VIRTUAL MERGERS: IS AMERICA READY?*

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I. Introduction

Virtual mergers, or "dual listed company" (DLC) structures, have existed in Europe for almost 100 years. However, there has yet to be a DLC involving a U.S. corporation.[1] A business combination between two public companies incorporated in different jurisdictions is referred to as a "virtual merger" when (1) the companies remain as separately traded companies because there is no shareholder-level exchange; (2) the shares in each company reflect the combined economics of the two companies; and (3) the operations of the two companies are managed through a common governance structure. A virtual merger may be structured in either of two ways: through a contractual arrangement to equalize distributions, perhaps on an after-tax basis, with respect to separately owned subsidiaries (referred to as DLC Structure I), or through the joint ownership of operating subsidiaries (referred to as DLC Structure II). There were three significant DLC transactions in 2001. First, BHP (Australia) combined with Billiton (U.K.), then Brambles (Australia) combined with GKN (U.K.), and, most recently, P&O Princess Cruises (Princess) (U.K.) and Royal Caribbean (Liberia) announced a business combination on November 20, 2001. If the Princess-Royal Caribbean transaction closes, it would be the first DLC transaction in which one of the companies (Royal Caribbean) was traded (though not incorporated) in the United States.[2]

Although the use of DLC structures is largely motivated by business exigencies and not by tax, such structures are important from a tax perspective for a number of reasons. First, many U.S. tax advisors believe that the United States is not the preferred jurisdiction for ownership of a multinational group with significant foreign source income. One principal reason is that, while many countries impose little or no tax on foreign source income, the United States has a comprehensive and complex system of taxing such income (*i.e.*, the United States does not have an exemption system and has an anti-deferral regime that includes

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subpart F).[3] The higher effective tax rate borne by U.S. multinationals relative to certain foreign multinationals may put U.S. companies in many industries at a competitive disadvantage in terms of the bottom line and earnings per share. The use of a DLC structure limits the amount of foreign source income that is earned by a U.S. multinational group. Second, even in a cross-border combination in which the U.S. company would likely be the target rather than the parent of the multinational group, a straight acquisition may not be the optimal solution for one or more of the following reasons: (1) the exchange is taxable to the U.S. target or its shareholders, (2) the resulting structure is tax-inefficient with respect to the payment of dividends, particularly from a withholding tax standpoint, and (3) "flowback" (*i.e.*, excessive selling pressure on the acquiror's stock in a cross-border acquisition caused by the acquiror issuing large amounts of stock outside of its natural home market, *e.g.*, sales of Daimler-Benz stock by former Chrysler shareholders). Although the flowback problem is not directly a tax issue, the manner in which the transaction is structured may cause or at least exacerbate flowback. All of these issues may be successfully managed in a DLC structure because there is no exchange of shares by the shareholders.

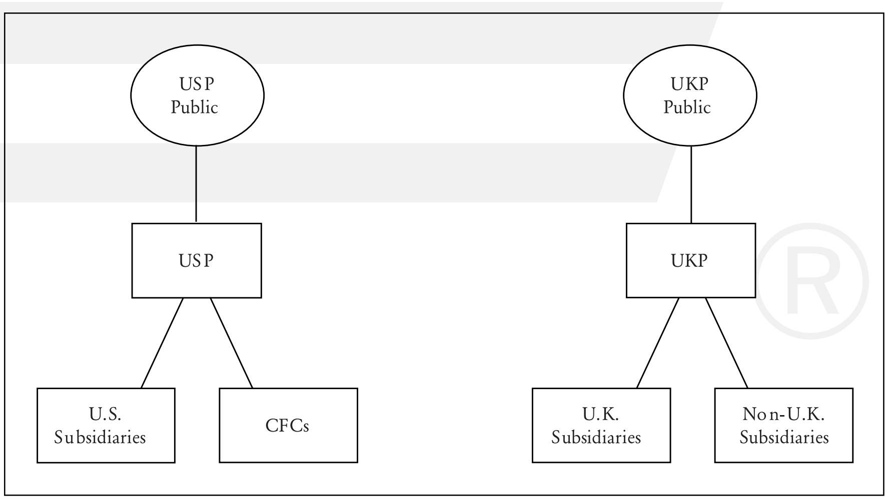
So, if a DLC structure seems preferable to a single-parent structure in a cross-border context, from both a tax and market standpoint, why hasn't a U.S. corporation ever been involved in a virtual merger? A number of reasons: (1) the fact that the favorable pooling method of accounting (which avoided goodwill amortization previously required by GAAP) could not be used by companies in a DLC structure, (2) the questionable reaction by U.S. investors and (3) U.S. tax uncertainty.

Now that the pooling method has been repealed for all acquisitions (as of June 30, 2001 pursuant to Financial Accounting Standards No. 141) such that DLCs are not treated disfavorably in comparison with other forms of business combinations, and U.S. investors have responded positively to the announced DLC arrangement between Royal Caribbean (a NYSE-traded company) and Princess,[4] the U.S. tax issues will become a principal focus in considering whether to use a DLC structure in a cross-border context. The key U.S. tax issues, described in greater detail below, are whether (1) the foreign company may be treated as a U.S. company under Code Sec. 269B, and (2) the arrangement would be classified as a partnership for U.S. tax purposes.

Rather than analyze a proposed cross-border business combination involving a U.S. company in the abstract, this article focuses specifically on a business combination between a U.S. company (USP) and a U.K. company (UKP). The parent companies are presumed to be publicly traded, of relatively equal value, and have resident and nonresident subsidiaries (*see* Diagram 1).

The article first summarizes market issues—the impact of flowback. It then includes a primer on U.K. taxation. Next, the article analyzes different ways in which the two companies may structure their combination, beginning with single-parent structures (*e.g.*, Daimler/Chrysler) in which either USP, UKP, or a third country holding company (Holdco) would be the parent of the group. Then, the article summarizes two intermediate structures that permit target shareholders to retain an interest in the target company (*e.g.*, exchangeable share structures, and access share arrangements such as SmithKline Beecham), but do not rise to the level of a DLC structure which permits both parent companies to remain in existence without a shareholder-level exchange. Finally, the article discusses two types of DLC structures: DLC Structure I (involving contractual equalization agreements and voting trusts, *e.g.*, Unilever NV/Unilever plc), and DLC Structure II (involving the joint ownership of operating subsidiaries, *e.g.*, Royal Dutch/Shell).

DIAGRAM 1



II. Market Issues: Flowback

A major concern in the case of a cross-border transaction is that flowback can significantly impact whether a transaction is successful. Flowback is excessive selling pressure caused by an acquiror issuing large amounts of stock as acquisition currency outside of its natural or "home" market. The basic problem with the single parent structure is that the parent company cannot be a home country corporation with respect to both sets of shareholder groups. As a result, many target shareholders, particularly institutional shareholders, will be compelled to sell stock of the acquiring company following completion of the transaction (because of restrictions on their investment powers), potentially depressing the stock price.

Shareholder selling is generally motivated by at least four factors. First, target index funds are forced to sell securities that are not constituents of the indices that the index funds track. For example, U.K. index funds invest only in stocks that are members of the major FTSE indices. Second, investors in general have a natural bias towards owning "domestic" equities. Third, domestic funds are often prohibited from holding stocks of American Depositary Receipts (ADRs) by charter (relevant if a foreign acquiror does not directly register its primary class of shares). Fourth, the investment style of certain target shareholders may not be consistent with the investment characteristics of the acquiror's stock. For example, where a premium is paid for a target's stock, any "value" investor will sell the shares they receive.

Chart 1 analyzes the market reaction to four recent cross-border acquisitions of U.S. companies. How the stock price of the acquiror performs from the date of announcement until closing is one way to gauge the market's view of the success or failure of the deal. Of course, flowback is only one component of the impact of the deal on the acquiror's stock price (the price paid, the performance of the companies from announcement to closing, potential synergies, and other factors are obviously critical), but excessive trading by target shareholders will contribute to any downward pressure on the acquiror's stock price. A review of Chart 1 indicates that the market approved of the BP/Amoco transaction (BP stock outperformed other stocks in its index by 19 percent), whereas the Scottish Power/Pacificorp transaction was relatively neutral, and the Daimler Benz/Chrysler and Deutsche Telecom/Voicestream transactions did not fare as well (the acquirors underperformed the market by 17 percent and 37 percent, respectively) during the period.

Chart 2 focuses specifically on flowback. Two columns merit discussion. First, the column on the far right lists the number of days of trading volume represented by the stock consideration. In the BP transaction where the acquiror's stock price fared well, the number of shares issued as consideration equaled the number of shares traded over 50 trading days. In the two cases where flowback was an issue (Daimler and DT), the acquiring companies offered consideration representing 200 and 130 days of trading, respectively. What this means is that companies considering cross-border mergers using their own stock must consider the size of their consideration in relation to their average daily trading volume. Simply stated, companies can create enormous "overhang" on their stock if the issued stock represents an excessive amount of the average daily trading volume.

