Liquidations That Run for the Border

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When a domestic company wants to liquidate a subsidiary or merge with another corporation, the first question is always whether any tax will follow. The resounding answer is almost always no, provided that certain ownership and mechanical tests are met. Tax advisors are adept at making a merger or the liquidation of a subsidiary tax-free. Indeed, in many cases it can be harder to make an ostensibly tax-free transaction taxable.

Yet if the liquidation crosses a border, yellow flags should rise. Often, the usual tax-free result runs into trouble when a foreign corporation is involved in the transaction. While there has been much in the news about mergers being used as a device to avoid taxes, little attention has been paid to international liquidations.

The IRS does not view these transactions as innocuous, particularly if it looks as though the United States is missing its last opportunity to impose tax on an asset. Such transactions fall into a complex web of exceptions and exceptions to exceptions. Internal Revenue Code Section ("Code Sec.") 367(a)(1) describes a general rule under which a foreign corporation is not treated as a corporation to the extent that gain is recognized for mergers, liquidations and other transactions that would normally be tax-free.

The effect of this "you're not a corporation" precept is to bar nonrecognition treatment for gains. That means transfers of assets abroad can incur tax to the extent of previously unrealized gain. In short, since the foreign corporation is not a corporation in the eyes of the IRS, the nonrecognition rules common to corporate reorganizations do not apply.

Tax accrues at the level of the domestic corporation that is engaging in the merger or liquidation. The painful part of Code Sec. 367(a), however, is that it preserves nonrecognition of losses. Without proper planning, the taxpayer is stuck with the IRS getting the best of both worlds.

The goal of the code and related Byzantine regulations is to prevent built-in gain from leaving the U.S. taxing power. If these rules did not exist, a U.S. corporation holding appreciated assets could simply merge and move the assets out of the United States, and then the IRS would lose its last chance to tax the eventual sale or gain of these assets. Any good rule to prevent abuse, however, catches many nonabusive transactions in its net.

Exceptions

Exceptions apply when a U.S. corporation merges with a foreign corporation or when a U.S. corporation is making a transfer of foreign assets to a foreign corporation. A merger will often involve the continuance of a business in the United States, leaving open the possibility of taxation at a later date. In a merger, some assets may escape U.S. tax jurisdiction.

Yet other assets remain and can have their bases or structures adjusted to preserve the possibility of being taxed. Some mergers, including the recent Applied Materials marriage with Tokyo Electro or even the older Daimler-Chrysler combination, could not have happened without these nonrecognition rules. Also, in a merger, the bases of shareholders in the new entity can be adjusted to reflect the built-in gain.

Example 1. Fantastic Licorice (FL) is a renowned American licorice manufacturer owned by four corporate shareholders. It has two small manufacturing facilities in the United States. Although FL's products are widely available in supermarkets in the United States and Canada, FL has been unable to gain a foothold in the European market. Yum (Y) is a large European Licorice manufacturer with all of its operations in Belgium. The two companies decide to merge, creating FLY; and a large number of assets with built-in gain is transferred out of the United States to expand operations in Belgium. Code Sec. 367(a)(3) and (5) will often bless nonrecognition treatment of this transaction, provided that certain administrative burdens are met. If only Code Sec. 367(a)(1) applied, there would be significant tax on built-in gain as the

Belgian corporation would not be treated as a corporation.

The problems really begin when there is nothing left within the taxing jurisdiction of the United States. When a U.S. subsidiary liquidates into a foreign parent, problems abound. Many corporate and even tax practitioners are shocked to discover—hopefully before they close the deal—that the normal nonrecognition rules do not apply.

Even those more familiar with international tax are often surprised that there is an exception to the rule destroying nonrecognition in the code and regulations themselves (essentially an exception to an exception). Fortunately, there are also methods not specifically blessed in the code that can produce tax-free liquidations. The "check-and-sell" method may sound vaguely like something sold *via* an infomercial. Actually, it is simply checking a box on a tax return. By making a well-planned "check-the-box" election, a disregarded entity can produce superb results for some. [*See Dover Corp. & Subsidiaries*, 122 TC 324, Dec. 55,630 (2004).] Of course, not all business entities can make a check-the-box election, which makes planning important from the very start.

