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AMERICAN BAR ASSOCIATION -- SECTION OF TAXATION

2006 Joint Fall CLE Meeting

TITLE: Mission Impossible III: Understanding Current Cross-Border M&A Issues

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PANEL: Mission Impossible III: Understanding Current Cross-Border M&A Issues

DATE: 10/20/06 3:35p

COMMITTEE: Foreign Activities of US Taxpayers

Topics Covered

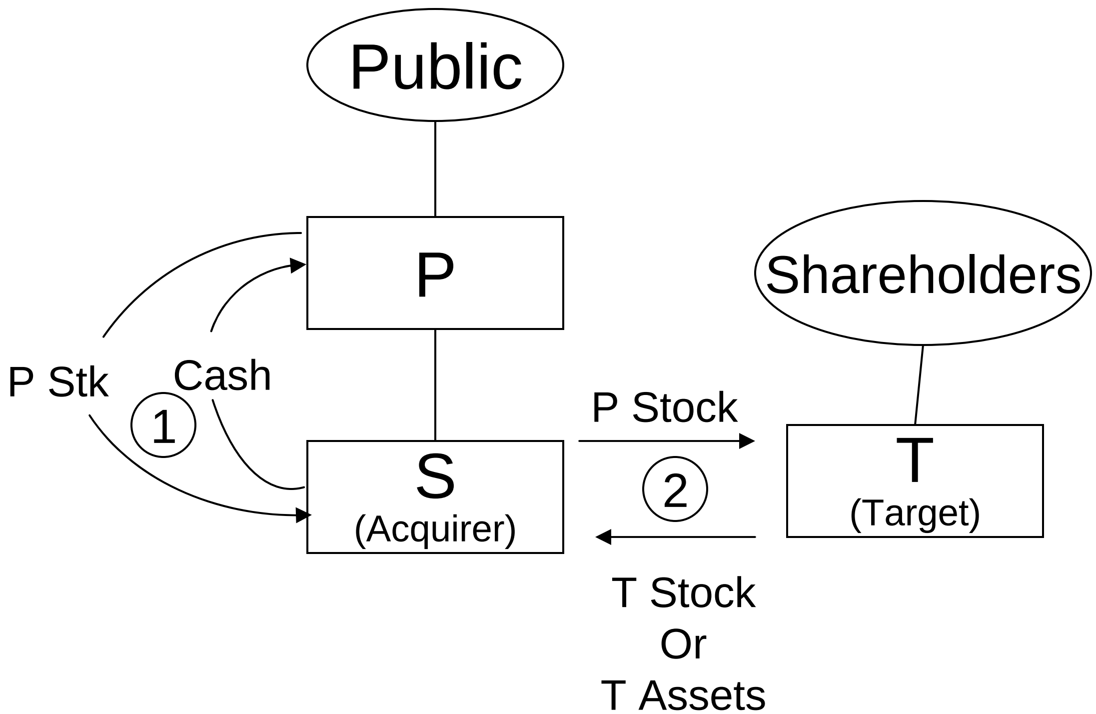
- Repatriating Triangular Reorganizations
- Section 367(b) Regulations
- Section 959 Regulations
- New GRA Regulations and Other Developments

Notice 2006-85

New Guidance Addressing Repatriating Triangular Reorganizations

Repatriating Triangular Reorganizations

Basic Unrelated Acquisition Example:



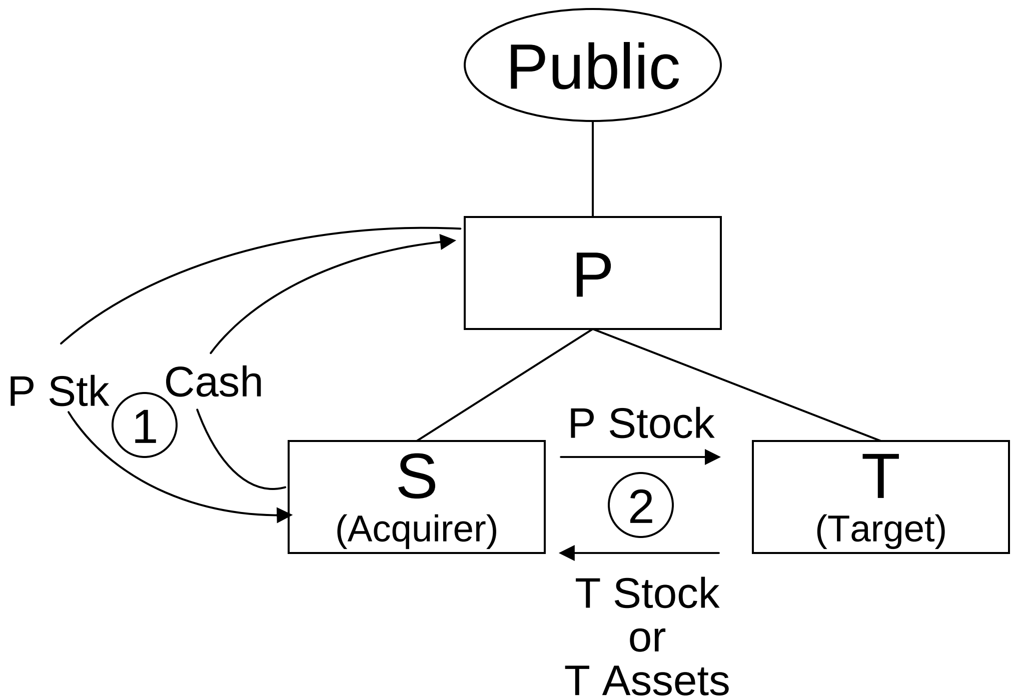
1 S acquires P stock for use in an acquisition of Target