Second, the column next to the column on the far right quantifies flowback as a percentage of the enlarged company. This is a product of two factors: (1) the percentage of stock issued by the acquiror to the target's shareholders, and (2) the percentage of stock selling by the target's shareholders. In the Deutsche Telecom (DT) deal, DT was substantially larger than Voicestream, so it issued only 23 percent of its stock in the acquisition (potentially fa-

CHART 1 Stock Price Performance from Announcement to Close

Transaction: (Acquiror/Target)	Date Announced	Date Closed	Acquiror % Price Change	Index	Index % Change	Comparison to Index
BP/Amoco	8/10/98	12/31/98	19%	FTSE*	0%	19%
Scottish Power/Pacificorp	12/7/98	11/30/99	(15%)	FTSE*	(11%)	(4%)
Daimler Benz/Chrysler	5/7/98	11/12/98	(27%)	DAX	(10%)	(17%)
Deutsche Telecom/Voicestream	7/24/00	5/31/01	(53%)	DAX	(16%)	(37%)

* FTSE Europe Index Euro top 100.

vorable in terms of minimizing flowback). However, the flowback as a percentage of stock consideration was a very high 86 percent. As a result, the flowback as a percentage of the combined company was 20 percent (23 percent of 86 percent), a fairly high number and a likely contributor to the fall in DT's stock price.[5] Flowback also put selling pressure on Daimler's stock price.[6] At announcement, U.S. shareholders comprised roughly 43 percent of the combined shareholder base of the two companies; six months after announcement, U.S. shareholders comprised roughly seven percent of the combined company.

If a company chooses not to use a DLC structure in a cross-border deal, how can flowback be managed in a single-parent structure? Some suggestions include (1) share repurchases, (2) insider lock-ups, (3) exchangeables and (4) derivatives. The facts differ in each deal. In BP (1) there was an intensive roadshow to promote the transaction, (2) BP had a liquid ADR prior to the transaction and (3) BP was recognized as a global company, rather than just a U.K. (or non-U.S.) company. As a result, in BP there was significantly less flowback than anticipated, about $12 billion out of a combined market capitalization of $120 billion pre-announcement or $176 billion six months after closing.[7] Further, upon the closing of the transaction, BP Amoco's weighting in the FTSE-100 Index increased, prompting most U.K. investors to increase their ownership of the stock.

From a market perspective, a DLC structure makes sense in terms of minimizing flowback, which is one reason why the structure is used in cross-border deals between non-U.S. companies. However, although the DLC structure has many tax and market advantages, there are other issues to consider. For example, because there are two companies, raising equity or debt, or acquiring another company, is more complex. One company, Fortis, recently said it will merge its Belgian and Dutch stock listings into a single listing by the end of 2001.[8] Investment advisors may question the viability of a DLC structure if one company is substantially larger than the other (DLC structures typically range from 50-50 to 60-40). If the split is, say 70-30 (or larger), the concern is that there may be a liquidity squeeze with respect to the smaller company's shares if shareholders of such company sell their stock. In a 70-30 split, for example, while flowback might be less of an issue because of the size disparity (*i.e.*, heavy selling by target shareholders will have less impact because they own a smaller percentage of the combined company), there should still be some tax and market benefits.

III. Primer on U.K. Taxation

It is assumed that the reader will have a greater familiarity with U.S. federal income tax than with U.K. taxation. Accordingly, it may be helpful to set out a few general points to assist with the understanding of the U.K. tax discussion.

U.K. shareholders in UKP can be divided into different categories. First, those U.K. shareholders who are U.K. taxpayers and hold their

CHART 2

	Approximate Market Capitalization ($ in billion)			Stock Consideration as % of Enlarged Company	Flowback as % of Stock Consideration	Flowback as % of Enlarged Company	Stock Consideration Equivalent Days of Trading Volume
Flowback not an Issue:	Date	Offerer	Target				
BP Acquisition of Amoco	8/98	$70	$40	40%	40%	16%	50 Days
Scottish Power Acquisition of Pacificorp	12/98	$7	$4	>30%	50%	15%	40 Days
Flowback Issue in Aftermarket:							
Daimler Benz Acquisition of Chrysler	5/98	$52	$40	43%	48%	20%	200 Days
Deutsche Telekom Acquisition of Voicestream	7/00	$150	$57	23%	86%	20%	130 Days

UKP shares as investments (Investors). Investors can be further sub-divided into individuals who are U.K. resident or ordinarily resident (whom we shall refer to as "U.K. Individuals") and companies who are either U.K. resident or carry on trade through a branch or agency in the U.K. where the UKP shares are used by the branch or agency (who we shall refer to as "U.K. Corporates"). Secondly, those U.K. shareholders who are U.K. taxpayers and hold their UKP shares as trading stock or "inventory" (Traders). Thirdly, those U.K. shareholders that are exempt from tax (Exempts).

Under the U.K. tax system, U.K. individuals pay income tax and capital gains tax, and U.K. Corporates pay corporation tax, which covers tax on income and tax on chargeable gains. It is, however, customary to use the abbreviation "CGT" to cover both capital gains tax (for U.K. Individuals) and corporation tax on chargeable gains (for U.K. Corporates).

U.K. Taxation of Dividends Received by U.K. Shareholders. Traders include dividends (whether from a U.K. or non-U.K. company) as part of their trading profits computation, and Exempts do not pay tax on dividends (again, whether from a U.K. or non-U.K. company). There is no UK corporation tax on dividends paid by a U.K. company when received by a U.K. Corporate (a 100-percent DRD in U.S. parlance, regardless of the corporate shareholder's level of ownership). U.K. Individuals get a partial imputation credit in relation to dividends received from a U.K. company.[9] U.K. Corporates and U.K. Individuals who receive a dividend from a non-U.K. company, such as USP, would be fully taxed on the gross dividend (the aggregate of the cash dividend and any U.S. withholding tax levied on the dividend) with a tax credit for the U.S. withholding tax.[10]

CGT. A U.K. shareholder is considered to make a "disposal" if it transfers shares of a U.K. company, such as UKP.[11] However, if the U.K. shareholder receives shares in another company (*e.g.*, USP) in exchange for their shares in UKP, the disposal will be ignored, and the U.K. shareholder's basis in the old shares will be carried over into the new shares.[12]

Stamp Duty/Stamp Duty Reserve Tax (SDRT). A company that acquires the stock of UKP, such as USP, will generally be liable for SDRT at the rate of 0.5 percent of the value of the consideration given (*i.e.*, the value of the USP shares) for the UKP shares, unless the UKP shares are in ADR form.[13]

Payment of Dividends by U.K. Company. The U.K. does not levy a withholding tax on dividends, so there would be no U.K. tax on the dividends paid by UKP to USP or any third-country shareholder.

U.K. Controlled Foreign Company (UK CFC) Rules. The UK CFC rules are somewhat less complex than the U.S. CFC rules and operate only where the tax a CFC pays under the law of where it is resident is less than the tax it would have paid had it been resident in the United Kingdom. In addition, there are a number of exemptions which enable a CFC charge to be avoided. Where the UK CFC rules apply, U.K. companies with an interest in the CFC have the CFC's chargeable profits apportioned amongst them.

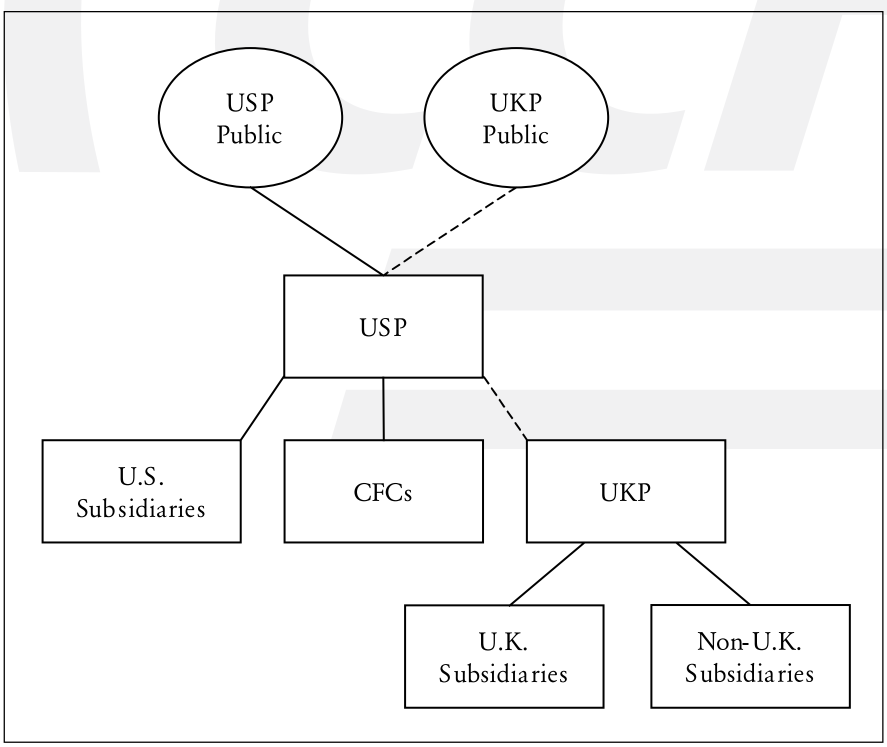
U.K. Foreign Tax Credit (UK FTC) Rules. The UK FTC rules have recently been entirely rewritten; however, they remain considerably simpler than the U.S. rules, even though more complex than the U.K. rules they replaced. The starting point is that the UK FTC rules entitle a U.K. company to a credit for foreign tax paid by a non-U.K. company on the profits out of which that non-U.K. company pays a dividend to the U.K. company if the U.K. company holds 10 percent or more of the voting power in that non-U.K. company.

