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In this article, the author discusses the final regulations for U.S. F reorganizations, focusing on the use of foreign-to-foreign F reorganizations to achieve non-U.S. business planning goals (including non-U.S. tax planning) while avoiding adverse tax consequences under U.S. federal law.

For many years, F reorganizations seemed like the little-loved stepchild of the U.S. reorganization provisions. However, the final F reorganization regulations issued in 2015 have offered more certainty and thus generated renewed interest among international tax practitioners in the use of F reorganizations.

Particularly in an international tax context, F reorganizations can be a useful tool to qualify local jurisdiction restructurings as tax-free reorganizations for U.S. federal income tax purposes. A local jurisdiction restructuring may be desirable for many reasons, including to permit tax and accounting consolidation; to reduce operating, administrative, or compliance costs; to eliminate the application of non-U.S. controlled foreign corporation rules; or to align a change in the company's or its individual owners' location or place of management with local tax rules.

While there are other tax-efficient ways to implement a restructuring (depending on the specific facts), this article focuses on the use of foreign-to-foreign type F reorganizations, particularly in the context of family businesses and other closely held businesses. This article focuses on the U.S. federal income tax consequences of the described transactions; while sometimes referenced as the reason for a reorganization, the tax consequences of the reorganization in other jurisdictions are generally beyond the scope of this article.

General U.S. Reorganization Provisions

While section 61 generally assesses U.S. federal income tax on "gross income . . . from whatever source derived," in specific cases the code acknowledges that a transaction may "effect only a readjustment of continuing interest in property" in a way that does not warrant tax being imposed.[1] For example, from a policy perspective, the IRS has determined that reorganizations defined in section 368 should not be subject to U.S. federal income tax.

If the transaction qualifies as a reorganization under section 368, a corporation's transfer of its assets for stock in another corporation and the shareholders' exchange of stock and securities in one corporation for stock and securities in another corporation are tax free, provided both corporations are parties to the reorganization.[2] An F reorganization is defined as "a mere change in identity, form, or place of organization of one corporation, however effected."[3]

In addition to meeting the applicable definition in section 368, most reorganizations

[1]Reg. section 1.368-1(b).

[2]Sections 354 and 361. A transaction that is not defined in section 368 is not treated as a reorganization, although some other corporate transactions (for example, a section 332 liquidation or section 351 contribution) also are tax free.

[3]Section 368(a)(1)(F).

must also pass the continuity of interest, continuity of business enterprise, and business purpose tests.[4] While the requirements for continuity of interest and continuity of business enterprise no longer apply to F reorganizations,[5] an F reorganization still must have a valid business purpose.[6] The business purpose test is typically read to require a "corporate or business purpose" for the transaction.[7] While it has also been stated as requiring one "non-Federal tax business purpose,"[8] a transaction that is effected solely for non-U.S. tax purposes still may be viewed as lacking a sufficient business purpose.[9] Also, the existence of a U.S. or non-U.S. tax reason for the transaction in addition to other commercial goals does not mean the transaction fails the business purpose test.[10]

F Reorganization Requirements

Reg. section 1.368-2(m) sets out the following requirements for an F reorganization[11]:

- immediately after the transaction, all the stock of the resulting corporation[12] must be distributed (or deemed distributed) in exchange for stock of the transferor corporation;
- the same person or persons must own the resulting corporation in the same proportion as they owned the transferor corporation;
- the resulting corporation cannot have prior assets or tax attributes;
- the transferor corporation must completely liquidate in the transaction for U.S. federal income tax purposes;
- the resulting corporation must be the only acquiring corporation; and
- the transferor corporation must be the only transferring corporation.

Not surprisingly, each of these prongs is somewhat more complex than the basic description implies.

The first prong of the test requires that all the stock of the resulting corporation be distributed (or deemed distributed) in exchange for the stock of the transferor corporation. However, the regulations specifically allow the resulting corporation to issue a de minimis amount of stock not in exchange for stock of the transferor corporation if necessary to form the resulting corporation or maintain its legal existence.[13] For example, a jurisdiction may require two shareholders to incorporate a company, or the entity may be a limited partnership that elects to be treated as a corporation for U.S. federal tax purposes under reg. section 301.7701-3(c). In either case, the issuance of a small amount of stock in the resulting corporation will be disregarded for purposes of this part of the test.

