Directive presents a rational approach to tax-free cross-border mergers and acquisitions, it does not go far enough. First, it is highly unlikely that U.S. Acquiror would want to acquire Council Directive Target in a direct merger, because U.S. Acquiror normally would not want to expose its assets to the liabilities of Council Directive Target. Consequently, the only viable acquisition of Council Directive Target that would be tax-free both in the United States and in the country of the Council Directive Target, is the exchange of shares under the Council Directive and the stock-for-stock (B) reorganization under the Code. This transaction could prove impractical, however, because U.S. Acquiror might not be able to acquire 80% of Council Directive Target in an exchange offer.

Second, it is unlikely that Council Directive Acquiror would want to acquire U.S. Target in a direct merger because Council Directive Acquiror would not normally want to expose its assets to U.S. Target's liabilities. Also, for tax reasons, Council Directive Acquiror probably would not want to have direct U.S. operations (i.e., it would likely conduct such operation through a subsidiary).

Consequently, for acquisitions both by U.S. Acquiror of Council Directive Target and by Council Directive Acquiror of U.S. Target, it would be beneficial if the Council Directive was either amended or interpreted to encompass both the forward and reverse subsidiary mergers. If this were done, U.S. Acquiror could acquire Council Directive Target in a tax-free reverse or forward subsidiary merger between Council Directive Target and a Council Directive sub of U.S. Acquiror, and Council Directive Acquiror could acquire U.S. Target in a tax-free reverse or forward subsidiary merger between U.S. Target and a U.S. sub of Council Directive Acquiror. In these transactions, the maximum boot that could be paid and still have the transaction treated as tax-free in both the U.S. and the country of Council Directive Target or Acquiror would be 10% of the stock consideration paid.

146. *See* Graph IX-1, *supra* Part IX.A.

As indicated above, the acquisition of MCI by British Telecommunications was structured as a forward subsidiary merger under section 368(a)(2)(D). If the approach suggested above were to apply to the United Kingdom, this type of acquisition would be tax-free to both U.S. and U.K. shareholders of MCI provided that the 10% boot limitation in the Council Directive were satisfied.

Finally, the Council Directive has a 10% limitation for boot, whereas the boot limitation under the Code depends on the form of reorganization. For example: (1) zero boot can be used in the straight and triangular (B) reorganization under section 368(a)(1)(B); (2) up to 20% boot can be used in the reverse subsidiary merger reorganization under section 368(a)(2)(D); (3) depending on the circumstances, up to 20% boot may be used in a straight or triangular (C) reorganization under section 368(a)(1)(C); and (4) 50% (and possibly more) boot may be used in a straight merger under the section 368(a)(1)(A) reorganization and in a forward subsidiary merger reorganization under section 368(a)(2)(E).

I have argued elsewhere that there are strong reasons for having a 20% uniform boot rule for all forms of acquisitive reorganizations.[147] Given the increasing globalization of mergers and acquisitions, the EU should also consider adopting a uniform 20% boot rule.

XII. CONCLUSION

In a 1996 letter to the Acting Assistant Secretary of Treasury for Tax Policy, the Chair of the Tax section of the New York State Bar Association asserted that the "existing guidance under section 367 is probably the most confusing of all the guidance that currently exists under the code."[148] The letter also stated that "even very knowledgeable tax practitioners, unless they have extensive experience and familiarity with the section 367 rules, have an extraordinary difficult time determining the answers to even simple section 367 questions."[149] The letter goes on to urge that an effort be made to "organize and unify all the section 367 regulations."[150]

These are valid criticisms of the current state of the regulations under section 367. I would add, however, that in revising these regulations,

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147. SAMUEL C. THOMPSON, REFORM OF THE TAXATION OF MERGERS, ACQUISITIONS AND LBOS 53-96 (1993).

148. *See* Letter from Richard L. Reinhold, Chair, Tax Section, New York Bar Ass'n, to Donald C. Lubick, Acting Assistant Treasury Secretary, and Margaret Richardson, IRS Commissioner, *reprinted in* 72 TAX NOTES 1549 (Sept. 16, 1996).

149. *Id.*

150. *Id.* at 1550.

the Treasury should focus separately on rules appropriate for cross-border acquisitive reorganizations involving publicly held firms that are not controlled foreign corporations. In most of these transactions, section 367 should not be an impediment to the nonrecognition treatment that is otherwise available under sections 354 and 361. With the increasing globalization of the merger and acquisitions marketplace, it is incumbent upon the Treasury to ensure that section 367 is not an unwarranted obstacle to the use of the acquisitive reorganization provisions.