2 S exchanges P stock for T stock or assets

Note: This transaction could also be effected with a purchase of P stock from the Public.

Repatriating Triangular Reorganizations

Basic Internal Restructuring Example:



1 S acquires P stock for use in an acquisition of T

2 S exchanges P stock for T stock or assets

Note: This transaction could also be effected with a purchase of P stock from the Public.

Results Prior to Notice 2006-85

- How were triangular reorganizations used by U.S. multinationals to repatriate cash?
- How were triangular reorganizations used by foreign multinationals to repatriate cash?
- Does it matter whether T is a related company?
- Does it matter whether T is directly owned by P, rather than through another subsidiary of P?
- Does it matter whether S acquires stock from the public or from P?

Authority Considered for New Guidance

- Section 956(e)
- *Bazley v. Commissioner* / Treas. Reg. § 1.301-1(l)
- Section 1032
- 367(b)

Authority Used for New Guidance (Notice 2006-85)

- New regulations under Section 367(b)

Addressing Transactions Prior to New Guidance

- Business Purpose
- *Bazley v. Commissioner* / Treas. Reg. § 1.301-1(l)

Notice 2006-85

- New regs will be issued under section 367(b) to address certain triangular reorganizations involving foreign corps.
- New regs will apply where P or S (or both) are foreign.
- New regs will apply where S acquires P stock from P in exchange for property.
- New regs will effect a distribution of property from S to P under 301(c) (including E&P adjustments) that is separate from the transfer by P of P stock to S pursuant to the reorganization.
- New regs will apply not withstanding section 1032.

Notice 2006-85 (Continued)

- Effective date of new regs will be to transactions occurring on or after September 22, 2006.
- New regs will not apply to transactions entered into before September 22, 2006 under a binding written agreement that are effected on or after September 22, 2006.
- Notice 2006-85 and the forthcoming regs do not prevent the IRS from challenging triangular transactions effected prior to September 22, 2006.

Notice 2006-85 (Continued)

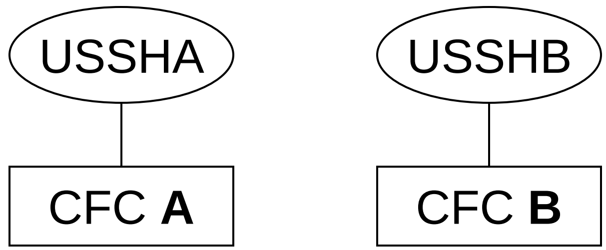
- Comments are requested on the following:
  - Possible exception for certain transactions described in the Notice.
  - Source and timing of adjustments to be made with respect to P and S.
  - Application of new regs to S's purchase of P shares from an unrelated person – *e.g.*, from public shareholders.
  - Transactions similar to those described in the Notice, but that do not do not qualify as a reorganization.

Final Section 367(b) Regulations

Overview

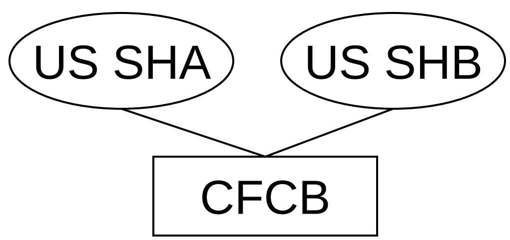
- General Principle: Hovering Deficits only offset post-transaction E&P that is not distributed, or deemed distributed.
  - Thus, E&P must "accumulate" to be available for offset.
  - For those purposes, Subpart F income considered a deemed distribution of E&P for this purpose.
- Related Foreign Taxes included foreign tax pool on a pro- rated basis as hovering deficit is utilized.