While the second prong requires that the shareholders of the transferor and resulting corporations are the same immediately before and after the transaction and own their stock in the

[4] Reg. section 1.368-1(b), (d), and (e). Broadly, the continuity of business enterprise and continuity of interest requirements are intended to ensure there is a sufficient continuation of both the transferor corporation's operations and its historic shareholder ownership to justify reorganization status from a policy perspective.

[5] Reg. sections 1.368-1(b) and 1.368-2(m)(2) (for transactions occurring on or after Feb. 25, 2005).

[6] A plan of reorganization is also required. Reg. section 1.368-1(c).

[7] *Gregory v. Helvering*, 293 U.S. 465 (1935). *See also* Martin Ginsburg, Jack Levin, and Donald Rocap, *Mergers, Acquisitions, and Buyouts*, section 609 (2014) ("to satisfy the business purpose requirement, the transaction must proceed from a commercial motive").

[8] ILM 201340016.

[9] Certainly this would be the conservative position, although it seems that the quality or level of business purpose required for an acquisitive reorganization (including an F reorganization) is not as stringent as that required for a section 355 spinoff. *See id.*; and Ginsburg, Levin, and Rocap, *supra* note 7.

[10] *See, e.g.*, ILM 201340016:

> Taxpayer documented potential foreign currency volatility and exposure and foreign tax reasons for restructuring the ownership . . . [w]e conclude that these purposes in regard to the F Reorganization . . . satisfy the business purpose threshold applicable to Section 368 reorganizations.

See also Gregory v. Helvering, 293 U.S. 465 (1935) ("the legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits cannot be doubted").

[11] These regulations are effective for transactions occurring on or after Sept. 21, 2015.

[12] The transferor corporation is the corporation from which the assets are transferred, and the resulting corporation is the corporation to which the assets are transferred. Reg. section 1.368-2(m)(1). In both cases, the determination of whether any entity is a corporation for U.S. federal tax purposes is based on the entity's classification under reg. section 301.7701-3, including any elective classifications. *See, e.g.*, reg. section 1.368-2(m)(4), example 8.

[13] Reg. section 1.368-2(m)(1)(i) and (m)(4), example 3.

same proportion, the de minimis exception in the preceding paragraph also applies for purposes of this requirement.[14] Perhaps surprisingly, this prong also may be satisfied if some of the transferor shareholders receive stock with different rights in the resulting corporation, or even if they receive a distribution of property or money from the resulting corporation.[15]

Third, the resulting corporation cannot have any assets or tax attributes immediately before the transaction. Again, however, the regulations take a practical approach and permit de minimis prior assets if required for the resulting corporation's formation or legal existence (for example, to meet statutory capital requirements under local law).[16]

Fourth, the transferor corporation must liquidate completely for U.S. federal income tax purposes in the transaction. This complete liquidation can be accomplished either by actual liquidation of the transferor corporation or by filing an entity classification election under reg. section 301.7701-3(c) to disregard the transferor corporation.[17] The transferor corporation can even remain in existence, including with de minimis assets if those assets are required to maintain the corporation's existence under local law.[18]

Finally, under the fifth and sixth prongs, the resulting corporation must be the sole acquirer, and there must be only one transferor corporation.[19] These final two requirements ensure that an F reorganization cannot be used in a divisive or amalgamating manner, which would be contrary to the statutory requirement that an F reorganization is the mere change of one corporation. For example, the simultaneous merger of two corporations into a third corporation followed by the liquidation of both transferring corporations could not qualify as an F reorganization.[20]

F Reorganizations 'in the Bubble'

Often, a potential F reorganization occurs within a larger transaction or series of transactions. In these cases, practitioners may wonder whether the potential F reorganization could be "stepped together" with other transactional phases, potentially leading to a different tax result. Historically, however, the IRS has held that F reorganizations stand alone; in other words, the IRS's position has been that because an F reorganization involves a mere change in only one corporation, an F reorganization cannot be stepped together with other transactions.[21] The IRS confirmed this position in the final F reorganization regulations under section 368.[22]

