

# International Tax Strategies

By David Buss, David Hryck and Robert Rothman\*

## Planning for Outbound Reorganizations—An Introduction

This month's column will address U.S. tax issues that arise in structuring certain cross-border acquisitions. Specifically, it addresses *outbound* acquisitions (that is, those in which a foreign acquiror acquires the stock or assets of a U.S. target corporation) which are intended to qualify as tax-free reorganizations. The column does not address internal restructurings in which the "acquiror" and the "target" corporation are direct or indirect subsidiaries of a common parent corporation or are otherwise owned by the same or related interests.

Treatment of an acquisition as a tax-free reorganization has several important consequences. First, shareholders of the target corporation do not recognize loss, and do not recognize gain to the extent they receive stock of the acquiring corporation in exchange for their target stock.<sup>1</sup> Where a target shareholder receives cash or other property (generally referred to as "boot") in addition to acquiror stock, gain (but not loss) is recognized, in an amount equal to the lesser of (i) the amount of "boot," or (ii) the amount of gain *realized* (that is, the excess of the total consideration received over the shareholder's basis in his target stock).<sup>2</sup> The second major consequence of a reorganization is that the target corporation generally does not recognize any gain or loss on the exchange of its assets or the distribution to its shareholders of consideration received.<sup>3</sup> However, in the context of outbound cross-border reorganizations in which assets are transferred to a foreign corporation, the availability of corporate-level nonrecognition is extremely limited.<sup>4</sup>

Finally, the acquiring corporation does not take a "stepped-up" basis in the stock or assets acquired



**David Buss** is a Partner at the law firm of DLA Piper US LLP, resident in its New York office.



**David Hryck** is a Partner at the law firm of DLA Piper US LLP, resident in its New York office.



**Robert Rothman** is Counsel to the law firm of DLA Piper US LLP, resident in its New York office.

(reflecting the price paid), but instead takes a basis equal to that of the transferor. However, if the reorganization involves a transfer of assets and the target recognizes gain, the basis is stepped up by the amount of gain recognized.<sup>5</sup> This means that future depreciation deductions will be lower than if the acquiror took the assets of the target corporation with a stepped-up basis.

It is worth noting that, in the context of an outbound reorganization, the basis of assets (and hence the amount of future depreciation deductions) may or may not, depending on the structure of the transaction, be significant. If the transaction is structured as an acquisition of stock, the U.S. target corporation will survive, and hence will continue to be a U.S. taxpayer. In that case, obviously the amount of depreciation deductions permitted under U.S. law is significant. This is also true if the transaction is structured as an acquisition of assets by a U.S. subsidiary of the foreign buyer. However, if the transaction is structured as an acquisition of assets by the foreign buyer directly, or by a foreign subsidiary, in order to qualify for tax-free treatment under Code Sec. 367 the foreign acquiror will generally have to use the transferred assets in an active trade or business *outside* the United States.<sup>6</sup> Under these circumstances, it is possible that either (i) the foreign corporation that acquires the assets may not be engaged in a U.S. trade or business at all following the acquisition, or (ii) if it is so engaged, a significant part of its income might not be effectively connected with such U.S. trade or business. In either case, the loss of higher depreciation deductions may not matter much (if at all) to the acquiring corporation.<sup>7</sup>

In order to structure an outbound acquisition so as to qualify for tax-free treatment as a reorganization, three sets of rules must be considered. First, there are several judicially created doctrines that apply to all acquisitive reorganizations. Second, the transaction must be structured to meet the strict requirements for one of several specific statutorily defined types of reorganizations. Finally, the rules of Code Sec. 367, which apply specifically to cross-border reorganizations, must be considered.

## Judicially Created Doctrines

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Generally, the judicially created doctrines of continuity of proprietary interest, continuity of business enterprise and business purpose apply to all forms of acquisitive reorganizations.

## Continuity of Proprietary Interest

The continuity of proprietary interest doctrine requires that, for a transaction to qualify as a reorganization, “a substantial part of the proprietary interests in the target corporation [must] be preserved.”<sup>8</sup> In practice, this generally means that at least 40 percent of the total value of the consideration paid must be in the form of stock of the acquiror.<sup>9</sup> There is nothing unique about the outbound context insofar as the continuity of proprietary interest doctrine is concerned.

## Continuity of Business Enterprise

This doctrine generally requires that, following a reorganization, the acquiring corporation *either* (i) continue a significant line of the target’s historic business (“business continuity”),<sup>10</sup> *or* (ii) continue to use a significant portion of the target’s historic business assets in any business (“asset continuity”).<sup>11</sup> As is the case for continuity of proprietary interest, the application of this doctrine in the context of outbound cross-border reorganizations does not raise any special considerations.

## Business Purpose

A transaction will qualify as a reorganization only if it is undertaken for a legitimate, nontax business purpose.<sup>12</sup> Regulations state that a reorganization “must be undertaken for reasons germane to the continuance of the business of a corporation.”<sup>13</sup> Recently, the IRS has become quite aggressive about asserting the business purpose doctrine in the context of transactions which it perceives as abusive tax shelters,<sup>14</sup> and the precise scope of the doctrine in that context remains unclear. In the context of acquisitions involving real businesses and unrelated parties, however, business purpose is rarely a major concern. Significantly, most practitioners believe that, provided the acquisition itself is not tax motivated, there does not need to be a separate business purpose for structuring it so as to qualify for reorganization treatment rather than as a taxable acquisition. In any event, the outbound context does not present any unique problems in applying the business purpose doctrine.