Example 1 –



	E&P	Taxes	E&P	Taxes
General	$300	$ 60	$300	$ 70
Passive	$100	$ 40		
Total	$400	$100		

CFC B aquires CFC A on Jan. 1, 2007 in a §368 (a)(1)(C) Reorg.



Example 1 – CFCB's Combined Attributes

	E&P	Taxes
General	$600	$130
Passive	$100	$ 40
Total	$700	$170

CFC B Earns No E&P in 2007 and makes a Distribution of $350 to its Shareholders on 12/31/07.

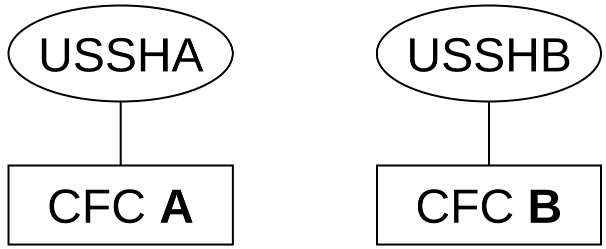
§1.902-1(d)(1) and §1.367(b)-(7)(c)(1) require the $350 to be prorated between the General and Passive baskets as follows:

General	$600 / $700 X $350 = $300
Passive	$100 / $700 X $350 = $ 50
Deemed Paid Credit	
General	$130 X $300 / $600 = $ 65
Passive	$ 40 X $ 50 / $100 = $ 20

Example 1 –

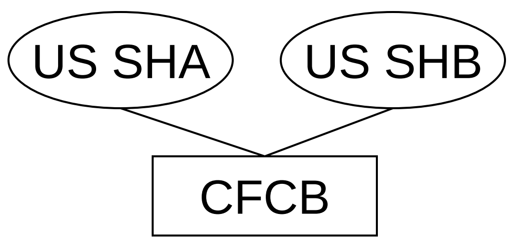
	E&P	Taxes
General	$300	$ 65
Passive	$ 50	$ 20
Total	$350	$ 85

Example 2 –



	E&P	Taxes	E&P	Taxes
General	$ 200	$ 30	$300	$ 60
Passive	$(100)	$ 10	$100	$ 30
Total	$ 100	$ 40	$400	$ 90

CFC B acquires CFC A on Jan. 1, 2007 in a §368 (a)(1)(C) Reorg.



Example 2 – CFCB's Combined Attributes

	Positive E&P	Hovering Deficit	Available Foreign Taxes	Foreign Taxes Associated with Hovering Deficit
General	$500	----	$ 90	---
Passive	$100	$(100)	$ 30	$ 10
Total	$600	$(100)	$120	$ 10

CFC B Earns No E&P in 2007 and makes a Distribution of $300 to its Shareholders on 12/31/07.

§1.902-1(d)(1) and §1.367(b)-(7)(c) require the $300 to be prorated between the General and Passive baskets as follows:

Example 2 –

General	\$500 / \$600 X \$300 = \$250
Passive	\$100 / \$600 X \$300 = \$ 50

Deemed Paid Credit

General	\$250 / \$500 X \$90 = \$45
Passive	\$ 50 / \$100 X \$30 = \$15

Pools at End of 2007

	Positive E&P	Hovering Deficit	Available Foreign Taxes	Foreign Taxes Associated with Hovering Deficit
General	\$250	----	\$ 45	---
Passive	\$ 50	\$(100)	\$ 15	\$ 10
Total	\$300	\$(100)	\$ 60	\$ 10

Example 2 –

CFCB Earns the following non Subpart F income and pays the following taxes for the year ending 12/31/08:

	E&P	Taxes
General	$100	$ 20
Passive	$ 50	$ 10
Total	$150	$ 40

Example 2 –

Under the Rules of 1.367(b)-7(d)(2)(ii) and (iii) the $50 of passive earnings in 2008 reduces the hovering deficit and releases a proportionate share of the Passive basket tax pool. At the end of 2008, the pools appear as follows

Pools at End of 2008

	Positive E&P	Hovering Deficit	Available Foreign Taxes	Foreign Taxes Associated with Hovering Deficit
General	$350	----	$ 65	--
Passive	$ 50	$ (50)	$ 30	$ 5
Total	$400	$ (50)	$ 95	$ 5

Note: $30 of available Passive basket tax pool comprised of (i) $15 year 2007 balance, (ii) $10 earned in 2008 and (iii) $5 release from hovering deficit.

