A Gambit Renewed: IRS Targets ‘Killer Bs’ Paired With Inversions

By William R. Pauls

In Notice 2014-32,1 the IRS described changes that will be made to the Treasury regulations under section 367(b) addressing “Killer B” transactions.2 As discussed in this article, a primary goal of Notice 2014-32 is to combat a cross-border acquisition structure typically used in connection with an inversion transaction. In this regard, the notice announced that the following changes, among others, will be made to the Killer B regulations:

- The section 367(a) priority rule in reg. section 1.367(b)-10(a)(2)(iii) will be modified such that the income and gain taken into account for purposes of that rule will include a section 301(c)(1) dividend or section 301(c)(3) gain that would arise if the Killer B regulations applied to the triangular reorganization at issue only to the extent that the dividend income or gain would be subject to U.S. tax or would give rise to an income inclusion under section 951(a)(1)(A) that would be subject to U.S. tax.3

- The antiabuse rule in reg. section 1.367(b)-10(d) will be “clarified” to provide that: (i) the earnings and profits of a corporation (or a “successor corporation”) may be taken into account for purposes of determining the consequences of the adjustments provided in the Killer B regulations, regardless of whether that corporation is related to the parent corporation (P) or P’s subsidiary (S) before the triangular reorganization at issue; and (ii) S’s acquisition of P stock or securities in exchange for a note may invoke the antiabuse rule.

In announcing these forthcoming changes to the Killer B regulations, Notice 2014-32 effectively admits that the current regulations have failed to eliminate Killer B transactions from the marketplace.4 Furthermore, the notice confirms that the Killer B regulations have shortcomings that reflect the difficulty associated with drafting rules in this area.

Background

The Killer B regulations apply to a triangular reorganization5 in which, “in connection with” the reorganization, S purchases stock or securities of P in exchange for property6 (P acquisition) and, thereafter, exchanges the P stock or securities for the stock, securities, or property of a target corporation.


2Reg. section 1.367(b)-10(a)(3)(iv) provides that, for purposes of reg. section 1.367(b)-10, the term “triangular reorganization” has the meaning set forth in reg. section 1.358-6(b)(2). Accordingly, the following transactions, among others, qualify as a triangular reorganization for purposes of the Killer B regulations: triangular B reorganizations, reverse triangular mergers, forward triangular mergers, and triangular C reorganizations.

3Reg. section 1.367(b)-10(a)(3)(ii) provides that, for purposes of reg. section 1.367(b)-10, the term “property” has the meaning set forth in section 317(a), except that the term also includes a liability assumed by S to acquire the P stock or securities, and S stock, but only to the extent such S stock is used by S to acquire P stock or securities from a person other than P. In other words, stock issued by S to P in exchange for P stock or securities does not constitute property for purposes of the Killer B regulations.
(T) in the triangular reorganization, but only if P or S (or both) is a foreign corporation. The Killer B regulations apply to a triangular reorganization regardless of whether P controls S within the meaning of section 368(c) at the time of the P acquisition.

The IRS initially provided an example of a Killer B transaction in Notice 2006-85. In that example, P, a domestic corporation, owns 100 percent of the stock of each of S, a foreign corporation, and S1, a domestic corporation. In turn, S1 owns 100 percent of the stock of T, a foreign corporation. S purchases P voting stock from P for either cash or a note and then transfers the P voting stock to S1 in exchange for all of the stock of T in a triangular B reorganization (hence, the Killer B moniker). The mechanics of the example are shown in Figure 1.

Furthermore, the post-transaction corporate structure is depicted in Figure 2.

As discussed in Notice 2006-85, the following federal income tax consequences generally had been ascribed to this series of transactions:

- S’s transfer of cash or a note to P in exchange for P stock does not constitute a distribution under section 301;
- P’s sale of its stock to S for cash or a note does not cause P to recognize gain or loss under section 1032, and S takes a cost basis in the P stock under section 1012;
- S does not recognize gain under reg. section 1.1032-2(c) upon the transfer of the P stock to S1 because the basis and fair market value of the P stock are equal (assuming that S’s transfer of the P stock to S1 occurs contemporaneously with S’s acquisition of that stock from P);
- no amount needs to be included in P’s income under section 951(a)(1)(B) because S acquires and disposes of the P stock before the close of a quarter of the tax year, which is the time at which P’s share of the average amount of U.S. property held by S is measured for purposes of section 956; and
- under reg. section 1.367(b)-4(b)(1)(ii)(B), S1 does not have to include in income as a deemed dividend the section 1248 amount attributable to the T stock that S1 exchanges.