## Statutory Forms of Reorganization

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In general, there are five statutory forms of acquisitive reorganization, each with its own specific rules.

## Direct “A” Reorganization

The statutory definition of an “A” reorganization is “a statutory merger or consolidation.”<sup>15</sup> Prior to 2006, Regulations required that such a merger or consolidation had to be effected pursuant to the laws of the United States, a state of the United States or the District of Columbia.<sup>16</sup> Therefore, a direct A reorganization could not be used for a cross-border acquisition.

In January 2006, the Treasury issued amended regulations which permit direct A reorganizations involving foreign companies. The current Regulations define a statutory merger or consolidation generally as a transaction, effected pursuant to a statute or statutes, in which, as a result of the operation of such statute or statutes, (i) all of the assets and liabilities of one company become the assets and liabilities of another company, and (ii) the first such company ceases its separate legal existence.<sup>17</sup> Thus, it is now possible to have an out-

bound direct A reorganization, provided that both jurisdictions have statutes under which assets and liabilities are transferred and the “merged” company (in the case of an outbound transaction, the U.S. company) goes out of existence. It is not necessary that the foreign statute use the term “merger.” On the other hand, if a particular jurisdiction allows the same effect to occur but the authority is found in case law without an authorizing statute, apparently an A reorganization cannot take place.<sup>18</sup>

There are no specific requirements for an A reorganization other than that there occur a statutory merger or consolidation (as so defined) and that the judicial doctrines described above are satisfied.

## “B” Reorganization

In a “B” reorganization, the target corporation remains in existence, and target shareholders exchange their target stock for stock of the acquiror. There are two statutory requirements for a B reorganization to qualify. First, immediately after the transaction, the acquiror must be in “control” of the target.<sup>19</sup> For this purpose, “control” means the ownership of at least 80 percent of the voting power, and at least 80 percent of each class of nonvoting stock.<sup>20</sup>

The second requirement for a B reorganization is that the *only* consideration which may be paid

to shareholders of the target corporation is voting stock of the acquiror.<sup>21</sup> Even a small amount of other consideration (such as cash or nonvoting stock) will disqualify the transaction definitionally as a reorganization, and render it fully taxable.

The solely for voting stock requirement may raise issues in the outbound context. Although there is scant authority as to what constitutes “voting stock” specifically in the reorganization context, authorities in analogous areas indicate that the crucial element of voting stock is that it embodies the right to vote for directors.<sup>22</sup> This formulation of the rule presupposes a corporate model similar to that which

exists under U.S. law, in which shareholders elect a Board of Directors, which in turn appoints management and exercises general supervisory authority over the affairs of a corporation. Not all jurisdictions follow this model. Depending on the jurisdiction in which the

acquiror is organized, it may be necessary to analyze local corporate law to determine whether stock issued in a putative B reorganization is voting stock.

In at least one private letter ruling, the IRS ruled that stock which had “the greatest level of rights granted to the shareholders” was voting stock for purposes of the reorganization provisions.<sup>23</sup> Although the officially released text of the ruling is too heavily redacted to discern the relevant facts, one commentator has stated that this ruling involved a Dutch corporation subject to the “large company” rules.<sup>24</sup> Under those rules, shareholders do not directly vote for a Board of Directors, but instead vote for a Supervisory Board, which in turn appoints the Board of Directors. Given that shareholders did not directly vote for the election of directors (which is the defining characteristic of voting stock), the advisors were evidently sufficiently concerned about the issue that they sought a ruling.

## “C” Reorganization

In a “C” reorganization, the target corporation transfers its assets to the acquiror. It has three basic requirements. First, the assets transferred must constitute “substantially all” of the assets of the target.<sup>25</sup> Although there is no statutory definition of “substantially all,” for purposes of rendering opinions many

**Tax planning for an outbound reorganization requires an understanding of the general rules applicable to reorganizations, as well as the rules of Code Sec. 367(a) and (d).**

practitioners require that at least 70 percent of the target's net assets, and at least 90 percent of its gross assets, be transferred. This standard is derived from guidelines issued by the IRS in connection with issuing private letter rulings.<sup>26</sup>

The second requirement is that, in general, a C reorganization, like a B reorganization, requires that the sole consideration be voting stock of the acquiror (or, in the triangular variant, voting stock of a corporation in control of the acquiror).<sup>27</sup>

The third requirement for a C reorganization is that the target corporation must liquidate, distributing the consideration received for the asset transfer to its shareholders.<sup>28</sup> The IRS (but not a taxpayer) has the ability to waive this requirement.<sup>29</sup>

In the outbound context, a C reorganization may raise the same issues as a B reorganization with respect to whether acquiror stock used as consideration is "voting stock."<sup>30</sup>

### Forward Triangular "(a)(2)(D)" Merger

As discussed above, B and C reorganizations have triangular variants in which stock of the acquiror's parent, rather than stock of the acquiror itself, is used as consideration. A reorganizations also have triangular variants. However, triangular A reorganizations have some additional requirements which do not apply to direct A reorganizations.