Grouping Rules. The U.K. tax system does not have a concept of "consolidation." Instead, under the U.K. tax system, companies with the requisite relationships can pass certain tax attributes from one to the other. There are currently four different types of attributes that are relevant. First, under the "group relief" rules, a company with current year losses can "surrender" the losses to another company in its group to set against that other company's profits. Secondly, under the CGT group rules, where a company transfers an asset to another company in the same CGT group, the transfer takes place at no gain and no loss, so the transferee takes over the transferor's base cost in the asset. Thirdly, for stamp duty purposes, where a company transfers an asset to an associated company, there is no stamp duty on the transfer. Finally, for value added tax (VAT) purposes, if a group of companies is registered as a group, supplies made to any member of the group are treated as supplies to the principal member, and any supplies made from one member of the group to another are ignored. As might be expected with the U.K. tax system, each of these group rules requires a slightly different relationship; although to be fair to the legislator, the rules have more in common now than they did in the past. The critical point is that certain cross-border business combinations may cause the former UKP subsidiaries to be de-grouped from each other or from UKP. This may have adverse on-going consequences. In addition, where within six years following an intra CGT group transfer the transferor and the transferee are de-grouped, there is a claw-back tax charge and this too will have to be considered.

IV. Traditional Single Parent Structures

The operation of the single-parent structure in a cross-border transaction traditionally results in tax inefficiencies. This is because dividends from a target to the parent are typically subject to withholding tax, and subsequent dividends from the parent to the target's former shareholders are also subject to withholding tax (and, in certain cases, the former target's shareholders may lose home-country imputation benefits). However, if the parties determine that a single parent structure is beneficial on their particular facts, they must decide on an optimal jurisdiction for the parent company. Among other things, the optimal jurisdiction would accommodate reasonable corporate and securities law and commercial considerations, would not impose prohibitive capital taxes, would exempt offshore earnings from corporate tax, would impose reasonable levels of withholding taxes on dividends paid to shareholders (which constitute an out-of-pocket cost to tax-exempt shareholders), and would have an income tax treaty with the United States, the United Kingdom and third countries that would allow it to receive dividends from operating subsidiaries at reduced withholding rates. Suffice it to say that no one jurisdiction may satisfy all of these criteria. Thus, the selection of a jurisdiction may be a difficult exercise involving a number of trade-offs. The discussion below evaluates three alternatives: the United States (USP), the United Kingdom (UKP) or a third country (Holdco).

DIAGRAM 2



A. USP Acquires UKP

If USP acquires the stock of UKP (*see* Diagram 2),[14] the shareholders of USP retain their USP stock. Accordingly, neither USP (pursuant to Code Sec. 1032) nor its shareholders will recognize gain on the exchange.[15] The result is the same regardless of whether the transaction is taxable[16] or tax-free for U.S. tax purposes. However, it may be beneficial to treat the transaction as taxable because USP would then get a fair market value basis in the UKP stock, and it would have the ability to make a Code Sec. 338 election and thereby obtain a basis step-up in UKP's assets for U.S. tax purposes. There is generally no reason not to obtain the basis step-up, since the gain or loss to UKP and its non-U.S. shareholders will not be impacted.[17] Separately, U.K. shareholders will not be taxed in the U.K. when they exchange shares of UKP for shares of USP.[18]

Even though the U.K. has no withholding tax, this structure still has inefficiencies. First, dividends paid by USP to the former shareholders of UKP will generally be subject to a 15-percent withholding tax.[19] Second, U.K. Individuals would lose imputation credits that they otherwise would have received if they continued to own UKP stock, and U.K. Corporations would be taxable on dividends they receive from USP. Third, because the U.K. corporate rate is currently 30 percent, lower than the U.S. rate of 35 percent, U.K. earnings would be subject to residual U.S. corporate tax (including alternative minimum tax (AMT)) in the hands of USP after taking into account the U.S. foreign tax credit.[20] Fourth, having USP as the parent will subject all of UKP's operations to the subpart F rules. And, finally, from a market perspective, there is a significant risk of flowback.

B. UKP Acquires USP

If there is appreciation in both the assets and the stock price of USP, USP would likely seek to structure the transaction as a tax-free stock or asset exchange for U.S. tax purposes (*see* Diagram 3). Otherwise, USP and/or its U.S. shareholders would be subject to U.S. tax on the exchange.

UKP Acquisition of USP Stock. UKP could, for example, simply acquire the stock of USP in a transaction that qualifies as a tax-free "B" reorganization.[21] However, because the acquiror, UKP, is a foreign corporation, even if the transaction otherwise qualifies as a tax-free exchange for U.S. tax purposes, the Code Sec. 367(a) "inversion" regulations must also be considered to determine whether such section overrides nonrecognition treatment and transforms the transaction into a taxable one for U.S. purposes with respect to USP's U.S. shareholders. (UKP's U.K. shareholders have no shareholder-level exchange; thus, UK CGT does not apply to them.)

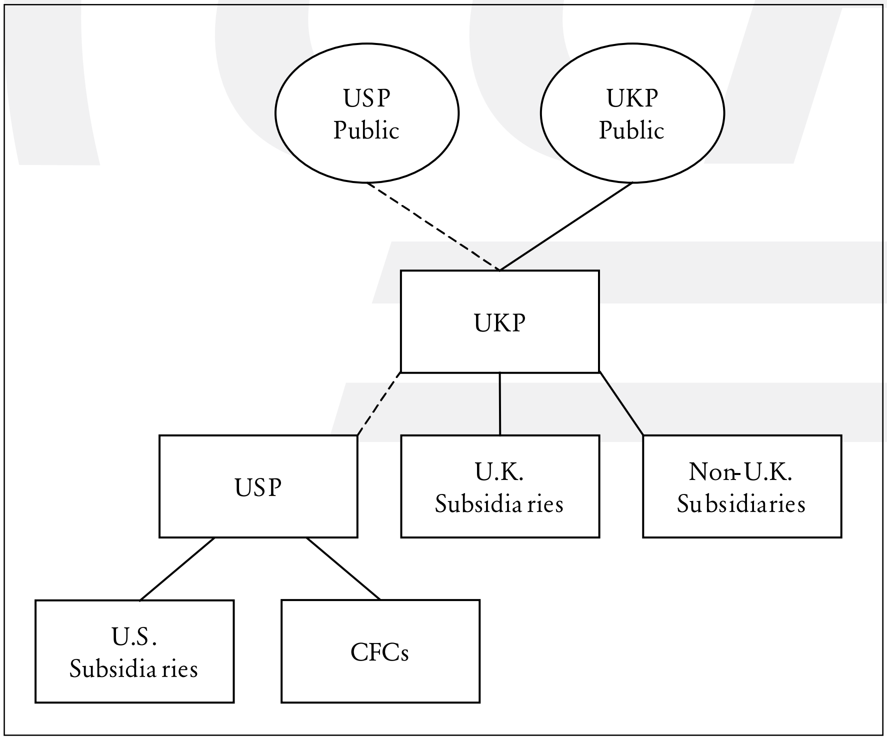
Code Sec. 367(a) generally permits U.S. shareholders of USP to retain tax-free treatment when they exchange their USP stock for UKP stock if the foreign company is larger, by market value, than the U.S. company (the "substantiality test"), and certain other requirements are satisfied.[22] Reg. §1.367(a)-3(c)(3). The IRS would likely argue that the regulations achieve a certain rough justice—the larger company should be the parent. Thus, the acquisition of a smaller U.S. company by a larger (active) foreign company (*e.g.*, Daimler's acquisition of Chrysler) should ordinarily qualify as a tax-free exchange by the shareholders of the U.S. target company.[23] Likewise, there is no U.S. corporate level tax in such transaction because assets remain in U.S. corporate solution.

If USP were larger than UKP, by value, Code Sec. 367(a) would tax U.S. shareholders on the gain in their USP stock.[24] Although Reg. §1.367(a)-3(c)(9) gives the IRS the authority to issue private letter rulings in cases where there is substantial compliance with the Code Sec. 367(a) "inversion" regulations, the current informal IRS position is not to issue rulings where a U.S. target is larger than a foreign acquiror on the closing date.[25]

So, what can be done? The inversion regulations prevent UKP from increasing its value in contemplation of the acquisition (via a broad anti-stuffing rule), but the inversion regulations do not prevent USP from shrinking its value (*e.g.*, via spin-off, stock buyback, cash dividend) to satisfy the substantiality (*i.e.*, valuation) test. Of course, although a distribution by USP to its shareholders has its own tax consequences, such strategy may be worth considering.[26]

If, based upon the facts, the transaction can be structured as tax-free to USP's shareholders, having UKP as the parent is potentially more efficient than having USP as a parent. This is because (1) there is no withholding tax on payments to public shareholders (because the U.K. has no withholding tax), (2) there is no withholding on dividends paid by USP to UKP when the new treaty is in effect (because UKP will own at least 80 percent of the USP stock) and (3) UKP's shareholders retain imputation benefits because they receive would receive dividends from a U.K. company. However, this structure still has a couple of inefficiencies. First, U.S. corporate shareholders will lose their dividends received deduction because dividends are paid by UKP, not USP. Second, UKP may

Diagram 3



be liable for incremental U.K. tax on dividends from USP. However, there may be no incremental tax because UKP would obtain a credit for any U.S. tax paid by USP on the profits out of which it pays dividends to UKP (and any U.S. withholding tax paid before the new treaty is in effect).[27] Third, U.S. shareholders would be liable for SDRT on a sale of the UKP shares at 0.5 percent of the consideration for that sale, unless the shares are issued in ADR form or into a clearing system (which would involve a one-off 1.5 percent SDRT charge but not the ongoing 0.5-percent charge on each sale of the shares). Fourth, USP and all of its subsidiaries would be subject to the UK CFC regime. And, finally, from a market standpoint, there is a risk that flowback would depress UKP's stock price.