The IRS used Notice 2006-85 to announce that Treasury regulations would be issued under section 367(b) to address Killer B transactions. Notably, Notice 2006-85 provided the following explanation in support of this approach:

In a triangular reorganization, the exchange by the T shareholders of their T stock for P stock is described in section 354 or 356. As a result, a triangular reorganization involving a foreign corporation is described in section 367(b) and, therefore, may be subject to regulations issued under the broad regulatory authority granted therein. It is on this basis that regulations will be issued to address the triangular reorganizations covered by this notice.

As explained in Notice 2006-85, the IRS believes that Killer B transactions generally “are designed to avoid U.S. income tax,” including the tax on the repatriation of S’s earnings, and, consequently, “raise significant policy concerns, particularly

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7See reg. section 1.367(b)-10(a)(1).
8Id.
10S likely is newly organized.
11Notice 2006-85, supra note 9, at section 4.
12Id. at section 1.
13For example, when P is domestic and S is foreign, the transaction could have the effect of repatriating foreign earnings of S to P without a corresponding dividend to P that would be subject to U.S. federal income tax. Similarly, when P is foreign and S is domestic, the transaction could have the effect of repatriating S’s U.S. earnings to P in a manner that is not subject to U.S. withholding tax.
when either P or S (or both) is a foreign corporation (regardless of whether T is related to P and S before the transaction).14

Treasury and the IRS published the Killer B regulations nearly five years after the issuance of Notice 2006-85.15 In the case of a triangular reorganization subject to those regulations, adjustments must be made that are consistent with the adjustments that would have been made if S actually had distributed property to P under section 301 (deemed distribution).16 For purposes of this rule, the amount of the deemed distribution is equal to the sum of the amount of money transferred by S, the amount of any liabilities that are assumed by S and constitute property, and the fair market value of any other property transferred by S in the P acquisition.17 Also, the Killer B regulations require that adjustments be made that are consistent with the adjustments that would have been made if P actually had contributed the same property to S (deemed contribution).18 The deemed contribution has the effect of increasing P’s basis in the stock of S by the amount of the deemed distribution.19

For purposes of making the required adjustments, the deemed distribution and deemed contribution are treated as separate transactions that occur immediately before the P acquisition or, if P does not control S at the time of the P acquisition, immediately after P acquires control of S, but before the triangular reorganization.20 The required adjustments otherwise do not affect the characterization of the P acquisition as provided under applicable provisions of the code and Treasury regulations.21

Under the exceptions provided in reg. section 1.367(b)-10(a)(2), the Killer B regulations do not apply to a triangular reorganization if:

- P and S are foreign corporations, and neither P nor S is a controlled foreign corporation (within the meaning of reg. section 1.367(b)-2(a)) immediately before or immediately after the triangular reorganization;22
- S is a domestic corporation, P’s stock in S is not a U.S. real property interest (within the meaning of section 897(c)), and P would not be subject to U.S. tax on a dividend (as determined under section 301(c)(1)) from S under either section 88123 (for example, by reason of an applicable treaty) or section 88224 (the “no-U.S.-tax exception”);25 or
- in an exchange under section 354 or section 356, one or more U.S. persons exchange stock or securities of T, and the amount of gain in the T stock or securities recognized by such U.S. persons under section 367(a)(1)26 is equal to or greater than the sum of the amount of the deemed distribution that would be treated by P as a dividend under section 301(c)(1) and the amount of such deemed distribution that would be treated by P as gain from the sale or exchange of property under section 301(c)(3) (together, such dividend and such gain constitute “section 367(b) income”) if reg. section 1.367(b)-10 otherwise applied to the triangular reorganization (the “section 367(a) priority rule”).27

(Footnote continued in next column.)
The Killer B regulations also include an antiabuse rule under reg. section 1.367(b)-10(d) (antiabuse rule) that provides that "appropriate adjustments shall be made under this section if, in connection with a triangular reorganization, a transaction is engaged in with a view to avoid the purpose of this section." Notably, the following example is included in reg. section 1.367(b)-10(d):

If S is created, organized, or funded to avoid the application of this section with respect to the earnings and profits of a corporation related (within the meaning of section 267(b)) to P or S, the earnings and profits of S will be deemed to include the earnings and profits of such related corporation for purposes of determining the consequences of the adjustments provided in this section, and appropriate corresponding adjustments will be made to account for the application of this section to the earnings and profits of such related corporation.

