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Foreign Acquisition of a United States Business: The Tax Considerations

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Messrs. Bricker and Boyd offer the foreign investor a number of practical suggestions for minimizing the tax burdens of acquiring a United States business. Among the most important of these suggestions is the use of bilateral tax treaties relating to the British Virgin Islands, the Netherlands and the Netherlands Antilles.

I. INTRODUCTION

THERE HAS BEEN a dramatic increase in the number of United States businesses acquired by foreign investors.[1] This article will discuss the income tax aspects of such an acquisition[2] when made directly or indirectly by a foreign corporation which is not a "controlled foreign corporation,"[3] "foreign investment company,"[4] or "foreign

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[1] In 1978, there were 199 reported acquisitions of domestic concerns by foreign persons. N.Y. Times, Feb. 25, 1979, § 6 at 1, col. 1.

[2] For a general discussion of other legal considerations of an acquisition of a United States business by a foreign person, *see* Young, *The Acquisition of United States Businesses by Foreign Investors*, 30 BUS. L. 111 (1974).

[3] A "controlled foreign corporation" is defined as a foreign corporation, of which more than fifty percent of the total combined voting power of all classes of voting stock is owned, directly, indirectly or constructively by United States shareholders. I.R.C. § 957(a). A United States shareholder is defined as a United States citizen or resident, domestic corporation, domestic partnership, or domestic estate or trust that owns ten percent or more of the foreign corporation's total combined voting power. I.R.C. §§ 951(b), 7701(a)(30).

[4] A "foreign investment company" is defined as a foreign corporation which is either (i) registered under the Investment Company Act of 1940 as a management company or as a unit investment trust, or (ii) engaged primarily in the business of investing, reinvesting, or trading in securities (within the meaning of section 3(a)(1) of

personal holding company"[5] as defined by the Internal Revenue Code. The term "Target Company" will refer to the United States business being acquired; the term "Acquiring Company" will refer to the corporation making the acquisition; and the foreign person making the acquisition through the Acquiring Company will be referred to as the "Foreign Investor." It is assumed that the acquired United States business will be conducted in corporate form, and will continue to be an "operating business" and not a "personal holding company."[6]

II. TAXATION OF FOREIGN CORPORATIONS

An understanding of the United States income tax laws as applied to foreign corporations is crucial in examining the income tax consequences of acquiring a United States business. The following summary will serve as a basis for the considerations discussed below.[7]

A. *Income Not Effectively Connected With a United States Trade or Business*

A foreign corporation may be subject to federal income tax on two types of income: passive income from domestic sources and business income, derived from the active conduct of a trade or business in the United States. A foreign corporation not engaged in a trade or business within the United States will be subject to United States income tax only on passive types of United States source income such as

the Investment Company Act) at a time when more than fifty percent of the total combined voting power of all classes of voting stock or the total value of all classes of stock is directly or indirectly held by United States citizens or residents, domestic corporations, domestic partnerships, or domestic estates or trusts. I.R.C. §§ 1246(b), 7701(a)(30).

[5] A "foreign personal holding company" is defined as a foreign corporation, of which at least sixty percent (or, under certain circumstances, fifty percent) of the gross income is foreign personal holding company income and more than fifty percent in value of the outstanding stock is owned, directly or indirectly, by or for no more than five individuals who are citizens or residents of the United States. I.R.C. § 552(a).

[6] A "personal holding company" is defined as any foreign or domestic corporation of which at least sixty percent of the gross income is personal holding company income as defined in I.R.C. § 543(a) and more than fifty percent in value of the outstanding stock is owned, directly or indirectly, by or for no more than five individuals. I.R.C. § 542(a).

[7] For a detailed discussion of United States tax rules applying to foreign corporations, *see* S. ROBERTS & W. WARREN, U.S. INCOME TAXATION OF FOREIGN CORPORATIONS AND NONRESIDENT ALIENS (Supp. 1970), and B. BITTKER & L. EBB, UNITED STATES TAXATION OF FOREIGN INCOME AND FOREIGN PERSONS (2d ed. 1968).

dividends, interest, rents, royalties, and other "fixed or determinable annual or periodical gains, profits, and income" which it receives.[8]

Foreign corporations are taxed on passive types of United States source income at a flat rate of thirty percent of gross income absent a treaty which provides otherwise.[9] This tax generally must be withheld by the person making payment of the income to the foreign corporation.[10] A foreign corporation not engaged in a trade or business within the United States is exempt from federal income tax on capital gains which it realizes.[11]

The tax treatment of dividend and interest payments made to a foreign corporation depends on whether the payments are from a domestic or foreign source. Dividends and interest paid by a domestic corporation deriving twenty percent or more of its gross income from sources within the United States are income from United States sources.[12] Similarly, all or part of the dividends and interest paid by a foreign corporation are from a domestic source if the foreign corporation is engaged in the conduct of a trade or business within the United States and at least fifty percent of its gross income is effectively connected with the conduct of that trade or business.[13]

B. *Income Effectively Connected With a United States Trade or Business*

A foreign corporation engaged in a trade or business within the United States is subject to federal income tax on all domestic source

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[8] I.R.C. § 881(a).

[9] *Id.*

[10] I.R.C. §§ 1441(a), 1442(a).

[11] I.R.C. § 881(a). Note, however, that certain types of income which ordinarily would be capital gain are nonetheless taxable to a foreign corporation which is not engaged in a trade or business within the United States. *See* I.R.C. §§ 881(a)(1)-(4).

[12] I.R.C. §§ 861(a)(1)(B), 861(a)(2)(A). The twenty percent gross income test applies to the three year period preceding the payment of interest or declaration of a dividend. If the corporation has not been in existence for three years, the twenty percent gross income test applies to the taxable year in which payment of the interest or dividends is made. I.R.C. § 861(d)(1).

[13] I.R.C. §§ 861(a)(1)(C), 861(a)(2)(B). If part of a foreign corporation's gross income for the applicable period is not effectively connected with the conduct of a trade or business within the United States, dividends or interest which it pays will be United States source income to the extent of the ratio that its effectively connected gross income bears to its gross income from all sources. I.R.C. §§ 861(a)(1)(D), 861(a)(2)(B). The fifty percent gross income test applies to the three year period preceding the payment of interest or declaration of a dividend, or, if the corporation has not been in existence for three years, the year in which the payment is made. I.R.C. § 861(d)(1).

income effectively connected with the conduct of the trade or business.[14] In addition, if the foreign corporation maintains an office or other fixed place of business within the United States, it may be subject to federal income tax on certain limited types of foreign source income effectively connected with the conduct of the trade or business within the United States.[15]

A foreign corporation is not engaged in a trade or business within the United States solely by reason of owning the stock of a domestic or foreign corporation engaged in a trade or business within the United States.[16] Such a corporation is engaged in a trade or business only if it "systematically and continuously" engages in commercial transactions within the United States.[17] A foreign corporation that purchases the assets of a United States business and conducts the business itself is engaged in a trade or business within the United States. If, however, the foreign corporation purchases the United States business through a domestic or foreign subsidiary or transfers the purchased business to such a subsidiary, the foreign corporation is not considered to be engaged in a trade or business within the United States.

III. STRUCTURE FOR THE ACQUISITION

The primary considerations for a Foreign Investor in structuring the acquisition of a United States business are the form of acquisition, the type of consideration, the source of financing, the means of repatriation of the profits of the United States business, and the form of operation for the acquired business.

A. *Form of Acquisition*

A Foreign Investor can acquire a United States business in any of five basic forms. These forms include a taxable purchase of assets, a taxable purchase of stock, a tax-free asset acquisition, a tax-free stock acquisition, and the creation of a jointly owned domestic corporation or partnership.[18]

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[14] I.R.C. § 882(a).

[15] I.R.C. §§ 864(c)(4)(B).

[16] *See* Treas. Reg. § 1.864-3(b), ex. 2 (1972). Note also that most of the United States bilateral income tax treaties provide that the ownership of the stock of a subsidiary engaged in a trade or business within the United States will not result in the shareholder being engaged in a trade or business within the United States.

[17] *See* Herbert v. Comm'r, 30 T.C. 26 (1958); Linen Thread Co. v. Comm'r, 14 T.C. 725 (1950); Continental Trading Inc. v. Comm'r, 16 T.C.M. 724 (1957).

[18] A corporation or partnership is domestic if it is created or organized in the

The simplest and most flexible form for acquiring a United States business is to purchase its assets. Any type of consideration may be used to purchase all or a portion of the assets of the United States business. A taxable purchase of the assets of a Target Company generally should be made by a domestic corporation. If a foreign corporation makes the acquisition directly, it will be engaged in a trade or business within the United States and thereby will be subject to federal income tax on income effectively connected with the trade or business. Although the taxes on the profits from the Target Company's business may be the same regardless of whether it is acquired by a domestic or foreign corporation, the advantage of using a domestic corporation is that it will permit the filing of a United States consolidated income tax return.[19]

Alternatively, the Foreign Investor may purchase all or a majority of the shares of stock of the Target Company. The reasons for making the acquisition in this form include preserving the "tax attributes" of the Target Company,[20] avoiding "recapture" or inclusion in income of income tax deductions or credits previously allowed or allowable to the Target Company,[21] and avoiding the necessity of obtaining approval for the acquisition from the Target Company's management and directors. The Foreign Investor can treat its purchase of the Target Company's shares as an acquisition of the company's assets (and therefore obtain a purchase cost basis for the assets) if it purchases at least eighty percent of the shares of the Target Company and liquidates the Target Company within two years after its purchase of the shares.[22]

United States or under the law of the United States or an individual state. I.R.C. § 7701(a)(4). A corporation or partnership is foreign if it is not domestic. I.R.C. § 7701(a)(5).

[19] I.R.C. § 1504(d). *See* text accompanying notes 78-86 *infra*.

[20] A Target Company's tax attributes will not be affected by a purchase of its stock unless I.R.C. §§ 269, 382 or 383 apply.

[21] *See, e.g.*, I.R.C. §§ 47(a)(1), 1245(a)(1), 1250(a)(1).

[22] I.R.C. § 334(b)(2). I.R.C. § 334(b)(2) provides as follows:

> (2) *Exception*—If property is received by a corporation in a distribution in complete liquidation of another corporation (within the meaning of section 332(b)), and if—
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> (A) the distribution is pursuant to a plan of liquidation adopted not more than 2 years after the date of the transaction described in subparagraph (B) (or, in the case of a series of transactions, the date of the last such transaction); and
>
> (B) stock of the distributing corporation possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote, and at least 80 percent of the total number of shares of all other classes of stock (except nonvoting stock which is limited and preferred as to dividends), was ac-

A taxable acquisition of the shares of the Target Company may be made either by a domestic or foreign corporation. One important consideration in determining whether the Acquiring Company should be domestic or foreign is whether the Foreign Investor intends to liquidate the Target Company to obtain a purchase cost basis for its assets. Liquidation of the Target Company by a foreign corporation is generally a taxable event. Therefore, if liquidation of the Target Company is intended, purchase of the Target Company's shares should be made by a domestic Acquiring Company.[23]

Assets or stock of the Target Company may also be acquired on a tax-free basis. An acquisition of the assets or shares of a Target Company which qualifies as a reorganization under the Internal Revenue Code is a tax-free transaction for the parties to the reorganization, although shareholders of the Target Company may recognize income if

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quired by the distributee by purchase (as defined in paragraph (3)) during a 12-month period beginning with the earlier of,

(i) the date of the first acquisition by purchase of such stock, or

(ii) if any of such stock was acquired in an acquisition which is a purchase within the meaning of the second sentence of paragraph (3), the date on which the distributee is first considered under section 318(a) as owning stock owned by the corporation from which such acquisition was made,

then the basis of the property in the hands of the distributee shall be the adjusted basis of the stock with respect to which the distribution was made. For purposes of the preceding sentence, under regulations prescribed by the Secretary, proper adjustment in the adjusted basis of any stock shall be made for any distribution made to the distributee with respect to such stock before the adoption of the plan of liquidation, for any money received, for any liabilities assumed or subject to which the property was received, and for other items.

[23] The liquidation is a taxable event unless a ruling under I.R.C. § 367(a) is obtained. To obtain such a ruling, the Target Company generally has to agree to include in its gross income the amount of appreciation of certain of its assets. Rev. Proc. 68-23, 1968-1 C.B. 821. If a ruling under section 367(a) is not obtained, the Internal Revenue Service may treat the liquidation as a taxable event under section 331. In this situation, gain recognized by the foreign corporate shareholder may be subject to United States income tax if the shareholder is engaged in a trade or business within the United States. If the foreign corporate shareholder is not so engaged, the gain that it recognizes on the liquidation of the Target Company is not subject to United States income tax. I.R.C. § 881. However, if section 334(b)(2) does not apply to the liquidation of the Target Company, the foreign corporate shareholder's basis for the Target Company's assets is the fair market value of the Target Company's assets on the date of distribution. I.R.C. § 334(a). The shareholder will not obtain any United States tax basis or benefit for any difference between the price it paid for the Target Company's shares and the fair market value of the Target Company's assets. I.R.C. § 1012.

they receive consideration other than shares of the Acquiring Company or the Foreign Investor if it is also a corporation.[24] An asset acquisition qualifies as a reorganization only if a significant amount (generally fifty percent) of the consideration received by the Target Company or its shareholders is stock of the Acquiring Company or its shareholder.[25] A stock acquisition is tax-free only if the *sole* consideration received by the shareholders of the Target Company in exchange for their Target Company shares is stock of the Acquiring Company or its parent.[26] In addition, the Acquiring Company must acquire "control" of the Target Company.[27]

A Foreign Investor may also make an acquisition through a joint venture corporation or partnership. In exchange for shares of the joint venture corporation or partnership interests, the Target Company contributes the desired assets and the Acquiring Company or Foreign Investor contributes cash or similar consideration. This approach allows the acquisition to be accomplished without adverse federal income tax consequences to either the Target Company or its shareholders which would otherwise result from a direct asset or stock acquisition. It also allows minority shareholders of the Target Company to exchange their shares tax-free.