UKP Acquisition of USP Assets. UKP may also acquire the assets, rather than the stock, of USP. However, for U.S. tax purposes, it is difficult to structure an "outbound" asset transaction that qualifies as a tax-free reorganization.[28] If the consideration is solely stock of UKP (*i.e.*, no cash or other boot), the transaction should qualify as a tax-free "C" reorganization.[29] However, because UKP is a foreign corporation, the Code would override tax-free treatment and treat USP as if it sold all of its assets at fair market value.[30] USP's shareholders, however, would not be subject to tax.[31] One way to ameliorate the corporate-level tax, particularly if it is determined that such tax would be substantial *vis-à-vis* a shareholder-level tax, is to utilize a "Transocean" structure (*see* Diagram 4). USP would transfer all of its assets to UKP pursuant to a reorganization (*e.g.*, corporate continuance), and UKP, in turn, would retain USP's nonappreciated assets but contribute USP's appreciated assets to a newly-formed U.S. subsidiary.[32]

Code Sec. 367(a) regulations treat this transaction as follows. USP is not subject to tax because all of its appreciated assets end up in U.S. corporate solution.[33] The Code Sec. 367(a) "indirect stock transfer" rules treat certain asset reorganizations, including the Transocean structure above (*i.e.*, a "C" reorganization followed by a Code Sec. 368(a)(2)(C) asset contribution), as a stock transfer subject to the inversion regulations when the target is a U.S. corporation.[34] To the extent that USP's assets are contributed to new U.S. subsidiaries owned by UKP, USP's shareholders are treated as having transferred a portion of their USP stock to UKP in the exchange.

Although the answer is not clear from the Code Sec. 367(a) regulations, the portion of the transaction that is deemed a stock transfer (and thus subject to Code Sec. 367(a) at the USP shareholder level) should be based upon the value of the net assets transferred by UKP to the U.S. subsidiary in comparison to the value of the net assets retained by UKP. In other words, if USP transfers $1,000 of net assets to UKP, and UKP contributes $600 of those net assets to a U.S. subsidiary, the indirect (or deemed) stock transfer with respect to each U.S. shareholder that is subject to Code Sec. 367(a) should be 60 percent. Accordingly, if a particular USP shareholder has a $5 basis and $15 value in its USP stock, if the shareholder's exchange for UKP stock is taxable, the gain arguably should equal 60 percent of the $10 of appreciation, or $6.[35] Of course, if the transaction qualifies for an exception under Code Sec. 367(a) (*e.g.*, UKP is the larger company), the U.S. shareholders would not recognize gain on the exchange.

DIAGRAM 4

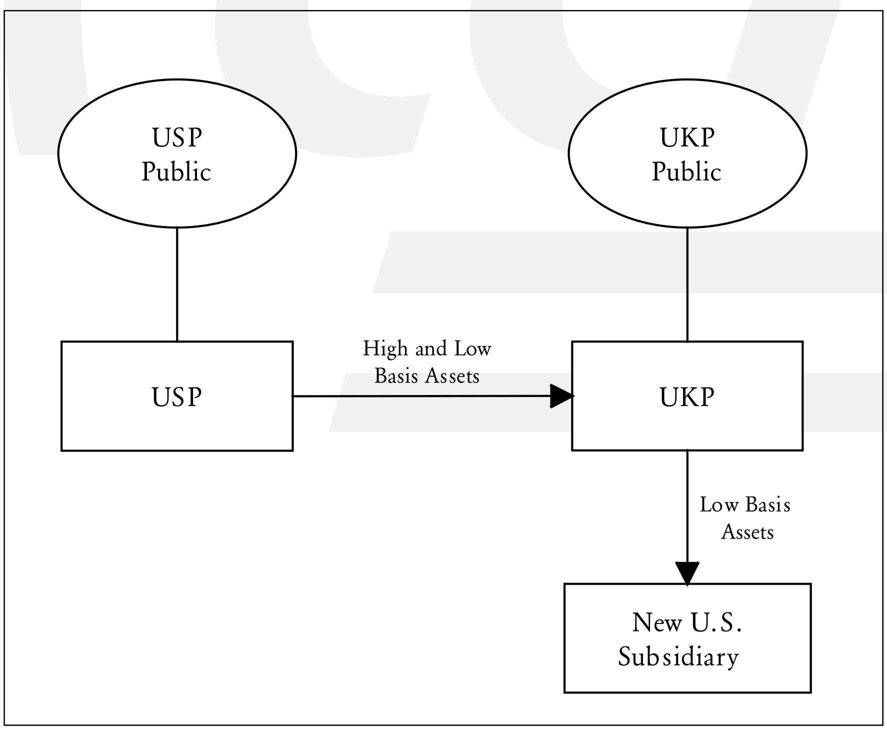
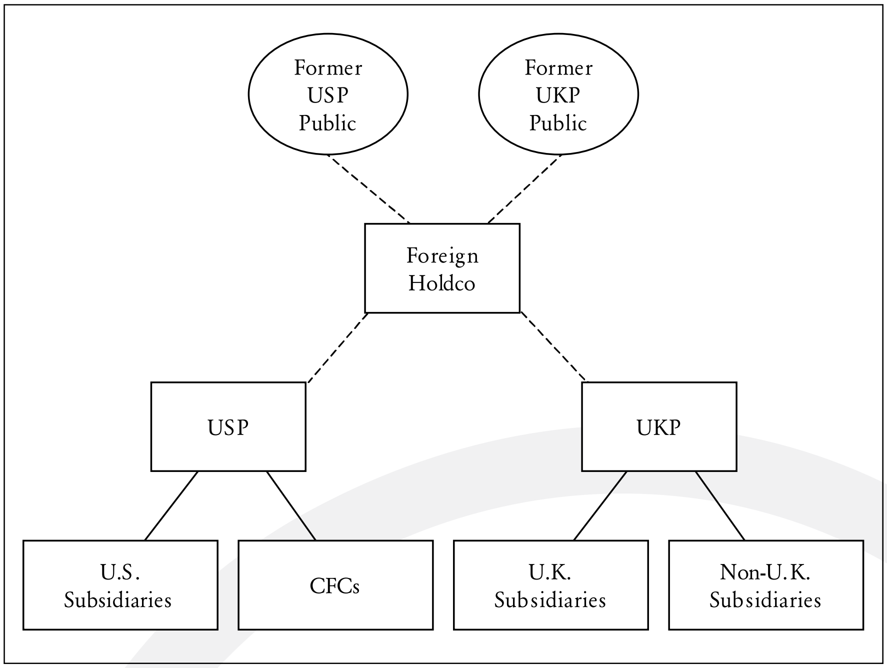


DIAGRAM 5



C. HOLDCO ACQUIRES USP AND UKP

Considerations relevant to whether it would make sense to have both groups acquired and held by Holdco are similar to the considerations discussed above regarding whether it makes sense to have USP acquired by UKP, or vice versa. In general, if the combined group's operations will be predominantly non-U.S. and non-U.K., and an appropriate jurisdiction in which to incorporate Holdco can be identified, then it may be beneficial to have Holdco own both groups—either directly or through intermediary holding companies (*see* Diagram 5). In that event, the U.S. earnings will not flow through a U.K. parent corporation, and the U.K. earnings will not flow through a U.S. corporation. Importantly, if third-country operations are conducted by third-country subsidiaries that are not owned through either USP or UKP, then those earnings will avoid potentially being subject to the additional layers of U.S. or U.K. tax identified above.

As discussed above, whether the ownership of the acquired groups by Holdco is feasible depends upon whether an appropriate jurisdiction can be identified in which to incorporate Holdco. Jurisdictions typically mentioned include tax havens (such as Bermuda and the Cayman Islands) as well as nontax havens with comprehensive treaty networks (including the Netherlands). In addition, the jurisdiction of incorporation of Holdco ideally would have an income tax treaty with the United States which, taking into account Limitations of Benefits provisions of the U.S. tax treaty, would allow it to receive dividends from U.S. operating subsidiaries at a reduced U.S. withholding rate. If Holdco is organized in a tax haven jurisdiction, distributions from the U.S. group may not be feasible because of the U.S. 30-percent withholding tax on dividends paid to a nontreaty recipient.[36]

When U.S. shareholders exchange stock in USP for stock of a non-U.S. company, the result is the same under Code Sec. 367(a), regardless of whether the foreign company is an existing company such as UKP, or a newly-formed foreign company such as Holdco (which acquires the stock of both USP and UKP), and regardless of whether a company is incorporated in a country with which the U.S. has an income tax treaty.[37] Thus, if the U.S. shareholders receive no more than 50 percent of the stock of Holdco (and certain other requirements are satisfied), the transaction may be structured as a tax-free exchange to such shareholders.