XIII. POSTSCRIPT

On June 19, 1998, the Treasury issued final and temporary regulations under sections 367(a) and (b) addressing principally the transfer of stock of foreign target corporations to foreign acquiring corporations in reorganization and section 351 transactions. *See* RIN Nos. 1545-AP81 and 1545-AI32, 63 F.R. 3350-01, 1998 WL 319984. Although it is not possible to fully analyze the impact of these complex regulations on the points covered in this Article, two points should be made.

First, Reg. § 1.367(a)-3(b)(2) provides that "[a] transfer of foreign stock or securities described in section 367(a) or any regulation thereunder, as well as in section 367(a) or any regulations thereunder, shall be concurrently subject to sections 367(a) and (b) and the regulations thereunder, except to the extent that the transferee foreign corporation is not treated as a corporation under section 367(a)(1)." Thus, for example, in the foreign-to-foreign (B) reorganization addressed in Part X of this Article, both the section 367(a) and (b) regulations would apply to the transaction and not just the section 367(b) regulations as indicated in the text. *See* Reg. § 1.367(a)-3(b)(2)(ii), example.

Second, Reg. § 1.367(a)-3(d) replaces the indirect stock transfer rules of Temp. Reg. § 1.367(a)-1T(c)(2), which are discussed in Part VI of this Article. However, no substantial changes are made in the results.

APPENDIX: COMMISSION OF THE EUROPEAN COMMUNITIES

COUNCIL DIRECTIVE 90/434/EEC[151]

COUNCIL DIRECTIVE of 23 July 1990 on the common system of taxation applicable to mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States (90/434/EEC)

THE COUNCIL OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Economic Community, and in particular Article 100 thereof,

Having regard to the proposal of the Commission (1),

Having regard to the opinion of the European Parliament (2),

Having regard to the opinion of the Economic and Social Committee (3),

Whereas mergers, divisions, transfers of assets and exchanges of shares concerning companies of different Member States may be necessary in order to create within the Community conditions analogous to those of an internal market and in order thus to ensure the establishment and effective functioning of the common market; whereas such operations ought not to be hampered by restrictions, disadvantages or distortions arising in particular from the tax provisions of the Member States; whereas to that end it is necessary to introduce with respect to such operations tax rules which are neutral from the point of view of competition, in order to allow enterprises to adapt to the requirements of the common market, to increase their productivity and to improve their competitive strength at the international level;

Whereas tax provisions disadvantage such operations, in comparison with those concerning companies of the same Member State; whereas it is necessary to remove such disadvantages;

Whereas it is not possible to attain this objective by an extension at the Community level of the systems presently in force in the Member States, since differences between these systems tend to produce distortions;

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151. *See* Council Directive 90/434/EEC of 23 July 1990 on the Common System of Taxation Applicable to Mergers, Divisions, Transfers of Assets and Exchanges of Shares Concerning Companies of Different Member States, *available in* LEXIS, Eurcom Library, EClaw File.

whereas only a common tax system is able to provide a satisfactory solution in this respect;

Whereas the common tax system ought to avoid the imposition of tax in connection with mergers, divisions, transfers of assets or exchanges of shares, while at the same time safeguarding the financial interests of the State of the transferring or acquired company;

Whereas in respect of mergers, divisions or transfers of assets, such operations normally result either in the transformation of the transferring company into a permanent establishment of the company receiving the assets or in the assets becoming connected with a permanent establishment of the latter company;

Whereas the system of deferral of the taxation of the capital gains relating to the assets transferred until their actual disposal, applied to such of those assets as are transferred to that permanent establishment, permits exemption from taxation of the corresponding capital gains, while at the same time ensuring their ultimate taxation by the State of the transferring company at the date of their disposal;

Whereas it is also necessary to define the tax regime applicable to certain provisions, reserves or losses of the transferring company and to solve the tax problems occurring where one of the two companies has a holding in the capital of the other;

Whereas the allotment to the shareholders of the transferring company of securities of the receiving or acquiring company would not in itself give rise to any taxation in the hands of such shareholders;

Whereas it is necessary to allow Member States the possibility of refusing to apply this Directive where the merger, division, transfer of assets or exchange of shares operation has as its objective tax evasion or avoidance or results in a company, whether or not it participates in the operation, no longer fulfilling the conditions required for the representation of employees in company organs,

HAS ADOPTED THIS DIRECTIVE:

TITLE I

General Provisions

Article 1

Each Member State shall apply this Directive to mergers, divisions, transfers of assets and exchanges of shares in which companies from two or more Member States are involved.

Article 2

For the purposes of this Directive:

(a) [Analogue to § 368(a)(1)(A)] 'merger' shall mean an operation whereby:

- one or more companies, on being dissolved without going into liquidation, transfer all their assets and liabilities to another existing company in exchange for the issue to their shareholders of securities representing the capital of that other company, and, if applicable, a cash payment not exceeding 10% of the nominal value, or, in the absence of a nominal value, of the accounting par value of those securities, . . .