Example 2 – Impact of Subpart F Income on Hovering Deficit

Assume the $50 of Passive basket income, earned in 2008 is Subpart F income. The hovering deficit does not offset the Subpart F inclusion. The deemed paid credit is calculated as follows:

Subpart F deemed dividend ($50) / Total E&P $50 from 1/1/08 plus $50 earned in 2008 X Total Taxes $25 = $12.50

Key Point 1: Hovering deficit may not be used to offset the U.S. inclusion for Subpart F income.

Key Point 2: Unlike the non-Subpart F transaction, the Subpart F income does not decrease the hovering deficit and does not release taxes associated therewith.

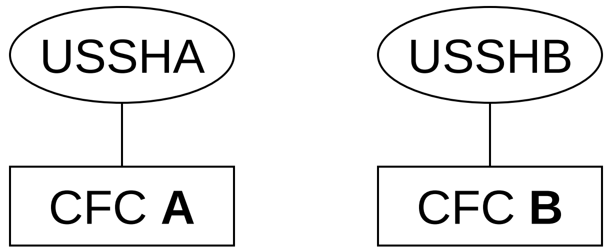
Example 2 –

Pools at End of 2008

	Positive E&P	Hovering Deficit	Available Foreign Taxes	Foreign Taxes Associated with Hovering Deficit
General	$350	----	$ 65	---
Passive	$ 50	$ (100)	$ 12.50	$ 10
	$400	$ (100)	$ 77.50	$ 10

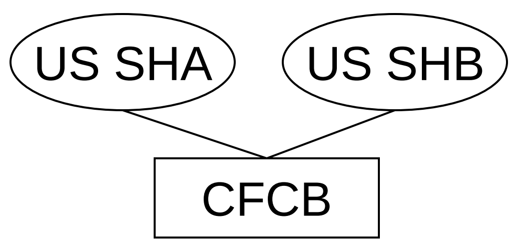
Note that the $50 of Subpart F is PTI.

Example 3 –



	E&P	Taxes	E&P	Taxes
General	$50	$10	$(100)	$20

CFC B Acquires CFC A on Jan.1, 2007 in a §368(a)(1)(C) Reorg.



Example 3 – CFC B's Combined Attributes

	Positive E&P	Hovering Deficit	Available Foreign Taxes	Tax Associated with Hovering Deficit
General	$50	$(100)	$10	$20

Example 3 – Non-Subpart F Income and Distribution

In its taxable year 2007, CFC B earns $100 in General basket income and pays related foreign taxes of $24. It also pays a $75 distribution.

Key Point: Similar to the Subpart F example immediately above, the post-transaction current E&P does not reduce the deficit to the extent that it is distributed (i.e., only the $25 undistributed e&p reduces the hovering deficit and releases taxes).

Therefore the amount of the §316 distribution is determined by reference to the full $100 of current E&P and the deemed paid credits are calculated by reference to the accumulated E&P of $50 plus the current E&P of $100 (total $150).

Example 3 –

Deemed Paid Credit

Total taxes ($10 + $24) X Dividend $75 / Total E&P $150 = $17

Post Distribution Impact on Hovering Deficit

There is $25 remaining positive E&P. It reduces the Hovering Deficit and the releases some of the taxes.

Pools at End of 2007

	Positive E&P	Hovering Deficit	Available Foreign Taxes	Tax Associated with Hovering Deficit
General	$50	$(75)	$22	$15

Note: Available Foreign Taxes equal to (i) $10 opening balance, plus (ii) $24 current taxes, plus (iii) $5 released from Hovering Deficit, minus (iv) the $17 credit.

Proposed Section 959 Regulations

Overview

General Principle. Consistent with legislative intent, the proposed regulations generally aim to avoid double taxation and enable U.S. persons to receive the full benefit of their PTI at the earliest possible time.

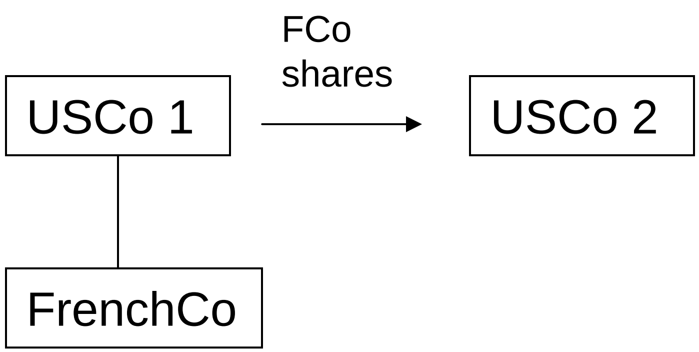
Basic Mechanism. Allows transfers of PTI accounts from one “covered shareholder” to another in specific contexts, including –

= upon a transfer of shares between members of the same US consolidated group; and

= upon an acquisition of shares by a “successor in interest”

Case 1 – Transfer to a Successor in Interest

USCo 1 transfers FrenchCo shares to USCo 2.

