

TAX

Tax benefits for US shareholders in foreign mergers

BY CLAIRE SPENCER



Formerly, foreign corporations could not participate in certain tax-deferred reorganisations and business combinations under US tax law. Furthermore, such deals involving one or more businesses were subject to relatively restrictive reorganisation regulations, making it difficult for US shareholders to exchange foreign stock on a tax-free basis. But in 2006, Treasury regulations were issued that expanded the definition of the flexible A-type reorganisation category, which now allows foreign entities to participate in such transactions. Most experts agree that the amendments have brought this area of US tax law up to date, although there are some concerns that it is more open to abuse.

The extended reach of A-type reorganisations

Under US tax law, most mergers or consolidations generally result in a taxable recognition event for the parties involved. However, the law also provides that, under certain conditions, a reorganisation involving a merger or consolidation can qualify for tax deferral. There are several types of such reorganisations defined under US tax law, but perhaps the most significant of these is an A-type reorganisation, named for Internal Revenue Code (IRC) Section 368(a)(1)(A), which provides for a tax-free statutory merger or consolidation of two or more companies. "In an 'A' reorganisation shareholders exchange their shares in one company for shares in a com-

bined company," explains Peter Connors, a partner at Orrick, Herrington & Sutcliffe LLP. "It is the most flexible of the tax free reorganisation provisions provided for under the Code, in that shareholders are allowed to receive taxable cash, voting stock and non-voting stock as part of the consideration," he says. Indeed, there is no restriction on the amount of non-voting stock that can be used, and up to 60 percent of the consideration can be satisfied using cash, securities and other non-proprietary property. By way of contrast, the considerations of other tax-free reorganisations are greatly restricted when using assets other than the voting stock of the acquiring corporation.

Such flexibility is a valuable commodity, and as such, the expansion of the qualification criteria for A-type reorganisations was a welcome move when it occurred in 2006. To qualify as a statutory merger or consolidation under the new rules, two events must occur simultaneously at the time of the transaction. Firstly, all the assets and liabilities of the one or more parties involved must become the assets and liabilities of a new combined entity, and secondly, the combining entity of each party must cease its separate legal existence for all purposes. Furthermore, the amendments have allowed mergers or consolidations of one or more non-US companies, where relevant, to qualify as an A-type reorganisation. This was not permitted under the old rules, which provided that mergers or consolidations had to be effected under US

corporate law to be considered a statutory merger. As such, mergers involving non-US companies were often subject to far more stringent requirements and could not often be accomplished in on a tax-deferred basis.

Both US and non-US companies can now conduct an A-type reorganisation under either a US statutory law or a foreign statutory law of similar effect in one of two ways – via merger or consolidation. When two or more entities combine under the former, one entity survives, and one will legally go out of business. Under the latter, where a new entity is formed, the two or more pre-existing entities are consolidated into the new entity, before legally going out of business. "In the US, a substantial number of A-type reorganisations are in the merger format since it is generally desired to have one of the legal entities remain in existence post reorganisation," explains Bill Armstrong, a partner at Moss Adams LLP. "However, within a foreign context, many foreign statutes do not allow for a merger whereby one of the entities remains in existence. Instead, many require a consolidation of entities to effect a statutory reorganisation."

In addition to satisfying the 'simultaneous events' that determine whether the merger/consolidation is statutory, the reorganisation must meet continuity of interest (COI) and continuity of business enterprise (COBE) requirements, and must be carried out for one or more corporate business purposes. "COI is present if a substantial part of the value of the proprietary interests in the combining corporation is preserved in the potential reorganisation. For this purpose, a proprietary interest is so preserved if it is exchanged for a proprietary interest in the combined corporation or if it otherwise continues as a proprietary interest in the combining corporation. The COBE requirement is met if the combined corporation either continues the combining corporation's historic business or uses a significant portion of the combining corporation's historic business assets in the new business," explains Mr Connors.

The changes were proposed in 2005, and were the latest in a long line of reforms to the tax-deferred reorganisation rules and definitions. "The US tax-deferred reorganisation rules and definitions have been around a long time," says Mr Armstrong. "Although

the Judiciary has applied concepts such as COI and COBE to limited the application of the tax deferred rules, the Administration has become more and more business minded. As time has passed, the Administration has made changes here and there to the underlying regulations.” He adds that the changes effected by the Internal Revenue Service (IRS) and Treasury have been working to bring symmetry between US and foreign reorganizations, focusing particularly on areas where relatively small unilateral changes would precipitate large amounts of much-needed simplicity. The regulatory language defining a statutory merger is one such area.

