

International Tax Developments

By Diana Wessells and Edward Tanenbaum

IRS Publishes Guidance Related to the Application of the Code Sec. 367(a) Anti-Stuffing Rule

On December 24, 2007, the IRS published guidance on what is commonly referred to under the Treasury regulations as the Code Sec. 367(a) “anti-stuffing rule.” See Chief Counsel Advice 200751024. The IRS has provided little in terms of substantive guidance on the anti-stuffing rule since its effective date more than 10 years ago. The Chief Counsel Advice now provides some helpful content to the rule, but also raises some uncertainties.

Background of the Code Sec. 367(a) Anti-Stuffing Rule

Where a foreign acquiring corporation (“foreign acquirer”) acquires a U.S. target corporation in a transaction that otherwise would be tax-free, Code Sec. 367(a) generally requires that the target shareholders recognize gain. Treasury regulations, however, provide that the shareholders of the U.S. target will not recognize gain under Code Sec. 367(a) if certain conditions are satisfied.

For example, in connection with a transfer of stock or securities of a U.S. target, U.S. shareholders will recognize gain under Code Sec. 367(a) unless the acquisition satisfies four specific requirements:

- First, the collective U.S. shareholders of the U.S. target may receive no more than 50 percent of the stock of the foreign acquirer.
- Second, officers, directors and five-percent shareholders of the U.S. target may own no more than 50 percent of the stock of the foreign acquirer immediately after the acquisition of the U.S. target; stock acquired before the acquisition of the U.S. target is included for this purpose.
- Third, an individual U.S. shareholder of the U.S. target must own less than five percent of the stock of the foreign acquirer immediately after the acquisition of the U.S. target or, if the U.S. share-



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holder owns five percent or more of the stock of the foreign acquirer after the acquisition of the U.S. target, the U.S. shareholder must enter into a gain recognition agreement with the IRS.

- Fourth, the acquisition must satisfy the active trade or business test of Reg. §1.367(a)-3(c). Under the active trade or business test:
 - the foreign acquirer must be engaged in an active trade or business outside the United States for the 36-month period before the acquisition;
 - at the time of the acquisition, neither the foreign acquirer nor the U.S. target corporation may have the intention to substantially dispose of or to discontinue the trade or business; and
 - the “substantiality test” must be satisfied.

The purpose of the substantiality test is to ensure that the active trade or business of the foreign acquirer is substantial in relation to the active trade or business of the U.S. target. Specifically, the substantiality test provides that the fair market value of the foreign acquirer must be at least equal to the fair market value of the U.S. target corporation at the time of the acquisition. In general, assets that the foreign acquirer acquires outside the ordinary course of business during the 36-month period before the acquisition of the U.S. target corporation are included in the fair market value of the foreign acquirer only if:

- the assets do not produce passive income, and
- the foreign acquirer did not acquire the assets for the principal purpose of satisfying the substantiality test.

This second criterion is the anti-stuffing rule. The anti-stuffing rule does not apply to assets acquired by the foreign acquirer in the ordinary course of business.

IRS Guidance

As described in the Chief Counsel Advice, the foreign acquirer purchased the U.S. target in an acquisition intended to qualify as a tax-free stock-for-stock reorganization. For the 36-month period preceding the acquisition, the foreign acquirer held cash from sales to customers in the normal course of business. Before the acquisition, the foreign acquirer owed a debt obliga-

tion to its majority shareholder. Several days before the acquisition of the U.S. target, the majority shareholder of the foreign acquirer contributed a debt obligation owed by the foreign acquirer to the majority shareholder in exchange for additional stock in the foreign acquirer.

The IRS reasoned that the cash received from customers should not be excluded from the fair market value

of the foreign acquirer for purposes of the substantiality test because the foreign acquirer acquired the cash in the ordinary course of business. Consequently, it was unnecessary for the IRS to consider the application of the anti-stuffing rule for the cash held by

the foreign acquirer. However, the IRS concluded that the contribution of the debt to the foreign acquirer was subject to the anti-stuffing rule, and that the value of the debt contribution thus could not be included in the fair market value of the foreign acquirer. Because of the exclusion of the debt contribution from the fair market value of the foreign acquirer, the fair market value of the U.S. target was greater than the fair market value of the foreign acquirer at the time of the acquisition. Consequently, the acquisition failed the substantiality test, and the shareholders of the U.S. target were subject to gain recognition under Code Sec. 367(a).

The IRS provided only a brief analysis in concluding that the contribution of the debt to the foreign acquirer would cause the shareholders of the U.S. target to recognize gain under Code Sec. 367(a). Citing earlier rulings outside the context of Code Sec. 367(a), the IRS stated that the shareholder’s contribution of the debt was analogous to a cash contribution or a capital infusion that would increase the value of the foreign acquirer (but for, presumably, the application of the anti-stuffing rule).

However, the IRS did not provide any particular guidance on the critical point of why the debt contribution ran afoul of the anti-stuffing rule—specifically, why the contribution of the debt was found to be made outside the ordinary course of business and with the principal purpose of avoiding the substantiality test. Without the benefit of a more detailed analysis, the IRS’s position may indicate that a capital contribution to a foreign acquirer (or the cancellation of a debt obligation owed by the foreign acquirer to a shareholder) may automatically be viewed as made both outside the ordinary course of business and with the principal

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purpose of increasing the fair market value of the foreign acquirer.

Moreover, it is not entirely clear whether debt forgiveness by a party unrelated to the foreign acquirer could potentially violate the anti-stuffing rule. Whereas a shareholder creditor typically forgives a debt in order to strengthen the capital of the obligor corporation, an unrelated creditor may forgive a corporate debt for a variety of business reasons, most often in exchange for valuable consideration. Nevertheless, it is uncertain

whether the IRS would take into account the differences between these motives and would automatically view an unrelated creditor's forgiveness of a foreign acquirer's debt as not made in the ordinary course of business. As a result, foreign acquirers should exercise the utmost caution in restructuring their outstanding debt in the 36 months preceding the acquisition of a U.S. target. Likewise, the U.S. target should exercise vigilance in connection with any such debt restructuring by its foreign acquirer.

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