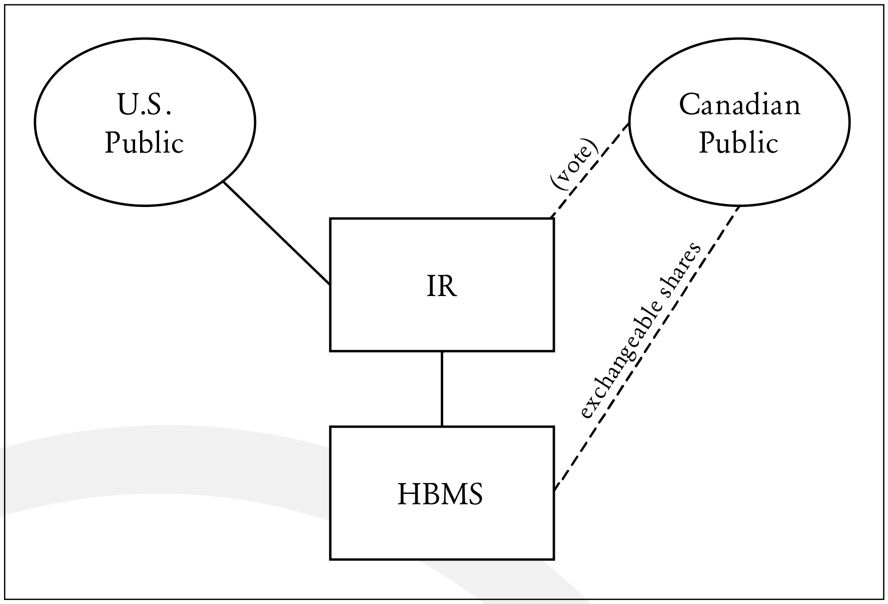
The use of Holdco may have tax advantages with respect to income generated from new corporate opportunities because such income need not be subject to tax in either the United States or the United Kingdom. However, this structure has a couple of inefficiencies. First, dividends from USP to Holdco would be subject to a 30-percent U.S. withholding tax unless Holdco qualifies for treaty relief. If Holdco is incorporated in a tax haven jurisdiction, the tax paid would not be creditable and would thus be a cash cost. In such case, distributions would not be made, and USP's excess funds would be loaned to Holdco or other affiliates. Second, although there is no U.K. withholding tax on dividends paid from UKP to Holdco, dividends received by former UKP shareholders from Holdco would not qualify for imputation credits (similar to dividends paid by USP to former U.K. shareholders).[38] Otherwise, the U.K. tax issues are similar to the ones discussed in relation to the structure in which USP acquires the shares of UKP. For example, the CGT issues are exactly the same. Similarly, the stamp duty/ SDRT issues on the transfer by shareholders of their UKP shares to Holdco will be exactly the same. U.K. shareholders should not in practice be subject to stamp duty or SDRT on any transfer of the Holdco shares they acquire unless those shares are registered in a register kept in the U.K. by or on behalf of Holdco. Finally, market issues would have to be considered.

V. Intermediate Structures

A. Exchangeable Stock

One type of intermediate structure, somewhere between a single-parent structure and a DLC structure, is an exchangeable share structure. This structure has been used extensively for Canadian tax purposes when a U.S. company acquires a Canadian company. The reason is that, for Canadian tax purposes, a Canadian shareholder is taxable upon the exchange of Canadian stock for non-Canadian stock. Although the structure is intended to provide deferral to Canadian shareholders (because they retain stock in the Canadian company), the structure also has withholding tax efficiencies because a dividend paid by the Canadian target to Canadian shareholders need not pass through the U.S. parent and bear potentially U.S. corporate tax and two layers of withholding tax (Canadian withholding tax on a distribution from the Canadian subsidiary to the U.S. parent, and U.S. withholding tax on a distribution from the U.S. parent to Canadian shareholders). In order to avoid any U.S. corporate tax remaining after foreign tax credit relief and the U.S. withholding tax, the exchangeable stock must be structured so that it is respected for U.S. tax purposes as stock in the Canadian company. In order to assure that treatment,

Diagram 6



the Canadian company should have the obligation and the financial ability to satisfy the dividend and exchange obligations of the exchangeable stock without a contractual obligation of support from its U.S. parent.

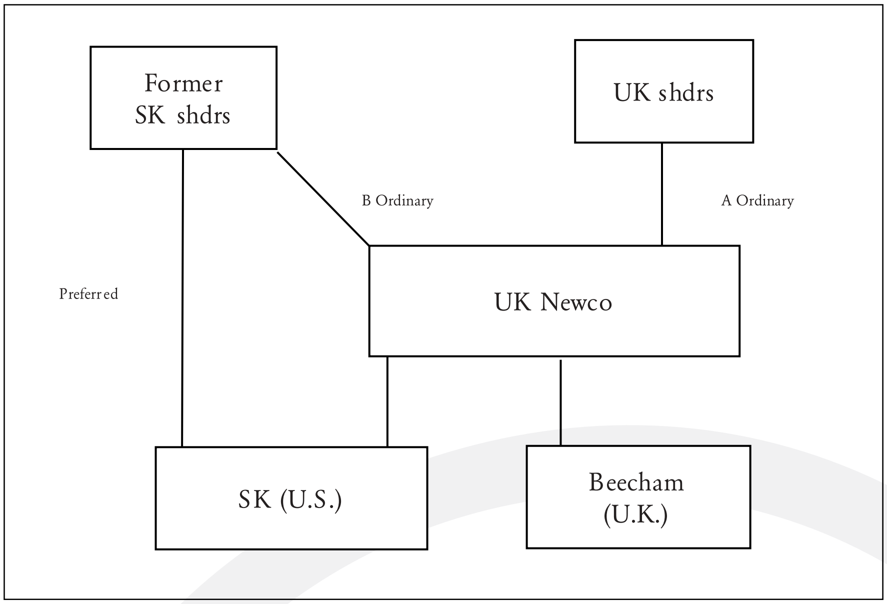
An example of an exchangeable share structure involves the acquisition of Hudson Bay Mining and Smelting Co. (HBMS), a Canadian publicly traded corporation, by Inspiration Resources (IR), a U.S. publicly traded corporation (*see* Diagram 6).[39] In the exchange, the HBMS shareholders could exchange their HBMS stock for either stock of IR or "special shares" (*i.e.*, exchangeable shares) of HBMS.[40]

In exchangeable stock structures, the target shareholder can generally exchange its shares for parent shares at will, much like in an UPREIT structure. At the time of the exchange, the holder of the special share will be taxable under Canadian law.[41] Unlike access share arrangements (discussed below), exchangeable stock is often mandatorily convertible after a fixed period (*e.g.*, five to seven years). Thus, the structure typically provides only temporary deferral to target shareholders.[42]

The main issue with respect to the Canadian special shares in HBMS and other Canadian exchangeables is the same as in the SmithKline Beecham transaction (discussed below). Namely, is the HBMS exchangeable stock owned by the Canadian public really stock in HBMS or is it stock in IR? Given the absence of preferences in HBMS, the parent keepwell as to dividends to be paid on HBMS stock, and apparent parent support with respect to HBMS's conversion obligation, there is some risk that the exchangeable shares might be treated as IR shares, such that distributions on the HBMS shares would be considered to be distributed through the U.S. parent, with the result that they would be subject potentially to U.S. corporate tax and to U.S. withholding tax.

To the authors' knowledge, U.K. companies have not undertaken this method of creating exchangeable stock. There are a number of difficulties, which

DIAGRAM 7



would arise if UKP took the place of HBMS.[43]

B. ACCESS SHARE ARRANGEMENTS

Another intermediate structure is a dividend access share arrangement. Like the DLC structure (and exchangeable stock structure), two sets of securities are traded. However, unlike a DLC structure, there is clearly an acquiror in the access share arrangement. In the access share arrangement, the target shareholders receive a dividend-paying class of stock in the target, often stapled to stock in the parent that carries voting rights. The unit of stock held by the target shareholder group is intended to be equivalent to stock in the public parent. Such a structure is typically put into place pursuant to an acquisition (although it may also be implemented pursuant to a public offering of the dividend access shares for cash). For example, Beecham (U.K.) used such an arrangement in its 1989 acquisition of SmithKline (U.S.) (*see* Diagram 7). It terminated the structure in 1996.

In that transaction, the shareholders of SmithKline (SK), a U.S. public corporation, received preferred shares in SK (SK Preferred) that represented most of the value in their SK shares. SK common stock was then acquired by a U.K. newco corporation (UK Newco) established by Beecham (U.K.), in exchange for Class B Ordinary shares of UK Newco. The SK Preferred shares and the UK Newco Class B Ordinary shares were stapled.[44] The UK shareholders of Beecham transferred their Beecham shares to UK Newco for Class A Ordinary shares of UK Newco.[45]