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[24] The term "reorganization" is defined in I.R.C. § 368. If a transaction qualifies as a reorganization, exchanges of stock (by the shareholders of the Target Company) or assets (by the Target Company) for stock of the Acquiring Company are tax-free. I.R.C. §§ 354 (stock for stock); 361 (assets for stock). Gain realized by exchanging shareholders will be recognized only if consideration other than qualified consideration is received in the reorganization transaction. I.R.C. § 356.

[25] *See* text accompanying notes 180-82 *infra*.

[26] I.R.C. § 368(a)(1)(B). *See also*, material cited in note 211 *infra*. The Internal Revenue Service has acknowledged several exceptions of this rule. *See* Rev. Rul. 79-89, 1979-11 I.R.B. 7 (Acquiring Company can contribute cash to Target Company to allow Target Company to repay a loan guaranteed by its shareholder); Rev. Rul. 73-54, 1973-1 C.B. 187 (Acquiring Company can pay Target Company's reorganization expenses); Rev. Rul 72-522, 1972-2 C.B. 215 (Target Company stock can be purchased for cash from the Target Company); Rev. Rul. 72-354, 1972-2 C.B. 216 (Acquiring Company's cash purchase of Target Company stock from its shareholders can be cleansed by a sale of that stock to an unrelated person): Rev. Rul. 68-562, 1968-2 C.B. 157 (shareholder of the Acquiring Company can purchase fifty percent of Target Company's shares); Rev. Rul. 68-285, 1968-1 C.B. 147 (Target Company can redeem dissenter's shares); Rev. Rul. 56-184, 1956-1 C.B. 190 (dividend of earnings by Target Company permissible to closing date of reorganization).

[27] Unless otherwise indicated, the term "control" in this article means "the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock . . . ." I.R.C. § 368(c).

Whether a tax-free acquisition of the assets or shares of the Target Company or a joint venture corporation is planned, the acquisition vehicle generally should be a domestic corporation. An acquisition of this nature is frequently impracticable or impossible when made through a foreign corporation since a significant percentage of the consideration in such an acquisition must be stock of the Acquiring Company. The stock of a foreign corporation generally is not attractive to the Target Company or its shareholders.[28]

B. Financing Arrangements

Two important aspects of the financing arrangements for the acquisition of a United States business are the country in which the funds will be borrowed, and the country in which the interest incurred on the loan will be tax deductible. If the acquisition will be financed in the United States, the corporation borrowing funds should be a domestic corporation. This facilitates borrowing the funds in the United States. In addition, interest on such loans is deductible for federal income tax purposes.[29] If the acquisition will be financed outside the United States, the corporation borrowing such funds should be a foreign corporation to avoid subjecting interest payments on the loan to federal income (withholding) tax.[30]

For the reasons discussed above, acquisition through a domestic subsidiary is preferable. Accordingly, the Foreign Investor may use an existing or new foreign subsidiary to borrow the necessary funds and advance these funds to the domestic subsidiary as a loan or a contribu-

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[28] Stock acquisitions have substantially lost their attractiveness due to the experience of the early 1970's when stock received in such transactions frequently proved to have a value significantly below the acquisition or exchange ratio. In addition, most United States shareholders and domestic corporations are not receptive to receiving the stock of a foreign corporation. Unless the foreign stock is traded on a United States or foreign exchange, liquidity becomes a major problem since there may be no market for the stock.

[29] *But see* I.R.C. § 279 which limits an Acquiring Company's annual deduction for interest paid or incurred with respect to "corporate acquisition indebtedness" to $5,000,000.

[30] I.R.C. §§ 861(a)(1)(C), 881(a), 1441(a), 1442(a). Interest paid by a domestic corporation will also be exempt from United States income (withholding) tax if the domestic corporation derives less than twenty percent of its gross income from United States sources. I.R.C. § 861(a)(1)(B). However, the use of such a domestic corporation to finance the acquisition of a United States business is not feasible unless the Target Company derives less than twenty percent of its gross income from United States sources and therefore interest which it pays is not from United States sources.

tion to its capital. United States income tax laws require that a loan to the domestic corporation bear appropriate interest.[31] Repayment of the principal amount of the loan will not result in any federal income tax being incurred. While a capital contribution of the loan proceeds to the domestic corporation avoids the necessity of paying interest on funds contributed, repayment of the funds so contributed is a dividend for federal income tax purposes.[32]

C. *Repatriation*

Repatriation of earnings and cash flow of the Target Company are important considerations in determining the acquisition structure. In the absence of an applicable United States income tax treaty or convention, United States source dividends or interest paid to a foreign corporation are subject to income tax at the rate of thirty percent of the gross amount of such payments.[33] Bilateral income tax treaties often eliminate this tax on interest payments and reduce the tax on dividends paid by wholly-owned or substantially wholly-owned domestic subsidiaries to five percent.[34] In addition, to prevent double taxation, bilateral income tax treaties normally allow a credit against the recipient's tax in the foreign country for the federal income tax withheld on dividends and interest it receives from a domestic corporation.[35]

If a Foreign Investor qualifies for the benefits of a United States bilateral income tax treaty, the primary focus should be the structure necessary to optimize the benefits under the treaty. If a Foreign Investor does not qualify for treaty benefits, it should consider using a

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[31] I.R.C. § 482; Treas. Reg. § 1.482-2(a), T.D. 6952, 1968-1 C.B. 218.

[32] The payments will be dividends only to the extent that the paying corporation has current or accumulated earnings and profits. I.R.C. §§ 301(c)(1), 316(a). However, the Internal Revenue Service's position is that United States income tax must be withheld from such distributions even if the paying corporation has no earnings and profits since post-distribution earnings and profits may result in the distribution being a dividend. Treas. Reg. § 1.1441-3(b)(1); Rev. Rul. 72-87, 1972-1 C.B. 274.

[33] I.R.C. § 881(a). If the Foreign Investor is a foreign government or an instrumentality of a foreign government, dividend and interest payments which it receives may be exempt from United States income tax. *See* I.R.C. § 892.

[34] *See, e.g.*, the United States bilateral income tax agreements with the Netherlands and the United Kingdom discussed *infra;* Treasury Department's Model Income Tax Treaty of May 17, 1977, 1 TAX TREATIES (CCH) ¶ 153 [hereinafter cited as Model Income Tax Treaty].

[35] *Id.*

foreign subsidiary corporation which does so qualify.[36] Of course, this approach is helpful in reducing the tax cost of repatriation only if the treaty country does not impose a significant tax on dividends and interest from the domestic corporation. A corporation formed in a non-treaty jurisdiction which imposes no tax or an insignificant tax is of limited use in reducing the tax cost of repatriation due to the thirty percent federal income (withholding) tax on payments to such a corporation. The British Virgin Islands, the Netherlands, and the Netherlands Antilles are jurisdictions in which the investor can reap the benefits of both a tax treaty and low domestic taxes.

1. British Virgin Islands Corporation

The bilateral income tax convention between the United States and the United Kingdom, as it applies to the British Virgin Islands,[37] subjects dividends paid by a domestic corporation to a British Virgin Islands corporation not engaged in a trade or business within the United States to the United States income tax at a rate of fifteen percent.[38] This rate is further reduced to five percent if (i) the British Virgin Islands corporation controls, directly or indirectly, at least ninety-five percent of the voting power of the domestic corporation at the time the dividend is paid, (ii) not more than twenty-five percent of the domestic corporation's gross income consists of interest and dividends (other than interest and dividends from a subsidiary), and (iii) a ruling is obtained from the Internal Revenue Service to the effect that the relationship between the British Virgin Islands corporation and the domestic corporation is not arranged or maintained

[36] While there has been a great deal of debate whether a third country national can avail itself of the benefits of a United States bilateral income tax agreement, it is generally accepted that this can be done. *See, e.g.*, Rev. Rul. 75-23, 1975-1 C.B. 290; Aiken Industries, Inc. v. Comm'r, 56 T.C. 925 *acq.* 1972-2 C.B. 1.

[37] Convention for the Avoidance of Double Taxation and the Prevention of Income Tax Evasion, April 16, 1945, United States-United Kingdom, 60 Stat. 1377, T.I.A.S. No. 1546 [hereinafter cited as the United Kingdom Convention]. This convention was subsequently modified June 6, 1946, 60 Stat. 1389, T.I.A.S. No. 1546 [hereinafter cited as Supplementary Protocol I]. The United Kingdom Convention, amended August 19, 1957, 9 U.S.T. 1329, T.I.A.S. No. 4124 [hereinafter cited as Supplementary Protocol II] was extended to the British Virgin Islands Jan. 1, 1959, 9 U.S.T. 1459, T.I.A.S. No. 4141 [hereinafter cited as Supplementary Protocol III]. A subsequent protocol between these two countries does not appear to apply to the British Virgin Islands. 17 U.S.T. 1254, T.I.A.S. No. 6089.

[38] The United Kingdom Convention, *supra* note 37, art. VI(1).

primarily with the intention of obtaining the reduced five percent tax rate on dividends.[39] The United Kingdom Convention does not reduce the rate of United States income tax on interest paid by a domestic corporation to a British Virgin Islands corporation.[40] It does provide that dividends and interest paid by a British Virgin Islands corporation to foreign persons are exempt from United States income tax.[41]

The United Kingdom Convention applies to dividends received by a British Virgin Islands corporation from a domestic corporation only if the dividends are subject to British Virgin Islands tax.[42] The British Virgin Islands taxes the net income of a corporation at a rate of fifteen percent.[43] For this purpose, dividends received by a British Virgin Islands corporation are included in its gross income. United States income taxes paid on the dividends received, as well as the corporate income tax paid by the domestic corporation with respect to the earnings paid as a dividend, may be credited against a British Virgin Islands corporation's British Virgin Islands income tax.[44] In most circumstances, credit for the United States income taxes paid with respect to a dividend received by a British Virgin Islands corporation from a domestic corporation will satisfy the British Virgin Islands tax on such dividend. In any event, dividends and interest paid by a British Virgin Islands corporation to nonresidents of the British Virgin Islands are exempt from British Virgin Islands tax.[45]

The use of a British Virgin Islands corporation to acquire the Target Company may be desirable if repatriation is planned in the form of dividends. The cost of repatriation would be a five percent United States income tax on dividends paid by the domestic corporation if the British Virign Islands corporation owns at least ninety-five percent of its voting power and satisfies the other two conditions men-

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[39] *Id.;* Treas. Reg. § 507.502(c) (1979). While the convention is silent as to the applicable period, the Internal Revenue Service's view is that the twenty-five percent gross income test must be satisfied by the domestic corporation for the three (taxable) year period preceding the taxable year in which it pays the dividend to the British Virgin Islands corporation. Treas. Reg. § 507.502(b) (1979).

[40] The United Kingdom Convention, *supra* note 37, art. VII relating to interest was not extended to the British Virgin Islands. 9 U.S.T. 1459, T.I.A.S. No. 4141.

[41] The United Kingdom Convention, *supra* note 37, art. XV.

[42] The United Kingdom Convention, *supra* note 37, art. VI (1).

[43] Virgin Islands Income Tax Ordinance, ch. 189, § 26 (1977) (copy on file at *Journal of International Law* office) [hereinafter cited as Income Tax Ordinance].

[44] *Id.* The United Kingdom Convention, *supra* note 37, art. XIII (2).

[45] Income Tax Ordinance, *supra* note 43, §§ 8(q), (r), 39.

tioned above. If the British Virgin Islands corporation owns more than twenty-five percent but less than ninety-five percent of the voting power, a fifteen percent tax is imposed. In both situations, there probably will be no British Virgin Islands income tax payable by the British Virgin Islands corporation on the dividend.[46] If funds are to be repatriated from the domestic corporation in the form of interest, the use of a British Virgin Islands corporation to make the acquisition is not beneficial since the United Kingdom Convention does not reduce the thirty percent United States income tax on such interest payments.

2. Netherlands Corporation

The bilateral income tax convention between the United States and the Netherlands (the "Netherlands Convention"),[47] provides that dividends paid by a domestic corporation to a Netherlands corporation which does not have a permanent establishment in the United States to which the dividends are effectively connected, are subject to United States income tax at a maximum rate of fifteen percent.[48] The rate of United States income tax on dividends is further reduced to five percent if two additional requirements are satisfied. The first requirement is that the Netherlands corporation must own at least twenty-five percent of the domestic corporation's voting stock during the part of the domestic corporation's taxable year preceding the date on which the dividend was paid and, assuming it was in existence, the domestic corporation's entire preceding taxable year.[49] The second requirement is that no more than twenty-five percent of the domestic corporation's gross income for its taxable year preceding the payment of the divi-

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[46] The British Virgin Islands imposes an annual license fee which, for resident companies, is imposed on gross foreign assets on a sliding scale. The fee approximates .1 percent of gross foreign assets with a maximum tax of $5,000. The Companies Act §§ 238-41 (sections added 1978) (copy on file at *Journal of International Law* office).

[47] The Income Tax Convention between the United States of America and the Kingdom of the Netherlands, April 29, 1958, 62 Stat. 1757, T.I.A.S. No. 1855, [hereinafter cited as the Netherlands Convention], as modified by supplementary protocols of June 15, 1955, 6 U.S.T. 3696, T.I.A.S. No. 3366; and December 30, 1965, 17 U.S.T. 896, T.I.A.S. No. 6051 [hereinafter cited as the 1965 Protocol]. The Department of the Treasury is considering the renegotiation of the Netherlands Convention. 44 Fed. Reg. 40758 (1979).

[48] The 1965 Protocol, *supra* note 47, art. V which appends art. VII (1)(a) and (3) of the Netherlands Convention, *supra* note 47.