Reg. section 1.368-2(m)(3)(ii) states that a potential F reorganization can occur before, during, or after other transactions that result in more than a mere change in the corporation, even if the resulting corporation has only a transitory existence. These related events generally do not disqualify the F reorganization, nor is the U.S. tax characterization of those other steps affected (including whether the step transaction doctrine may apply to those steps).[23] Similarly, distributions by the transferor or resulting corporation to a shareholder are treated as separate transactions subject to the general rules of section 301 and do not adversely affect the

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[14] Reg. section 1.368-2(m)(1)(i).

[15] Reg. section 1.368-2(m)(1)(ii).

[16] Reg. section 1.368-2(m)(1)(iii).

[17] Reg. section 1.368-2(m)(3)(iv) and (m)(4), example 5. An election under reg. section 301.7701-3(c) for the transferor corporation to be treated as a partnership (because it had more than one owner) should also qualify as a complete liquidation for this purpose. *See, e.g.*, T.D. 9739 ("deemed asset transfers include, but are not limited to, those transfers treated as occurring as a result of an entity classification election under paragraph 301.7701-3(c)(1)(i)"). Reg. section 301.7701-3(c)(1)(i) contains the general rule allowing eligible entities to elect their desired U.S. federal tax classification.

[18] Reg. section 1.368-2(m)(1)(iv).

[19] Reg. section 1.368-2(m)(3)(v) and (vi).

[20] Reg. section 1.368-2(m)(4), example 14. Example 14 notes that if one corporation first merged into another, that transaction could qualify as an F reorganization (if the other requirements are met). The second merger, however, would have to qualify under another reorganization provision in order to be tax free.

[21] *See, e.g.*, Rev. Rul. 79-250, 1979-2 C.B. 156 (reincorporation of a corporation in another U.S. state was sufficiently meaningful from an economic perspective to be treated as separate from the forward subsidiary merger that occurred immediately before the F reorganization), as modified by Rev. Rul. 96-29, 1996-24 IRB 1. Interestingly, while the forward subsidiary merger in Rev. Rul. 79-250 had several commercial purposes, the only reason stated in the revenue ruling for the F reorganization was the "further economies" resulting from the lower state corporation tax rate in the new state. Despite this purportedly (and solely) tax reduction purpose, the revenue ruling concludes that the reincorporation qualifies as an F reorganization because it had sufficient economic independence. *See also* LTR 201250004.

[22] T.D. 9739; and reg. section 1.368-2(m)(3)(ii).

[23] Reg. section 1.368-2(m)(3)(ii).

qualification of the transaction or series of transactions as an F reorganization.[24]

Finally, a series of transactions that could otherwise be analyzed under different code provisions (for example, section 351 or section 332) may qualify as an F reorganization[25] — for example, when the contribution of the stock of the transferor corporation to the resulting corporation is followed by an actual or deemed liquidation of the transferor corporation into the resulting corporation.[26]

Application of Section 367

Even if a transaction meets the requirements of an F reorganization, in an international context it also must clear the hurdle of section 367. Generally, section 367 taxes stock and asset transfers to non-U.S. corporations, as well as some inbound transfers.

An in-depth review of the section 367 rules is beyond the scope of this article. However, very broadly, section 367(a) applies to transfers by U.S. persons and generally treats a non-U.S. transferee corporation as not a corporation (thus, section 367(a) transfers are typically taxable).[27] Conversely, section 367(b) applies to specified transactions that may not involve a U.S. person transferor, including some foreign-to-foreign transfers, and generally treats a non-U.S. transferee corporation as a corporation (so transfers not covered by section 367(b) may be nontaxable).[28]

Under the section 367(b) regulations, the following steps are treated as occurring in an F reorganization regardless of the form of the transaction:

- the transferor corporation transfers its assets to the resulting corporation in exchange for stock of the resulting corporation;
- the transferor corporation distributes the resulting corporation's stock to its shareholders; and
- the transferor corporation's shareholders are treated as having exchanged their stock in the transferor corporation for stock in the resulting corporation.[29]

