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## Recent Developments Relating to Code Section 367

Over the past month or so, the Internal Revenue Service (“IRS”) and the Treasury have issued the following guidance relating to Internal Revenue Code (the “Code”) Section 367: (1) information reporting for corporate inversions; (2) amendments to the anti-abuse rule of Treasury Regulation Section 1.367(e)-2(d); and (3) forthcoming amendments to the indirect stock transfer rules of Treasury Regulation Section 1.367(a)-3(d).

### Information Reporting For Corporate Investors

On November 12, 2002, the IRS and Treasury issued temporary and proposed regulations under Code Sections 6043 and 6045 that require information reporting by a corporation that effects an inversion that gives rise to a corporate or shareholder level tax.<sup>1</sup> More specifically, the regulations provide that if there is an “acquisition of control” or a “substantial change in the capital structure” of a domestic corporation (the “reporting corporation”), the reporting corporation must file new Form 8806.<sup>2</sup> The regulations apply to transactions occurring after December 31, 2001, if the reporting corporation or any shareholder is required to recognize gain as a result of the application of Code Section 367(a).<sup>3</sup>

For purposes of the regulations, an acquisition of control of a corporation (the “first corporation”) occurs if, in a transaction or series of related transactions, stock representing control of the first corporation is (i) distributed by a second corporation to its shareholders or (ii) acquired (directly or indirectly) by a second corporation and the shareholders of the first corporation receive cash, stock or other property.<sup>4</sup> Acquisitions of control within an affiliated group are excepted from this definition,<sup>5</sup> as are acquisitions in which the fair market value of the stock acquired in the transaction or series of related transactions is less than \$100,000,000.<sup>6</sup> “Control” is determined in accordance with the first sentence of Code Section 304(c)(1)<sup>7</sup> and by application of a modified version of the constructive ownership rules of Code Section 318.<sup>8</sup>

For purposes of the regulations, a corporation has a “substantial change in its capital structure” if the corporation in a single transaction or in a series of related transactions:

- undergoes a recapitalization with respect to its stock;
- redeems its stock (including deemed redemptions);
- merges, consolidates or otherwise combines with another corporation or transfers substantially all of its assets to one or more corporations;
- transfers all or part of its assets to another corporation in a title 11 or similar case and, in pursuance of the plan, distributes stock or securities of that other corporation; or
- changes its identity, form or place of organization.<sup>1</sup>

Again, transactions in which the amount of any cash plus the fair market value of any property (including stock) provided to shareholders is less than \$100,000,000 are excepted from this definition,<sup>2</sup> as are transactions within an affiliated group.<sup>3</sup>

As noted above, if there is an acquisition of control or a substantial change in the capital structure of a domestic corporation, the reporting corporation must file new Form 8806.<sup>4</sup> Form 8806 (or interim statement) must be filed with the reporting corporation’s timely filed income tax return

(including extensions) for the year in which acquisition of control or substantial change in capital structure occurs.<sup>5</sup> That said, Form 8806 is not required if the transaction is reported pursuant to Treasury Regulation Sections 1.351-3(b), 1.355-5(a) or 1.368-3(a).<sup>1</sup> Further, Form 8806 is not required if all the shareholders of the reporting corporation prior to the transaction are exempt recipients.<sup>2</sup>

In addition, the temporary regulations impose certain Form 1096/Form 1099 reporting with respect to each shareholder who receives cash, stock or other property pursuant to the transaction.<sup>3</sup>

### **Amendments to the Anti-abuse Rule of Treasury Regulation Section 1.367(e)-2(d)**

On November 20, 2002, the IRS and Treasury issued proposed regulations under Code Section 367(e) that would amend the anti-abuse rule of Treasury Regulation Section 1.367(e)-2(d).<sup>1</sup>

The anti-abuse rule of Treasury Regulation Section 1.367(e)-2(d) provides that the Commissioner may require a foreign or domestic liquidating company to recognize gain (or treat the liquidating corporation as if it had recognized a loss) on a liquidating distribution if a principal purpose of the liquidation is the avoidance of U.S. tax.<sup>2</sup> The rule provides that a liquidation may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes (taken together or separately).<sup>3</sup>