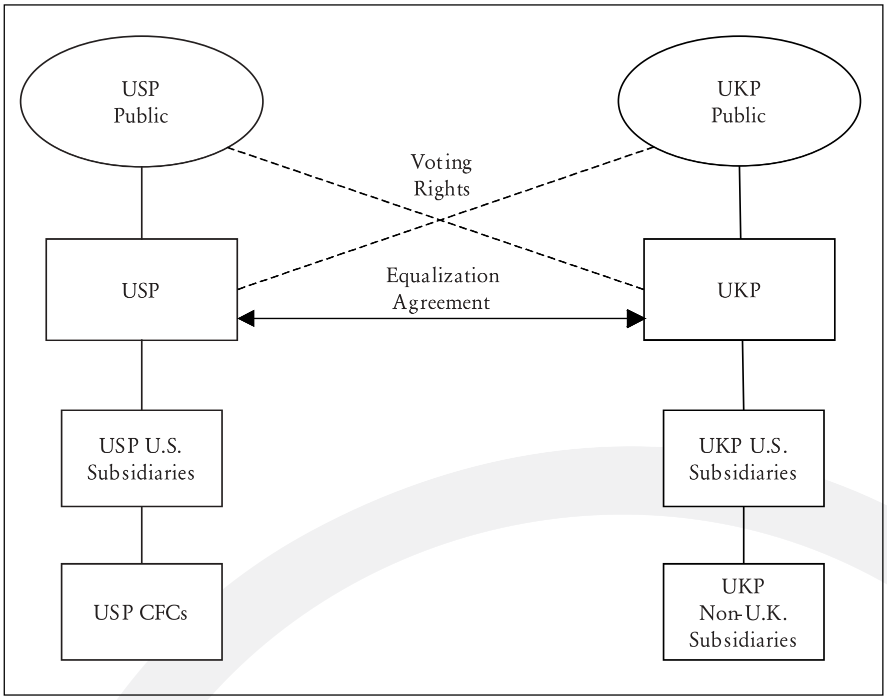
The main tax benefit of the structure was to enable both former SK shareholders and former Beecham shareholders to receive dividends in the same form as before the merger. In addition, dividends paid to the former SK shareholders need not have been first paid from SK to UK Newco (and subject to U.S. withholding tax under the law in effect at that time). Moreover, U.S. corporate shareholders could avail themselves of the dividends received deduction (DRD). The structure also provided UK Newco with significant U.K. tax savings. If UK Newco had simply issued ordinary dividend paying shares to the former SK shareholders, this would have caused a significant surplus advance corporation tax (ACT) problem.[46]

There were two main U.S. tax issues with respect to the structure. First, whether the IRS could have argued that the SK shareholders really received stock of UK Newco, rather than a stapled unit of SK preferred (access) shares and Class B Ordinary shares, given their economic equivalence to the Class A Ordinary Shares. Second, whether Code Sec. 269B, discussed below, applied to the structure.

If SK shareholders were deemed to be shareholders of UK Newco, the dividends paid on the SK Preferred shares would be considered to be dividends from UK Newco, such that the dividends would not be considered to be paid by a U.S. corporation and, therefore, would not qualify for the DRD. In addition, since the amounts that were in fact paid by SK would be considered to be distributed by UK Newco, the distributed amounts would be considered to be distributed by SK to UK Newco and would have been subject to U.S. withholding tax.

Although the stapled shares were intended to be viewed by investors as having parity with the Class A Ordinary shares, there were a number of differences, which, for tax purposes, would make it difficult for the IRS to argue that a holder of the stapled stock was really a holder of the Class A Ordinary shares. For example, (1) The SK Preferred

DIAGRAM 8



shares had substantial dividend preferences, liquidation preferences, and voting rights in the issuer (SK), and (2) there did not appear to be a keepwell or other contractual obligation on the part of the parent (UK Newco) to provide support to the issuer/ subsidiary (SK) for purposes permitting the issuer to make dividend and liquidation distributions equivalent to those of the parent. As a result, the SK Preferred shareholders would in certain circumstances be in a better position than the Class A Ordinary shareholders. These provisions avoided equivalency between the SK Preferred shares and the UK Newco Class A Ordinary shares and, therefore, would make it difficult to argue that the SK Preferred was not really stock in SK.

The second potential U.S. tax issue involves the potential application of Code Sec. 269B, which may apply if stock in a foreign corporation is stapled to stock in a U.S. corporation. If Code Sec. 269B applies, then the foreign corporation that is stapled to a U.S. corporation will be considered to be a U.S. corporation for U.S. tax purposes. Quite obviously, Code Sec. 269B is punitive and must be avoided. The stapling rules do not apply if either (1) 50 percent or less in value of the beneficial interests in *either* entity is stapled, or (2) 50 percent or more of *both* the domestic and foreign entities are owned by foreign persons (they are "foreign controlled").

The stapling rules can be avoided in dividend access share arrangements if less than 50 percent of the shares in the parent are stapled to subsidiary preference stock. For example, in the SmithKline Beecham transaction, since the parent shares that were stapled (*e.g.*, the UK Newco Class B Ordinary shares) were less in number than the unstapled parent shares (*e.g.*, the UK Newco Class A Ordinary shares) and had inferior dividend rights, the stapled parent shares necessarily represented less than 50 percent of the value of the parent, and the first exception to the stapling rules applied.

So, why did the company terminate the access share arrangement in 1996? The stated reasons were:

- difference in share valuation;[47]
- financing complexities for future investment opportunities;
- administrative burdens;
- ineligibility of the stapled units for automatic inclusion in the relevant U.K. stock indices; and
- the introduction of the FID legislation in the Finance Act of 1994.

VI. Dual Holding Companies—Virtual Mergers

If the goal of a cross-border combination is tax and market efficiency (including significantly reducing flowback), a virtual merger may be the answer.[48] As noted above, a cross-border business combination is referred to as a virtual merger when (1) the companies remain as separately traded companies because there is no shareholder-level exchange; (2) the shares in each company reflect the combined economics of the two companies; and (3) the operations of the two companies are managed through a common governance structure. With the elimination of the pooling method of accounting, and with U.S.-shareholder acceptance of the announced virtual merger between Princess (U.K.) and Royal Caribbean (a U.S.-traded foreign company), the principal considerations regarding a DLC structure involving a U.S. and a non-U.S. company may be the U.S. tax rules. Two DLC structures are discussed below.

A. DLC Structure I: Virtual Merger Through Equalization and Cross-Voting Arrangements

In this structure (*see* Diagram 8), the two companies remain separate but are bound together through (1) an equalization agreement that provides that the companies will make identical distributions (both dividends and liquidating distributions), perhaps equalized on an after-tax basis, and that each will guarantee the other's payment of equalized distributions via a support payment if the other is unable to pay; and (2) cross-voting arrangements (typically voting trust arrangements) under which the shareholder group of each public company casts votes in the other public company pursuant to voting shares issued in such other public company for this purpose, thereby assuring that there will be a common board for the two public companies and common governance of the two companies. This type of arrangement has been utilized by Unilever NV/Unilever plc and Rio Tinto (formerly RTZ (UK) and CRA (Australia)).

The viability and tax efficiency of this structure hinges on two major issues. First, whether Code Sec. 269B applies to treat UKP as a domestic corporation. If Code Sec. 269B applies, the structure is likely not viable and should not be implemented.[49] Second, assuming that the parties can get comfortable that Code Sec. 269B would not apply to the structure, the level of tax efficiency depends, in part, on whether the arrangement is treated as a partnership for U.S. tax purposes. For U.K. tax purposes, the form of the transaction should be respected so that there is no deemed partnership issue. Also, thankfully, the U.K. has no equivalent of Code Sec. 269B to treat USP as a U.K. company.[50]

Code Sec. 269B. As noted above, the viability of DLC Structure I, the equalization structure, likely hinges on the application of Code Sec. 269B. If applicable, such section would treat UKP as a U.S. corporation, subject to U.S. tax on its worldwide income. Before considering the potential application of Code Sec. 269B to this structure, it is useful to understand why Code Sec. 269B was enacted in 1984. Prior to the enactment of Code Sec. 269B, U.S. multinationals could potentially avoid the anti-deferral regime (principally subpart F) by stapling shares of a CFC to the U.S. parent, and distributing the shares of the CFC to the public. If successful, the CFC would lose its CFC status (and the subpart F rules would thus be avoided) because the foreign corporation would no longer be controlled by "United States shareholders" (*i.e.*, U.S. persons owning at least 10 percent of the vote of the foreign corporation).[51] Congress was concerned that a U.S. multinational could avoid U.S. corporate tax on its foreign source income (either through subpart F income or actual distributions from a foreign subsidiary to its U.S. parent) while maintaining practical managerial control over the spun-off entity via the stapling arrangement.[52] The remedy (or penalty) was to treat the stapled foreign company as a U.S. corporation if the foreign company and the U.S. company are stapled entities.[53]

As a technical matter, would USP and UKP be treated as "stapled entities," such that UKP would be treated as a domestic corporation? Code Sec. 269B(a)(1) applies only if a domestic corporation and a foreign corporation are "stapled entities." The term "stapled entities" means any group of two or more entities if more than 50 percent in value of the beneficial ownership in each of such entities consists of "stapled interests." Two or more interests are concidered "stapled interests" if by reason of form of ownership restrictions on transfer, or other terms or conditions, in connection with the transfer of one of such interests the other of such interests are also transferred or required to be transferred.[54] Thus, as stated earlier, Code Sec. 269B does not apply if either (1) 50 percent or less in value of the beneficial interests in *either* entity is stapled, or (2) 50 percent or more of *both* the domestic and foreign entities are owned by foreign persons (they are "foreign controlled").

The two aspects of DLC Structure I that are unique, of course, are the (1) equalization agreement and (2) the voting trust. The USP shareholders have no rights in UKP as a result of the equalization agreement. Thus, the equalization agreement should not cause a Code Sec. 269B problem. However, through the voting trust arrangement, USP shareholders have voting rights in UKP (and vice versa). The voting rights in each company are stapled to the stock of the other company. An initial question is whether a voting interest with no economics is an "interest" that, if stapled to more than 50 percent in value of the beneficial interests in the other company, is a "stapled interest" subject to Code Sec. 269B. A second question is whether, in order to be "stapled entities," more than 50 percent in value of the beneficial interests of the two corporations must be stapled to each other—which is not the case in DLC Structure I. It would seem that an "interest" in a corporation would not include a voting right that is devoid of economics because the definition of "stapled entities" contemplates the stapling of "beneficial interests." Even if that were not the case, or even if a voting right had some economics, it would seem that more than 50 percent of the beneficial interests of the two corporations would have to be stapled to each other—again because that is contemplated by the definition of "stapled entities."

