

International Taxation

By Kevin Rowe and Jack Cummings

IRS Expands Restrictions on “Killer B” Transactions¹

Notice 2007-48, IRB 2007-25, 1.

Overview

Notice 2007-48, expanding on Notice 2006-85, shuts down the variation of the Killer B transaction in which a controlled foreign corporation (CFC) acquires stock in its parent from the parent's shareholders for use in a triangular reorganization. Like the classic Killer B transaction in which the CFC paid the parent for its stock, this transaction is also apparently seen as a way for the CFC to repatriate foreign earnings without drawing U.S. corporate-level income tax.

Background

Generally speaking, in a “triangular” reorganization the acquiring corporation uses stock of its parent company as the consideration issued in exchange for the target's assets or stock. So, for example, in a triangular B reorganization, the acquiring corporation acquires target stock solely in exchange for voting stock of its parent corporation. Neither the acquiring corporation nor the target shareholders recognize gain in this transaction. Under Code Sec. 1032, no gain is recognized by the parent company whether it first transfers its shares to the acquiring subsidiary that then transfers them to the target shareholders, or whether it transfers the shares directly to the target shareholders.

The Killer B Transaction and Notice 2006-85

In the classic Killer B transaction, a CFC that is 100-percent owned by a U.S. corporation (USP)



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purchases USP voting stock from USP for cash equal to the fair market value of the USP stock. Next, the CFC acquires all of the stock of a target company in exchange for USP voting stock in a transaction that qualifies as a tax-free triangular B reorganization. Under Code Sec. 1032, USP does not recognize income on the receipt of cash from the CFC for USP voting stock.

The Killer B transaction avoids the deemed dividend under Code Sec. 956 that, in general terms, is triggered when a CFC with positive earnings and profits acquires U.S. property (including stock in an affiliated company). The Code Sec. 956 inclusion for a year equals the average of the CFC's cost basis in U.S. property on the last day of each quarter during the year or the accumulated untaxed earnings profits, if lower. The Killer B structure avoids this provision by ensuring that the CFC does not hold stock of the U.S. parent on the last day of any of the four quarters of the year. Notice 2006-85 states that regulations will be issued under Code Sec. 367(b) to shut down the classic Killer B transaction by treating the payment from the CFC to USP for USP stock as a taxable distribution that is separate from the acquisition of USP stock in connection with the triangular reorganization. The rule is generally effective for transactions occurring on or after September 22, 2006, subject to a grandfather rule for transactions that occur pursuant to a binding contract in effect on September 22, 2006.

Notice 2007-48

Notice 2007-48 expands the constructive dividend treatment of Notice 2006-85 to a CFC that acquires parent stock from parent shareholders for use as consideration in a triangular reorganization. This rule will apply to transactions occurring on or after May 31, 2007. A grandfather rule excludes transactions completed on or after May 31, 2007, if the reorganization was entered pursuant to an agreement that was binding on or before May 31, 2007.

The IBM Stock Buy-Back

On May 30, 2007, The WALL STREET JOURNAL reported that IBM implemented a \$12 billion stock buy-back program using a foreign subsidiary in order to avoid U.S. tax on foreign earnings.

The article reported that IBM's structure would violate Notice 2007-48 but for the effective date and grandfather rules. However, the article did not discuss the important issue of what the IBM subsidiary did with the IBM stock it acquired. The foreign subsidiary cannot hold the IBM shares for any period of time because dividends received on the stock are income to the CFC that will generate earnings and profits (at a minimum), and the parent stock is U.S. property under Code Sec. 956 that ultimately could trigger a dividend.

On June 7, 2007, THE NEW YORK TIMES reported on the IBM stock buy-back program stating, among other things, that IBM's foreign subsidiary would use the IBM shares to acquire goods and services from IBM in the United States, but the article did not discuss the tax consequences to either IBM or the foreign subsidiary of the transfer of IBM shares in exchange for goods and services. The transfer of stock to the issuer of the stock for property is a redemption of the transferred stock (although an IRS attempt to recast the transaction cannot be ruled out). The foreign subsidiary will recognize any gain in the parent stock (*i.e.*, the value of the stock on the day of its transfer less the purchase price) and the parent would recognize any built-in gain on property transferred in the redemption.

Analysis

As seems typical of the foreign tax area, the IRS has extended the fix of Notice 2006-85 to a less obviously abusive transaction: a CFC using its own funds or borrowed funds buys the parent's stock in the market and spends it to acquire the stock or assets of a target in a triangular reorganization. Observe that no funds of the CFC have moved inbound to the parent in this transaction. This transaction can be viewed as an indirect repatriation only if the parent wanted its stock repurchased anyway and effectively had the CFC satisfy its obligation to effect the repurchase, or where the acquisition of the target through the subsidiary confers a dividend-like benefit to the parent. A special rule is not needed to address either scenario.

Notice 2007-48 does not require that there be any obligation on the parent to repurchase its stock. As a practical matter, it could not have any such requirement and hope to be effective, because public companies don't place any such requirements

on themselves before the moment of announcing a buyback. Nevertheless, the IRS might view the absence of a legal obligation as insignificant given the high degree of regularity with which most public companies repurchase their own stock. Alternatively, the IRS might think that triangular reorganizations always should be viewed as acquisitions by the parent rather than acquisitions by the subsidiary that uses the parent stock to acquire the target. Finally, whatever the proper position when the CFC uses the parent stock in a triangular reorganization, there seems to be little grounds for

finding a constructive dividend when the CFC uses the parent stock in a taxable transaction.

Notice 2006-85 is an example of how foreign tax provision guidance starts down a slippery slope, at the end of which is frequently found a rule that is not understandable, out of context and has only a tenuous connection with the policy from which it sprang.

ENDNOTES

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