The preamble to the final regulations under Code Section 367(e) stated that the anti-abuse rule would apply, for example, if a principal purpose of a liquidation is the distribution of a domestic liquidating corporation's earnings and profits without a U.S. withholding tax.<sup>4</sup> The preamble also states that, in certain circumstances, the IRS is also concerned about a liquidation of a domestic corporation into a U.S. branch of a foreign corporation in a manner that facilitates the avoidance of U.S. tax, including the inappropriate use of attributes such as a net operating loss.<sup>5</sup>

Since the publication of the final regulations under Code Section 367(e)(2), commentators have expressed concern that the anti-abuse rule is overly broad because it is not limited by its express terms to outbound liquidations and that it is preventing taxpayers from engaging in legitimate business transactions involving foreign-to-foreign liquidations.<sup>6</sup> Such legitimate business transactions might be where a U.S. parent owns one hundred percent of a foreign corporation ("F1"), F1 owns one hundred percent of the stock of another foreign corporation ("F2"), and F2 is liquidated under foreign law to eliminate duplicative entities. (See the enclosed organization chart entitled "Anti-abuse Rule of Treasury Regulation Section 1.367(e)-2(d).")

Seemingly, the IRS and Treasury now agree with the commentators; the preamble to the proposed regulations states:

Application of this rule to require gain recognition in a foreign-to-foreign liquidation is not consistent with the approach of the final regulations that require gain recognition in the case of a foreign-to-foreign liquidation only in particular and limited circumstances. Accordingly, these proposed regulations would amend the anti-abuse rule to limit its application only to outbound liquidations.<sup>7</sup>

As such, Proposed Treasury Regulation Section 1.367(e)-2(d) provides:

The Commissioner may require a domestic liquidating corporation to recognize gain on a distribution in liquidation . . . if a principal purpose of the liquidation is the avoidance of U.S. tax (including, but not limited to, the distribution of a liquidating corporation's earnings and profits with a principal purpose of avoiding U.S. tax). A liquidation may have a principal purpose of tax avoidance even though the tax avoidance purpose is outweighed by other purposes when taken together (emphasis added).

The regulations are proposed to apply to distributions occurring on or after September 7, 1999, or to distributions in taxable years ending after August 8, 1999 if the taxpayer elected to apply the final regulations to such distributions.<sup>8</sup> Until the proposed regulations are finalized, the IRS intends that the Commissioner will exercise its authority under the anti-abuse rule in a way that is consistent with the proposed regulations.<sup>9</sup>

**Revenue Ruling 2002-85; Notice 2002-77**

In Revenue Ruling 2002-85,<sup>10</sup> the IRS considered whether an acquiring corporation's transfer of a target corporation's assets to a subsidiary controlled by the acquiring corporation as part of a plan of reorganization would prevent a transaction that otherwise qualifies as a reorganization under Code Section 368(a)(1)(D) from so qualifying.<sup>11</sup>

In the revenue ruling, A, an individual, owns 100 percent of T, a State X corporation. A also owns 100 percent of P, a State Y corporation. For valid business reasons and pursuant to a plan of reorganization:

- T transfers all of its assets to P in exchange for consideration consisting of 70 percent P voting stock and 30 percent cash;
- T liquidates, distributing the P voting stock and cash to A; and
- P subsequently transfers all of the T assets to S, a preexisting, wholly owned State X subsidiary of P, in exchange for additional stock of S.

S will continue T's historic business after the transfer, and P will retain the S stock. Without regard to P's transfer of all the T assets to S, the transaction qualifies as a reorganization under Code Section 368(a)(1)(D). (See the attached organization chart entitled "Revenue Ruling 2002-85.")