Furthermore, the changes seem to be an acknowledgement of globalisation, something that may not have been such a big consideration when the rules were first written. Indeed, the requirement whereby an A-type reorganisation had to be effected under US corporate law precluded mergers involving non-US entities. “But now, the IRS and Treasury Department acknowledged that many foreign jurisdictions have merger or consolidation statutes that operate in material respects like those of the states in the US. Accordingly, they revised the definition of statutory merger or consolidation to allow transactions effected pursuant to the statutes of a foreign jurisdiction to qualify as a statutory merger or consolidation,” says Hope Krebs, co-chair of the International Practice Group at Duane Morris.

Ultimately, keeping legislation simple and up-to-date keeps it effective, but some teething problems are somewhat inevitable. In this case, the simplicity of the definition of a statutory merger may leave it open to abuse. Anecdotally, a number of statutory mergers that have been classified as an A-type reorganisation under the new rules have already raised questions as to whether that should have been the case. It is yet to be seen whether this will become a serious issue. But as lawmakers wished to classify more

reorganisations among non-US organisations as being A-type, they are unlikely to kick up a fuss in the near term. As such, it is sufficient that such organisations meet the existing criteria laid out for A-type reorganisations.

Evaluating the effects

Of course, these rules will only concern a minority of transactions – most of the time, foreign shareholders that are effecting a merger of corporate entities would not be affected by having a taxable transaction. On balance though, the amendments (so far) can be considered a success, in that they achieve putting non-US corporations and their shareholders on an equal footing with their US-based counterparts when it comes to how they are treated by this area of tax law. “Without these rules, most multinational mergers that sought tax deferral needed to be characterised under either a B-type or C-type reorganisation for US tax purposes,” explains Mr Armstrong. “These were not always easy to structure into, given the robust dynamics of a multinational consolidation. Many consolidations are designed to provide assets to some shareholders or liability segregation, and in the context of a B-type reorganisation, such flexibility simply doesn’t exist, as they specifically require that only voting stock of the transferor can be given to the transferee.” He adds that C-type reorganisations are also problematic, due to their requirement that all of the assets must be transferred. As such, if shareholders are only looking to merge part of a business and retain the remainder, this will not be possible.

However, the rules were not subject to wholesale change – none of the ancillary provisions that could apply to an otherwise tax-deferred exchange were altered. For example, IRC Section 367 imposes an income tax on the outbound transfer of certain assets – so an A-type merger between a US company and a non-US company where the non-US company

is the surviving entity would be treated as such a transfer. Furthermore, the Obama administration indicated earlier this year that they are likely to make this provision even stricter in the near future, possibly by substantially increasing the exit taxes. It may also be the case that foreign taxing authorities have similar rules to the US regarding expatriation of assets outside their taxing jurisdiction.

Overall then, it seems to be the case that more non-US companies qualify as A-type reorganisations under the amended rules. “We have seen a number of companies take advantage of the flexibility of the ‘A’ reorganisation since the final regulations were issued in 2006,” notes Ms Krebs. Notably, there has been an increase in foreign-to-foreign mergers which seek to be characterised as such – A-type classification makes the whole process rather less cumbersome. “Assuming that the global economy stabilises, we would expect to see an uptick in cross-border mergers, including an increase in the use of flexible ‘A’ reorganisations,” she continues. Furthermore, the A-type reorganisations are also set to rise among US-based companies, which are divesting of or acquiring a foreign component of their business. However, there has not been an increase in the use of A-type reorganisations where the US acquirer wishes to merge with a non-US target, mostly because that there are already other beneficial rules which apply when the seller is not based in the US.

Ultimately, all rules dealing with tax-deferred reorganisations – be they A, B, C or D-type – are definitional, not elective. There is no grey area – the definition either applies or it does not, and this can be problematic in some transactions. But it can now be applied in more cases than before, and the fact that the rules have been simplified has been helpful in as much as A-type reorganisations tend to be faster, cheaper and more flexible – no bad thing in the current climate. ■



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