



## Triangular Reorganizations Involving Foreign Corporations and Inbound Nonrecognition Transactions

On December 2, 2016, the U.S. Department of the Treasury ("Treasury") and the Internal Revenue Service (IRS) issued Notice 2016-73 (the "Notice") to target transactions purportedly designed to repatriate earnings and basis of foreign corporations without incurring U.S. tax. In particular, the Notice announces the intent of Treasury and the IRS to modify the regulations under section 367 applicable to:

- Certain triangular reorganizations described in the so-called "Killer B Regulations" under Treas. Reg. §1.367(b)-10, as modified by Notice 2014-32 ([see U.S. International Alert dated April 25, 2014](#)), which generally apply when (i) a subsidiary (S) purchases shares of its parent (P) for property, (ii) either P or S (or both) is a foreign corporation, and (iii) S uses the P shares to acquire a target (T) in a section 368 reorganization; and
- Certain inbound nonrecognition transactions in which a domestic corporation (the "domestic acquiring corporation") acquires the assets of a foreign corporation (the "foreign acquired corporation") in a transaction to which Treas. Reg. §1.367(b)-3 applies.

### Summary of Transactions Impacted

The Notice appears to target the following transactions:

- Foreign-to-foreign triangular reorganizations relying on section 954(c)(6) and/or the “30-day rule” to avoid subpart F income;
- Triangular reorganizations utilizing Nonqualified Preferred Stock (“NQPS”);
- Foreign-to-foreign triangular reorganizations if the foreign issuing corporation subsequently comes inbound;
- Triangular reorganizations utilizing previously-taxed income (“PTI”);
- All inbound reorganizations or liquidations, even if they were not preceded by a triangular reorganization.

As discussed in more detail below, the modifications provided in the Notice will generally:

- (1) Limit the application of the priority rule under Treas. Reg. §1.367(b)-10(a)(2)(iii) (and corresponding priority rule under Treas. Reg. §1.367(a)-3(a)(2)(iv)) to transactions in which T is a domestic corporation, and provide that Treas. Reg. §§1.367(b)-4 and -4T and/or section 367(a)(1) apply to transactions in which T is a foreign corporation;
- (2) Modify Treas. Reg. §§1.367(b)-4 and -4T to include, and make fully taxable, exchanges of T stock or securities when T is a foreign corporation and the T stock or securities are exchanged for P stock or securities that were acquired by S in exchange for property (regardless of whether T was held by one or more U.S. persons);
- (3) Increase the “all E&P amount” under Treas. Reg. §1.367(b)-2(d) in the case of an exchanging shareholder to which Treas. Reg. §1.367(b)-3(b)(3) applies if there is “excess asset basis” (described below) with respect to the foreign acquired corporation; and
- (4) Treat NQPS as “property” for purposes of Treas. Reg. §1.367(b)-10.

These changes will apply to transactions completed on or after December 2, 2016, and to any inbound nonrecognition transactions treated as completed before December 2, 2016 as a result of an entity classification election filed on or after December 2, 2016. In addition, the modifications to the “all E&P amount” are applicable to all inbound nonrecognition transactions, including inbound nonrecognition transactions that were preceded by a triangular reorganization and those that were not. Consequently, triangular reorganizations and inbound nonrecognition transactions (whether preceded by a triangular reorganization or not) that have not yet been executed are immediately subject to the modifications in the Notice.

## **Changes Announced in Notice 2016-73**

### **Limitation of Priority Rule to Targets that are Domestic Corporations**

The Notice announces that Treasury and the IRS intend to modify the priority rule under Treas. Reg. §1.367(b)-10(a)(2)(iii) so that it will continue to apply only when T is a domestic corporation.<sup>1</sup> When T is a foreign corporation, the following rules will instead apply to section 354 or 356 exchanges in connection with triangular reorganizations:

- If one or more U.S. persons exchange stock or securities of T for P stock or securities acquired by S in exchange for property (as defined under Treas. Reg. §1.367(b)-

10(a)(3)(ii), and as modified by the Notice), Treas. Reg. §§1.367(b)-4 and -4T (as modified by the Notice) will apply, and section 367(a)(1) will not apply (which precludes the exchanging shareholder from entering into a gain recognition agreement with respect to the transferred T stock or securities);<sup>2</sup> and

- Section 367(a)(1) will apply to the exchange of stock or securities of T for P stock or securities that were not acquired by S in exchange for property.<sup>3</sup>

If T is a domestic corporation, the priority rule (as modified by Notice 2014-32) will continue to apply.