(c) [Analogue to § 368(a)(1)(C), without liquidation of Target] 'transfer of assets' shall mean an operation whereby a company transfers without being dissolved all or one or more branches of its activity to another company in exchange for the transfer of securities representing the capital of the company receiving the transfer;

(d) [Analogue to § 368(a)(1)(B)] 'exchange of shares' shall mean an operation whereby a company acquires a holding in the capital of another company such that it obtains a majority of the voting rights in that company in exchange for the issue to the shareholders of the latter company, in exchange for their securities, of securities representing the capital of the former company, and, if applicable, a cash payment not exceeding 10% of the nominal value or, in the absence of a nominal value, of the accounting par value of the securities issued in exchange;

(e) 'transferring company' shall mean the company transferring its assets and liabilities or transferring all or one or more branches of its activity;

(f) 'receiving company' shall mean the company receiving the assets and liabilities or all or one or more branches of the activity of the transferring company;
(g) 'acquired company' shall mean the company in which a holding is acquired by another company by means of an exchange of securities;
(h) 'acquiring company' shall mean the company which acquires a holding by means of an exchange of securities;
(i) 'branch of activity' shall mean all the assets and liabilities of a division of a company which from an organizational point of view constitute an independent business, that is to say an entity capable of functioning by its own means.

. . . .

TITLE II

Rules Applicable to Mergers, Divisions and Exchanges of Shares

Article 4

1. [Analogue to § 361] A merger or division shall not give rise to any taxation of capital gains calculated by reference to the difference between the real values of the assets and liabilities transferred and their values for tax purposes. The following expressions shall have the meanings assigned to them:

- value for tax purposes: the value on the basis of which any gain or loss would have been computed for the purposes of tax upon the income, profits or capital gains of the transferring company if such assets or liabilities had been sold at the time of the merger or division but independently of it,

- transferred assets and liabilities: those assets and liabilities of the transferring company which, in consequence of the merger or division, are effectively connected with a permanent establishment of the receiving company in the Member State of the transferring company and play a part in generating the profits or losses taken into account for tax purposes.

2. [Analogue to § 362(b)] The Member States shall make the application of paragraph 1 conditional upon the receiving company's computing any new depreciation and any gains or losses in respect of the assets and liabilities transferred according to the rules that would have applied to the transferring company or companies if the merger or division had not taken place.

. . . .

Article 8

1. [Analogue to § 354] On a merger, division or exchange of shares, the allotment of securities representing the capital of the receiving or acquiring company to a shareholder of the transferring or acquired company in exchange for securities representing the capital of the latter company shall not, of itself, give rise to any taxation of the income, profits or capital gains of that shareholder.

2. [Analogue to § 358] The Member States shall make the application of paragraph 1 conditional upon the shareholder's not attributing to the securities received a value for tax purposes higher than the securities exchanged had immediately before the merger, division or exchange.

The application of paragraph 1 shall not prevent the Member States from taxing the gain arising out of the subsequent transfer of securities received in the same way as the gain arising out of the transfer of securities existing before the acquisition.

. . . .

TITLE IV

Special Case of the Transfer of a Permanent Establishment

Article 10

1. Where the assets transferred in a merger, a division or a transfer of assets include a permanent establishment of the transferring company which is situated in a Member State other than that of the transferring company, the latter State shall renounce any right to tax that permanent establishment. However, the State of the transferring company may reinstate in the taxable profits of that company such losses of the permanent establishment as may previously have been set off against the taxable profits of the company in that State and which have not been recovered. The State in which the permanent establishment is situated and the State of the receiving company shall apply the provisions of this Directive to such a transfer as if the former State were the State of the transferring company.

2. By way of derogation from paragraph 1, where the Member State of the transferring company applies a system of taxing world-wide profits, that Member State shall have the right to tax any profits or capital gains of the permanent establishment resulting from the merger, division or transfer of assets, on condition that it gives relief for the tax that, but for

the provisions of this Directive, would have been charged on those profits or capital gains in the Member State in which that permanent establishment is situated, in the same way and in the same amount as it would have done if that tax had actually been charged and paid.

TITLE V

Final Provisions

Article 11

1. [Analogue to § 367] A Member State may refuse to apply or withdraw the benefit of all or any part of the provisions of Titles II, III and IV where it appears that the merger, division, transfer of assets or exchange of shares:

(a) has as its principal objective or as one of its principal objectives tax evasion or tax avoidance; the fact that one of the operations referred to in Article 1 is not carried out for valid commercial reasons such as the restructuring or rationalization of the activities of the companies participating in the operation may constitute a presumption that the operation has tax evasion or tax avoidance as its principal objective or as one of its principal objectives; . . . .