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Killing the Killer B: The Treasury and IRS Issue a Sixth Set of Rules on Killer B Transactions

On December 2, 2016, the Treasury issued Notice 2016-73, describing future regulations that will modify the Killer B regulation issued in 2011; the modifications will stymie newly discovered variations of the Killer B transaction. In the classic Killer B transaction, a CFC (Acquiring A) buys stock of the U.S. parent (Issuer A) from Issuer A or its shareholders and uses that stock as acquisition currency in a triangular reorganization, usually a stock-for-stock B reorganization. The target can be either unrelated or owned by Issuer A. In either case, Acquiring A's cash goes to or for the benefit of Issuer A without dividend inclusion.

That is what the Treasury disliked: the inbound movement of property to or for the benefit of a U.S. shareholder from its CFC that had earnings and profits (E&P) without incurring tax on an inbound dividend. The reason the Killer B transaction worked before the Notices and regulation was that the CFC's purchase of U.S. stock would not result in a Section 956 inclusion if the CFC quickly disposed of the U.S. stock, which it would by acquiring the stock of a foreign corporation in the triangular reorganization. Section 956 does not have a successor asset rule that would carry the Section 956 taint of U.S. stock over to the stock of a foreign corporation.

After issuing several Notices, the Treasury adopted Reg. § 1.367(b)-10, which over-described cases to which its basic rule would apply; the basic rule treats the purchase of Issuer A stock as a Section 301 distribution to Issuer A from Acquiring A when the Issuer A stock is to be used in a triangular reorganization. The regulation excepted three cases from its application. The exceptions turned out to allow transactions that the Treasury regretted. The Treasury first issued Notice 2014-32, and then the current Notice, to correct the regulation.

The current Notice deals primarily with three glitches in the regulation, as modified by the 2014 Notice, and other Section 367 regulations.

The Downstairs Killer B

Tax planners realized that they could work around the regulation and still obtain the same end result: repatriation of cash without inbound dividend income reflecting E&P in the CFCs as a group. One method relied on a structure that has long served to facilitate nontaxable inbound “dividends”: create a top-tier CFC with no E&P, arrange for it to obtain cash without earning E&P, and have it pay inbound a return of basis distribution.

The twist on the Killer B transaction was that the top-tier holding company obtained the cash by issuing its stock to its subsidiary for cash. So the basic Killer B cash movement was pushed down one tier. To move the cash onshore, a second step was required: substitute an inbound Section 332 liquidation of Issuer B, the top-tier CFC with no E&P, in place of a return of basis distribution by Issuer B to the U.S. parent. First, a profitable subsidiary of Issuer B (Acquiring B) buys Issuer B stock from Issuer B. This exchange does not generate any income at the Issuer B level. Then Acquiring B exchanges the Issuer B stock with the U.S. parent for the stock of the target, another CFC.

The modified deal works because it fit the third exception in the Killer B regulation, even as modified by the 2014 Notice. The third exception originally applied whenever the gain recognized by U.S. persons on the shareholder side of the triangular reorganization (here, the U.S. parent) was equal to or more than the dividend or gain that would have been included by Issuer B if the regulation applied. The 2014 Notice said that the dividend or gain counted only if it were currently subject to U.S. tax (the Killer B regulation as originally written does not say that).

The modified plan relies on the fact that the CFC to CFC dividend (Acquiring B to Issuer B) would not be currently subject to U.S. tax. The deal planners could have taken the position that zero gain recognition is equal to zero dividend inclusion and so the third exception applies. Evidently the planners were cautious and allowed the U.S. parent to recognize a small gain on the B reorganization exchange by filing a gain recognition agreement that did not cover the entire amount of the gain in the target stock, leaving a de minimis amount to be recognized. As a result, the U.S. shareholder recognized gain greater than the income that would be included under the reorganization’s rule, and so the rule did not apply and the taxpayer included the de minimis gain.

The remedy in the 2016 Notice is to make the third exception inapplicable when the target is foreign. As a result, Acquiring B’s purchase of Issuer B stock will be treated as a distribution to Issuer B, which has the effect of bringing E&P into Issuer B, which will cause an all-E&P inclusion if Issuer B later effects an inbound liquidation.

The Notice goes further to impose an immediate penalty when the target is foreign: the U.S. parent must immediately take into income its Section 1248 amount with respect to the target’s stock, and if there is any gain left in that stock after the basis adjustment, it must recognize that gain. The effect is to render Section 354 inapplicable and counter the fact that the all-E&P inclusion on the inbound liquidation of Issuer B will be limited to the E&P of Issuer B (as augmented by Acquiring B’s E&P).

The Cash Pump Transaction

The Notice goes even further to remedy a previously undiscovered shortcoming of the all-E&P inclusion upon an inbound Section 332 liquidation. The Treasury now sees that the inbounding assets can include property that the CFC acquired in ways other than earnings, borrowings and contributions by shareholders to capital because it does not view the capital contribution in a case like the modified Killer B transaction described above to have been a genuine contribution to capital. So the Notice creates a new regime to identify such bad contributions and arrange to pump up the all-E&P amount by their amount. This rule will apply without regard to application of the Killer B regulation.

The Nonqualified Preferred Stock Transaction

This is a modification of the classic Killer B transaction, going back to having the acquiring corporation be a CFC without E&P (Acquiring C) that is a direct subsidiary of the U.S. parent (Issuer C). Again, Acquiring C exchanges the Issuer C stock for stock of the target, an indirect subsidiary of Issuer C that is a CFC. The change is that Acquiring C obtains the Issuer C stock by exchanging its nonqualified preferred stock with Issuer C. The taxpayer claims that exchange is a taxable sale by Issuer C, which obtains a cost basis in the nonqualified preferred stock, and that the Killer B regulation does not apply because the stock of Acquiring C is not "property" for purposes of the regulation, which applies only if property is exchanged for Issuer C's stock. Later, the nonqualified preferred stock will be redeemed without a dividend because Acquiring C still has no E&P. The fix provided in the Notice is to include nonqualified preferred stock within the definition of property for this purpose.

The regulations described in the Notice will apply to transactions completed on or after December 2, 2016.

For more information, contact Jack Cummings at 919.862.2302 or Stefanie Kavanagh at 202.239.3914.

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