## **Modifications to Treas. Reg. §§1.367(b)-4 and -4T**

Treas. Reg. §§1.367(b)-4 and -4T generally apply to the acquisition by a foreign corporation of the stock or assets of a foreign corporation (the “foreign acquired corporation”) in a section 351 exchange or reorganization described in section 368(a)(1).<sup>4</sup> Treas. Reg. §1.367(b)-4(b) generally provides that if a section 1248 amount with respect to the foreign acquired corporation cannot be preserved following such an acquisition, then certain exchanging shareholders of the foreign acquired corporation must include in income as a deemed dividend the section 1248 amount attributable to the foreign acquired corporation stock that was exchanged in the transaction.<sup>5</sup>

The Notice announced that Treas. Reg. §§1.367(b)-4 and -4T will be modified, however, to apply to all exchanges under section 354 or 356 that occur in connection with a triangular reorganization (regardless of whether T was held by one or more U.S. persons) to the extent that an exchanging shareholder exchanges stock or securities of a foreign acquired corporation for P stock or securities acquired by S in exchange for property.<sup>6</sup> If applicable, the exchanging shareholder is required to:

- Include as a deemed dividend the section 1248 amount attributable to the stock of the foreign acquired corporation that was exchanged in the transaction;<sup>7</sup> and
- After taking into account the increase in basis under Treas. Reg. §1.367(b)-2(e)(3)(ii) as a result of the deemed dividend, recognize all realized gain with respect to the stock of the foreign acquired corporation that was exchanged and that would not have otherwise been recognized in the transaction.<sup>8</sup>

For purposes of these modifications, an “exchanging shareholder” includes both a U.S. and foreign person, regardless of whether the U.S. person is a section 1248 shareholder and the foreign person a foreign corporation that has a section 1248 shareholder.<sup>9</sup> The effect of these modifications is to treat the transfer of T stock or securities as fully taxable, regardless of whether there was a section 1248 amount attributable to the stock or securities of T.

## **Modifications to the “all E&P amount”**

Treas. Reg. §1.367(b)-3 generally applies when a domestic acquiring corporation acquires the assets of a foreign acquired corporation in a liquidation described in section 332 or a reorganization described in section 368(a)(1) (referred to above as “inbound nonrecognition transactions”).<sup>10</sup> As a result of such inbound nonrecognition transactions, certain shareholders of the foreign acquired corporation are generally required to include in income as a deemed dividend the

“all E&P amount” with respect to the shares of the foreign acquired corporation that were exchanged in the inbound transaction.<sup>11</sup>

The Notice modifies the computation of the “all E&P amount” under Treas. Reg. §1.367(b)-2(d)(3). Specifically, Treas. Reg. §1.367(b)-2(d)(3)(ii) (which otherwise provides for the exclusion of lower-tier earnings and profits) is intended to be modified in the case of an exchanging shareholder to which Treas. Reg. §1.367(b)-3(b)(3) applies to provide that, if there is “excess asset basis” with respect to the foreign acquired corporation, the “all E&P amount” with respect to the stock of the foreign acquired corporation will be increased by the “specified earnings” with respect to such stock.<sup>12</sup>

For this purpose, the term “excess asset basis” is defined as the amount by which the inside asset basis of the foreign acquired corporation exceeds the sum of the following amounts:<sup>13</sup>

- The earnings and profits of the foreign acquired corporation attributable to the outstanding stock of the foreign acquired corporation;<sup>14</sup>
- The aggregate basis in the outstanding stock of the foreign acquired corporation determined immediately before the inbound nonrecognition transaction;<sup>15</sup> and
- The aggregate amount of liabilities of the foreign acquired corporation that are assumed by the domestic acquiring corporation in the inbound nonrecognition transaction (as determined under section 357(d) principles).<sup>16</sup>

The Notice provides that excess asset basis may be reduced to the extent it is not attributable, either directly or indirectly, to property provided by a foreign subsidiary of the foreign acquired corporation.<sup>17</sup> For this purpose, property used by S to purchase P stock in connection with a triangular reorganization is treated as property provided by a foreign subsidiary.<sup>18</sup> In addition, references to a foreign acquired corporation or foreign subsidiary will include a predecessor of such corporations.<sup>19</sup>

The excess asset basis calculation seems to address inbound nonrecognition transactions that have been preceded by a triangular reorganization in which the acquisition of P stock by S has created a basis disparity between the outside basis of P, and P’s inside basis in its assets. This disparity could occur, for example, if the amount of the property exchanged by S for P’s stock or securities to be used as consideration in the triangular reorganization exceeds the outside basis of the stock of T immediately prior to the triangular reorganization.<sup>20</sup> However, the Notice does not provide that a triangular reorganization must occur prior to the inbound transaction for these modifications to apply.

In addition, the term “specified earnings” with respect to the stock of a foreign acquired corporation is defined as the lesser of the following three amounts (but limited to zero):<sup>21</sup>

- The sum of the earnings and profits (including deficits) with respect to each foreign subsidiary of the foreign acquired corporation attributable to the stock of the foreign acquired corporation under section 1248(c)(2) (“lower-tier earnings”);<sup>22</sup>
- The product of the excess asset basis multiplied by the exchanging shareholder’s “specified percentage”;<sup>23</sup> and
- The amount of gain that would be realized by the exchanging shareholder if, immediately before the inbound transaction, the exchanging shareholder sold the stock of the foreign acquired corporation for fair market value, reduced by the

exchanging shareholder's "all E&P amount" (the "specified stock gain").<sup>24</sup>

In effect, "specified earnings" becomes the lesser of (i) lower-tier earnings attributable to the exchanging shareholder's stock in the foreign acquired corporation (i.e., the first bullet above) or (ii) the exchanging shareholder's built-in gain in the stock of the foreign acquired corporation, reduced by such shareholder's "all E&P amount" (i.e., the third bullet above), *provided that* such amount cannot exceed the exchanging shareholder's attributable portion of the excess asset basis (i.e., the second bullet above).