One type of triangular A reorganization (a so-called forward triangular merger, or "(a)(2)(D)" reorganization) is a merger (as defined above<sup>31</sup>) of the target corporation into a corporation controlled by the "acquiror," with the target merging out of existence and the controlled subsidiary surviving. This type of reorganization, like a C reorganization, requires that substantially all of the assets of the target be acquired in the merger.<sup>32</sup> It also precludes the use of any stock of the controlled subsidiary as consideration,<sup>33</sup> but otherwise does not impose any restrictions on permissible consideration other than those required by the continuity of proprietary interest doctrine.<sup>34</sup> Thus, in general, in an (a)(2)(D) reorganization, at least 40 percent of the total consideration must be stock (whether voting or nonvoting) of the acquiror parent; the remaining 60 percent can be anything *except* stock of the acquiror subsidiary.

The Code also imposes the requirement that, for a reorganization to qualify under (a)(2)(D), it would have qualified as a direct A reorganization had the merger been into the parent.<sup>35</sup> However, this requirement has been interpreted as meaning simply that the

judicial doctrines of continuity of proprietary interest, continuity of business enterprise and business purpose also apply to (a)(2)(D) reorganizations.<sup>36</sup>

In the outbound context, now that it is possible to have a "merger" in which one of the constituent corporations is foreign,<sup>37</sup> there are really two types of (a)(2)(D) reorganizations. In one type, a domestic target is merged into a domestic subsidiary of a foreign parent corporation. In this scenario, the assets remain the property of a U.S. corporation (albeit a different U.S. corporation than the historic owner of those assets), but the target shareholders exchange stock in the U.S. target for stock of the foreign parent. In the other variant, the target merges into a foreign subsidiary of a foreign parent. In this case, the assets have been transferred to a foreign corporation, in addition to the U.S.-for-foreign stock exchange.<sup>38</sup> Although the requirements for reorganization status are the same in both cases, the tax consequences going forward, as well as the analysis under Code Sec. 367, will be different.

### Reverse Triangular "(a)(2)(E)" Merger

The other triangular variant of an A reorganization is one in which a controlled subsidiary of the acquiror merges into the target, with the target surviving (a "reverse triangular merger" or "(a)(2)(E)."<sup>39</sup> In this form of reorganization, the target (which survives and becomes a subsidiary of the acquiror) must continue, after the merger, to hold "substantially all" of its assets.<sup>40</sup>

An (a)(2)(E) reorganization has a rather confusing rule as to the types of permissible consideration. Specifically, in the transaction, former shareholders of the target must exchange an amount of target stock constituting "control" of target for voting stock of the acquiring parent.<sup>41</sup> As discussed above, "control" means at least 80 percent of the voting power, and at least 80 percent of each class of nonvoting stock.<sup>42</sup> Where (i) the target has only one class of stock outstanding, (ii) the acquiror does not own any target stock before the transaction, and (iii) all shareholders receive the same per-share consideration, this effectively means that at least 80 percent of the total consideration must be in the form of acquiror voting stock. Where any of those three conditions are not satisfied, however, the permissible consideration in an (a)(2)(E) reorganization cannot be specified in terms of an overall mix of consideration, but must be analyzed in light of the specific statutory rule.

Because an (a)(2)(E) reorganization requires that a certain amount of the consideration be in the form of voting stock, in the outbound context it can raise the same issues as B and C reorganizations as to whether stock of a foreign company is properly characterized as voting stock, particularly where the corporate law of the acquiror's jurisdiction of incorporation differs from the U.S. model.<sup>43</sup>

Because the target corporation survives in an (a)(2)(E) reorganization, there is no "outbound" transfer of assets. However, shareholders of the target will have exchanged stock in a U.S. corporation (the target) for stock of a foreign corporation (the acquiror parent).

### Considerations in Choice of Form

A number of different considerations come into play in choosing an appropriate form of reorganization. For example, the mix of consideration is generally a function of the business deal; to the extent that mix is inconsistent with the permissible consideration for a particular form of reorganization, obviously that form will be precluded. Thus, if any "boot" at all is part of the deal, neither a B nor (in general) a C reorganization is possible. An (a)(2)(E) permits some boot, but generally less than a direct A or an (a)(2)(D) (in which the only limitation on permissible consideration is that imposed by the continuity of proprietary interest doctrine).

Business considerations will also largely drive whether the buyer intends to acquire (and retain) all of the target's historic assets. If it desires to get rid of a significant amount of assets, those forms of reorganizations which impose a "substantially all" requirement are contraindicated, and only a direct A or a B reorganization will be available.

In general, a direct A reorganization has the simplest requirements of all. Historically, however, direct A reorganizations have not been all that popular, due largely to the facts that (i) they result in the buyer's assets and those acquired from the target being in a single entity, which may not be optimum from a liability perspective, and (ii) they frequently require a shareholder vote for the acquiror as well as the target. Since 2003, however, it is frequently possible to avoid these problems by merging the target into a disregarded entity which is wholly owned by the acquiror.<sup>44</sup>

Another consideration is transferability of the target's assets. The target may own assets (such as key contracts) which may be nontransferable with-

out consent of third parties, which consent may be difficult, time consuming or expensive to obtain. In that case, a B or an (a)(2)(E) reorganization, in which the target's assets remain in the same entity, may be preferable. If local law allows assets to be transferred by operation of law in a merger, but not otherwise, a direct A or an (a)(2)(D) become possibilities, but not a C.

Finally, as discussed below, different forms of reorganization call into play different rules under Code Sec. 367, and this may be a factor in the choice of form.