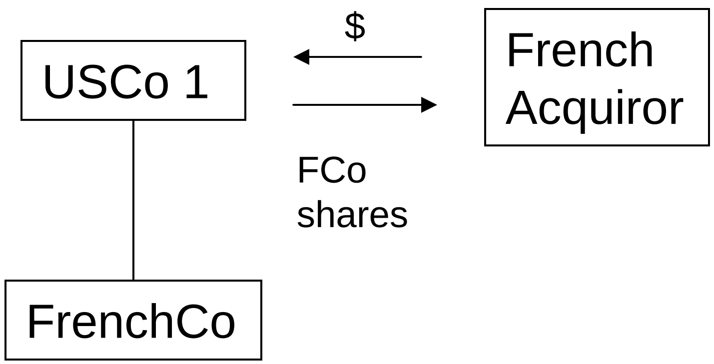


At the time of transfer, USCo 1 has a PTI account of $100 with respect to its FrenchCo shares.

Prop. Reg. § 1.959-1(d)(2)(i) – Subject to proof of entitlement as a "successor in interest," USCo 2 acquires the FrenchCo shares along with the related $100 PTI account.

Case 2 – "Delayed" Successor in Interest

Year 1 – USCo 1 sells FrenchCo shares to French Acquiror (not a "covered shareholder")

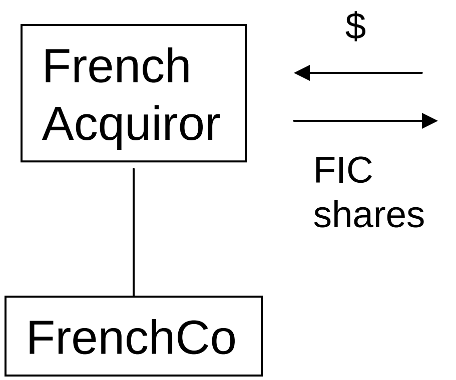


At the time of sale, USCo 1 has a PTI account of $100 with respect to its FrenchCo shares.

Prop. Reg. §1.959-1(d)(2)(ii) – The PTI account is preserved unchanged during the period of French Acquiror's ownership.

Case 2 – "Delayed" Successor in Interest (cont.)

Year 5 – French Acquiror sells FrenchCo shares to USCo 2 (a "covered shareholder")



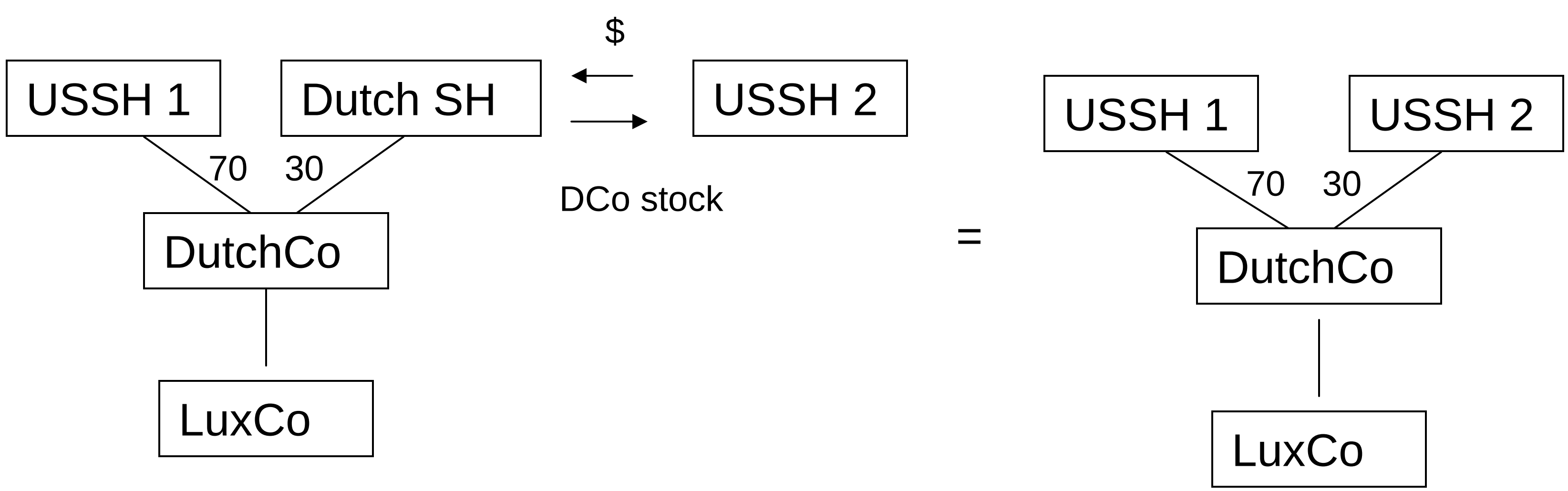
At the time of sale, there is a dormant PTI account of $100 with respect to the FrenchCo shares.