[49] The 1965 Protocol, *supra* note 47, art. V which appends art. VII(1)(b) of the Netherlands Convention, *supra* note 47.

dend can be from interest and dividends other than interest and dividends from a subsidiary.[50] The Netherlands Convention further provides that interest paid by a domestic corporation to a Netherlands corporation is exempt from United States income tax.[51] In addition, dividends and interest paid by a Netherlands corporation to foreign persons are exempt from United States income tax.[52]

Although it would appear that if the Netherlands Convention stock ownership and gross income tests are satisfied, a Netherlands corporation would qualify for the five percent rate on dividends it receives from a domestic corporation, the Internal Revenue Service's position is that the five percent tax rate applies only if it issues an advance ruling to that effect.[53] Dividends received by a Netherlands corporation from a more than twenty-five percent owned operating corporation are generally exempt from Netherlands tax under the "substantial participation privilege."[54] While interest received by a Netherlands corporation is subject to Netherlands corporate income tax (at rates of up to forty-eight percent), this tax can be minimized by the interest

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[50] The 1965 Protocol, *supra* note 47, art. V which appends art. VII(2) of the Netherlands Convention, *supra* note 47. A subsidiary is defined by art. VII(2) of the Netherlands Convention as a corporation, fifty percent or more of the voting stock of which was owned by the domestic corporation at the time it received the dividends or interest. In applying the twenty-five percent gross income test, interest derived by a corporation in the conduct of a banking, insurance or financing business is disregarded.

[51] The 1965 Protocol, *supra* note 47, art. VI which appends art. VIII of the Netherlands Convention, *supra* note 47.

[52] The 1965 Protocol, *supra* note 47, art. V which appends art. VII of the Netherlands Convention, *supra* note 47.

[53] This position is apparently based upon Treas. Reg. § 505.108(a)(2)(iii) (1948). If the gross income and stock ownership tests are met, the Internal Revenue Service apparently will issue a favorable ruling. *See, e.g.*, Rev. Rul. 75-118, 1975-1 C.B. 390. The five percent withholding rate on dividends under the Netherlands Convention is not dependent upon establishing that the primary purpose of the use of the Netherlands corporation is not to obtain such reduced rate of withholding. In contrast, the lack of such a purpose must be established to obtain the five percent withholding rate on dividends paid to a Netherlands Antilles corporation.

[54] Netherlands Corporate Tax Act of 1969, [1969] Stb. 445, art. 13 (Neth. 1969) in Netherlands Corporate Tax Act of 1969: An English Translation, [Supp. No. 149] COMMON MKT. REP. (CCH) 22-23 (Issue No. 99, Dec. 8, 1970) [hereinafter cited as Netherlands Corporate Tax Act]. In general, the participation privilege will apply if (i) there is at least a five percent holding in the foreign company, (ii) the foreign company is subject to some local corporate tax on profits, (iii) the holding is not a portfolio investment, and (iv) the Netherlands corporation is not an investment company (to which separate favorable tax provisions apply).

deduction resulting from the Netherlands corporation borrowing a substantial portion of the funds it lends to the domestic corporation.[55]

Interest paid by a Netherlands corporation to a nonresident of the Netherlands is not subject to the Netherlands withholding tax.[56] However, dividends paid by a Netherlands corporation are subject to a Netherlands withholding tax unless the shares of the Netherlands corporation are in turn owned by a Netherlands Antilles corporation.[57] A Netherlands corporation paying dividends to a Netherlands Antilles corporation is taxed in the Netherlands Antilles at a rate of up to three percent.

While it may be possible to avoid or minimize the Netherlands income tax payable by a Netherlands corporation in this manner, such a corporation is subject to a one percent capital tax on capital which it receives.[58] This tax frequently can be minimized by capitalizing the Netherlands corporation with a significant amount of debt since the capital tax does not apply to debt.

3. Netherlands Antilles Corporation

The Netherlands Convention has been extended by protocol to the Netherlands Antilles (the "1963 Protocol") with several important modifications.[59] The most important of these modifications concern

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[55] Interest is generally deductible in computing income subject to the Netherlands corporate income tax. However, interest on loans obtained to finance a "participation" is deductible only to the extent the subsidiary produces income subject to Netherlands taxation. *Id.*

[56] Netherlands Corporate Tax Act, art. 17, *supra* note 54, at 24-25; Individual Income Tax Act of 1964, [1964] Stb. 572, art. 49 (Neth. 1964), appended to Netherlands Corporate Tax Act, *supra* note 54, at 38-39.

[57] Tax Agreement for the Kingdom (of the Netherlands), October 28, 1964, ch. II, Part 1, Section 11 *reprinted in Business Operations in the Netherlands Antilles*, 263 TAX MNGM'T FOREIGN INCOME PORTFOLIOS (BNA) at B-67 (Aug. 30, 1976).

[58] Act of December 24, 1970, on the Taxation of Various Legal Transactions (Wet op belastingen van rechtsverkeer), [1970] Stb. 611 (Neth. 1970) (copy in Dutch on file at *Journal of International Law* office).

[59] The 1948 Netherlands Convention, *supra* note 47, was extended to the Netherlands Antilles by protocol dated June 15, 1955. 6 U.S.T. 3696, T.I.A.S. No. 3366. It was amended by protocol dated October 23, 1963, applicable only to the Netherlands Antilles. 15 U.S.T. 1900, T.I.A.S. No. 5665 [hereinafter cited as the 1963 Protocol]. A 1965 convention modified and supplemented the original 1948 treaty. 17 U.S.T. 896, T.I.A.S. No. 6051. The 1965 supplementary convention does not apply to the Netherlands Antilles. Therefore, the United States income tax treaty provisions which apply to the Netherlands differ significantly from the United States income tax treaty provisions which apply to the Netherlands Antilles.

the application of the Netherlands Convention dividend, interest, and royalty provisions to a Netherlands Antilles corporation which is subject to reduced rates of Netherlands Antilles tax as a holding company.[60] A holding company is normally subject to Netherlands Antilles tax on its net income at a maximum rate of three percent.[61] Under Netherlands Antilles tax law, however, a Netherlands Antilles holding company may elect not to be taxed as a holding company on its United States source income. The corporation is then subject to Netherlands Antilles tax on its net profit from United States source dividends at a rate of fifteen percent and on its net profit from other United States source income at a rate of up to thirty percent.[62] Non-United States source net profit continues to be taxed at the holding company rate.[63]

Dividends and interest paid by a domestic corporation to a Netherlands Antilles corporation are generally entitled to reduced rates of United States income tax under the 1963 Protocol only if the Netherlands Antilles corporation is not engaged in a trade or business within the United States through a permanent establishment[64] and the corporation makes an election.[65] However, there are two exceptions to the requirement that an election be made to qualify for the 1963 Protocol dividend and interest provisions. These provisions will apply if: (i) the Netherlands Antilles corporation owns at least twenty-five percent of the stock of the domestic corporation;[66] (ii) less than sixty percent of the gross income of the domestic corporation is from passive sources;[67] and (iii) a ruling is obtained from the Internal Revenue Ser-

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[60] The 1963 Protocol, *supra* note 59, art. I.

[61] Territorial State Ordinance on Profit Tax 1940, art. 14 *reprinted in Business Operations in the Netherlands Antilles,* 263 TAX MNGM'T FOREIGN INCOME PORTFOLIOS (BNA) at B-28(6) (Jan. 3, 1977) [hereinafter cited as Territorial State Ordinance on Profit Tax].

[62] *Id.* arts. 8A, 14, 15 at B-28(3), B-28(6), B-28(7); Guarantee Ordinance Profit Tax 1969 (copy may be obtained from Pierson, Heldring, & Pierson, Curacao, N.V., John B. Gorsiraweg 6, P.O. Box 889, Curacao, Netherlands, Antilles [hereinafter cited as Guarantee Ordinance Profit Tax 1969].

[63] Territorial State Ordinance on Profit Tax, *supra* note 61, art. 8A at B-28(3); Guarantee Ordinance Profit Tax 1969, *supra* note 62.

[64] The 1965 Protocol, *supra* note 47, arts. V and VI which append arts. VII and VIII of the Netherlands Convention, *supra* note 47; Treas. Reg. § 505.302 (1955); Treas. Reg. § 505.304 (1955).

[65] Rev. Rul. 65-16, 1965-1 C.B. 626.

[66] The 1963 Protocol, *supra* note 59, art. I(2)(a).

[67] *Id.* Passive source income for this purpose includes interest (except for a corporation the principal business of which is making loans), dividends, royalties, real

vice.[68] The 1963 Protocol dividend and interest provisions also apply without making an election if all the stock of the Netherlands Antilles corporation is owned by one or more Netherlands corporations.[69]

Assuming the 1963 Protocol dividend provision applies, dividends paid by a domestic corporation to a Netherlands Antilles corporation are subject to United States income tax at a maximum rate of fifteen percent.[70] This rate is further reduced to five percent if three additional requirements are satisfied: (i) the Netherlands Antilles corporation must control, directly or indirectly, at least ninety-five percent of the voting power of the domestic corporation; (ii) not more than twenty-five percent of the domestic corporation's gross income for the three-year period immediately preceding the taxable year in which the dividend is paid is derived from interest and dividends (other than payments from a subsidiary);[71] and, (iii) a ruling is obtained from the Internal Revenue Service to the effect that the relationship between the Netherlands Antilles corporation and the domestic corporation has not been arranged or maintained primarily with the intention of securing the reduced (1963 Protocol) rate of tax.[72]

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property rents and gains from the sale or other disposition of stock, securities or real property. For the purposes of this test, dividends include those received from a subsidiary. Rev. Rul. 77-435, 1977-2 C.B. 491. Although the 1963 Protocol is silent on the point, the Internal Revenue Service's view is that when a domestic subsidiary pays dividends to a Netherlands Antilles corporation, the sixty percent test applies to the domestic corporation's total gross income for its three taxable years immediately preceding the taxable year in which the dividend is paid. Rev. Rul. 77-435, 1977-2 C.B. 491. The ruling is silent as to the period for interest paid by the domestic corporation, although it would seem that it would also be the aggregate of the three-year period immediately preceding the taxable year in which the interest is paid. *Cf.* I.R.C. § 861(a)(1)(B), (C).

[68] Rev. Proc. 79-40, §§ 2.02(1)(b), 3.02(1)(b), 1979-36 I.R.B. 19.

[69] The 1963 Protocol, *supra* note 59, art. I(2)(h); Rev. Proc. 66-40, §§ 2(b)(1)(ii), 3(b)(1)(ii), 1966-2 C.B. 1245.

[70] The 1965 Protocol, *supra* note 47, art. V which appends art. VII (i) of the Netherlands Convention, *supra* note 47.

[71] *Id.* While the 1963 Protocol is silent on the point, the Internal Revenue Service's view is that the twenty-five percent gross income test must be satisfied by the domestic corporation for the three-year period preceding the taxable year in which the dividend is paid. Treas. Reg. § 505.302(c)(1) (1955).

[72] Rev. Proc. 66-40, 1966-2 C.B. 1245, § 2(b)(iii); Treas. Reg. § 505.302(c)(2) and (3) (1955). *See* I.R.S. Letter Ruling 7742058 for an example of reasons justifying reducing dividend withholding to five percent. It should be noted that letter rulings may not be used or cited as precedent. I.R.C. § 6110(j)(3). *See also* Rev. Rul. 79-65, 1979-8 I.R.B. 48 for the effect of failing to supply information to the Internal Revenue Service to establish that the relationship between the Netherlands Antilles

Assuming the 1963 Protocol interest provision applies, interest paid by a domestic corporation to a Netherlands Antilles corporation is exempt from United States income tax. This exemption does not apply to interest payments if the Netherlands Antilles corporation owns, directly or indirectly, more than fifty percent of the voting power of the domestic corporation.[73] Dividends and interest paid by a Netherlands Antilles corporation to non-United States persons are exempt from United States income tax.[74] In addition, if such payments are made to nonresidents of the Netherlands Antilles, they are exempt from Netherlands Antilles income tax.[75]

4. Multi-Tier Structures

Provisions of both the Netherlands Convention and the 1963 Protocol are frequently utilized by a Foreign Investor in structuring its acquisition of a United States business. For example, if funds from the Target Company's business are to be repatriated in the form of dividends, it may be desirable for a Netherlands corporation owned by a Netherlands Antilles corporation to make the acquisition. In this circumstance, the tax cost of repatriation would be as follows: (i) a five percent United States income tax on dividend payments to the Netherlands corporation; (ii) no tax in the Netherlands; and (iii) a Netherlands Antilles tax (at a rate of up to three percent) on dividends which the Netherlands Antilles corporation receives from the Netherlands corporation. Since there would be no further tax on payments by the Netherlands Antilles corporation, the net tax cost of repatriation by dividends would be approximately eight percent.

The Netherlands Antilles corporate profit tax in the foregoing structure may be avoided if the Netherlands corporation uses the funds directly rather than paying a dividend to the Netherlands Antilles corporation. The dividends paid to the Netherlands corporation ordinarily

and domestic corporations was not established or maintained to obtain the five percent rate.

[73] The 1965 Protocol, *supra* note 47, art. VI which appends art. VIII (1) of the Netherlands Convention, *supra* note 47.

[74] The Netherlands Convention, *supra* note 47, art. XII; Rev. Rul. 75-23, 1975-1 C.B. 290.