### Code Sec. 367

Code Sec. 367(a) generally provides that, with certain exceptions, where a U.S. person transfers property to a foreign corporation in a transaction which qualifies as a reorganization,<sup>45</sup> the transferee is not, for purposes of determining gain recognition on such transfer, treated as a corporation. The effect of this is that, unless an exception is available, the transferor will recognize gain on the transferor even though the transaction otherwise qualifies as a reorganization. Detailed rules for the exceptions are provided for in Regulations, and are discussed below.<sup>46</sup>

It is important to understand that the application of Code Sec. 367(a) does not affect the definitional qualification of a reorganization as such. Rather, it affects whether a particular transfer within the context of a reorganization is entitled to nonrecognition. Thus, it is quite possible for nonrecognition to be available for some transfers, but not others, in the context of a transaction which meets the definitional rules for reorganization status.

Fundamentally, there are two types of transfers to foreign corporations which may occur in the context of an outbound reorganization. In some types of reorganizations, the target corporation itself may transfer its assets to a foreign corporation. In addition, in some types of reorganizations U.S. shareholders of the target may transfer (or be deemed to transfer) stock of the target to a foreign corporation. Each such outbound transfer is analyzed separately under Code Sec. 367.

### Transfers by the Target Corporation

In certain types of outbound reorganizations, the target corporation transfers its assets to a foreign corporation. But for the possible application of Code Sec. 367, this transfer will generally be entitled to

nonrecognition under Code Sec. 361. This type of transfer occurs in the context of direct A and C reorganizations. It will also occur in a (a)(2)(D) reorganization if the acquiror subsidiary is foreign. On the other hand, in the case of B and (a)(2)(E) reorganizations, the target remains alive as a subsidiary of the acquiror, and does not transfer any assets. In the case of an (a)(2)(D) reorganization where the acquiror subsidiary is domestic, the target does transfer its assets, but the transferee is domestic, so Code Sec. 367(a) does not come into play.

Transfers by target corporations that may give rise to the application of Code Sec. 367(a) generally involve four types of assets. These are (i) tangible operating assets, (ii) stock of domestic subsidiaries, (iii) stock of foreign subsidiaries, and (iv) intangibles. Each of these types of property is subject to different rules. In addition, even if the specific rules for nonrecognition with respect to that type of property are satisfied, there exists an overriding rule which frequently will require gain recognition.<sup>47</sup>

### ***Overriding Rule for Outbound Asset Reorganizations***

As discussed below, special requirements must be met for corporate-level nonrecognition to be available, depending on whether the assets transferred represent business assets, stock of domestic corporations, or stock of foreign corporations. Even if those requirements are satisfied, however, the target corporation in an outbound reorganization will only be entitled to nonrecognition if it is controlled, within the meaning of Code Sec. 368(c),<sup>48</sup> by five or fewer U.S. corporations (counting members of an affiliated group as a single corporation for this purpose).<sup>49</sup> This rule often precludes corporate-level nonrecognition for publicly traded targets, as well as for closely held targets where a significant amount of stock is owned by individuals.

### ***Tangible Operating Assets***

An exception to Code Sec. 367(a) generally allows nonrecognition (subject to the overriding rule discussed above) for property which is transferred to a foreign corporation for use by that corporation in the active conduct of a trade or business outside the United States.<sup>50</sup> This rule has several elements.

First, the foreign corporation must be engaged in a trade or business. This generally requires that it engage in "a specific unified group of activities that constitute (or could constitute) an independent

economic enterprise carried on for profit." Ordinarily, this must include "every operation which forms a part of, or a step in, a process by which an enterprise may earn income or profit," including specifically the collection of income and the payment of expenses.<sup>51</sup>

The second element is that the foreign corporation's trade or business must be "active." This generally requires that officers and employees of the corporation carry out substantial managerial and operational activities. Activities carried out by independent contractors do not count, although incidental activities can be carried out by independent contractors as long as the activities of the officers and employees are adequate.<sup>52</sup>

The third element is that the trade or business must be conducted outside the United States. This generally requires that, following the transfer (i) the primary managerial and operational activities must be conducted outside the United States, and (ii) substantially all of the transferred assets are located outside the United States.<sup>53</sup> Significantly, the business does *not* have to be conducted in the same country as that in which the transferee is organized.

The fourth element is that the assets must be used or held for use in the trade or business. This generally requires that those assets be (i) held for the principal purpose of promoting the present conduct of the trade or business, (ii) acquired and held in the ordinary course of the trade or business, or (iii) otherwise held in a direct relationship to the trade or business. Property is considered held in a direct relationship to a trade or business if it is held to meet the present needs of that trade or business and not its anticipated future needs.<sup>54</sup>

Certain types of property are not entitled to the exception for active business assets, even if they would otherwise qualify for that exception. These include (i) inventory and certain other types of ordinary income property,<sup>55</sup> (ii) installment obligations and accounts receivable,<sup>56</sup> (iii) foreign currency and certain foreign currency-denominated financial instruments,<sup>57</sup> and (iv) certain leased property.<sup>58</sup> In addition, intangible property, even if used in an active foreign trade or business, is subject to special rules described below.<sup>59</sup> Regulations also require that where depreciation deductions were previously claimed with respect to an item of transferred property, recapture income is recognized even if the property would otherwise qualify for the foreign active business exception.<sup>60</sup>

## ***Stock of U.S. Subsidiaries***

Where stock of a U.S. corporation is transferred by the target in an outbound reorganization, in addition to the “five or fewer” test described above<sup>61</sup> (which is applied with regard to the target corporation itself, not to the subsidiary), four requirements must be satisfied for corporate-level nonrecognition to be available.