Prop. Reg. §1.959-1(d)(2)(i) – Subject to proof of entitlement, USCo 2 acquires both the FrenchCo shares and the related PTI account.

Case 3 – Dividends for Transferee Shareholders

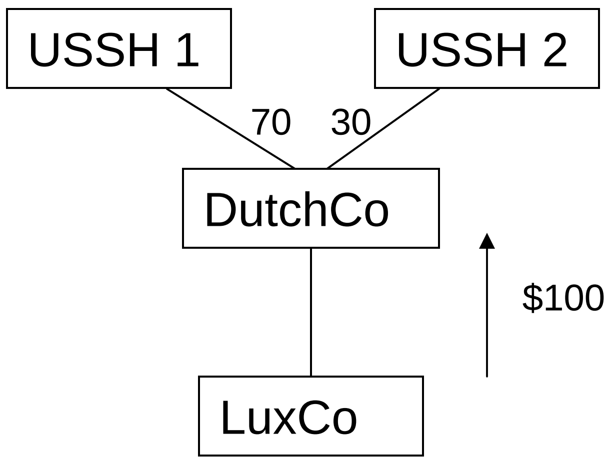
In Year 1, LuxCo earns $100 subpart F income ($70 of which had been included in USSH 1's gross income) and $50 of non-subpart F income.

In Year 2, Dutch SH sells stock to USSH 2.



Case 3 – Dividends for Transferee Shareholders (cont.)

In Year 3, LuxCo makes a $100 distribution.



At the time of the distribution, USSH 2 has a $0 PTI account (no PTI acquired from Dutch SH and no PTI arising during Year 2).

Case 3 – Dividends for Transferee Shareholders (cont.)

Consequences:

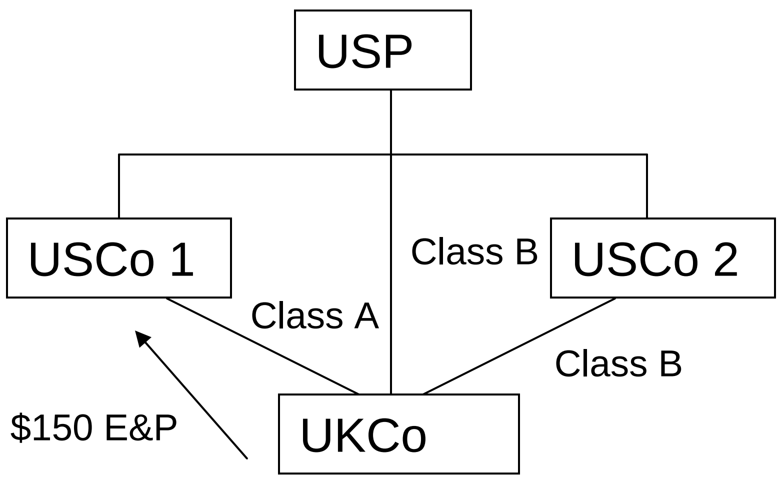
- As above, the entire $100 distribution is excluded from DutchCo's gross income for purposes of determining USSH 1's tax consequences.
- However, $0 is excluded from DutchCo's gross income for purposes of determining USSH 2's consequences (as USSH 2 has a $0 PTI account).
- As a result, USSH 2 has a $30 section 951 inclusion (and thereafter, a $30 PTI account with respect to its DutchCo stock).
- DutchCo's E&P is increased by $100 of PTI.

PTI Sharing Rules

- Allows sharing of PTI accounts between members of the same US consolidated group
- Allows a single US shareholder to “share” PTI accounts among blocks of stock in the same foreign corporation.
- Provides specific PTI rules in the context of section 304 transactions.

Case 1 – Sharing Between US Group Members

USP, USCo 1 and USCo 2 are members of the same US Group and shareholders of UKCo. UKCo pays a $150 Class A dividend to USCo 1.