The Notice provides that if the specified earnings are less than the lower-tier earnings, then the portion of the "all E&P amount" related to the specified earnings will be sourced from lower-tier earnings in accordance with the principles of Treas. Reg. §1.1248-1(d)(3).<sup>25</sup>

The Notice does not provide any guidance on the treatment of amounts maintained in different currencies for purposes of computing either "excess asset basis" or "specified earnings."

Finally, the Notice announced that regulations to be issued under Treas. Reg. §1.367(b)-3 will also include an anti-abuse rule targeted at transactions engaged in to avoid the purposes of the modifications to the "all E&P amount" described in the Notice.<sup>26</sup>

## Nonqualified preferred stock (NQPS)

The Notice also announced that the definition of "property" under Treas. Reg. §1.367(b)-10 will be modified to include S stock that is NQPS (as defined in section 351(g)(2)).<sup>27</sup> Currently, the provision cross-references section 317(a) for the definition of property, which would not have included S stock, whether NQPS or not. As such, an acquisition of P stock or securities by S in exchange for NQPS of S in a triangular reorganization that does not otherwise meet an exception is now subject to Treas. Reg. §1.367(b)-10 (as modified by Notice 2014-32 and the modifications of the Notice).

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<sup>1</sup>Notice, section 4.01.

<sup>2</sup>*Id.*

<sup>3</sup>*Id.*

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

<sup>5</sup>See Treas. Reg. §§1.367(b)-4(b) and -4T(b).

<sup>6</sup>Notice, section 4.02.

<sup>7</sup>*Id.*

<sup>8</sup>*Id.*

<sup>9</sup>*Id.*

<sup>10</sup>Treas. Reg. §1.367(b)-3(a).

<sup>11</sup>Treas. Reg. §1.367(b)-3(b)(3)(i). The "all E&P amount" is defined under Treas. Reg. §1.367(b)-2(d) and is generally determined using the principles of section 1248 taking into account certain modifications (e.g., the "all E&P amount" does not include the earnings and profits of foreign subsidiaries of the foreign acquired corporation). See Treas. Reg. §1.367(b)-2(d)(1) through (3).

<sup>12</sup>Notice, section 4.03(a).

<sup>13</sup>Notice, section 4.03(b). The inside asset basis with respect to a foreign corporation is calculated based on the adjusted basis of the assets of the foreign acquired corporation in the hands of the domestic acquiring corporation immediately after the inbound transaction. Notice, pg. 16.

<sup>14</sup>Notice, section 4.03(b)(i). For this purpose, the earnings and profits of the foreign acquired corporation are determined under the principles of Treas. Reg. §1.367(b)-2(d), subject to various modifications. For example, the earnings and profits are determined without regard to whether the exchanging shareholder is a U.S. or foreign person and without regard to whether the U.S. person is a "U.S. shareholder" as defined under section 951(b) or the foreign person a foreign corporation that has a U.S. shareholder. *Id.*

<sup>15</sup>Notice, section 4.03(b)(ii).

<sup>16</sup>Notice, section 4.03(b)(iii).

<sup>17</sup>Notice, section 4.03(g).

<sup>18</sup>*Id.*

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

<sup>20</sup>See *Treas. Reg. §1.358-6(c)* (increasing P's basis in the stock of S by the amount of basis in T's stock in a triangular "B" reorganization); *Treas. Reg. §1.358-6(d)* (decreasing P's basis in the stock of S by the amount of property issued by S to acquire P stock, but not by more than the adjustment provided in (c), and never below zero).

<sup>21</sup>*Notice, section 4.03(d).*

<sup>22</sup>*Notice, section 4.03(d)(i).* For this purpose, "lower-tier earnings" are determined by taking into account the modifications under *Treas. Reg. §1.367(b)-2(d)(2)* and (d)(3)(i). *Id.*

<sup>23</sup>*Notice, section 4.03(d)(ii).* An exchanging shareholder's "specified percentage" is calculated as the exchanging shareholder's "specified stock gain" (as defined in the text associated with footnote 25) divided by the sum of the aggregate "specified stock gain" of all exchanging shareholders and the aggregate gain realized by all other exchanging shareholders in the transaction. See *Notice, section 4.03(e).*

<sup>24</sup>*Notice, section 4.03(d)(iii).* For purposes of the calculating the "specified stock gain," the "all E&P amount" is calculated without regard to the modification provided in the *Notice*. *Id.*

<sup>25</sup>*Notice, section 4.03(f).*

<sup>26</sup>*Notice, section 4.03(h).* One example provided by the *Notice* are transactions engaged in to reduce excess asset basis, including transactions that increase the basis in the stock of the foreign acquired corporation without increasing the basis in the assets of the foreign acquired corporation. The *Notice* provides that such transactions would be disregarded for purposes of calculating excess asset basis. *Id.*

<sup>27</sup>*Notice, section 4.04.*

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