First, no more than 50 percent (measured by either vote or value) of the stock of the acquiror corporation may be received in the transaction in exchange for stock of the transferred U.S. subsidiary (the “50-percent receipt rule”).<sup>62</sup>

Second, immediately after the transaction, no more than 50 percent (measured by either vote or value) of the stock of the acquiror may be owned by U.S. persons who are officers, directors or five percent or greater shareholders of the transferred subsidiary (the “50-percent ownership rule”).<sup>63</sup> Although this looks to a narrower class of persons than the 50 percent receipt rule, it is not limited to stock issued in the transaction.

The third requirement is a three-part foreign active business test.<sup>64</sup> In order to meet this test, in general, (i) the transferee foreign corporation must have been engaged, for at least 36 months prior to the transfer, in an active trade or business outside the United States,<sup>65</sup> (ii) there is no intention to dispose of such business,<sup>66</sup> and (iii) the fair market value of the transferee foreign corporation must be at least equal to the fair market value of the transferred U.S. subsidiary.<sup>67</sup>

The fourth requirement is that each five percent or greater (by vote or value) target shareholder that is a domestic corporation must execute a gain recognition agreement (GRA) with respect to its *pro rata* share of the realized (but unrecognized) gain on the transferred stock.<sup>68</sup> Under a GRA, the taxpayer generally agrees that, upon the occurrence of certain triggering events within a specified period of time, the taxpayer will pay tax on the original gain, plus interest.<sup>69</sup> Triggering events generally include (i) a disposition by the acquiror of the transferred stock,<sup>70</sup> (ii) a disposition by the transferred corporation of substantially all of its assets,<sup>71</sup> and (iii) a disposition by the target shareholder of the acquiror stock received in the reorganization.<sup>72</sup> The specified period of time runs until the close of the fifth full taxable year (no less than 60 months) from the close of the year in which the transfer occurred.<sup>73</sup> The general rules for GRAs allow the taxpayer to elect whether to pay

such tax by amending the return for the year of transfer, or by including the gain in the year of the subsequent disposition<sup>74</sup>; however, in the context of a transfer by the target in an asset reorganization, only the latter option is available.<sup>75</sup> The taxpayer must also agree to extend the statute of limitations with respect to the year of transfer.<sup>76</sup> The GRA must comply with a number of formal requirements specified in the Regulations.<sup>77</sup>

It is important to understand that gain recognition under a GRA can be triggered by actions which are totally outside of the taxpayer’s control. Specifically, in the context of an acquisition, gain can be triggered if the acquiror disposes of the transferred subsidiary, or if the subsidiary disposes of substantially all of its assets after

the acquisition. Thus, where reliance is placed on a GRA to avoid corporate-level tax, the shareholders of the target should seek contractual protection against the buyer disposing of the subsidiary

stock (or causing the subsidiary to dispose of its assets) and thereby triggering tax under the GRA.

**Careful legal analysis and planning is essential to ensure the intended tax treatment to all parties.**

## ***Stock of Foreign Subsidiaries***

Subject to the overriding rule for outbound asset reorganizations, a domestic target corporation that transfers stock of a foreign subsidiary to a foreign corporation in a reorganization is generally entitled to nonrecognition provided that each of its five percent or greater shareholders that is a domestic corporation executes a GRA with respect to stock of the transferred stock.<sup>78</sup> The rules for, and issues raised by, GRAs in this context are essentially the same as those which apply to GRAs with respect to domestic subsidiaries, discussed above.

## ***Intangibles***

In general, transfers of intangibles in the context of what would otherwise qualify as a Code Sec. 361 transaction are addressed in Code Sec. 367(d). “Intangibles” for this purpose includes most intellectual property, such as patents, copyrights, trademarks, trade names, franchises, business methods and similar items, but only if they have substantial value independent of the services of any individual.<sup>79</sup> However, it does not include foreign goodwill or going-concern value.<sup>80</sup> Foreign goodwill or going-concern value is defined as the residual value of a business conducted outside the United States, after all other assets (both tangible and intangible) have been identified and valued. However, notwithstanding this limited definition, foreign good-

will or going-concern value includes the value of the right to use a corporate name in a foreign country.<sup>81</sup>

In analyzing the treatment of intangible property subject to Code Sec. 367(d) in the context of an outbound asset acquisition, it is important to realize that conceptually, two transactions are involved. First, the assets of the target corporation (including the intangibles) are transferred to the acquiror; second, the target transfers the acquiror stock (and any other consideration received) to its shareholders in liquidation.<sup>82</sup> With respect to the transfer of the intangibles themselves by the target, there is no immediate gain recognition. Instead, Code Sec. 367(d) generally requires the transferor to impute an arm's-length royalty for the use of the property. In theory, if the target remained in existence and did not distribute the consideration received in the acquisition, it would be required to include this deemed royalty in income over the useful life of the intangibles (or, if less, 20 years).<sup>83</sup>

Because the target (which is the transferor of the intangibles) goes out of existence, this scheme of deemed royalty inclusions over the property's useful life doesn't work. Instead, the treatment depends on whether the shareholders to whom the consideration is distributed in the liquidation are treated as "related persons." For this purpose, "related person" is defined under the Code Sec. 267 rules, except that (i) a 10-percent ownership threshold is substituted for 50 percent, and (ii) in applying the controlled group definition, tax-exempt entities, foreign corporations and certain other types of corporations that are otherwise excluded are included.<sup>84</sup> Thus, in general, 10 percent or greater individual shareholders and 80 percent or greater corporate shareholders are treated as "related persons."