[75] It is the authors' understanding that there is no Netherlands Antilles provision for withholding on dividend and interest payments. Nonresident corporations which do not have a permanent establishment in the Netherlands Antilles are generally not subject to the Netherlands Antilles income tax. Territorial State Ordinance on Profit Tax, *supra* note 61, art. 1, § 1c at B-28(1).

are exempt from Netherlands income tax under the participation privilege. Due to the favorable bilateral income tax treaties which apply to the Netherlands, a Netherlands corporation frequently will be a vehicle for further acquisition or investment by the Foreign Investor in other countries.[76]

The use of a Netherlands corporation as the Acquiring Company may not be beneficial if funds are to be repatriated in the form of interest since interest received is subject to the Netherlands corporate income tax. However, a Netherlands Antilles corporation is exempt from United States income tax on interest payments and subject only to Netherlands Antilles tax on such payments at a maximum rate of three percent if its shares are owned by a Netherlands corporation. Thus, a more desirable structure is an acquisition through a Netherlands corporation owned by a Netherlands Antilles corporation. Loans could be made by a second Netherlands Antilles corporation owned by the Netherlands Acquiring Company. This structure permits the repatriation of profits through dividend and interest payments by the Target Company at a total tax cost of approximately eight and three percent, respectively.[77]

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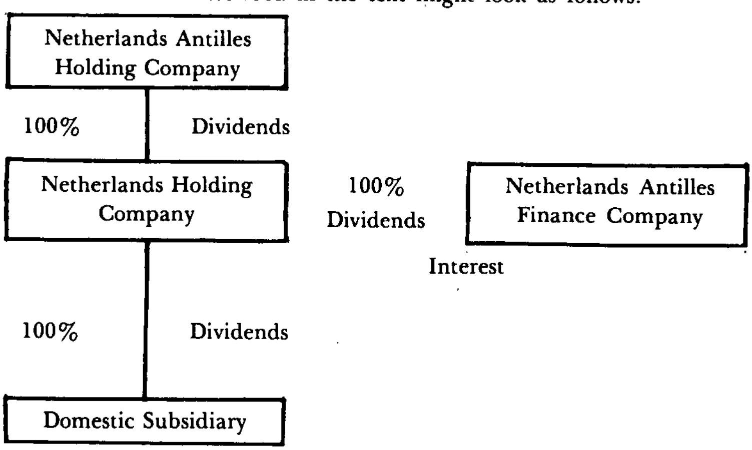
[76] The Netherlands has entered into bilateral income tax treaties with, or extended such a treaty to, the following countries: Australia, Austria, Belgium, Canada, Czechoslovakia, Denmark, Finland, France, (West) Germany, Hungary, Indonesia, Ireland, Israel, Italy, Japan, Luxembourg, Malawi, Malta, Netherlands Antilles, Norway, Singapore, South Africa, Spain, Surinam, Sweden, Switzerland, Thailand, the United Kingdom, and Zambia. BOARD OF INLAND REVIEW, *Netherlands* in INCOME TAXES OUTSIDE THE UNITED KINGDOM 15-17 (1978).

[77] The structure described in the text might look as follows:



D. Domestic Holding Company

An important decision in structuring the acquisition of a United States business by a Foreign Investor is whether or not to use a domestic holding company. Depending upon the form of the acquisition, the Acquiring Company itself may be a domestic holding company. However, if the Acquiring Company is or may be an operating company, consideration should be given to the interposition of a domestic holding company between the domestic operating company and the Foreign Investor.

The primary benefit of a domestic holding company is that it allows the filing of a United States consolidation income tax return. Such a return can only be filed by an affiliated group of corporations.[78] These include one or more domestic corporations controlled by a domestic corporation.[79] Control for this purpose is generally ownership of at least eighty percent of each class of stock of a corporation. Nonvoting stock, limited and preferred as to dividends, is not stock for purposes of this requirement.[80] For example, if a domestic holding company owns all of the common stock of a domestic Acquiring Company which acquires the Target Company's assets in exchange for one or more classes of nonvoting preferred stock, the domestic holding company controls the Acquiring Company and therefore may file a United States consolidated income tax return with the Acquiring Company.

If the conduct of the Target Company's former business is the only current United States undertaking of the Foreign Investor, the primary benefit of a United States consolidated income tax return is to facilitate the deduction of interest paid on acquisition related loans against profits of the Target Company's business. It may be advantageous to arrange any loans through the holding company when structuring the financing of the Target Company's business. Furthermore, it may be necessary if less than all of the Target Company's shares are acquired since the minority shareholders of the Target Company normally will object if such borrowings are made by the Target Company. Funds can be paid by the operating corporation to the domestic

[78] I.R.C. § 1501.

[79] I.R.C. § 1504(a). However, certain domestic corporations may not be included in a consolidated income tax return while certain contiguous country real estate corporations may be included in a consolidated income tax return. I.R.C. §§ 1504(a), 1504(d).

[80] I.R.C. § 1504(a).

holding company without any United States income tax[81] and, depending upon the states and localities where the holding company is subject to tax, without any state and local income tax.[82] Funds paid to the domestic holding company can be used to service the debt incurred in making the acquisition or to finance other business ventures.

If the Foreign Investor commences or acquires other United States businesses, further benefits result from the filing of a United States consolidated income tax return. Under the consolidated income tax return rules, losses of one member of the affiliated group can be used to offset profits of other members of the group.[83] In addition, funds can be shifted effectively among members of the affiliated group (*e.g.*, by dividends, loans or capital contributions) without any current United States income tax effects.

Interest paid by one member of an affiliated group to another member generally has no effect if a United States consolidated income tax return is filed.[84] The interest payments may be deductible, however, by the paying company for state and local tax purposes.[85] If the domestic holding company is not subject to state and local tax on the interest income it receives,[86] the effect of such an arrangement can be to reduce the operating company's state and local income taxes.

Frequently, a Foreign Investor acquiring a United States business fails to consider future expansion of its United States business undertakings. If it later decides to expand, it may be quite difficult, or impossible, to restructure its operations in a manner which will permit the use of net operating loss carryovers or tax credit carryovers of the original United States business it acquired against profits of a new United States business. This problem generally can be avoided if a domestic holding company is interposed in the original structure. If the domestic holding company is to be held in turn by a Netherlands Antilles corporation, consideration should be given to placing sufficient income producing activities in the domestic holding company to generate over forty percent non-passive gross income so that the five percent 1963 Protocol tax rate on dividends may be obtained.

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[81] I.R.C. § 243(a)(1); Treas. Reg. § 1.1502-14(a)(1) (1966).

[82] *See* the text accompanying notes 85 and 86.

[83] Treas. Reg. § 1.1502-21 (1966).

[84] Treas. Reg. § 1.1502-11(a) (1966).

[85] *See, e.g.*, MASS. GEN. LAWS ANN. ch. 63, § 30 (West).

[86] *See, e.g.*, DEL. CODE tit. 30, § 1902(b)(8).

IV. ACQUIRING COMPANY CAPITAL STRUCTURE

The debt and equity composition of the capital structure of an Acquiring Company must be considered carefully. As discussed below, if the Acquiring Company is not sufficiently capitalized, all or part of the loans made to it by its parent or affiliates may be recharacterized for United States income tax purposes as equity. If the loans are from third parties, the Acquiring Company may not be treated as the debtor. Rather, the corporation (generally the parent corporation) furnishing the guarantee which is the basis for the loan to the Acquiring Company, and without which the loan would not be made, may be viewed as the true debtor. In both situations, the result is that payments made by the Acquiring Company on the loans are not deductible as interest. Furthermore, the payments may be characterized as dividends which will result in taxable income for the recipient.

The Internal Revenue Code provides that the Secretary of the Treasury is authorized to publish regulations prescribing factors to be taken into account in distinguishing debt from equity. While no such regulations have been published, the Code provides that the following factors may be included in the regulations:

1. Whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for adequate consideration, and to pay a fixed rate of interest;
2. Whether the alleged indebtedness is subordinated to or preferred over any other corporate indebtedness;
3. The ratio of debt to equity;
4. Whether the alleged indebtedness is convertible into the issuing corporation's stock; and
5. The relationship between the alleged debt and the actual stock ownership in the issuing corporation.[87]

Courts addressing the issue of whether a shareholder advance made in the form of debt is debt or equity have held that each case turns on its particular facts and have used various criteria to determine the true nature of the advance.[88] Although it is difficult to generalize, the cases

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[87] I.R.C. § 385.

[88] *See, e.g.*, Fin Hay Realty Co. v. United States, 398 F.2d 694, 696 (3d Cir. 1968) where after a detailed analysis of the decided cases, the court enumerated sixteen factors which should be considered in determining the true nature of shareholder advances. For an exhaustive analysis of the issue of when advances will be considered equity, *see* Plumb, *The Federal Income Tax Significance of Corporate Debt: A Critical Analysis and a Proposal*, 26 TAX L. REV. 369 (1971).

have generally held that a shareholder advance denominated as debt is debt if (i) the advance is evidenced by a written instrument having all the indicia of true debt,[89] (ii) the intent of the parties conforms to the form (*i.e.*, the funds are not advanced in reality as risk capital),[90] and (iii) there is a reasonable expectation of repayment.[91] More recently decided cases have phrased the issue as whether an unrelated lender would have made a loan in the particular circumstances.[92]

Although the issue in shareholder loan situations is whether an unrelated party would have made the loans, the focus shifts in third party loan situations to the significance of any guarantees of the loan. A lender frequently will require that a Foreign Investor (or possibly one or more of its affiliates) guarantee loans which the lender is requested to make to the Acquiring Company. While the existence of such a guarantee will not result in recharacterization of the loan, if the guarantee is the primary credit upon which the lender is relying, the loan may be considered to have been made to the guarantor, with the guarantor then contributing the proceeds to the corporation as a capital contribution.[93] The guarantee may be considered the primary credit if absent the guarantee, a reasonable lender would not have made such a loan on reasonable commercial terms.

A typical case in which a guarantor has been considered the debtor is *Plantation Patterns, Inc. v. United States,*[94] which involved the formation of a corporation ("Patterns") to acquire an unrelated corporation ("Target"). Patterns had a paid-in capital of $5,000. Patterns bought all the stock of Target for a purchase price which included $610,000 of corporate notes guaranteed by its sole shareholder, an individual capable of repaying the loan. The Internal Revenue Service determined that the guaranteed loan was in reality a loan to the shareholder and a contribution of capital by him to Patterns. Therefore, payments on the notes were considered dividends to the shareholders.[95]

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[89] *See, e.g.*, Raymond v. United States, 511 F.2d 185 (6th Cir. 1975).

[90] *See, e.g.*, Slappey Drive Ind. Park v. United States, 561 F.2d 572 (5th Cir. 1977).

[91] *See, e.g.*, Scriptomatic, Inc. v. United States, 555 F.2d 364 (3d Cir. 1977).

[92] *See, e.g.*, *id.*; Fin Hay Realty Co. v. United States, 398 F.2d 694 (3d Cir. 1968).

[93] *Compare* Plantation Patterns, Inc. v. United States, 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972) *with* Murphy Logging Co. v. United States, 378 F.2d 222 (9th Cir. 1967).

[94] 462 F.2d 712 (5th Cir.), *cert. denied*, 409 U.S. 1076 (1972).

[95] 462 F.2d at 721.

The Court of Appeals in *Plantation Patterns* concluded that in reality the sellers were looking to the guarantor as the true debtor. It found the following factors to be of critical importance: (1) the funds were used to purchase operating assets; (2) the notes were subordinated to most of Patterns' indebtedness; (3) viewed at the time of the loans, it was not reasonable to believe that Patterns would be able to repay the loans (*although in fact it did so*); and (4) Patterns was thinly capitalized.[96] In contrast, in cases where the taxpayer has successfully demonstrated that (i) as of the time of the loan, the debtor had the apparent ability to repay the loan, and (ii) the debtor was amply capitalized, the record debtor has been found to be the true debtor notwithstanding the fact that its shareholder had guaranteed the debt.[97]

The uncertainty as to when shareholder advances or shareholder guaranteed loans will be recharacterized as equity has been compounded by two unfortunate developments. First, many of the decided cases have confused the issues and have failed to articulate in any discernible manner the basis for the decision reached. Second, the debt-to-equity ratio of the borrower has been overemphasized in making the decision. The latter development results in significant part from several rulings issued by the Internal Revenue Service concerning whether a subsidiary, frequently referred to as an "international finance subsidiary," established by a domestic corporation to borrow funds outside the United States is considered the true borrower. Motivated by the then defined policy of encouraging foreign borrowings as reflected in the interest equalization tax,[98] the rulings indicated that the subsidiary would be considered the true borrower (notwithstanding its shareholder's guarantee of its loans) if it had a debt-to-equity ratio of five-to-one.[99] While the rulings were revoked shortly after the interest

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[96] *Id.* at 722-723.

[97] Santa Anita Consol., Inc. v. Comm'r, 50 T.C. 536 (1968).

[98] I.R.C. §§ 4911-4931, which lapsed on June 30, 1974.

[99] Rev. Rul. 69-377, 1969-2 C.B. 231; Rev. Rul. 69-501, 1969-2 C.B. 233; Rev. Rul. 70-645, 1970-2 C.B. 273; Rev. Rul. 73-110, 1973-1 C.B. 454. The preceding Revenue Rulings were revoked by Rev. Rul. 74-464, 1974-2 C.B. 46, which stated that:

> In light of the inseparability of the IET [interest equalization tax] and the five to one debt to equity ratio and resultant Federal income tax consequences, the expiration of the IET on June 30, 1974, eliminated any rationale for treating finance subsidiaries any differently than other corporations with respect to their corporate validity or the validity of their corporate

equalization tax expired, a five-to-one debt-to-equity ratio continues to be considered by many as a safe capital structure. In fact, the only determination in characterizing a shareholder advance or guaranteed loan should be whether the advance or third party loan would have been made by a reasonable unrelated lender at reasonable commercial rates without the shareholder guaranteeing the loan.

If debt is recharacterized as equity, payments of interest or principal are considered distributions with respect to stock. As a result, if the subsidiary has either current or accumulated earnings and profits, the distributions will be dividends.[100] If there are neither current nor accumulated earnings and profits, or if earnings and profits are insufficient to cover the full amount of the distribution, the distribution will first be applied against the basis of the stock of the distributing corporation, with any remainder treated as gain from a sale or exchange of the stock.[101] Since the recharacterization of the shareholder's loan or guarantee as a contribution to capital increases the parent's basis in the stock, loan payments not considered dividends normally result in a corresponding decrease in the shareholder's basis in the subsidiary's stock.

V. Acquisition Costs

Primary consideration in the acquisition of a United States business is the deductibility of the costs incurred in finding and acquiring the business. Such costs generally are not currently deductible for United States income tax purposes, but rather are considered part of the cost of the assets or stock acquired. Accordingly, if the Foreign Investor can deduct such costs currently under the laws of its taxing jurisdiction, it is generally preferable for the Foreign Investor to incur such expenses directly.