In Revenue Ruling 2002-85, the IRS ruled that P's transfer of the T assets to S will not prevent P's acquisition of the T assets in exchange for P voting stock and cash from qualifying as a "D" reorganization. More specifically, the IRS found that:

- The original transferee (P) should be treated as acquiring substantially all of the assets of the target corporation (T) because P retains the stock of S;<sup>12</sup>
- The transaction satisfies the continuity of business enterprise ("COBE") requirement because P and S constitute a qualified group, and S will continue T's historic business after the transfer;<sup>13</sup> and
- That P should be treated as a party to the reorganization notwithstanding P's subsequent transfer of the T assets to S.<sup>14</sup>

In a companion notice, Notice 2002-77,<sup>15</sup> the IRS and Treasury announced their intentions to amend the regulations under Treasury Regulation Section 1.367(a)-3(d) to provide specifically that a reorganization that otherwise qualifies as a reorganization under Code Section 368(a)(1)(D) followed by the transfer of all or a portion of a target corporation's assets to a controlled subsidiary pursuant to a plan of reorganization constitutes an indirect transfer of stock or securities for purposes of Treasury Regulation Section 1.367(a)-3(d). As such, a U.S. transferor would be required to enter into a gain recognition agreement to preserve nonrecognition treatment under Code Section 367(a).<sup>16</sup>

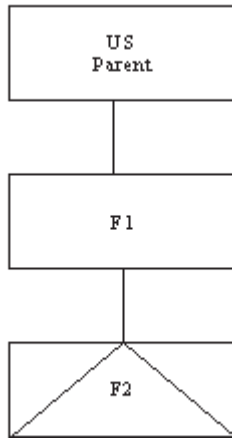
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If you have any questions regarding the above, please contact Lewis J. Greenwald or another member of our Tax Department at (617) 338-2800.

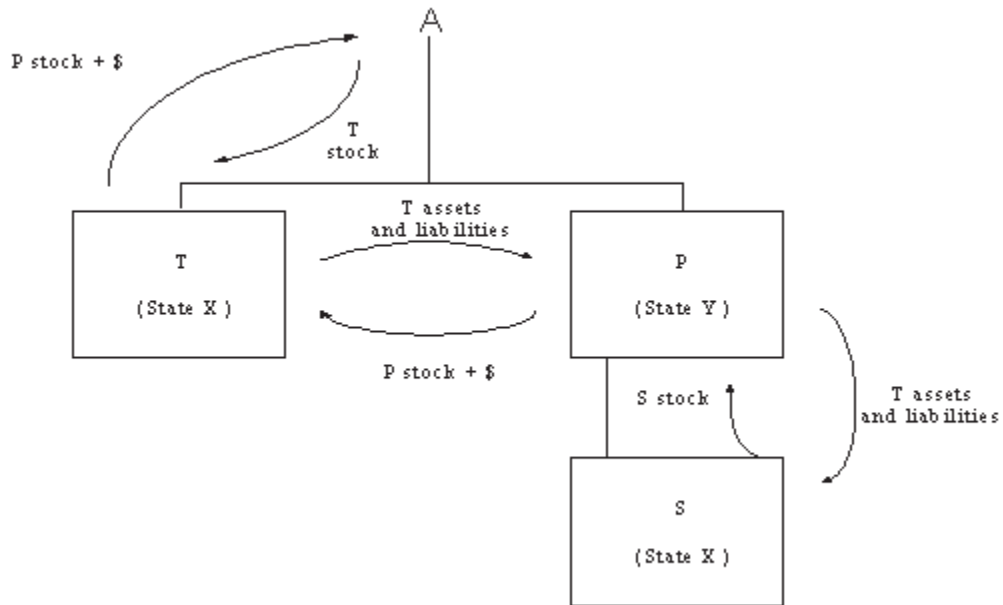
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*Because sound legal advice must necessarily take into account all relevant facts and developments in the law, the information you will find in this Advisory is not intended to constitute legal advice or a legal opinion as to any particular matter.*

Revenue Ruling 2002-85  
"D" Reorganization Followed by Asset Drop



Anti-abuse Rule of Treasury Regulation Section 1.367(e)-2(d)  
Liquidation of F2 Into F1



ENDNOTES

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<sup>1</sup> Treasury Decision 9022, 67 FR 69468. Interestingly, proposed regulations were previously issued under Code Section 6043(c). *See* 55 FR 27648. Those proposed regulations were withdrawn after the IRS considered comments it had received and in light of the IRS's "goals of simplification and elimination of unnecessary regulatory burdens. . . . The Service, however, may promulgate regulations under section 6043(c) in the future if it becomes apparent that the information is needed to properly administer the tax system." *See* 57 FR 47428. At this time the IRS believes that "information reporting under Code Section 6043(c) for certain large corporate transactions is appropriate." *See* T.D. 9022, Preamble.