Assume that 100 percent of class A common in USP representing 75 percent of the value of USP were stapled to class B common stock in UKP representing 25 percent of UKP's value, and that 100 percent of Class A stock in UKP representing 75 percent of the value of UKP were stapled to Class B common stock of USP representing 25 percent of USP's value. In such case, the IRS might argue that more than 50 percent of the value of the beneficial ownership of each of USP and UKP are stapled interests and that, therefore, USP and UKP are "stapled entities," even though the more than 50 percent interests in each of USP and UKP are not stapled to the more than 50 percent interests in the other. The definition of "stapled interest" does not itself contain a numerical threshold for what constitutes a "stapled interest." On the other hand, the focus on beneficial interests in the definition of "stapled entities" suggests that Code Sec. 269B is directed toward situations in which common shareholders of USP and UKP own more than 50 percent of the beneficial value of both companies. At a minimum, the focus on beneficial ownership in the definition of "stapled entities" suggests that a voting interest with no economic rights should not be considered an interest that can be stapled for purposes of Code Sec. 269B.

Code Sec. 269B was enacted to combat a particular abuse that is not present in the case of a stapled voting interest. It was clearly addressed toward situations in which a common group of shareholders, through the stapling arrangement, owned more than 50 percent of the value of both companies. Thus, a stapling arrangement in which the shareholders of one company have no economic interest in the other company is certainly not a situation that was intended to be addressed by Code Sec. 269B. Nevertheless, given the draconian results if Code Sec. 269B were to apply, and the likelihood that there will be no IRS guidance on the subject in the near term (either public guidance or private letter rulings), clients must independently get comfortable on the issue.[55]

Deemed Partnership. Arguments have been made to either support or dispute the notion that DLC Structure I creates a partnership for U.S. tax purposes. If a partnership exists, one would think that it would have to exist between USP and UKP, and not among their thousands of shareholders, because the parties to the equalization arrangement, which is what gives rise to possible partnership characterization, are the public companies, not their shareholders. If there is no partnership, the U.S. tax advisor has an easy job (much like it is for tax advisors in every country other than the United States). If the form of DLC Structure I is respected, dividends from USP's subsidiaries are respected as 100 percent paid to USP, and dividends paid from UKP's subsidiaries are respected as 100 percent paid to UKP. If there is a deemed partnership between USP and UKP for U.S. tax purposes, each public company would been deemed to have an interest in all of the combined assets of the companies, with the result that income received by either company is treated, for U.S. tax but not U.K. tax purposes, as shared by USP and UKP in accordance with their deemed ownership interests.

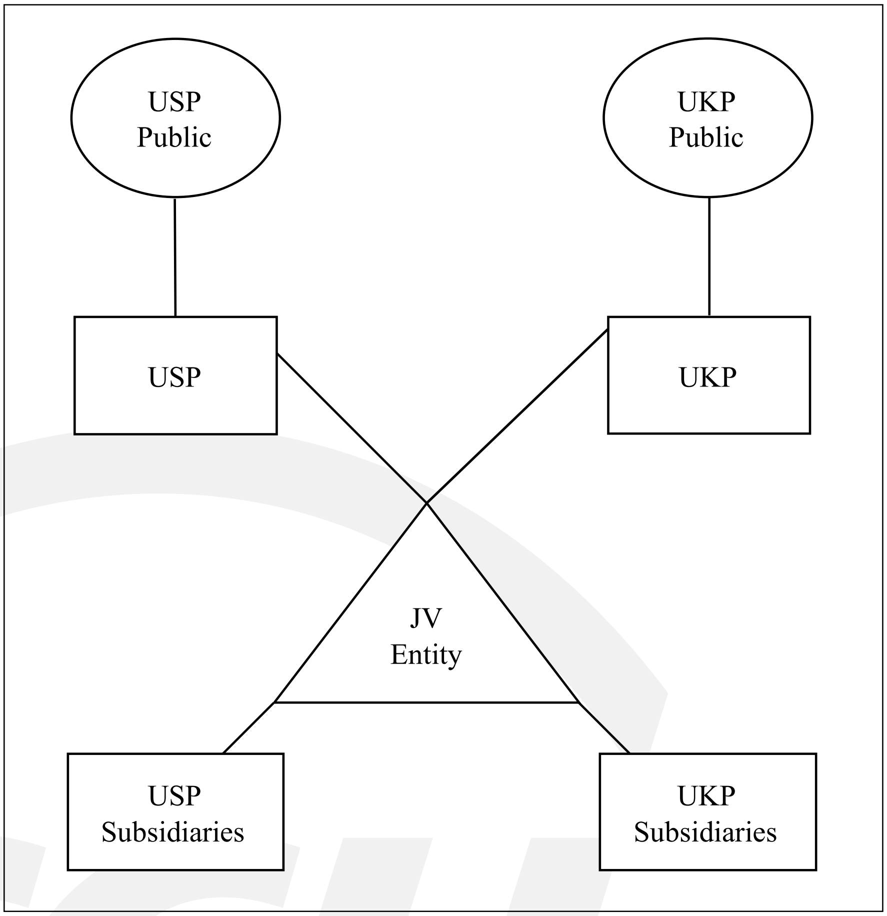
There are two possible courses of action. One is to weigh the competing authorities, determine that the better argument is that a partnership does not exist, and proceed as if there is no partnership. The risk, of course, is that the parties will not have planned for the arrangement to be treated as a partnership, and that the IRS will successfully assert that a partnership exists between USP and UKP. The other course of action, which is certainly more complex from a tax planning perspective but should provide relative certainty, is for USP to simply take the position that the DLC arrangement constitutes a partnership, and proceed on that basis. The balance of this discussion explores briefly the results if the client affirmatively treats DLC Structure I as a partnership for U.S. tax purposes. In that event, DLC Structure I largely resembles DLC Structure II to the extent that, as described below, the economics of the latter structure are achieved by contract.

When USP and UKP enter into the virtual merger, both parties will be deemed to have transferred all of their assets to a partnership. For U.S. tax purposes, the formation of the structure should be treated as a tax-free contribution of assets (*i.e.*, the stock in operating subsidiaries) to a partnership.[56] Since the repeal of Code Sec. 1491 in 1997, the result is the same (*i.e.*, tax-free), regardless of whether the partnership is domestic or foreign.[57] Separately, because there is no transfer for U.K. tax purposes, there would be no U.K. tax or stamp tax resulting from the arrangement.

The manner in which the income of the deemed (or contractual) partnership is taxed is somewhat more complicated. USP and UKP would have to carefully examine their particular circumstances to determine the best way to operate the "partnership." The income of the partnership will be allocated to USP and UKP based upon their "agreed" profit percentages (*i.e.*, the profit percentages contained in the equalization agreement).[58] Thus, for example, a $100 dividend paid by a U.S. subsidiary (USSub) to USP would not be treated as received solely by USP, and would thus not qualify for the 100 percent DRD. Instead, it would be treated as if $50 was paid to USP and $50 was paid to UKP (assuming a 50-50 equalization agreement). The $50 deemed paid from USSub to USP would not qualify for the 100 percent DRD, but would instead qualify for an 80 percent DRD because USP is deemed to own 50 percent of the stock of USSub (effectively a seven-percent tax rate on those dividends, or 20 percent of a 35-percent tax rate). The $50 deemed paid to UKP would be subject to U.S. withholding tax.[59] Conversely, dividends paid from UKP's subsidiaries to UKP are treated as paid, in part, to USP, thus impacting USP's foreign tax credit position.

One way to remedy the DRD issue with respect to domestic subsidiaries of USP would be to convert the subsidiaries to LLCs under state law, and elect to treat

DIAGRAM 9



the LLCs as disregarded entities (*i.e.* branches) under the U.S. check-the-box rules.[60] This would eliminate leakage to USP, but the impact on UKP would need to be considered. For example, UKP would be deemed to have a permanent establishment and be engaged in a U.S. business as a result of being a partner in a partnership that conducts a U.S. business.[61] The parties would weigh retaining U.S. subsidiaries as corporations (and the attendant leakage on dividends) with converting the subsidiaries to LLC branches (and issues such as "effectively connected" income and Code Sec. 1446 withholding).

If the parties terminate the arrangement after seven years, such termination should be accomplished on a tax-free basis to both parties. Under Code Sec. 731, a partner recognizes gain only if the amount of cash and marketable securities received exceeds such partner's basis in the partnership. Distributions of other types of property trigger tax only if they run afoul of the "mixing bowl" provisions (*i.e.*, certain distributions made within seven years of the formation of the partnership if the partners do not receive back the property that they were deemed to contribute to the partnership).[62] However, UKP, as a foreign person, may not be taxable under the mixing bowl provisions or Code Sec. 704(c)(1)(A) with respect to partnership sales or distributions of assets if those assets that are not connected with a U.S. trade or business.[63]

B. DLC Structure II: Virtual Merger Through Actual or "Virtual" Joint Ownership of Operating Subgroups

DLC Structure II involves a structure in which each holding company owns an interest in one joint venture (JV) company (*see* Diagram 9). The combination of the two public companies is virtual, because USP and UKP each remain a separate company with a separate group of shareholders. The economics of the combined enterprise are shared through the interest of each public company in the JV company. A variation of this approach would be to have USP and UKP have ownership interests in a number of different JV operating companies (opcos).