> indebtedness. Thus, the mere existence of a five to one debt to equity ratio, as a basis for concluding that debt obligations of a finance subsidiary constitute its own bona fide indebtedness, should no longer be relied upon.

1974-2 C.B. at 47.

[100] I.R.C. §§ 301, 316; Treas. Reg. § 1.316-1, T.D. 6949, 1968-1 C.B. 107.

[101] I.R.C. § 301(c). The determination as to whether there are sufficient earnings and profits to result in the distribution being a dividend is made at the end of the distributor's taxable year. I.R.C. § 316(a). Until that determination can be made, the distributions are considered dividends for withholding tax purposes. *See* discussion in note 32 *supra*.

Under certain limited circumstances, acquisition costs may be deductible for United States income tax purposes. For example, if and to the extent costs are incurred for the acquisition of specific wasting assets, it may be possible to allocate such costs to the wasting assets and amortize or depreciate the costs so allocated over the life of the wasting assets.[102] However, some cases have held that costs incurred in finding and acquiring a business are similar to such non-wasting assets as goodwill and therefore may not be depreciated or amortized but rather continue throughout the life of the business acquired.[103] If costs are incurred in searching for and acquiring a prospective business which is not acquired, a loss deduction may be claimed when the effort is abandoned.[104]

Costs incurred in organizing a corporation (such as the Acquiring Company) may be amortized over a period of not less than sixty months.[105] Organization expenses for this purpose are expenses incident to the creation of the corporation which are chargeable to the capital account and of a character that, if expended incident to the creation of a corporation having a limited life, would be amortizable over this lifetime. Organization expenses include state incorporation fees, the cost of organizational meetings, accounting and legal fees incident to the organization, such as for drafting the charter, by-laws, minutes, and expenses of temporary directors.[106] If the corporation formed is to be merged with the Target Company pursuant to the plan of acquisition, the organizational expenses should be carried over to the Target

[102] *Cf.* Rev. Rul. 77-254, 1977-2 C.B. 63.

[103] Mid-State Products Co. v. Commissioner, 21 T.C. 696 (1954). *See also* David Schwartz Co., Inc. v. Commissioner, 1 B.T.A. 971 (1925) (sums expended by taxpayer to open and equip a foreign branch office disallowed as a deduction).

[104] I.R.C. § 165; Rev. Rul. 57-418, 1957-2 C.B. 143. With regard to individual taxpayers, Revenue Ruling 57-418 is amplified to state that the general expenses incurred in the course of a search to acquire a business are nondeductible personal expenditures. Such expenses would include those incurred to determine whether to enter into a transaction and which transaction to enter. Where a business or investment has been focused upon, subsequent expenses are then capital in nature. Rev. Rul. 77-254, 1977-2 C.B. 63. Apparently, this "general" versus "specific" preliminary expense distinction applies only to individuals, perhaps on the theory that a corporation is presumed already to be in a trade or business while an individual is not. *See* J. RABKIN & M. JOHNSON, FEDERAL INCOME, GIFT AND ESTATE TAXATION §§ 3.02(1), 3.03 (1978).

[105] I.R.C. § 248.

[106] Treas. Reg. § 1.248-1(b)(2) (1956).

Company and should be deductible by it over the remainder of the amortization period elected.[107]

VI. ASSET PURCHASE

A taxable purchase of the Target Company's assets is the most flexible form of acquisition. All or any portion of the Target Company's assets may be purchased by one or more domestic or foreign corporations. Any type or mix of consideration can be used to purchase the assets of the Target Company including the assumption of all or any portion of the Target Company's liabilities.

A sale by the Target Company of its assets is a taxable transaction, with the Target Company recognizing gain or loss equal to the difference between the consideration which it receives for each of its assets and its adjusted basis for each of the assets.[108] The shareholders of the Target Company will be taxed if the Target Company distributes the consideration which it receives for its assets.[109] The distribution generally results in dividend income to the shareholders,[110] unless the distribution is made pursuant to a partial liquidation[111] of the Target Company or is a distribution in redemption[112] of their shares of the Target Company. The Target Company can generally avoid the recognition of most of the gain realized on the sale of its assets and assure its shareholders that any gain which they recognize on distributions of the sales proceeds will be capital gain if it adopts a plan of complete liquidation prior to the sale of its assets.[113]

[107] Canal-Randolph Corp. v. United States, 77-1 U.S. Tax Cas. ¶ 9158 (N.D. Ill.), *aff'd per curiam*, 568 F.2d 28 (7th Cir. 1977).

[108] I.R.C. §§ 61, 1001.

[109] I.R.C. § 61(a).

[110] I.R.C. § 301(c).

[111] I.R.C. §§ 331(a)(2), 346.

[112] I.R.C. §§ 302, 317(b).

[113] I.R.C. §§ 337; 331(a)(1); 302(a), (b)(3). If the Target Company's gain on the sale of its asset is not significant in amount, it may be desirable for the Target Company not to adopt a plan of liquidation and to pay the tax on the gain recognized on the sale of its assets. In this situation, there would be no need for the Target Company to distribute its assets in liquidation with the resulting immediate tax to its shareholders. Rather, the Target Company can redeem all of the shares of its shareholders who desire to receive the sale proceeds and invest the remaining proceeds from the sale in a new business or other assets such as municipal bonds producing tax-free income. Alternatively, it may be possible to merge the Target Company into a registered investment company, thereby providing diversification and marketability for the shareholders of the Target Company. The Internal Revenue Service had issued a number of private

A Target Company which adopts a plan of complete liquidation and distributes all of the proceeds from the sale of its assets to its shareholders within twelve months from the date on which the plan of liquidation is adopted, subject to the exceptions noted below, will not recognize any gain or loss on the sale of its assets.[114] The Target Company will recognize gain on such sales to the extent of any depreciation recapture,[115] certain bad debt reserves,[116] and any gain realized on a sale of certain of its installment receivables or on a sale of its inventory unless the inventory is sold in bulk to one person.[117] In addition, the Target Company will be required to increase its federal income tax liability by all or a portion of any investment tax credits it has taken with respect to the property sold if it has not held such property as of the date of the sale for the period on the basis of which the investment tax credit was claimed as of the date of the sale.[118] It may also be required to include in its income under the "tax benefit rule" the amount of certain items which it has previously deducted under the "tax benefit rule."[119]

The sale of the Target Company's assets may be accomplished by the Foreign Investor contributing the consideration to be paid for the assets to a subsidiary corporation which "merges" into the Target Company. Shareholders of the Target Company then receive the consideration contributed to the subsidiary in exchange for their Target Com-

letter rulings sanctioning the latter approach, although, pending further consideration of the issues raised by such a merger, the Internal Revenue Service has ceased issuing such rulings.

[114] I.R.C. § 337(a).

[115] I.R.C. §§ 1245(a)(1), 1250(i).

[116] If a corporation which has adopted the accrual method of accounting and the reserve method of accounting for bad debts sells its accounts receivable for an amount in excess of the face amount of the receivables less the reserve, the corporation will recognize income to the extent of the previous tax benefit. I.R.C. § 111; Rev. Rul. 78-279, 1978-2 C.B. 135.

[117] I.R.C. §§ 337(b)(1)(A), (2).

[118] I.R.C. § 47(a)(1). An investment tax credit generally will be allowed with respect to "section 38" property with a useful life of three years, although the full investment tax credit results only if the property has a useful life of at least seven years. I.R.C. § 46(c).

[119] I.R.C. § 111; Rev. Rul. 68-104, 1968-1 C.B. 361. The tax benefit rule principle has been referred to by various names. *See, e.g.*, Storz v. Comm'r, 583 F.2d 972 (8th Cir. 1978); 78-2 USTC ¶ 9597 (liquidating corporation must recognize income under "assignment of income" doctrine). For a general discussion of the application of the tax benefit rule to a section 337 sale of assets, *see* B. BITTKER & J. EUSTICE, FEDERAL INCOME TAXATION OF CORPORATIONS AND SHAREHOLDERS (3d ed. Supp. 1978) at 11-69.

pany shares. A merger of this nature is deemed for tax purposes to be a sale by the Target Company of its assets pursuant to a plan of, and followed by, complete liquidation.[120]

When the Target Company distributes the proceeds from the sale of its assets to its shareholders as a part of a plan of complete liquidation, the shareholders are considered to have sold or exchanged their Target Company shares.[121] A Target Company shareholder will recognize gain or loss on such distribution equal to the difference between the amount of the distribution received and the adjusted basis for the shares.[122] Any gain or loss recognized on the distribution is a capital gain or loss if the shares are capital assets in the hands of a shareholder. Furthermore, the gain or loss is a long-term capital gain or loss if the shareholder has held its shares for more than twelve months as of the date on which it received the liquidating distribution.[123] Since the Target Company need not distribute the proceeds of the sale of its assets for twelve months after the sale,[124] the Target Company can virtually assure that any capital gain recognized by a shareholder will be long-term capital gain by deferring the distribution of the proceeds until the end of the twelve month period. Furthermore, by making two or more liquidating distributions, the Target Company may allow a shareholder to defer the recognition of the gain for a taxable year or to split the recognized gain over two taxable years.[125] If gain recognized by a Target Company shareholder is long-term capital gain, the maximum federal income tax on such gain generally is twenty-eight percent.[126]

The shareholders of the Target Company will recognize any gain realized on the liquidation of the Target Company in the taxable years in which they receive or have the right to receive liquidating distribu-

[120] Rev. Rul. 73-427, 1973-2 C.B. 301; Rev. Rul. 78-250, 1978-1 C.B. 83.

[121] I.R.C. § 331(a).

[122] I.R.C. § 1001.

[123] I.R.C. §§ 1221, 1222(3), (4).

[124] I.R.C. § 337(a).

[125] I.R.C. § 1001. *Cf.* I.R.S. Letter Ruling 7839118.

[126] The maximum income tax rate on capital gains for corporations (exclusive of the minimum income tax) is twenty-eight percent. I.R.C. §§ 11, 1201. The deduction for net capital gain is no longer a tax preference item for individuals subject to the minimum tax. I.R.C. § 57(a). However, the alternative minimum tax, the maximum rate of which is twenty-five percent, may apply if the liability calculated thereunder exceeds the "regular" income tax. I.R.C. § 55. The maximum regular income tax rate for net capital gains for individuals is seventy percent times forty percent of gain, or twenty-eight percent. I.R.C. §§ 1, 1202.

tions from the Target Company. Recognition of this gain cannot be deferred by electing the installment method of reporting.[127] The benefit of such an election, however, frequently may be achieved by an installment sale of the stock of the Target Company (prior to liquidating distributions) to a third party or to a trust created by the shareholder.[128]

An Acquiring Company which purchases the assets of a Target Company obtains a tax basis for each asset it purchases equal to the purchase price paid for the asset.[129] Thus, it is advantageous for the Acquiring Company to allocate as much as possible of the purchase price to assets (*e.g.*, depreciable assets), the costs of which are deductible for federal income tax purposes. Conversely, it is disadvantageous to allocate the purchase price to assets (*e.g.*, goodwill), the costs of which are not deductible. An allocation of the purchase price to depreciable assets in excess of their adjusted basis frequently is, however, disadvantageous to the Target Company since it may result in depreciation recapture income to the Target Company.

Often, the most difficult aspect of a purchase of a Target Company's assets is agreeing upon an allocation of the purchase price to its assets. If the parties agree upon an allocation, it generally is recognized for federal income tax purposes if their tax objectives and results differ and the allocation is realistic.[130] In the absence of such an agreement, the Internal Revenue Service will allocate the consideration to the assets acquired based upon its determination of the fair market value of the assets.[131] That determination may differ with respect to the Acquiring Company and the Target Company.

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[127] I.R.C. § 453.

[128] *See, e.g.*, James H. Weaver, Jr. v. Comm'r, 71 T.C. No. 42 (1979); W.B. Rushing v. Comm'r, 52 T.C. 888 (1969), *aff'd* 441 F.2d 593 (5th Cir. 1971).

[129] I.R.C. § 1012.

[130] *See, e.g.*, Yandell v. United States, 315 F.2d 141 (9th Cir. 1963); Hamlin's Trust v. Comm'r, 209 F.2d 761 (10th Cir. 1954); KFOX, Inc. v. United States, 510 F.2d 1365 (Ct. Cl. 1975). The converse of this principle is also true; namely, a taxpayer is generally bound to an agreed upon allocation of the purchase price. *See, e.g.*, Palo Alto Town & Country Village, Inc. v. Comm'r, 565 F.2d 1388 (9th Cir. 1977); Comm'r v. Danielson, 378 F.2d 771 (3d Cir. 1967).

[131] Note also that Internal Revenue Service agents are instructed that in the absence of an agreed upon allocation of the purchase price, they are to obtain the tax return of the other party to the sale of the assets to insure that such party is not allocating the purchase price in a manner inconsistent with the party under examination with the result that the Internal Revenue Service may be "whipsawed" by the allocation. IRS MANUAL-AUDIT (CCH), Part IV, § 4229 at 7233.

Once a Foreign Investor has decided to purchase the assets of a Target Company it should consider the possibility of having the assets purchased by more than one corporation. For example, the Acquiring Company could purchase only the operating assets of the Target Company. The stock of any foreign subsidiaries of the Target Company could be purchased by the Foreign Investor, one of its foreign subsidiaries, or a foreign corporation formed for this purpose. This approach generally reduces the tax cost of remitting the profits from the Target Company's foreign subsidiaries to the Foreign Investor since there should be no federal income tax on such remittances. If the Target Company retains the stock of the foreign subsidiaries, the Acquiring Company must pay federal income tax (at a rate of up to forty-six percent)[132] when dividends are paid to it by the foreign subsidiaries and withholding tax (at a rate of up to thirty percent) when it pays dividends to the Foreign Investor.[133] A further benefit to be derived when the Target Company's foreign subsidiaries are purchased by a foreign corporation is that the Foreign Investor is able to deal freely with the foreign subsidiaries without any adverse federal income tax consequences since the foreign subsidiaries will not be controlled foreign corporations as would be the case if a domestic Acquiring Company purchased their shares.