When a U.S. subsidiary of a foreign corporation liquidates into its parent, there may be no assets left in the U.S. tax jurisdiction. This presents an obvious problem. Unlike a merger where shareholders will remain in the United States, there is no one remaining "on the hook." However, liquidations of subsidiaries are a necessity for many foreign corporations.

Messy History

As a result, Congress and the Treasury have made a series of abortive and disorganized attempts to allow for some tax-free liquidations of U.S. subsidiaries into foreign parents. The story touches upon our old friend, *General Utilities*. [SCt, 36-1 USTC ¶9012, 296 US 200 (1935).] Although Code Sec. 367(a) as described above existed at the time, the *General Utilities* doctrine did not treat distributions to shareholders of appreciated assets as a taxable event.

The result was that Code Sec. 367(a) was rendered mostly ineffective for liquidations of U.S. subsidiaries into foreign parents. After all, the corporate status of the foreign parent was irrelevant. The predecessor to Code Sec. 367(e)(2) was enacted in 1984. It would be two years later that Congress would act sweepingly to repeal the *General Utilities* doctrine. For a time, taxpayers were unsure what rule applied. Eventually, Congress was forced to remind the Treasury and spur it to action:

One's knee-jerk reaction—that a subsidiary liquidation into a parent must always be tax-free—can be wrong.

> The conferees expect that the regulations may permit nonrecognition if the appreciation on the distributed property is not being removed from the US tax jurisdiction prior to recognition. [1986 Conference Report, 1986-3 C.B. (Vol. 4), at 202.]

Essentially, Congress recognized that the same theory under which tax-free international mergers are allowed can be applied to international liquidations. If there remains something to tax in the United States, the IRS has not lost its last chance!

The Treasury eventually acted and promulgated regulations. They offer some limited circumstances for a U.S. subsidiary to liquidate into a foreign parent without triggering gain. Reg. §1.367(e)-2 explains that Code Sec. 367(e)(2)—not Code Sec. 367(a)—applies to these parent-sub liquidations.

Of course, Code Sec. 367(a) and (e)(2) state that they apply to liquidations of U.S. subsidiaries into their foreign parents. It almost seems to have been written in an intentionally confusing way. As a side note, however, Code Sec. 367(b) continues to apply in conjunction with Code Sec. 367(e). That makes transactions involving stock held as an asset all the more complicated.

Confused yet? The three situations in which the foreign parent can liquidate its U.S. subsidiaries and receive assets tax-free are (1) the foreign parent continues to use the assets in a trade or business in the United States for 10 years; (2) the asset is real property in the United States; or (3) the asset is a lower-tier U.S. subsidiary. There is an inherent logic in these situations where nonrecognition is permitted. After all, in each such case, there is still something left in the United States to tax at a later date.

What are real world examples in which these provisions are important? A manufacturer may want to cease production in the United States because of high labor costs. A foreign pharmaceutical company may want to do away with an unnecessary U.S.-tier subsidiary in between it and more substantive U.S. subsidiaries.

Tax goals are not necessarily bad either. A foreign corporation may want to liquidate its subsidiary but avoid paying tax on the built-in gain in the real property which the foreign parent will continue to hold. These are all situations where Reg. §1.367(e)-2 comes to the rescue.

Example 2. A hosiery manufacturer in the United Kingdom has a U.S. Subsidiary that has two lower-tier subsidiaries. The U.K. hosiery manufacturer wants to keep the two lower-tier subsidiaries, but wants to do away with the unnecessary U.S. Subsidiary in between it and the two lower-tier subsidiaries. Prior to Reg. §1.367(e)-2, the middle subsidiary would incur tax upon liquidation into its foreign parent. Now, this can be accomplished tax-free.

Like so much else in the tax law, these exceptions can prove to be useful as planning devices. Suppose that there are no plans for a U.S.-to-foreign liquidation in the near future. Nevertheless, creating multiple subsidiaries may be of great use down the road. A foreign corporation may want nonrecognition for one business group but not for another. By placing different business groups in different subsidiaries, a foreign corporation preserves choices.

Of course, nonrecognition is easier said than done. One's knee-jerk reaction—that a subsidiary liquidation into a parent must always be tax-free—can be wrong. And since putting broken eggs back in the carton isn't easy, it is far better to bone up on these areas before effecting a plan, not after.

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