At the time of the distribution, the US group members had the following PTI accounts:

- USCo1: $100
- USP: $20
- USCo 2: $80

UKCo had a total of $200 of PTI and $200 of non-PTI E&P.

Case 1 – Sharing Between US Group Members (cont.)

Treas. Reg. §1.959-3(g) allows sharing of PTI between shareholders that are members of the same US consolidated group --

1. USCo 1: Distribution of $150 reduces $100 PTI account to 0.

2. The excess distribution of $50 is allocated pro rata to PTI accounts of other US members with respect to their UKCo stock.

<u>USP</u>:

$$\$50 \times \frac{\$20}{\$100} = \$10$$

<u>USCo 2</u>:

$$\$50 \times \frac{\$80}{\$100} = \$40$$

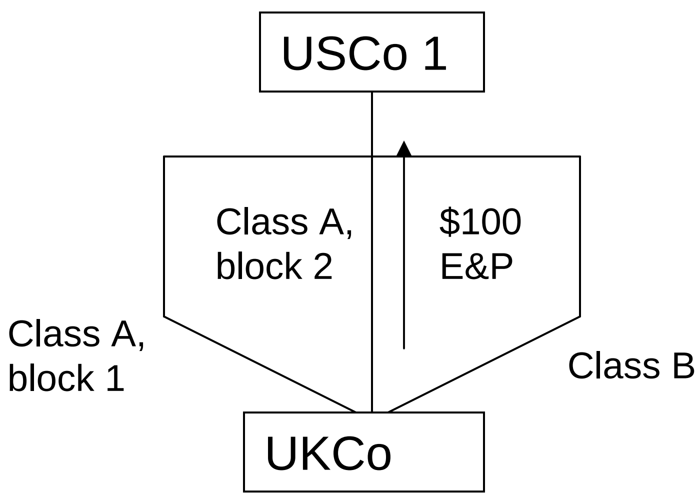
3. USP's and USCo 2's PTI accounts are reduced accordingly.

<u>USP</u>: $20 - $10 = $10

<u>USCo 2</u>: $80 - $40 = $40

Case 2 – Sharing Among Blocks of Stock

USCo 1 owns 3 blocks of UKCo stock – 2 blocks of Class A and 1 block of Class B. UKCo distributes $50x of E&P on each block of Class A stock.



Prior to the distribution, USCo 1 had PTI accounts as follows:

- Class A, Block 1: $25

- Class A, Block 2: $65

- Class B: $60

UKCo had a total of $150 of PTI and $200 of non-PTI E&P.

Case 2 – Sharing Among Blocks of Stock (cont.)

Treas. Reg. § 1.959-3(f) allows sharing between the blocks of stock --

1. Class A, Block 1: Distribution of $50 reduces $25 PTI account to 0.

2. Class A, Block 2: Distribution of $50 reduces $65 PTI account to $15.

3. The excess distribution from Class A, Block 1 ($25) is allocated pro rata to PTI remaining in the other blocks, which is reduced accordingly.

Class A, Block 2:

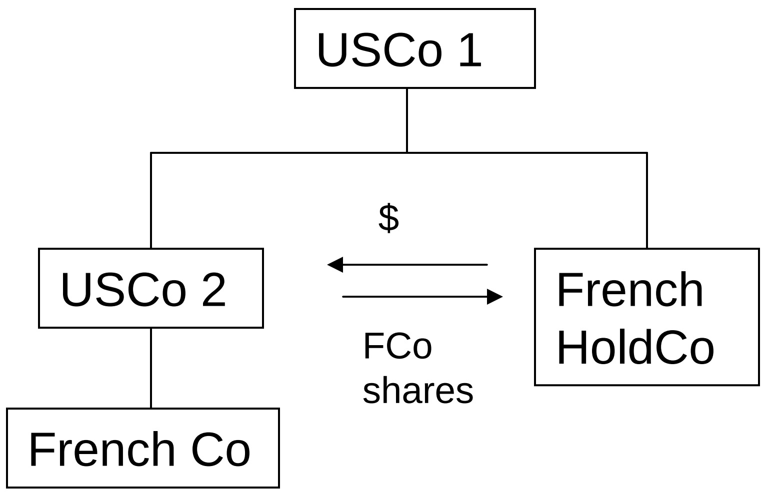
$\$25 \times \frac{\$15}{\$75} = \$5$ (leaving $10)

Class B:

$\$25 \times \frac{\$60}{\$75} = \$20$ (leaving $40)

Case 3 – Section 304 Transfer (Dividend-Equivalent Redemption)