Another beneficial approach may be for the Foreign Investor (or its foreign subsidiary) to purchase any copyrights, patents, trademarks or similar intangible assets which the Target Company may own and license them to the Acquiring Company for an appropriate royalty or other consideration.[134] The Acquiring Company is entitled to deduct such payments for federal income tax purposes.[135] If the Foreign Investor (or its foreign subsidiary) qualifies for the benefits of a United States bilateral income tax treaty, the payment by the Acquiring Company generally is exempt from federal income tax.[136]

VII. STOCK PURCHASE

A taxable purchase of the stock of the Target Company, much like a taxable purchase of assets, affords the Foreign Investor considerable

[132] I.R.C. § 11.

[133] I.R.C. §§ 882, 1442(a).

[134] *See,* I.R.C. § 482; Treas. Reg. § 1.482-2(c).

[135] I.R.C. § 162. *See, e.g.,* Rev. Rul. 69-513, 1969-2 C.B. 29.

[136] *See, e.g.,* Netherlands Convention, *supra* note 47, art. IX; United Kingdom Convention, *supra* note 37, art. VIII(1); Model Income Tax Treaty, art. 2, *supra* note 34.

flexibility. The Foreign Investor can use any type of consideration and can acquire any percentage of the Target Company's shares, although this article assumes that at least eighty percent of all classes of the Target Company's stock will be purchased. A purchase of the stock of the Target Company can result in several tax and non-tax advantages to both the Acquiring Company and the Target Company's shareholders.

A taxable purchase of stock can be accomplished without the approval of the directors or officers of the Target Company.[137] Thus, if management of the Target Company opposes the acquisition, the Foreign Investor can tender for the stock of the Target Company and bypass its management. Moreover, since the Target Company will thus retain its corporate existence, favorable contracts, licenses, franchises and similar rights of the Target Company will not be affected by the acquisition. However, the acquisition may accelerate the repayment schedule of the Target Company's institutional loans and the loans might have to be renegotiated or satisfied. The primary disadvantage of a taxable purchase of stock is that the assets of the Target Company are acquired subject to all its stated and unstated liabilities. If the Target Company is closely held, this problem frequently can be overcome by an appropriate indemnification from the Target Company shareholders.

The major tax advantage to the Foreign Investor resulting from a taxable purchase of the stock of the Target Company is that the Target Company and its tax attributes continue intact for federal income tax purposes. This can be a very significant tax advantage if, for example, the purchase price for the Target Company's stock is less than the Target Company's basis for its assets. In addition, a taxable purchase of the Target Company's stock can be beneficial if the Target Company has other desirable tax attributes such as net operating loss carryovers, capital loss carryovers, investment tax credit carryovers, work incentive program credit carryovers or foreign tax credit carryovers. While the Internal Revenue Code limits the use of such "tax benefits" following a purchase of the Target Company's stock,[138] as in a purely domestic acquisition it may be possible to avoid the effect of such limitations with the result that the carryovers will be available to offset the Target Company's post-acquisition income and profits.

[137] Normally, the board of directors of a corporation must approve the sale of all or substantially all of the corporation's assets. *See, e.g.*, DEL. CODE tit. 8, § 271.

[138] I.R.C. §§ 269(a)(1), 382(a), 383.

A taxable purchase of stock may also be advantageous if the Target Company has unfavorable tax attributes. For example, the purchase price may be substantially above the adjusted basis of the Target Company's assets with the result that if the Target Company sold its assets it would recognize substantial "recapture" income. If the Acquiring Company purchases the stock of the Target Company it may still obtain a purchase basis for the assets by liquidating the Target Company within two years of the purchase, although such a liquidation would cause the Acquiring Company to bear the tax burden of any "recapture income."[139] Accordingly, the purchase price is reduced to reflect the tax cost of the recapture income. Since the Acquiring Company has up to two years to "convert" its stock purchase into an asset purchase, it may be advantageous to purchase the stock of the Target Company at the reduced price and wait two years before liquidating the Target Company. Alternatively, it may be possible to avoid the recapture income by having the Target Company transfer the assets which will result in such income to a domestic subsidiary prior to the Target Company's liquidation.

A taxable purchase of the Target Company's stock can also result in tax advantages for the shareholders of the Target Company. The purchase of the stock is a taxable event. Assuming that the stock of the Target Company is a capital asset in the hands of a Target Company shareholder, any gain or loss recognized by the shareholder on the sale of its stock generally is a capital gain or capital loss.[140] If the shareholder has held its stock for more than twelve months, the capital

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[139] I.R.C. § 334(b)(2). Although a corporate liquidation is generally tax-free to both the parent corporation and the liquidating subsidiary pursuant to sections 332 and 336, respectively, as with a sale after the adoption of a plan of liquidation under section 337, the liquidating corporation will recognize income by reason of (i) depreciation and investment credit recapture, (ii) the disposition of installment obligations, and (iii) the application of the tax benefit rule. I.R.C. §§ 47(a)(1), 1245(a)(1), 1250(i). *See* authorities cited notes 21 and 118 *supra.*

[140] I.R.C. § 1222. Under certain circumstances, stock and securities of a subsidiary corporation may be a noncapital asset. Booth Newspapers Inc. v. United States, 303 F.2d 916 (Ct. Cl. 1962); Tulane Hardwood Lumber Co. v. Comm'r, 24 T.C. 1146 (1955); Western Wine & Liquor Co. v. Comm'r, 18 T.C. 1090 (1952) *acq.* 1958-1 C.B. 6. Stock acquired with mixed business and investment motives may be a capital or noncapital asset. *Compare* W.W. Windle Co. v. Comm'r, 65 T.C. 694 (1976), *appeal dismissed,* 550 F.2d 43, (1st Cir. 1977), *cert. denied,* 431 U.S. 966 (1977) *with* Union Pacific R.R. v. United States, 524 F.2d 1343 (Ct. Cl. 1975), *cert. denied,* 429 U.S. 827 (1976). *See also,* I.R.C. §§ 306 and 341 which may act to tax realized gain as ordinary income.

gain or loss will be long-term.[141] The maximum federal income tax on a long-term capital gain is twenty-eight percent.[142]

A Target Company shareholder may defer reporting part of the gain recognized by electing the installment method of reporting.[143] An election can be made only if the selling shareholder receives no more than thirty percent of the selling price for its shares in the taxable year in which the sale occurs and the selling price for its shares exceeds one thousand dollars.[144] The deferred portion of the shareholder's selling price can be, and invariably is, represented by a promissory note from the purchaser. However, if the note is either payable on demand, issued with interest coupons attached or in registered form, or is readily tradeable in an established security market, it will be considered the equivalent of cash. As a result, installment reporting will not be available since more than thirty percent of the purchase price will have been received in the year of sale.[145] If the selling shareholder does not satisfy the installment reporting requirements, it may be possible for the selling shareholder to defer the recognition of the capital gain realized on the sale of its Target Company shares in other ways.[146] In either event, the deferred portion of the purchase price payable more than six months after the sale will have to bear at least six percent simple interest per year. If it does not, the selling price will be reduced to reflect seven percent simple interest on such amounts.[147]

Shareholders who are themselves corporations may prefer that any gain recognized on the sale of their shares of the Target Company be a dividend. Depending upon the percentage of the Target Company's shares they own, dividends received by a corporate shareholder will be either exempt from tax[148] or taxed at a maximum rate of approximately seven percent.[149] While dividends paid to corporate shareholders of the Target Company as part of a plan involving a sale of their Target Company shares may be recharacterized as part of the

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[141] I.R.C. § 1222.

[142] *See* the discussion in note 126 *supra*.

[143] I.R.C. § 453.

[144] *Id.*

[145] I.R.C. § 453(b)(3).

[146] *See* discussion accompanying note 128 *supra*.

[147] I.R.C. § 483; Treas. Reg. § 1.483-1(c)(2)(ii)(B), T.D. 7394, 1976-1 C.B. 135.

[148] I.R.C. § 243(a)(3).

[149] I.R.C. § 243(a)(1). Only fifteen percent of dividends received by a corporate shareholder are subject to tax. A corporation's income is subject to tax at a maximum rate of forty-six percent. I.R.C. § 11.

sales price for their shares,[150] it frequently is possible to structure the purchase of their shares in a manner which will allow all or a significant part of their gain to be in the form of dividends.[151]

It may be possible for the Foreign Investor to purchase the stock of the Target Company in a manner which allows Target Company's shareholders so desiring to exchange their shares of the Target Company on a tax-free basis. One approach is for the Target Company to offer such shareholders non-voting preferred stock of the Target Company in exchange for their shares of Target Company common stock. Shareholders who exchange their shares solely for preferred shares would not recognize gain or loss on the exchange since it is a tax-free recapitalization.[152] The Acquiring Company could then purchase the remaining Target Company common stock.

A cash purchase of the Target Company stock may be accomplished by a taxable merger of a domestic Acquiring Company into the Target Company. The shareholders of the Target Company receive in the merger the cash or other taxable consideration which was contributed to the capital of, or borrowed by, the company merging with the Target Company. The Foreign Investor or Acquiring Company receives, in what is considered a taxable purchase for United States income tax purposes, the Target Company stock.[153] Unlike a direct purchase of their shares, however, the shareholders of the Target Company generally cannot elect to report the gain they recognized on such a sale of their stock under the installment method of reporting.[154]

VIII. TAX-FREE ACQUISITIONS

Although a foreign corporation can acquire the assets or stock of a United States corporation in a reorganization described in section 368 of the Internal Revenue Code (hereafter described as a "tax-free

[150] Waterman Steamship Co. v. Comm'r, 430 F.2d 1185 (5th Cir. 1970); Steel Improvement and Forge Co. v. Comm'r, 314 F.2d 96 (6th Cir. 1963); Rev. Rul. 75-493, 1975-2 C.B. 109.

[151] *See, e.g.*, Casner v. Comm'r, 450 F.2d 379 (5th Cir. 1971).

[152] I.R.C. § 368(a)(1)(E). Continuity of proprietary interest is not a requirement for a recapitalization of a single corporation to qualify as a tax-free reorganization. Rev. Rul. 77-415, 1977-2 C.B. 311; Rev. Rul. 77-479, 1977-2 C.B. 119. *See also* Hickock v. Comm'r., 32 T.C. 80 (1959), *nonacq.*, 1959-2 C.B. 8, *nonacq. withdrawn*, 1977-2 C.B. 3.

[153] Rev. Rul. 73-427, 1973-2 C.B. 301. For an example of such a "cash merger" treated as a purchase for tax purposes, *see* I.R.S. Letter Ruling 7729037.

[154] I.R.C. § 453. *But see, e.g.*, I.R.S. Letter Ruling 7914062.

reorganization"), a practical limitation on this type of acquisition is the amount of consideration which must be stock of the Acquiring Company or the Foreign Investor. In addition, section 367 of the Internal Revenue Code governs if the stock of the Foreign Investor or a foreign Acquiring Company is used to make the acquisition. Section 367 provides that the acquisition will not be a tax-free reorganization unless a favorable ruling is obtained from the Internal Revenue Service.

A. *Section 367*

Until amended by the Tax Reform Act of 1976,[155] section 367 provided that a transaction involving the exchange by a United States person of assets or shares for stock of a foreign corporation would qualify as a tax-free reorganization only if, prior to the transaction, a ruling was obtained from the Internal Revenue Service to the effect that the transaction was not in pursuance of "a plan having as one of its principal purposes the avoidance of federal income taxes."[156] The Tax Reform Act amendments to section 367 eliminated the requirement for a prior section 367 ruling and in many cases eliminated the requirement for any section 367 ruling. If no ruling is required, the consequences of the transaction are governed by regulations published by the Internal Revenue Service.[157]

Section 367(a)(1) generally applies to tax-free acquisitions of the assets or stock of a domestic corporation by a foreign corporation.[158]

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[155] Pub. L. No. 94-455, § 1042, 90 Stat. 1634 (1976).

[156] I.R.C. § 367(a)(1), Pub. L. No. 91-681, § 1(a), 84 Stat. 2065 (1971), *as amended by* Tax Reform Act of 1976 § 1042. For a discussion of the 1976 amendments to section 367 and their effect on acquisitions by foreign persons of United States businesses, *see* Pugh and Samuels, *Tax-Free International Corporate Combinations Under New Sections 367 and 1491,* 30 TAX L. REV. 263 (1977).

[157] Temporary regulations under section 367, which were simultaneously designated as proposed regulations, were approved on December 27, 1977 and published on December 30, 1977. T.D. 7530, 42 Fed. Reg. 65,152 (1977). No further action has been taken with respect to these regulations. For an analysis of the proposed and temporary section 367 regulations, *see* New York State Bar Association, Tax Section, *Report on the Proposed Regulations Under Section 367,* 34 TAX L. REV. 79 (1978).

[158] Section 367(a)(1) provides:

> If, in connection with any exchange described in section 332, 351, 354, 355, 356, or 361, there is a transfer of property (other than stock or securities of a foreign corporation which is a party to the exchange or a party to the reorganization) by a United States person to a foreign corporation, for purposes of determining the extent to which gain shall be recognized on such

The statutory purpose of Section 367(a)(1) is to prevent the removal of appreciated assets or inventories from the United States taxing jurisdiction without any inherent gain being recognized.[159] In such situations the requirement of a favorable ruling from the Internal Revenue Service has been retained, although the ruling may now be requested at any time before the close of the one hundred eighty third day after the beginning of the transfer. While section 367(a)(2) provides that the Internal Revenue Service may by regulation provide that a ruling is not required, no such regulations have been proposed.[160]

B. *Tax Consequences to Parties to a Reorganization*

If an exchange qualifies as a reorganization, neither the Acquiring Company nor the Foreign Investor will recognize any gain or loss on the exchange of their shares for the assets or shares of the Target Company.[161] The Target Company will, however, recognize gain it may realize on the exchange to the extent consideration other than stock or securities of the Acquiring Company or Foreign Investor is received.[162] If other consideration is received, the realized gain need not be recognized by the Target Company if it distributes this consideration to its shareholders pursuant to the tax-free reorganization.[163] Similarly, the Target Company shareholders will not recognize any

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> transfer, a foreign corporation shall not be considered to be a corporation unless, pursuant to a request filed not later than the close of the 183d day after the beginning of such transfer (and filed in such form and manner as may be prescribed by regulations by the Secretary), it is established to the satisfaction of the Secretary that such exchange is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes.