<sup>2</sup> Temporary Treasury Regulation Section 1.6403-4T(a)(1).

<sup>3</sup> Temporary Treasury Regulation Section 1.6043-4T(i).

<sup>4</sup> Temporary Treasury Regulation Section 1.6403-4T(c)(1).

<sup>5</sup> T.D. 9022, Preamble. Although the Preamble notes that neither acquisitions of control nor substantial changes in capital structure include transactions within an affiliated group, the regulations do not provide so explicitly.

<sup>6</sup> Temporary Treasury Regulation Section 1.6403-4T(c)(1)(i).

<sup>7</sup> Temporary Treasury Regulation Section 1.6403-4T(c)(2).

<sup>8</sup> Temporary Treasury Regulation Section 1.6403-4T(c)(3).

<sup>9</sup> Temporary Treasury Regulation Section 1.6403-4T(d)(2).

<sup>10</sup> Temporary Treasury Regulation Section 1.6403-4T(d)(1).

<sup>11</sup> *See supra* n.5.

<sup>12</sup> Temporary Treasury Regulation Section 1.6403-4T(a)(1).

<sup>13</sup> Temporary Treasury Regulation Section 1.6403-4T(a)(2).

<sup>14</sup> Temporary Treasury Regulation Section 1.6043-4T(a)(4).

<sup>15</sup> Temporary Treasury Regulation Section 1.6043-4T(a)(5).

<sup>16</sup> Temporary Treasury Regulation Sections 1.6043-4T(b) and 1.6045-3T.

<sup>17</sup> 67 FR 70031.

<sup>18</sup> Treasury Regulation Section 1.367(e)-2(d).

<sup>19</sup> *Id.*

<sup>20</sup> T.D. 8834, Preamble.

<sup>21</sup> *Id.*

<sup>22</sup> 67 FR 70031.

<sup>23</sup> *Id.*

<sup>24</sup> 67 FR 70031, Preamble.

<sup>25</sup> *Id.*

<sup>26</sup> 2002-52 I.R.B. 986.

<sup>27</sup> At the recent GWG/IRS International Tax Conference, IRS officials announced that guidance will be forthcoming that would provide a similar result for a reorganization described in Code Section 368(a)(1)(F).

<sup>28</sup> *Citing* Rev. Rul. 2001-24, 2001-1 C.B. 1290 and Rev. Rul. 88-48, 1988-1 C.B. 117.

<sup>29</sup> *Citing* Treasury Regulation Section 1.368-1(d) (often referred to as the "COBE regulations").

<sup>30</sup> In the revenue ruling, the IRS stated:

Reorganizations under [Code Section] 368(a)(1)(D), like reorganizations under [Code Sections] 368(a)(1)(A) and 368(a)(1)(C), are asset reorganizations. In reorganizations under [Code Sections] 368(a)(1)(A) and 368(a)(1)(C), the original transferee is treated as a party to a reorganization, even if the acquired assets are transferred to a controlled subsidiary of the original transferee. The differences between reorganizations under [Code Section] 368(a)(1)(D) on the one hand and reorganizations under [Code Sections] 368(a)(1)(A) and 368(a)(1)(C) on the other hand do not warrant treating the original transferee in a transaction that otherwise satisfies the requirements of a reorganization under [Code Section] 368(a)(1)(D) differently from the original transferee in a reorganization under [Code Sections] 368(a)(1)(A) or 368(a)(1)(C) for purposes of [Code Section] 368(b).

<sup>31</sup> 2002-77 I.R.B. 997.

<sup>32</sup> *See* Treasury Regulation Section 1.367(a)-3(d)(1).