As discussed below, the IRS has taken issue with (i) the manner in which some taxpayers have applied the plain language of the no-U.S.-tax exception and the section 367(a) priority rule, and (ii) the "narrow" fashion in which some taxpayers have read the antiabuse rule.

Transaction Targeted by the IRS in Notice 2014-32

Notice 2014-32 describes a cross-border acquisition structure that is subject to the Killer B regulations and falls outside the rules of section 367(a)(1) on account of the section 367(b) priority rule (targeted transaction).²⁸ Although the notice neither uses the term "inversion" nor describes an inversion transaction, the targeted transaction typically occurs in connection with those transactions.²⁹ An example illustrating this technique follows below.

USP, a public corporation organized in the United States, owns all of the stock of USS, another domestic corporation. USP and USS comprise an affiliated group that files a consolidated return for U.S. federal tax purposes. For valid business reasons, USP and FP, a public corporation organized under the laws of Country X, desire to combine and do so under New FP, a new foreign parent company that will be organized under the laws of Country Y, a country that has entered into a comprehensive income tax treaty with the United States. To accomplish that combination transaction, the following steps are completed:

1. USP organizes New FP. Initially, New FP is organized as an entity that is disregarded as separate from USP for U.S. federal tax purposes. Thereafter, New FP elects to be treated as an association that is taxable as a corporation for U.S. federal tax purposes less than 30 days before the date of the combination of USP and FP.

2. New FP organizes (i) Foreign Merger Sub, a transitory merger subsidiary organized under Country X law that will be used to acquire FP; and (ii) New USS, a new domestic subsidiary, which subsequently forms US Merger Sub, a transitory domestic merger subsidiary.

3. New USS acquires New FP voting stock from New FP in exchange for a note of equivalent fair market value.³⁰

4. Foreign Merger Sub merges with and into FP, with FP surviving. As a result of this transaction, New FP acquires FP, and FP Public exchanges the stock of FP for stock of New FP (or the stock of FP otherwise is converted into stock of New FP by operation of law).

³⁰New USS’s issuance of a note to New FP in exchange for New FP voting stock in this example follows from the facts of the Killer B transaction described in Notice 2006-85, in which the IRS posited that S used either cash or a note to purchase P voting stock from P. That being the case, assume that the New USS note constitutes bona fide indebtedness for U.S. federal tax purposes.
5. New FP contributes additional voting stock to New USS. At this point, it is asserted that New USS holds New FP stock with a fair market value approximately equal to the fair market value of the stock of USP.

6. US Merger Sub merges with and into USP, with USP surviving, that is, the targeted transaction is completed. At the conclusion of the targeted transaction, which the parties treat as a triangular B reorganization, New USS (and, correspondingly, New FP) acquires USP, and USP Public exchanges the stock of USP for voting stock of New FP (or the stock of USP otherwise is converted into voting stock of New FP by operation of law) representing less than 80 percent, but at least 60 percent, of New FP’s stock (in terms of voting power and value).31

At the conclusion of this series of transactions, New FP wholly owns each of New USS and FP, USP Public owns at least 60 percent, but less than 80 percent, of the voting power and value of the stock of New FP, and FP Public owns the remaining stock of New FP. As a consequence, the anti-inversion rules of section 7874, that is, the rules relating to expatriated entities and their foreign parents, provide for the following results:

- New FP likely constitutes a “surrogate foreign corporation” (as defined in section 7874(a)(2)(B)) because USP Public owns at least 60 percent, but less than 80 percent, of the voting power and value of the stock of New FP following this series of transactions.32 For purposes of this conclusion, it is necessary to take into account the stock of New FP held by FP Public in the denominator of the ownership fraction under the rules of section 7874(c)(2)(B) and the recently published temporary regulations under reg. section 1.7874-4T.33

- Assuming that New FP constitutes a surrogate foreign corporation, each of USP and USS constitutes an “expatriated entity” (as defined in section 7874(a)(2)(A)).34

Taking into account these consequences, section 7874(a)(1) directs that the taxable income of each of USP and USS for any tax year that includes any portion of the 10-year “applicable period” (as defined in section 7874(d)(1)) in no event will be less than the “inversion gain” (as defined in section 7874(d)(2)) of the entity for the tax year.35 For purposes of this conclusion, it is necessary to take into account the stock of New FP held by FP Public in the denominator of the ownership fraction under the rules of section 7874(c)(2)(B) and the recently published temporary regulations under reg. section 1.7874-4T.33

31Assume that the stock of New USS is not a U.S. real property interest (within the meaning of section 897(c)), and New FP would not be subject to U.S. tax under section 882 on a disposition of the stock of New USS.

