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Proposed rules permit tax-free cross-border mergers

TAX LAW

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Section 368 of the Internal Revenue Code (IRC) allows corporations to engage in tax-free reorganizations provided that certain requirements are met. The acquisition of assets or stock that would otherwise trigger the recognition of gain at both the shareholder and corporate level may be treated as a non-taxable event under the reorganization provisions of IRC § 368. One type of reorganization defined in the IRC is the "statutory merger," commonly known as the Type A merger, in which the assets and liabilities of a corporation — the target corporation — are transferred by operation of law to another corporation — the acquiring corporation. As a result of the merger, the acquiring corporation survives, and the target corporation ceases to exist, by operation of law.

The treasury regulations define a Type A merger as a transaction "effected pursuant to the laws of the United States or a state or the District of Columbia." Thus, a merger that occurs under foreign law cannot qualify as a Type A merger. In recognizing that the laws of many foreign jurisdictions are similar to those in the United States, the Internal Revenue Service (IRS) recently issued proposed regulations, allowing certain mergers and consolidations effective under foreign law to qualify as tax-free A reorganizations. The proposed regulations allow the transaction to be effected "pursuant to the statute or statutes necessary to effect the merger or consolidation." This is a welcome change for many tax practitioners attempting to qualify mergers involving one or more foreign corporations as a Type A statutory merger.

Although it was possible to structure some cross-border transactions to qualify as a Type A merger, this was generally limited to transactions involving the foreign acquisition of a U.S. company.

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The foreign acquirer could form a U.S. acquisition subsidiary and then merge the U.S. subsidiary with the U.S. company, and thus qualify the transaction as a Type A merger.

Many tax practitioners also attempted to structure transactions involving foreign corporations under one of the other tax-free reorganization provisions, including B, C or D Type reorganizations, because those reorganization provisions do not prohibit the use of a foreign corporation. However, many practitioners found it difficult to meet the conditions under the other reorganization provisions because the provisions generally have more stringent technical requirements than Type A reorganizations. For example, an A reorganization generally has less stringent requirements in areas such as the amount of non-stock, or cash, consideration that can be given by the acquiring corporation, the amount of unwanted assets of the acquired company that can be retained or disposed of prior to the acquisition and the treatment of option holders. In particular, a statutory A merger generally has no restriction on the use of cash and other non-stock consideration given by the acquiring corporation, other than the general continuity of proprietary-interest requirement. The continuity of proprietary-interest requirement generally allows at least 50 percent cash. However, a B or C Type reorganization generally imposes lower thresholds or prohibits the use of any cash altogether as part of the consideration for the transaction.

The proposed regulations also remove certain restrictions for statutory mergers and consolidations that involve foreign-disregarded entities. There has been some confusion over whether a transaction involving a U.S. corporation that owns a foreign-disregarded entity, such as a Nova Scotia unlimited liability company, could qualify as a statutory A merger because of the "effected under" U.S. law requirement, despite the fact that both corporations involved in the merger are domestic. The proposed regulations eliminate this uncertainty.

Although the proposed regulations will provide tax practitioners with greater planning flexibility, they do not come without concern. As mentioned, the proposed regulations require the transaction to qualify as a reorganization under foreign law. Notably, the regulations require that the assets and liabilities of the participating corporations be transferred by operation of law, or by statutory rule rather than by contract. Thus, some foreign statutes may not qualify if the statute does not provide for the transfer of assets and liabilities by operation of law. Furthermore, the proposed regulations do not apply to statutes that do not require the termination of the target company after all of its assets and liabilities have been acquired.

Moreover, other foreign jurisdictions may not provide for a typical statutory merger. For instance, Canadian law does not provide for a statutory merger, but instead provides for an amalgamation that involves two entities combining to form a new third entity. Although a Canadian amalgamation will not qualify under the U.S. merger structure where one corporation survives and the other disappears, it may qualify as a consolidation for U.S. tax purposes where a new third corporation is deemed to be created.

In addition to the proposed regulations involving Type A mergers, the IRS also proposed changes to the regulations under IRC § 367. IRC § 367 generally imposes tax on certain U.S. taxpayers owning an interest in a foreign corporation that engages in a tax-free reorganization. The U.S. shareholder of the foreign corporation may enter into a gain recognition agreement with the IRS to pay the tax upon the occurrence of a future event. The proposed changes to IRC § 367 generally apply to U.S. shareholders who own more than 10 percent of the voting power of a foreign corporation and most of the proposed changes apply only where the foreign corporation is considered a controlled foreign corporation (CFC). A foreign corporation is generally considered a CFC if at least 50 percent of the foreign corporation is owned by U.S. shareholders who generally own at least 10 percent of the voting power.

The proposed regulations are not effective until they are published as temporary or final regulations. It is uncertain at this time when, or in what form, the regulations will become effective. Once they are effective, the regulations will provide many tax practitioners with increased flexibility in structuring cross-border transactions by allowing foreign-to-foreign mergers and mergers between U.S. and foreign corporations.

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