Thus, U.S. shareholders of the transferor corporation in an F reorganization should not be treated as having transferred assets to the resulting corporation. Rather, the foreign transferor corporation is treated as the transferor. Therefore, section 367(a) should not apply.[30] Likewise, section 367(d) (addressing outbound transfers of intellectual property and other intangibles) should not apply, as that provision only applies to U.S. transferors.[31] Further, in a foreign-to-foreign F reorganization, the section 367(b) regulations do not treat the resulting corporation as other than a corporation. Therefore, if the transaction meets the general F reorganization tests set out above, a foreign-to-foreign F reorganization should not be subject to tax under section 367.

If the non-U.S. transferor corporation does not own any U.S. assets, including any U.S. real estate, a foreign-to-foreign F reorganization should be nontaxable under both the general section 368 rules[32] and the section 367 cross-border transfer rules.[33] However, if the transferor corporation holds any U.S. assets, including U.S. real estate, further analysis will be required to determine the U.S. federal income tax position. For example, the analysis may involve the application of the U.S. 1980 Foreign Investment in Real Property Tax Act rules.

Foreign-to-Foreign F Reorganizations

F reorganizations can be useful when it is desirable for an entity to change structure or form

[24] Reg. section 1.368-2(m)(3)(iii).

[25] Reg. section 1.368-2(m)(3)(i).

[26] *See also* T.D. 9739:

> the first step in an F reorganization of a corporation owned by individual shareholders could be a dissolution of the Transferor Corporation, so long as this step is followed by a transfer of all the assets of the Transferor Corporation to a Resulting Corporation.

[27] This very general rule is subject to several exceptions, including specified transfers of non-U.S. stock or non-U.S. trade or business assets.

[28] Other provisions of section 367 address the outbound transfer of intellectual property, spinoffs, and subsidiary liquidations.

[29] Reg. section 1.367(b)-2(f).

[30] *See, e.g.*, Joel Kuntz and Robert Peroni, "Changes in Identity, Form or Place of Organization (Type F)," in *U.S. International Taxation* (1991).

[31] Section 367(d).

[32] More precisely, the foreign-to-foreign F reorganization will be tax free to the corporation under section 361 and to the shareholders under section 354.

[33] Importantly, failure to comply with any applicable reporting requirements may allow the IRS to treat the transaction as taxable, making meeting those obligations especially critical.

for local law reasons (for example, from a limited company to a limited liability partnership) or when it is helpful for an entity to redomicile from one jurisdiction to another. This may be because the company is going to be managed in a different location;[34] when one or more of the individual shareholders have moved; or to streamline accounting, management, or administrative expenses. The change also may have non-U.S. tax or accounting benefits, such as the ability to file on a consolidated basis under local law, the elimination of local CFC rules,[35] or inheritance tax advantages.

The following examples are taken from my professional experience.

Example One

In one example, a U.K. limited company operated a trading business in the U.K. For U.K. business and inheritance tax reasons, the company wanted to convert to a U.K. LLP. Because the company had significant U.S. individual ownership, the restructuring needed to be U.S. tax free. The shareholders of the U.K. limited company set up a new U.K. LLP,[36] which they owned in the same percentages as they owned the U.K. limited company. Then, the U.K. limited company transferred all its assets and liabilities to the U.K. LLP and liquidated (first via a check-the-box election to be treated as a partnership, then by an actual liquidation).

Although this transaction could have been treated as a nondivisive D reorganization, under overlap rules a reorganization that could qualify as both an F reorganization and a D reorganization will qualify solely as an F reorganization.[37] The U.K. limited company was the sole transferor corporation and the U.K. LLP was the sole acquiring corporation; further, the U.K. LLP was newly formed, and, other than de minimis assets that may have been required for its formation under U.K. law (if any), it had no previous assets or tax attributes. Therefore, the transaction should qualify as an F reorganization under the regulations. Section 367 should not alter this result.[38]

Example Two

In another case, an individual tax resident of Portugal wholly owned a company organized in a Caribbean jurisdiction that, in turn, owned a piece of U.S. real property. To streamline the holding structure and its administration (the individual owned several other Portuguese companies) and to eliminate the application of Portugal's CFC rules, the company was redomiciled from the Caribbean jurisdiction to Portugal. The redomiciliation was effected under the laws of the Caribbean jurisdiction and Portugal, both of which permitted the company to be continued in Portugal in a manner similar to redomesticating a company in the U.S. Other than adding a de minimis second shareholder required under Portuguese law,[39] the individual wholly owned the redomiciled Portuguese company and the Caribbean company ceased to exist for all purposes.