To the extent the acquisition consideration is distributed to persons other than related persons, the target recognizes gain on the intangible as though it had been sold.<sup>85</sup> To the extent the consideration is distributed to related persons who are U.S. persons, those U.S. persons, in effect, inherit the future stream of income inclusions (which will be treated as ordinary, U.S.-source income in their hands).<sup>86</sup> To the extent the consideration is distributed to related foreign persons, the Regulations provide that the transferor corporation continues to include the stream of deemed royalties as though the consideration has not been distributed.<sup>87</sup> In the context of an outbound asset reorganization, however, the target corporation goes out of existence. It is not clear how the Regulations should be applied in this context.

Intangibles subject to Code Sec. 367(d) are not subject to the overriding "five or fewer corporate share-

holders" rule discussed above, because that rule is phrased as a limitation on the exceptions to Code Sec. 367(a). However, foreign goodwill and going concern value, which are not subject to Code Sec. 367(d), are subject to Code Sec. 367(a). Accordingly, those types of intangibles should be entitled to nonrecognition if they qualify under the active foreign business exception<sup>88</sup> and the target satisfies the "five or fewer" test.

## Transfers by Shareholders

In addition to transfers of assets by the target corporation, Code Sec. 367 may also apply to preclude nonrecognition to U.S. shareholders who transfer (or are treated as transferring) stock of the target corporation to a foreign corporation as part of a reorganization.

In the case of a direct B reorganization or an (a)(2)(E)<sup>89</sup> reorganization, there is an actual transfer of stock of the target to stock of the foreign acquiror, and Code Sec. 367(a) thereby is potentially applicable. In the case of certain types of triangular reorganizations, The Regulations state that there is an "indirect" transfer of stock to the foreign acquiror parent corporation whose stock is issued as consideration,<sup>90</sup> so that Code Sec. 367(a) may apply even though there has been no actual outbound transfer of stock by the target shareholders. Such an indirect transfer is deemed to occur in the context of (i) an (a)(2)(D) forward triangular merger (regardless of whether the acquiror subsidiary is domestic or foreign),<sup>91</sup> (ii) a triangular B reorganization, even if the direct acquiror (*i.e.*, the subsidiary) is domestic,<sup>92</sup> and (iii) a triangular C reorganization (regardless of whether the acquiror subsidiary is domestic or foreign).<sup>93</sup> In addition, a direct A or C reorganization is treated as an indirect transfer of stock if, as part of the plan, the acquiror "drops down" the acquired assets to a controlled corporation.<sup>94</sup> On the other hand, a direct A or C reorganization which is not followed by a drop-down of assets is not treated as an outbound transfer of stock, and hence the target stockholders are not subject to Code Sec. 367(a) even though they exchange their stock in the U.S. target for stock in the foreign acquiror.

Because Code Sec. 367(a) can be implicated by a drop-down following a direct A or C reorganization, target shareholders in such a transaction may wish to consider seeking a contractual covenant that the acquiror will not effect such a drop-down (or at least a representation that it has no plan or intention to do so). Without such contractual protection, the acquiror, following the acquisition, would be free to take actions which would cause the target sharehold-

ers to become subject to possible gain recognition under Code Sec. 367(a).

If Code Sec. 367(a) applies, four requirements must be satisfied in order for nonrecognition to be available to target U.S. shareholders. The requirements are essentially the same as those which apply to corporate-level nonrecognition on transfers of stock in U.S. subsidiaries.<sup>95</sup> However, the rules are applied in the context of the transferred stock being that of the target. Thus, as applied in this context, the 50-percent receipt rule looks to acquiror stock issued to target U.S. shareholders in the acquisition,<sup>96</sup> and the 50-percent ownership rule looks to acquiror stock owned by U.S. persons who are officers, directors or five percent or greater shareholders of the *target*.<sup>97</sup> Moreover, in applying part (iii) of the active business test, the value of the acquiror is compared to that of the *target*.

The fourth requirement is that five-percent shareholders of the target must execute a GRA.<sup>98</sup> The events which will trigger gain recognition to shareholders under a GRA will depend on the particular form of reorganization. When there has been a direct outbound transfer of target stock (*i.e.*, in a B or (a)(2)(E)

reorganization), disposition of that stock by the target, or disposition by the target of substantially all of its assets, will trigger gain recognition. Where a transaction is treated as an indirect outbound transfer of target stock, certain indirect dispositions will give rise to gain recognition.<sup>99</sup> In some cases, more than one event can trigger gain recognition.

Because some events which can trigger gain recognition under a GRA are within the control of the acquiror, but the consequences will fall on the target shareholders, an advisor to a target corporation in an outbound reorganization would be well advised to identify the specific triggering events applicable to the particular type of reorganization, and seek a contractual covenant that the acquiror will not cause any of such events to occur during the relevant period.

## Conclusion

Tax planning for an outbound reorganization requires an understanding of the general rules applicable to reorganizations, as well as the rules of Code Sec. 367(a) and (d). Careful legal analysis and planning is essential to ensure the intended tax treatment to all parties.