32See reg. section 1.7874-2(c)(1) (describing indirect acquisitions of properties held by a domestic corporation for purposes of section 7874(a)(2)(B)(i)). As relevant to this conclusion, consideration should be given to the substantial business activities exception described in section 7874(a)(2)(B)(iii) and the temporary regulations published in 2012 that effectively (and rather inexplicably) nullified that exception in many instances. See reg. section 1.7874-3T; T.D. 9592.

33See reg. section 1.7874-4T(b), (c)(1)(i), (i)(6), (i)(7); see also T.D. 9654.

34Alternatively, if USP Public owns at least 80 percent of the voting power or value of the stock of New FP following this series of transactions, (i) New FP ought to be treated as a domestic corporation for U.S. federal tax purposes under section 7874(b); and (ii) neither USP nor USS likely constitutes an expatriated entity, as expatriated entity status relies on the existence of a foreign corporation that is a surrogate foreign corporation. See section 7874(a)(2)(A).

35In the absence of any inversion gain attributable to USP or USS, the primary impacts of the inversion transaction fall outside the purview of section 7874. In general, inversion gain is (i) income or gain recognized during the 10-year applicable (Footnote continued on next page.)

TAX NOTES, June 30, 2014 1529
purposes of determining inversion gain for a particular tax year, USP’s and USS’s use of some U.S. federal income tax attributes generally is limited.36

Regarding the application of the Killer B regulations to the targeted transaction, that is, the triangular B reorganization described in Step 6 of this example, the following considerations should be taken into account:

- New USS should be deemed to make a distribution to New FP in an amount equal to the fair market value of the note that New USS issued to New FP in exchange for the New FP voting stock in Step 3.37 In this example, assume that the deemed distribution from New USS to New FP gives rise to dividend income under section 301(c)(1) that is subject to U.S. withholding tax (at potentially reduced rates under the income tax treaty between the United States and Country Y), stock basis recovery under section 301(c)(2), and gain from the sale or exchange of property under section 301(c)(3). Therefore, the no-U.S.-tax exception is inapplicable to the targeted transaction because New USS has made a taxable dividend distribution to New FP, and a potentially significant amount of section 367(b) income has been generated for purposes of determining the application of the section 367(a) priority rule and, correspondingly, the section 367(b) priority rule to that transaction.

- Assuming that the section 367(b) income attributable to the targeted transaction exceeds the amount of gain that the U.S. shareholders of USP recognize under section 367(a)(1) on account of that transaction,38 the section 367(a) priority rule is inapplicable to the targeted transaction. It bears repeating here that, as relevant to the application of the section 367(a) priority rule, section 367(b) income is equal to the sum of (i) the amount of the deemed distribution that “would be treated by P as a dividend under section 301(c)(1)” and (ii) the amount of such deemed distribution that “would be treated by P as gain from the sale or exchange of property under section 301(c)(3).”39 Thus, even though the portion of the deemed distribution that is treated by New FP as gain from the sale or exchange of property under section 301(c)(3) is not subject to U.S. tax,40 it nevertheless is taken into account for purposes of determining section 367(b) income.

- Finally, this example does not appear to offer an occasion to invoke the antibuse rule. In particular, USP and FP desired to combine for valid business reasons, New USS’s use of a note to acquire voting stock of New FP follows from the example used by the IRS in Notice 2006-85, and the Killer B regulations actually apply to the targeted transaction in this instance and cause a taxable dividend to be recognized by New FP. Therefore, no transaction was completed “in connection with” the targeted transaction “with a view to avoid the purpose of” the Killer B regulations.41

In sum, on account of this series of transactions, USP and FP have achieved their business goal of combining under New FP and, in so doing, have not subjected the U.S. shareholders of USP to the gain recognition rules of section 367(a)(1).42 Instead, New FP has been subjected to U.S. tax on the deemed dividend from New USS resulting from the deemed distribution mechanism of the Killer B regulations. While some might argue that shifting the current U.S. tax burden from the U.S. shareholders of USP to New FP is inappropriate, that result nevertheless follows from the application of the plain language of the Killer B regulations.43 Also,