Again, there was one transferor corporation and one acquirer. Thus, this transaction also qualified as an F reorganization and section 367 did not change this result. The U.S. real estate made the analysis more complex,[40] but ultimately, provided specific reporting obligations were met, the transaction was U.S. tax free.

Example Three

Yet another case involved the parent company of a real estate business, which originally was incorporated in the Channel Islands. Over time, the group came to acquire, manage, and operate several U.K. properties. Further, the U.K. tax rules changed during the company's existence, and the sole individual owner of the company (a dual U.S.-U.K. taxpayer) no longer obtained a U.K. tax benefit from having the parent company outside

[34] Many jurisdictions have "management and control" provisions that deem a company subject to local corporate income tax if substantial and strategic decisions are made in the jurisdiction.

[35] For example, many jurisdictions have CFC rules that apply to companies organized in blacklisted jurisdictions.

[36] By default, a U.K. LLP should be classified as a corporation for U.S. tax purposes under reg. section 301.7701-3(b)(2)(i)(B) because all its members have limited liability. Still, to confirm this status, a timely U.S. entity classification election should be filed using Form 8832 to confirm the U.K. LLP classification status as a corporation. *See also supra* note 12.

[37] Reg. section 1.368-2(m)(3)(iv)(B).

[38] *See supra* notes 29 through 33 and accompanying text.

[39] *See* reg. section 1.368-2(m)(1)(i).

[40] FIRPTA analysis is outside the scope of this article.

the U.K.[41] Also, if the parent company was incorporated in the U.K., the group could reduce operating and administration costs outside the U.K. and file consolidated corporate tax returns in the U.K., thereby reducing compliance costs and burdens. The individual owner formed a new U.K. holding company, contributed the shares of the Channel Islands parent to the new company, and then liquidated the Channel Islands company, via a check-the-box election to be treated as disregarded (and, in due course, an actual liquidation).

The same individual wholly owned both the Channel Islands company and the new U.K. company. The U.K. company was newly incorporated, so it had no (or de minimis) assets and tax attributes before the transaction. In the U.S., the transaction might otherwise be analysed under sections 351 and 332 but should instead be treated as an F reorganization.[42] Again, section 367 should not alter this result.

Notably, this transaction may have had an extra benefit for the individual shareholder. If the parent company qualified for benefits under the U.K.-U.S. income tax treaty, dividends paid by the parent company should be qualified dividends rather than ordinary dividends.[43]

Conclusion

While not appropriate in all circumstances, a foreign-to-foreign F reorganization can be useful for international tax practitioners looking to accomplish non-U.S. business and tax goals without triggering adverse U.S. federal income tax consequences. The final F reorganization regulations offer enhanced certainty regarding the classification of a transaction or series of transactions as an F reorganization, and this has led practitioners to refocus on the tool. However, the proposed transaction(s) must be carefully reviewed to ensure that all applicable requirements are met. ■

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[41] The original U.K. planning involved the U.K.'s remittance system for some taxpayers, which has changed significantly over the years.

[42] *See supra* notes 25 and 26 and accompanying text. *See also* reg. section 1.368-2(m)(4), example 5 (section 351 followed by state law merger):

> result would be the same with respect to qualification under section 368(a)(1)(F) if, instead of merging into S2, S1 completely liquidates or is deemed to liquidate by reason of a conversion into an entity disregarded as separate from its owner under Regulations Section 301.7701-3.

[43] This also assumes the U.K. company does not have subpart F income under the U.S. CFC rules. Further, all of these examples assume none of the relevant companies are passive foreign investment companies.