[159] H.R. REP. NO. 658, 94th Cong., 1st Sess. 239, 242-43 (1975), *reprinted in* 1976-3 (Vol. 2) C.B. 695; S. Rep. No. 938, 94th Cong., 2d Sess. 261, 264-65 (1976), *reprinted in* 1976-3 (Vol. 3) C.B. 49; Staff of Joint Comm. on Taxation, 94th Cong., 2d Sess., *General Explanation of the Tax Reform Act of 1976* at 260-61 (Comm. Print 1976), *reprinted in* 1976-3 (Vol. 2) C.B. 1.

[160] Section 367(a)(2) provides: "[Section 367(a)(1)] shall not apply to an exchange (otherwise within [section 367(a)(1)]), or to any type of property, which the Secretary by regulations designates as not requiring the filing of a request." Since regulations under section 367(a)(2) have not been published, it will be assumed (as is presently the case) that all transactions described in section 367(a)(1) will require a section 367 ruling.

[161] I.R.C. § 1032.

[162] I.R.C. § 361.

[163] I.R.C. § 361(b)(1).

gain realized except and to the extent they receive consideration other than stock of the Acquiring Company or the Foreign Investor.[164]

In general, the tax attributes of the Target Company continue intact whether stock or assets of the Target Company are acquired.[165] Thus, earnings and profits, net operating loss carryovers, capital loss carryovers, foreign tax credit carryovers and similar tax attributes of the Target Company will carry over to the Acquiring Company. In an asset acquisition, the Acquiring Company's assets will be the same as the Target Company's adjusted basis for those assets immediately prior to the acquisition, increased by any gain recognized by the Target Company.[166]

The Acquiring Company's basis for the Target Company stock will be the same as the basis of such stock in the hands of the Target Company's shareholders, increased by the amount of any gain they recognize on the exchange.[167] The basis for the shares received by the Target Company shareholders in the exchange will be the same as their basis for the Target Company shares they exchange, decreased by the amount of any disqualified consideration they receive and increased by any gain they recognize on the exchange.[168] Their holding period for the shares received will include the period they held the Target Company's shares.[169]

C. *Asset Acquisitions*

1. Mergers

The merger of a domestic Acquiring Company into or with a Target Company is the most common means of acquiring the assets of a United States business tax-free. The Acquiring Company may be an existing domestic subsidiary or, as is frequently the case, a domestic subsidiary formed solely for the purpose of making the acquisition. Three types of mergers can be used to accomplish the acquisition. The Foreign Investor can form a domestic Acquiring Company into which the Target Company merges with the shareholders of the Target Com-

[164] I.R.C. §§ 354, 356, 361.

[165] I.R.C. § 381. *But see* I.R.C. §§ 269, 382, 383. *See also* Treas. Reg. § 1.382(b)-1(a)(6), T.D. 7564, 1978-2 C.B. 19 ("B" reorganization followed by a liquidation may be considered a "C" reorganization for purposes of section 382).

[166] I.R.C. § 362(b).

[167] *Id.*

[168] I.R.C. § 358(a).

[169] I.R.C. § 1223(1).

pany receiving stock of the Acquiring Company.[170] Alternatively, the Foreign Investor can form a domestic Acquiring Company into which the Target Company merges in a "triangular merger" with the shareholders of the Target Company receiving stock of the Foreign Investor.[171] Finally, the acquisition may occur in the form of a "reverse triangular merger" in which a domestic Acquiring Company formed by the Foreign Investor merges into the Target Company with the Target Company's shareholders receiving stock of the Foreign Investor.[172] The federal income tax requirements for a tax-free reorganization of each type of merger are discussed below.

(a) Statutory Merger

A combination of two domestic corporations properly approved by the shareholders of each corporation qualifies as a "merger" for United States corporate law purposes regardless of (i) the purpose of the merger, (ii) whether any business is conducted by the surviving corporation, and (iii) the type of consideration received by the shareholders of the corporation whose existence is terminated by reason of the merger.[173] In contrast, for a merger to qualify as a tax-free reorganization not only must the merger comply with applicable United States corporate laws,[174] but three additional requirements must be satisfied: (i) there must be a "business purpose" for the merger;[175] (ii) the business of the Target Company must be continued after the merger in some form;[176] and (iii) the shareholders of the Target Company must have a continuing proprietary interest in the Acquiring Company.[177]

The business purpose requirement generally presents little problem. In most situations, the fact that the merger is the means of accomplishing a business motivated acquisition is a sufficient business purpose.[178] Similarly, the continuity of business enterprise requirement

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[170] I.R.C. § 368(a)(1)(A).

[171] I.R.C. §§ 368(a)(1)(A), 368(a)(2)(D).

[172] I.R.C. §§ 368(a)(1)(A), 368(a)(2)(E).

[173] *See, e.g.*, DEL. CODE tit. 8, § 251.

[174] Rev. Rul. 55-305, 1955-1 C.B. 345; Treas. Reg. § 1.368-2(b)(1) (1955).

[175] Treas. Reg. §§ 1.368-1(b), 1.368-1(c) (1955).

[176] Treas. Reg. § 1.368-1(c) (1955).

[177] *See, e.g.*, Southwest Natural Gas Co. v. Comm'r, 189 F.2d 332 (5th Cir.) *cert. denied*, 342 U.S. 860 (1951); Roebling v. Comm'r, 143 F.2d 810 (3rd Cir.), *cert. denied*, 323 U.S. 773 (1944).

[178] *See, e.g.*, American Bronze Corp. v. Comm'r, 64 T.C. 1111 (1975) (simplification of administration and operations was a sufficient business purpose).

is satisfied if the surviving corporation engages in any business activity or enterprise requirement is satisfied if the surviving corporation engaged in any business activity or enterprise after the merger.[179]

The continuity of proprietary interest requirement is also readily satisfied. A merger satisfies this requirement if fifty percent or more of the consideration received by the Target Company shareholders is stock of the Acquiring Company or the Foreign Investor.[180] The continuity of proprietary interest requirement applies to the aggregate consideration received by the shareholders of the Target Company in the merger; some or even a majority of the shareholders of the Target Company can receive consideration other than stock.[181] The shares received by the shareholders of the Target Company in exchange for their Target Company shares may be voting or nonvoting, common or preferred shares.[182]

Since an Acquiring Company typically does not want voting minority shareholders, the consideration received by shareholders of the Target Company typically is non-voting preferred stock. If desired, the preferred stock can be convertible into common stock of the Acquiring Company or the Foreign Investor. A conversion of the preferred stock of the Acquiring Company into its common stock is a tax-free event for both the converting shareholder and the Acquiring Company.[183] Conversion of the Acquiring Company's preferred stock into common or preferred stock of the Foreign Investor, however, is a

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[179] Rev. Rul. 63-29, 1963-1 C.B. 77.

[180] Rev. Proc. 77-37, 1977-2 C.B. 568. It may be possible for a merger to qualify as a tax-free reorganization even though less than fifty percent of the total consideration is stock of the Acquiring Corporation or its parent. *See, e.g.*, Miller v. Comm'r, 84 F.2d 415 (6th Cir. 1936) (merger was tax-free even though only twenty-five percent of the consideration received by shareholders of the Target Company was stock of the Acquiring Company); *cf.* May B. Kass v. Comm'r, 60 T.C. 218 (1973), (aff'd mem. by Third Circuit in unpublished opinion) (sixteen percent stock consideration held to be insufficient for merger to be tax-free). The Internal Revenue Service will not issue a ruling that a merger is a tax-free reorganization unless at least fifty percent in value of the consideration received by the shareholders of the Target Company is stock of the Acquiring Company or the Foreign Investor.

[181] Rev. Proc. 77-37, 1977-2 C.B. 568; Rev. Rul. 66-224, 1966-2 C.B. 114.

[182] John A. Nelson Co. v. Helvering, 296 U.S. 374 (1935); Morgan Mfg. Co. v. Comm'r, 124 F.2d 602 (4th Cir. 1941).

[183] Rev. Rul. 77-238, 1977-2 C.B. 115 (the conversion is a "recapitalization" within the meaning of I.R.C. § 368(a)(1)(E)). If cash is distributed in lieu of fractional shares, the fractional shares will be considered to have been redeemed. *See* Rev. Rul. 66-365, 1966-2 C.B. 116.

taxable event to the converting shareholder and possibly to the Acquiring Company.[184] If the conversion right is granted to the shareholders of the Target Company directly by the Foreign Investor, the shareholders of the Target Company may recognize income at the time of the merger.[185]

Section 367 does not apply to a merger of two domestic corporations in which the consideration received by the shareholders of the Target Company is stock of the domestic Acquiring Company.[186] Thus, if the applicable United States corporate laws are complied with and the business purpose, continuity of business, and proprietary interest requirements are satisfied, a merger qualifies as a tax-free reorganization in which neither the Target Company nor the Acquiring Company recognizes gain or loss on the transaction.[187] Shareholders of the Target Company can be given the option to receive stock of the Acquiring Company or cash or other disqualified consideration (up to the fifty percent limit). Whether or not such an option is offered, the Target Company shareholders will not recognize gain or loss on the exchange if the only consideration received is stock of the Acquiring Company.[188] If the shareholders of the Target Company receive cash or other disqualified consideration in exchange for their shares, any realized gain is recognized to the extent of such disqualified consideration.[189]

(b) Triangular and Reverse Triangular Mergers

Acquisition of the Target Company's assets also can be accomplished by a merger in which the consideration received by the shareholders of the Target Company is stock of the Foreign Investor. Since the Internal Revenue Service's position is that a merger of a foreign corporation and a domestic corporation is not a tax-free

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[184] The converting shareholder would be taxed since the conversion would not qualify as a recapitalization within the meaning of I.R.C. § 368(a)(1)(E). *See* Rev. Rul. 69-135, 1969-1 C.B. 198. Sections 1032 and 1036 which also normally would provide for nonrecognition of gain on a corporation's issuance of its stock would not apply to the Acquiring Company since it is not issuing its stock in the exchange.

[185] Rev. Rul. 69-265, 1969-1 C.B. 109.

[186] I.R.C. § 367(a).

[187] I.R.C. §§ 354(a)(1) (shareholders exchange is tax-free); 361(a) (Target Company's transfer of its assets is tax-free).

[188] I.R.C. § 354(a)(1).

[189] I.R.C. § 356(a).

reorganization for federal income tax purposes,[190] such a merger must be accomplished through the merger of a domestic subsidiary of the Foreign Investor with (in a triangular merger) or into (in a reverse triangular merger) the Target Company. In both situations, the business purpose, continuity of business enterprise and continuity of proprietary interest requirements of a tax-free reorganization must also be satisfied. Of course, the continuity of proprietary interest requirement applies with respect to the shares of the Foreign Investor received in the merger by the shareholders of the Target Company.

Additional requirements must also be satisfied for a triangular or reverse triangular merger to qualify as a tax-free reorganization. Since in both a triangular and a reverse triangular merger the shareholders of the Target Company "transfer" their Target Company shares in exchange for shares of the Foreign Investor, section 367(a) applies to the transaction.[191] Therefore, a request for a ruling under section 367(a) must be filed with the Internal Revenue Service within 183 days after the merger.[192]

For section 367 ruling purposes, the Internal Revenue Service views a triangular or reverse triangular merger as similar to a type "B" reorganization.[193] As with a type "B" reorganization, the Internal Revenue Service generally issues a favorable ruling without requiring that any of the parties to the reorganization agree to include as gross income any realized gain (*i.e.*, a "toll charge") if, immediately after the merger, the shareholders of the Target Company do not own directly or indirectly[194] more than fifty percent of the total combined voting power of the Foreign Investor, and the assets of the Target Company do not consist principally of stock or securities.[195] If these requirements are not satisfied, the Internal Revenue Service will issue a favorable section 367 ruling only if the shareholders of the Target

[190] Under the regulations, it would appear that a merger of a foreign corporation and a United States corporation could qualify as a merger for United States income tax purposes. *See* Treas. Reg. § 1.368-2(b), T.D. 7422, 1976-2 C.B. 105.

[191] Temp. Treas. Reg. § 7.367(a)-1(b)(3)(ii), T.D. 7530, 1978-1 C.B. 92.

[192] I.R.C. § 367(a)(1).

[193] The ruling guidelines under Revenue Procedure 68-23, 1968-1 C.B. 821 are silent as to the treatment of triangular and reverse triangular mergers. *But see, e.g.*, I.R.S. Letter Ruling 7748014 applying "B" ruling guidelines.

[194] Indirect ownership is determined under the rules of I.R.C. § 958.

[195] Rev. Rul. 74-297, 1974-1 C.B. 84; Rev. Proc. 68-23, § 3.03(1)(d), 1968-1 C.B. 821.

Company agree to include in their income an amount equal to the appreciation of the Target Company's assets.[196]

If the form of acquisition is a triangular merger of the Target Company into the Acquiring Company with the Target Company's shareholders receiving shares of the Foreign Investor, the merger is a tax-free reorganization only if the Acquiring Company acquires "substantially all" of the assets of the Target Company, and no shares of the Acquiring Company are used in the acquisition.[197] The Acquiring Company has acquired substantially all of the assets of the Target Company if it acquires "at least ninety percent of the fair market value of the net assets and at least seventy percent of the fair market value of the gross assets" held by the Target Company immediately prior to the merger.[198] The stock of the Foreign Investor used in a triangular merger need not be voting stock. In contrast, the stock of the Foreign Investor used in a reverse triangular merger must be voting stock. Furthermore, in a reverse triangular merger, up to twenty percent of the Target Company shares may be acquired for other consideration, while in a triangular merger, the only limitation on other consideration is that the continuity of interest requirement (*i.e.*, generally fifty percent of the consideration being stock) must be satisfied.