36Reg. section 1.367(b)-10(a)(2)(iii).
37As a general matter, such gain is not treated as U.S.-source income. See section 865(a)(2); see also supra note 31 (assumption that New FP would not be subject to U.S. tax under section 882 on a disposition of the stock of New USS).
38This statement is not meant to suggest that “the purpose” of the Killer B regulations is readily ascertainable from either reg. sec. 1.367(b)-10 or T.D. 9526, the latter of which neither referenced (nor replaced) the purpose described in the 2008 temporary regulations nor offered an explanation as to why that purpose was not included in reg. sec. 1.367(b)-10. Cf. former reg. sec. 1.367(b)-14T(a)(1) (“The purpose of this section is to prevent what is in effect a distribution of property to P without the application of provisions otherwise applicable to property distributions, when in connection with a triangular reorganization S acquires, in exchange for property, all or a portion of the P stock used in the reorganization.”); T roy’ regulations), (d) (the indirect stock transfer rules).
39Reg. section 1.367(b)-10(a)(2)(iii).
40As a general matter, such gain is not treated as U.S.-source income. See section 865(a)(2); see also supra note 31 (assumption that New FP would not be subject to U.S. tax under section 882 on a disposition of the stock of New USS).
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42See generally reg. section 1.367(a)-3(a)(1), (c) (the ‘Helen of Troy’ regulations), (d) (the indirect stock transfer rules).
43The U.S. shareholders of USP and, more broadly, USP Public likely should be viewed as bearing some incidence of the (Footnote continued on next page.)
any suggestion that the antiabuse rule should be construed in a liberal or broad fashion against taxpayers is not one that finds a firm footing in applicable law.\footnote{44}

\textbf{Proposed Amendments to the Killer B Regs}

Notice 2014-32 aims to combat the targeted transaction by modifying the section 367(a) priority rule and “clarifying” the antiabuse rule.\footnote{45} Specifically, the notice announced that the section 367(a) priority rule will be modified such that section 367(b) income will include a section 301(c)(1) dividend or section 301(c)(3) gain that would arise if the Killer B regulations applied to the targeted transaction only to the extent that such dividend income or gain would be subject to U.S. tax or would give rise to an income inclusion under section 951(a)(1)(A) that would be subject to U.S. tax.\footnote{46} In addition, the notice announced that the antiabuse rule will be clarified to provide that (i) the earnings and profits of a corporation (or a “successor corporation”) may be taken into account for purposes of determining the consequences of the adjustments provided in the Killer B regulations, regardless of whether such corporation is related to P or S before the triangular reorganization; and (ii) S’s acquisition of P stock or securities in exchange for a note may invoke the antiabuse rule. Thus, under the facts of the preceding example, the IRS may assert that the deemed distribution from New USS to New FP is a dividend to the extent of the E&P of New USS and USP\footnote{47} based on the proposed clarification of the antiabuse rule.

It is anticipated that the proposed changes to the Killer B regulations will apply to triangular reorganizations completed on or after April 25, 2014.\footnote{48} However, a grandfathering provision generally will apply to a triangular reorganization if (i) T was not related to P or S (within the meaning of section 267(b)) immediately before the triangular reorganization; and (ii) the triangular reorganization was entered into either under a written agreement that, subject to customary conditions, was binding before April 25, 2014, and all times thereafter, or under a tender offer announced before April 25, 2014.\footnote{49}

\textbf{Conclusion}

As a parting shot, the IRS stated in Notice 2014-32 that “no inference is intended regarding the treatment of transactions described in ... this notice under current law, and the IRS may challenge such transactions under applicable Code provisions or judicial doctrines.”\footnote{50} Thus, notwithstanding the plain language of the Killer B regulations, and Treasury and the IRS’s apparent inability to articulate the purpose of those regulations (or at least stick with an articulated purpose), it seems that previously completed transactions that fall within the bounds of the targeted transaction may be subject to further scrutiny. Given the IRS’s “constrained” resources,\footnote{51} it seems that a better plan might be for it to police areas fraught with fewer hazards.

\footnote{47}{The E&P of USP likely reflect the E&P of USS under the consolidated return rules. See reg. section 1.1502-33(b)(1).}
\footnote{48}{See Notice 2014-32, section 5.}
\footnote{49}{Id.}
\footnote{50}{Id.}