## ENDNOTES

For additional information, contact David Buss ([david.buss@dlapiper.com](mailto:david.buss@dlapiper.com)), David Hryck ([david.hryck@dlapiper.com](mailto:david.hryck@dlapiper.com)) or Robert Rothman ([robert.rothman@dlapiper.com](mailto:robert.rothman@dlapiper.com)).

<sup>1</sup> Code Sec. 354(a).

<sup>2</sup> Code Sec. 356(a).

<sup>3</sup> Code Sec. 361.

<sup>4</sup> See text accompanying notes 48–49, *infra*.

<sup>5</sup> Code Sec. 362.

<sup>6</sup> See text accompanying notes 50–60, *infra*.

<sup>7</sup> Even if the foreign corporation is not a U.S. taxpayer, the amount of depreciation deductions could still affect the foreign corporation's earnings and profits, which might affect the character of actual or constructive distributions to U.S. shareholders. See Code Secs. 316(a), 952(c)(1).

<sup>8</sup> Reg. §1.368-1(e)(1).

<sup>9</sup> See Reg. §1.368-1(e)(2)(v), Example 1. As discussed below, certain types of reorganizations impose more restrictive rules as to the type of permissible consideration.

<sup>10</sup> Reg. §1.368-1(d)(2).

<sup>11</sup> Reg. §1.368-1(d)(3).

<sup>12</sup> See *Gregory v. Helvering*, S Ct, 35-1 USTC ¶9043, 293 US 465.

<sup>13</sup> Reg. §1.368-2(g).

<sup>14</sup> See, e.g., *Coltec Industries, Inc.*, CA-FC, 2006-2 USTC ¶50,389, 454 F3d 1340; *Klamath Strategic Investment Fund, LLC*, DC-TX, 2007-1 USTC ¶50,223.

<sup>15</sup> Code Sec. 368(a)(1)(A).

<sup>16</sup> Reg. §1.368-2(b)(1)(ii) before amendment by T.D. 9242 (Jan. 23, 2006).

<sup>17</sup> Reg. §1.368-2(b)(1)(ii).

<sup>18</sup> Such a transaction could nevertheless qualify as a C reorganization if the requirements for that type of reorganization (discussed in the text accompanying notes 25–30, *infra*) are satisfied.

<sup>19</sup> Code Sec. 368(a)(1)(B).

<sup>20</sup> Code Sec. 368(c); Rev. Rul. 59-259, 1959-2 CB 115.

<sup>21</sup> Code Sec. 368(a)(1)(B). There is also a triangular variant of the B reorganization, in which voting stock of a corporation in control of the acquiror is used.

<sup>22</sup> See, e.g., *Rudolph Wurlitzer Co. et al.*, 29 BTA 443, Dec. 8303 (1933), *aff'd*, CA-6, 36-1 USTC ¶9077, 81 F2d 971, *cert. den.*, 298 US 676 (1936); Rev. Rul. 69-126, 1969-1 CB 218 (both interpreting “voting stock” for purposes of the requirements for filing a consolidated return, currently found in Code Sec. 1504).

<sup>23</sup> LTR 9412038.

<sup>24</sup> DOLOBOFF & WILCOX, 771-2nd TM, *CORPORATE ACQUISITIONS—(A), (B), AND (C) REORGANIZATIONS*, at A-28.

<sup>25</sup> Code Sec. 368(a)(1)(C).

<sup>26</sup> Rev. Proc. 77-37, 1977-2 CB 568, at §3.01.

<sup>27</sup> Code Sec. 368(a)(1)(C). In the case of C reorganizations (unlike B reorganizations), there is a limited exception which permits up to 20-percent boot. However, if there is any actual boot paid under this section, then liabilities of the target

assumed by the acquiror also count as boot for purposes of determining whether the 20-percent test is satisfied. Code Sec. 368(a)(2)(B). In the authors' experience, this “boot relaxation rule” is of extremely limited practical utility.

<sup>28</sup> Code Sec. 368(a)(2)(G)(i).

<sup>29</sup> Code Sec. 368(a)(2)(G)(ii).

<sup>30</sup> See text accompanying notes 22–24, *supra*.

<sup>31</sup> See text accompanying notes 15–18, *supra*.

<sup>32</sup> Code Sec. 368(a)(2)(D).

<sup>33</sup> Code Sec. 368(a)(2)(D)(i).

<sup>34</sup> See text accompanying notes 8–9, *supra*.

<sup>35</sup> Code Sec. 368(a)(2)(D)(ii).

<sup>36</sup> Reg. §1.368-2(b)(2).

<sup>37</sup> See text accompanying note 17, *supra*.

<sup>38</sup> In theory, it is also possible for a U.S. target to merge into a foreign subsidiary of a U.S. parent, although it is unlikely that this would create an efficient structure going forward.

<sup>39</sup> Code Sec. 368(a)(2)(E).

<sup>40</sup> Code Sec. 368(a)(2)(E)(i). Technically, it must also acquire substantially all of the assets of the acquiror subsidiary which merges out of existence. In most cases, that subsidiary is a shell corporation set up for purposes of effecting the acquisition, and has no assets other than perhaps a nominal amount if required under local law. In theory, however, it is possible to use a historic subsidiary with real assets and operations; in that case, the application of the “substantially all” requirement to both companies can have real significance.

<sup>41</sup> Code Sec. 368(a)(2)(E)(ii).