In a reverse triangular merger, the Acquiring Company merges into the Target Company with the Target Company shareholders receiving shares of the Foreign Investor. The merger qualifies as a tax-free reorganization only if the Target Company's total assets after the transaction include substantially all of its assets prior to the transaction

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[196] If the Target Company's shareholders acquire more than fifty percent but less than eighty percent of the Foreign Investor's stock, the Internal Revenue Service may issue a ruling if the shareholders enter into a closing agreement providing for the inclusion of the income attributable to the Target Company's appreciated assets upon the occurrence of certain events such as the liquidation or acquisition of the Foreign Investor or the shareholder's disposition of the Foreign Investor's shares. *Cf.* Rev. Proc. 75-29, 1975-1 C.B. 754 (Target Company foreign, not domestic). If the Target Company's shareholders acquire more than eighty percent of the stock of the Foreign Investor, the acquisition apparently will be treated as a section 351 transaction to which section 367(a)(1) applies. *See* Temp. Treas. Reg. § 7.367(b)-4(b), T.D. 7530, 1978-1 C.B. 92. A section 367 ruling will be issued in this situation subject to a toll charge in an amount equal to the appreciation of the "tainted" assets of the Target Company. *See* Rev. Proc. 68-23, § 3.02(1)(d), 1968-1 C.B. 821.

[197] I.R.C. § 368(a)(2)(D); Rev. Rul. 74-297, 1974-1 C.B. 84.

[198] Rev. Proc. 77-37, 1977-2 C.B. 568. The ruling guideline for satisfying the "substantially all" requirement is the same for a reverse triangular merger and a type "C" reorganization.

and the assets of the Acquiring Company,[199] and the shareholders of the Target Company exchange for *voting stock* of the Foreign Investor, stock representing at least eighty percent of the Target Company's voting stock and eighty percent of each other class of its nonvoting stock.[200] The "substantially all" of the assets requirement for a reverse triangular reorganization is the same as for a triangular reorganization.[201]

The federal income tax consequences of a triangular or reverse triangular merger are similar. The only significant difference is that the Target Company is the survivor in a reverse triangular merger and any post-acquisition losses of the Target Company can be carried back against it pre-acquisition profits.[202] This could not be done if the acquisition were made in the form of a triangular merger. In addition, a reverse triangular merger may be the more desirable form due to non-tax considerations such as regulatory approvals required for mergers in which the Target Company is not the survivor. Finally, a reverse triangular merger does not result in the Target Company transferring its assets and thereby avoids the normal mechanical and legal problems inherent in such a transfer.

2. Type "C" Reorganization

The Target Company's assets can also be acquired through an exchange of the Foreign Investor's voting stock for substantially all of the properties of the Target Company by either the Foreign Investor or the Acquiring Company. An acquisition in this form qualifies as a type "C" reorganization if the Foreign Investor or the Acquiring Company acquires solely in exchange for *voting stock* of the Foreign Investor "substantially all" of the properties of the Target Company.[203] The "substantially all" requirement in a type "C" reorganization is satisfied if all "assets representing at least ninety percent of the fair market value of the net assets and at least seventy percent of the fair market value of the gross assets" held by the Target Company immediately prior to the transaction are acquired.[204]

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[199] I.R.C. § 368(a)(2)(E)(i).

[200] I.R.C. § 368(a)(2)(E)(ii). A reverse triangular merger frequently will also qualify as a type "B" reorganization. *See* Rev. Rul. 67-448, 1967-2 C.B. 144.

[201] Rev. Proc. 77-37, § 3.01, 1977-2 C.B. 568.

[202] I.R.C. § 381(b)(3).

[203] I.R.C. § 368(a)(1)(C).

[204] Rev. Proc. 77-37, § 3.01, 1977-2 C.B. 568.

If the consideration for the Target Company's assets consists solely of voting stock of the Foreign Investor and assumption of the liabilities of the Target Company, the latter is disregarded in applying the solely for voting stock test.[205] If any consideration other than voting stock is used, then all assumed liabilities of the Target Company plus the other consideration used must represent twenty percent or less of the value of the assets acquired or the transaction will not qualify as a type "C" reorganization.[206]

Section 367(a) applies to a type "C" reorganization in which the consideration is voting stock of the Foreign Investor. Accordingly, a ruling under section 367 must be requested within 183 days after the acquisition. If the acquisition is made through a domestic Acquiring Company, it will be treated as a triangular merger for section 367 ruling purposes. Thus, the Internal Revenue Service generally issues a favorable section 367 ruling if the shareholders of the Target Company do not own more than fifty percent of the voting power of the Foreign Investor after the acquisition and the assets of the Target Company do not consist principally of stocks or securities.[207] If the acquisition is made directly by the Foreign Investor, the Internal Revenue Service usually issues a favorable ruling only if the Target Company agrees to include in its gross income as a "toll charge" an appropriate amount reflecting appreciation of certain of its assets.[208] These assets include inventory, property in respect of which income has not been earned, certain stocks and securities, accounts receivable and certain intangible property.[209] Thus, a direct type "C" reorganization generally is not an acceptable form for a foreign person acquiring a United States business with any significant amount of appreciated assets.

D. *Stock Acquisition*

A Target Company may also be acquired by the Foreign Investor exchanging its voting stock for the stock of the Target Company. This type of acquisition qualifies as a tax-free type "B" reorganization only if at least eighty percent of all classes of stock of the Target Company is acquired solely in exchange for voting stock of the Foreign Investor.[210] The Foreign Investor may acquire the Target Company's

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[205] I.R.C. § 368(a)(1)(C).

[206] I.R.C. §§ 368(a)(1)(C), 368(a)(2)(B).

[207] Rev. Proc. 68-23, § 3.03(1)(d), 1968-1 C.B. 821.

[208] *Id.* § 3.03(1)(b).

[209] *Id.* § 3.02(1)(d).

[210] I.R.C. §§ 368(a)(1)(B), 368(c).

shares directly through an Acquiring Company exchanging the Foreign Investor's voting stock for stock of the Target Company in a triangular type "B" reorganization. In either case, a type "B" reorganization is the most restrictive form of acquisition since the only consideration which may be given in exchange for the stock of the Target Company is either voting stock of the Acquiring Company or voting stock of the Foreign Investor. Any other type of consideration results in a completely taxable transaction.[211]

In a triangular type "B" reorganization, the Acquiring Company may obtain the shares of the Foreign Investor as a contribution to its capital by purchasing the shares from the Foreign Investor, or by purchasing the shares from a shareholder or shareholders of the Foreign Investor.[212] A type "B" reorganization acquisition by a Foreign Investor frequently is made in this manner in order to file a consolidated federal income tax return with the Target Company. Another means of accomplishing this objective is for the Foreign Investor to contribute the shares of the Target Company to a domestic subsidiary at the time of, or after, the acquisition.[213]

If a type "B" reorganization involves the shareholders of the Target Company exchanging their shares for shares of the Foreign Investor, a favorable ruling under section 367(a) is required. Such a ruling in a type "B" reorganization is issued without requiring a "toll charge" if, immediately after the exchange, the shareholders of the Target Company do not own directly or indirectly more than fifty percent of the total combined voting power of the Foreign Investor and the assets of the Foreign Investor do not consist principally of stocks or securities.[214]

IX. JOINT VENTURE ENTERPRISE

A. *Joint Venture Corporation*

A frequent form for a tax-free acquisition of less than all of the assets of a Target Company is the use of a joint venture domestic corporation. In this situation, the Target Company contributes the

[211] Helvering v. Southwest Consol. Corp., 315 U.S. 194 (1941); Comm'r v. Turnbow, 286 F.2d 669 (9th Cir. 1960), *aff'd on other grounds,* 368 U.S. 337 (1961). *But see* C. E. Graham Reeves v. Comm'r, 71 T.C. No. 69 (1979); Pierson v. United States, 79-2 U.S. Tax Cas. ¶ 9432 (D.C. Del. 1979).

[212] I.R.C. § 368(a)(1)(B). *Cf.* I.R.S. Letter Ruling 7850058 *as supplemented by* I.R.S. Letter Ruling 7905112.

[213] I.R.C. § 368(a)(2)(C).

[214] Rev. Proc. 68-23, § 3.03(1)(d), 1968-1 C.B. 821.

desired assets to a new domestic corporation in exchange for stock or securities of the new corporation. The remaining stock or securities of the new corporation are acquired by the Foreign Investor (or Acquiring Company) in exchange for cash or property. The transfers to the joint venture corporation in exchange for its stock are tax-free to both the Foreign Investor and the Target Company.[215]

A partial asset acquisition can also be accomplished by the Target Company contributing the desired assets and the Foreign Investor (or Acquiring Company) contributing consideration for the assets to a domestic partnership organized for this purpose. The use of a partnership affords a number of planning opportunities, including the manner in which the income, gains, losses, deductions or credits of the partnership are allocated to its partners.[216] However, if the partnership is engaged in a trade or business within the United States, its foreign partners are also considered engaged in a trade or business within the United States.[217] While the Foreign Investor as a partner may not be subject to federal income tax on its share of the partnership's income,[218] it would be required to file a United States income tax return[219] and possibly one or more state or local income tax returns.[220] Accordingly, the Foreign Investor generally should form a domestic or foreign subsidiary to act as the partner in any domestic partnership.

A joint venture corporation can also be used as a vehicle for a tax-free stock acquisition of the interests of a minority of the shareholders of the Target Company. Shareholders of the Target Company who desire to exchange their shares on a tax-free basis contribute their Target Company shares to a new corporation in exchange for preferred stock of the corporation while the Foreign Investor (or Acquiring Company) contributes cash to the new corporation in exchange for its common stock. The new corporation then uses the cash to purchase the remaining stock of the Target Company or contributes the cash to a subsidiary which merges into the Target Company. This transaction is tax-free to the Target Company shareholders who exchange their shares for shares of the new corporation[221] and is taxable to the other

[215] I.R.C. § 351.

[216] *See* I.R.C. § 704.

[217] I.R.C. § 875(1).

[218] *See* I.R.C. §§ 882, 864.

[219] I.R.C. § 6012(a); Treas. Reg. § 1.6012-2(g), T.D. 6532, 1961-1 C.B. 665.

[220] *See, e.g.*, Badische Anilin & Soda Fabrik v. Roberts, 152 N.Y. 59, 46 N.E. 161 (1897).

[221] I.R.C. § 351.

shareholders of the Target Company. The primary advantage of this form of acquisition is that a minority of the Target Company shareholders may obtain tax-free treatment. As in a normal merger or any other reorganization, at least fifty percent of the Target Company's shares must be acquired in exchange for stock in order for the transaction to qualify as a tax-free reorganization.[222]

B. *Joint Venture Partnership*

A joint venture domestic partnership is frequently the only feasible form by which a Foreign Investor may acquire the operations of a domestic corporation conducted through "controlled foreign corporations." If the domestic corporation exchanges the stock of the controlled foreign corporation for stock of the Foreign Investor, the domestic corporation recognizes any gain which it realized on the exchange. To the extent that the controlled foreign corporations' earnings and profits are attributable to the period when the foreign corporations were "controlled foreign corporations" and the Target Company was a United States shareholder, the gain generally is ordinary (dividend) income.[223] While the Target Company is entitled to a deemed foreign tax credit for any foreign income taxes paid or accrued by the foreign corporation with respect to the earnings and profits that the Target Company must include in its income as a dividend,[224] frequently the Target Company will have a significant federal income tax liability. The use of a joint venture foreign corporation is not feasible in this situation since any transfer of the stock of the controlled foreign corporations to such a corporation is a taxable event unless the Target Company owns more than fifty percent of the voting power of the joint venture foreign corporation.[225] Transfer of the stock of the controlled foreign corporations to a foreign partnership is also a taxable event.[226] The use of a

[222] Rev. Proc. 77-36, § 3.02, 1977-2 C.B. 568; Rev. Proc. 77-41, 1977-2 C.B. 574.

[223] I.R.C. § 1248.

[224] I.R.C. §§ 901, 902, 1248; Treas. Reg. § 1.1248-1(d) (1964).

[225] Rev. Proc. 68-23, § 3.02(1)(a)(iii), 1968-1 C.B. 821.

[226] Such a transfer will result in the difference between the fair market value and adjusted basis of the assets transferred to the foreign partnership being subject to a thirty-five percent excise tax. I.R.C. § 1491. The section 1491 excise tax can be avoided if a prior ruling is obtained from the Internal Revenue Service to the effect that the transfer is not "in pursuance of a plan having as one of its principal purposes the avoidance of Federal income taxes." I.R.C. § 1492(2). If the tax has been paid or assessed, a refund or abatement can be obtained if the Internal Revenue Service issues such a ruling. I.R.C. § 1494. In addition, the excise tax will not apply if the Target

joint venture United States corporation is therefore not acceptable to the Foreign Investor for any number of reasons. The use of a domestic partnership, however, allows the Target Company to transfer the stock of the controlled foreign corporations to the joint venture partnership without any current federal income tax consequences.

X. Conclusion

An acquisition of a United States business by a foreign person presents a myriad of tax considerations, problems and planning opportunities requiring the foreign person to become familiar with a number of complex provisions of the United States tax laws and to recognize the tax opportunities and problems presented by the acquisition. While this requires considerable effort by the foreign person, the rewards are commensurate with the effort. A properly structured acquisition of a United States business invariably results in substantial reduction of the federal tax costs of acquiring and operating a business. In many situations, minimizing the federal taxes payable can result in the financing which will make the acquisition financially feasible.

Company elects under section 1057 to treat the transfer of the appreciated assets as a sale. I.R.C. § 1492(4). Aside from the fact that the tax on the transfer of appreciated property generally will be less if the election under section 1057 is made, the election will result in the transferee having a purchase (fair market value) basis for the asset, whereas if section 1491 applies, the transferee will have a carryover basis.