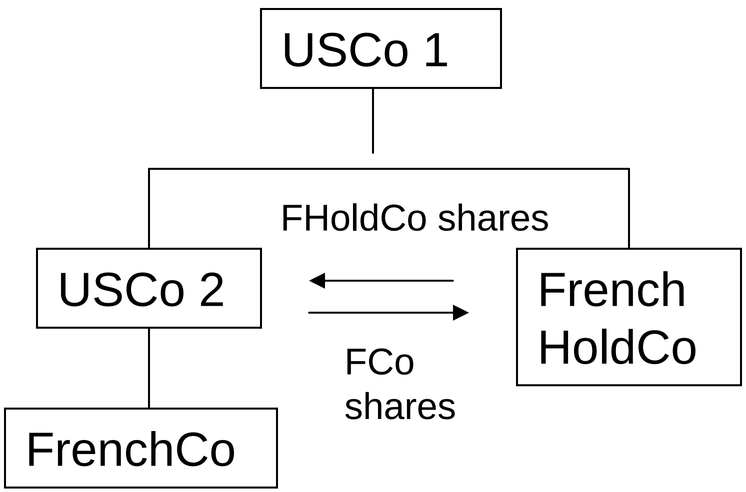
USCo 2 transfers FrenchCo shares to French HoldCo for $80, in a transaction to which section 304(a)(1) applies.



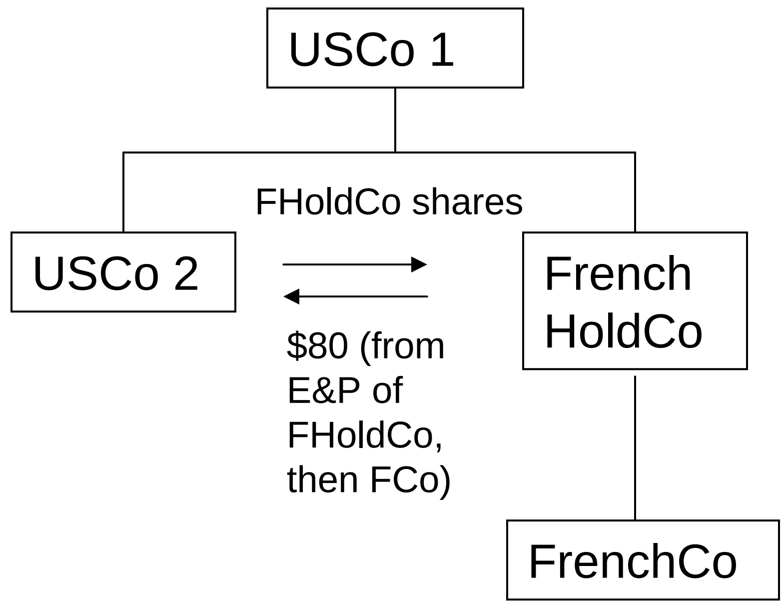
At the time of the transfer, French HoldCo has $30 of E&P -- $20 of PTI and $10 of non-PTI. FrenchCo has $50 of PTI and $0 of non-PTI E&P. USCo 2 has no PTI account with respect to French HoldCo stock.

Case 3 – Section 304 Transfer (cont.)

Step 1: deemed §351 transaction



Step 2: redemption of "issued" FHoldCo shares, dividend under section 302(d)



Case 3 – Section 304 Transfer (cont.)

Consequences:

- Pursuant to sections 302(d) and 304(b)(2), the $80 is treated as a dividend to the extent of French HoldCo's, then FrenchCo's, E&P.
- Under Treas. Reg. §1.959-3(h)(4)(i), USCo 2 is treated as having a PTI account with respect to French HoldCo 2 stock. This enables USCo 2 to share USCo 1's $20 PTI account for its French HoldCo stock.
- The $80 is treated as a $30 distribution to USCo 2 from French HoldCo ($20 PTI and $10 non-PTI), and a $50 distribution from FrenchCo (all PTI).
- USCo 2 excludes $70 ($20 + $50) of the distribution, but includes $10 in gross income.

Additional Highlights

- Foreign taxes imposed on PTI distributions between foreign corporations are kept in a separate PTI account (and not added to section 902 tax pools).
- Deficits only reduce non-PTI E&P of the foreign corporation.
- Section 961(c) basis rules added – very narrow in scope.
- Subsequent guidance is expected relating to section 954(c)(6) (FPHC look-through rules).

New Guidance Addressing Gain Recognition Agreements

Understanding Current Cross-Border M&A Issues

- Notice 2005-74, 2005-42 IRB 726 (Sep. 28, 2005).
- New regulations address numerous issues identified in current regulations related to GRA triggering events and other scenarios.
- New regulations respond to comments received regarding Notice 2005-74.