<sup>42</sup> See text accompanying note 20, *supra*.

<sup>43</sup> See text accompanying notes 22–24, *supra*.

<sup>44</sup> See Reg. §1.368-2(b).

<sup>45</sup> Code Sec. 367(a) also applies to certain nonreorganization transfers, including Code Sec. 351 incorporations and Code Sec. 332 liquidations. Discussion of these transactions is beyond the scope of this column.

<sup>46</sup> The Regulations under Code Sec. 367(a) are exceedingly complex. This column does not purport to present a complete analysis of the subject, but rather introduces the general framework within which these rules operate.

<sup>47</sup> See text accompanying notes 48–49, *infra*.

<sup>48</sup> See text accompanying note 20, *supra*.

<sup>49</sup> Code Sec. 367(a)(5).

<sup>50</sup> Reg. §1.367(a)-2T(a)(1).

<sup>51</sup> Reg. §1.367(a)-2T(b)(2).

<sup>52</sup> Reg. §1.367(a)-2T(b)(3).

<sup>53</sup> Reg. §1.367(a)-2T(b)(4).

<sup>54</sup> Reg. §1.367(a)-2T(b)(5).

<sup>55</sup> Reg. §1.367(a)-5T(b).

<sup>56</sup> Reg. §1.367(a)-5T(c).

<sup>57</sup> Reg. §1.367(a)-5T(d).

<sup>58</sup> Reg. §1.367(a)-5T(f).

<sup>59</sup> See text accompanying notes 79–88, *infra*.

<sup>60</sup> Reg. §1.367(a)-4T(b). Special rules also apply where there is a transfer of a foreign

branch with respect to which losses were previously deducted. Reg. §1.367(a)-6T. A detailed discussion of the foreign branch rules is beyond the scope of this column.

<sup>61</sup> Reg. §1.367(a)-3T(e)(1)(i).

<sup>62</sup> Reg. §§1.367(a)-3T(e)(1)(ii); 1.367(a)-3(c)(1)(i).

<sup>63</sup> Reg. §§1.367(a)-3T(e)(1)(ii); 1.367(a)-3(c)(1)(ii).

<sup>64</sup> Reg. §1.367(a)-3T(e)(1)(iii).

<sup>65</sup> Reg. §1.367(a)-3(c)(3)(i)(A). Under certain circumstances, businesses conducted indirectly through subsidiaries or partnerships may count.

<sup>66</sup> Reg. §1.367(a)-3(c)(3)(i)(B).

<sup>67</sup> Reg. §1.367(a)-3(c)(3)(i)(C).

<sup>68</sup> Reg. §1.367(a)-3T(e)(1)(iii).

<sup>69</sup> Reg. §1.367(a)-8T(b)(3).

<sup>70</sup> Reg. §1.367(a)-8T(d)(1).

<sup>71</sup> Reg. §1.367(a)-8T(d)(2).

<sup>72</sup> Reg. §1.367(a)-8T(d)(3).

<sup>73</sup> Reg. §1.367(a)-8T(b)(3)(i).

<sup>74</sup> *Id.*

<sup>75</sup> Reg. §1.367(a)-3T(e)(1)(iv).

<sup>76</sup> Reg. §1.367(a)-8T(b)(4).

<sup>77</sup> Reg. §1.367(a)-8T.

<sup>78</sup> Reg. §1.367(a)-3T(e)(1)(iii).

<sup>79</sup> Code Secs. 367(d)(1); 936(h)(3)(B).

<sup>80</sup> Reg. §1.367(d)-1T(b).

<sup>81</sup> Reg. §1.367(a)-1T(d)(5)(iii).

<sup>82</sup> In the case of a C reorganization, the liquidation is required by the statutory definition (unless waived by the IRS); in the case of a merger (whether direct or forward triangular), it occurs by operation of law.

<sup>83</sup> Reg. §1.367(d)-1T(c).

<sup>84</sup> Reg. §1.367(d)-1T(h).

<sup>85</sup> Reg. §1.367(d)-1T(d).

<sup>86</sup> Reg. §1.367(d)-1T(e)(1).

<sup>87</sup> Reg. §1.367(d)-1T(e)(3).

<sup>88</sup> See text accompanying notes 50–60, *supra*.

<sup>89</sup> Interestingly, Reg. §1.367(a)-3(d)(1)(ii) identifies an (a)(2)(E) reverse triangular merger as an example of an “indirect” outbound transfer of stock; this doesn’t seem to be necessary, since such a transaction seems to involve a direct transfer.

<sup>90</sup> Reg. §1.367(a)-3(d)(2)(i).

<sup>91</sup> Reg. §1.367(a)-3(d)(1)(i).

<sup>92</sup> Reg. §1.367(a)-3(d)(1)(iii).

<sup>93</sup> Reg. §1.367(a)-3(d)(1)(iv).

<sup>94</sup> Reg. §1.367(a)-3(d)(1)(v).

<sup>95</sup> See text accompanying notes 61–77, *supra*. Note that the “five or fewer” overriding rule is not relevant to nonrecognition by target shareholders.

<sup>96</sup> Reg. §1.367(a)-3(c)(1)(i).

<sup>97</sup> Reg. §1.367(a)-3(c)(1)(ii).

<sup>98</sup> Reg. §1.367(a)-3(c)(1)(iii).

<sup>99</sup> Reg. §1.367(a)-3(d)(2)(iv).

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