In DLC Structure II, there is an actual JV entity. As a result, U.K. tax consequences, as well as U.S. tax consequences, need to be closely considered. For example, the parties may seek to use a U.K. partnership as the JV entity. If so, the parties should confirm that the transfer of assets to the JV is tax-free for U.K. purposes (as it generally is for U.S. tax purposes).[64] If the transfer of assets to a U.K. partnership raises U.K. tax issues, the parties may consider a hybrid entity (treated as a corporation for U.K. tax purposes and a partnership for U.S. tax purposes).[65] One potential disadvantage with this structure *vis-à-vis* DLC Structure I is that the U.K. stamp tax may apply in this alternative. If there is a U.K. tax or stamp tax issue with respect to certain assets, however, UKP may simply retain legal ownership of those assets, but hold, operate and dispose of those assets for the benefit of both partners.[66]

Unlike DLC Structure I, there is no need for a common Board of Directors. Instead, each public company will have a specified number of directors or the JV entity (or multiple JV entities) and all operating subsidiaries will be subject to common management—*i.e.*, the board and management of the JV entity. The joint interests in opcos that are the fundamental aspect of DLC Structure I could be achieved by contractual arrangements that would be viewed as contractual partnerships for U.S. tax purposes, in lieu of a JV entity. In such case, USP and UKP each would retain legal ownership of 100 percent of specific operating companies (*e.g.*, USP retains legal ownership of all U.S. opcos). The joint interests also would appropriately be viewed as virtual.

Common governance could be achieved through the establishment of a common management or operating committee to oversee all of the jointly owned opcos, with each public company appointing half (or its specified percentage) of the members of the committee. DLC Structure II largely resembles DLC Structure I if the partnership arrangement in the former structure is achieved by contract. If it is not a 50-50 deal, then the governance issues may be more complex and may push parties to the goverance features of DLC structure I.

As in DLC Structure I, the shareholders remain shareholders of their respective public companies. Thus, the structure avoids withholding tax on dividends to nonresident shareholders and, where applicable, may avoid the loss of imputation benefits on dividends paid to those same shareholders. Although this DLC structure, similar to ones utilized by Royal Dutch/Shell, Reed/Elsevier and others, may achieve better tax efficiency *vis-à-vis* a single-parent structure, some tax inefficiency still exists because, absent additional features, USP will be taxed on some portion of the U.K. opco's earnings, and UKP will be taxed on some portion of the U.S. opco's earnings. The Royal Dutch/Shell structure involved preferential distributions of Netherlands Opco earnings to the Netherlands public holding company and of U.K. Opco earnings to the UK public holding company. Such a distribution preference would be unlikely to be respected for U.S. tax purposes absent the use of the dividend access shares, which give each holding company real preferences in its respective same country opco.[67]

The U.S. tax consequences will differ depending upon the percentages owned by USP and UKP. As discussed above with respect to DLC Structure I, in the case of 50-50 joint ownership of each Opco subgroup, for example, there would be some tax leakage on dividends paid from US Opco to USP, because USP would not own 80 percent of the vote and value of US Opco. Thus, USP and US Opco would not be eligible to file a consolidated return, and USP would receive only an 80-percent DRD on dividends from US Opco. Distributions from U.S. Opco to UKP generally would be subject to U.S. withholding tax even under the new U.S.-UK Treaty, because the exemption from U.S. withholding tax applies only to a dividend paid by a U.S. company to an 80-percent U.K. shareholder. If U.S. Opco is not a corporation for U.S. tax purposes, there would be no tax leakage on the distribution of the entity's profits (*i.e.*, effectively a 100-percent DRD) to USP. Also, if U.S. Opco is not a corporation for U.S. purposes, UKP might want choose to hold its interest in the JV entity invest through a U.S. subsidiary so that UKP would avoid having a permanent establishment for U.S. tax purposes and being subject to U.S. corporate tax, and potential withholding tax under Code Sec. 1446.[68]

DLC Structure II involves a juridical JV entity (or a contractual partnership that is acknowledged as such), so there is no "deemed partnership" issue as there is in DLC Structure I. The structure also avoids the risk that UKP should be treated as a domestic corporation under Code Sec. 269B. Through either actual joint ownership of the operating subgroups or an acknowledged contractual partnership pursuant to which the public companies have joint interests in the stock of the operating subgroups, there is nothing left to deem—the joint interests are acknowledged. Further, because joint governance is established by the public holding companies with respect to the operating subgroups by the establishment of a common operating committee for the operating subgroups, there is no reason for the public companies to have common boards and, therefore, no need for stapled interests to achieve common boards. Finally, this structure would address the flowback problem as well as DLC Structure I.

For U.K. tax purposes, there will be no CGT, stamp duty or SDRT implications for UK shareholders as they will continue to hold their existing shares in UKP. Similarly, U.K. shareholders will continue to receive dividends on their shares in UKP and will be treated as before. The structuring of any lower tier reorganization of U.K. activities will have to be considered from both U.S. and U.K. tax perspectives. The transfer of assets or shares held by a UK company or shares in a UK company potentially involves CGT/Stamp Duty/SDRT charges.

VII. Conclusion

If a U.S. and a U.K. company, USP and UKP, seek to combine, there are many ways to do so, and the most advantageous method obviously depends upon the particular facts. If the companies can get comfortable with the flowback issue and opt for a more conventional single parent structure, having USP as the parent company is perhaps less efficient for a number of reasons: (1) dividends paid by UKP will likely be subject to incremental U.S. tax, (2) USP will increase its exposure to the subpart F regime, (3) dividends paid by USP to U.K. shareholders will be subject to U.S. withholding tax (even under the new treaty) and (4) U.K. shareholders will lose imputation benefits. Having UKP as the parent is somewhat more tax efficient because there would be no U.S. withholding tax on dividends from USP to UKP when the new treaty is in effect, and there is no U.K. withholding tax on dividends paid to USP's former U.S. shareholders. There is still some inefficiency because USP's former shareholders that are corporations would not qualify for the DRD. Finally, having a third-country company (Holdco) as the single parent may have some future use in terms of generating low taxed earnings that are neither subject to U.S. or U.K. taxation. Earnings from U.S. subsidiaries would not be repatriated as dividends because of the U.S. 30-percent withholding tax. Dividends from UKP to Holdco would not be subject to U.K. withholding tax, but U.K. shareholders lose their imputation benefits, at least in the case of a 50-50 deal. Access shares could ameliorate these inefficiencies.

Intermediate structures may have some utility from a tax standpoint, but at least in the context of a cross-border U.S.-U.K. transaction, there may be market impediments that may favor a DLC structure. The access share structure was used in SmithKline Beecham with a U.K. acquiror and a U.S. target, but that structure was terminated in 1996, largely for market and business reasons. Moreover, when the new treaty is in effect, there would be less impetus to use such a structure because dividends from a U.S. target to a U.K. parent will no longer be subject to U.S. withholding tax (and U.K. ACT, a factor in implementing the structure, has been repealed). In other words, although the structure may still provide some tax efficiency (*e.g.*, preserving the DRD to U.S. corporate shareholders of the U.S. target), the market and business difficulties may outweigh any tax benefit.

Finally, a virtual merger, which is potentially a very important alternative where flowback is an issue. DLC Structure I (*e.g.*, Unilever), which uses equalization agreements and voting trusts, has the potential for pure tax efficiency if it is respected. However, it may be advisable to forfeit some tax efficiency for tax certainty (and complexity) by treating the structure as a partnership, in which case DLC Structure I largely resembles DLC Structure II where, in the later structure, contractual JVs are used in lieu of JV entities. The companies and their counsel need to get comfortable that there is no significant Code Sec. 269B risk that UKP will be treated as a domestic corporation under DLC Structure I. Alternatively, DLC Structure II (*e.g.*, Royal Dutch/Shell), can use one JV company or a series of JV companies holding various opcos or equivalent contractual arrangements. Using preference distributions or having each company holding access shares directly in various opcos may permit the parties to customize their sharing of profits and losses to achieve greater tax efficiency. Common governance is achieved (or largely achieved) through the management of the JV. If the deal is not a 50-50 deal, then the parties may prefer the governance features in DLC Structure I. Both DLC structures offer increased tax efficiency and a solution to the very real problem of flowback, which may determine whether a deal gets done at all, and if so, whether it is viewed as a success or failure.

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* This article is dedicated to the "quiet Beatle." He demonstrated that one may be talented, prosperous and spiritual, but still complain about the Taxman. *See*, George Harrison, *Taxman*, REVOLVER, Track 1 (U.S. version 1966).

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1 Although a pioneer in many areas, the United States has lagged behind Europe with respect to DLC structures and high-speed trains. The first known DLC structure, between Royal Dutch (Netherlands) and Shell (U.K.), has existed since 1907.

2 At the time this article was being completed, the status of the combination between Royal Caribbean and Princess was in doubt because of a competing offer for Princess by Carnival (Panama). *See* Soma Biswas, *P&O Princess Cruises Postpones Vote*, *www.thedeal.com*, Dec. 19, 2001.

3 To avoid tax on foreign source income, many U.S. multinationals keep such income offshore in controlled foreign corporations (CFCs), with no plans to repatriate the income. For example, Pfizer, Inc., reported unremitted foreign earnings of $14 billion, while Johnson & Johnson said the amount it considers permanently invested overseas totaled $9.5 billion last year. A proposal by Sen. Torricelli, which has not become part of any legislation, would exempt from tax 85 percent of dividends distributed by foreign affiliates during a fixed window of time. *See* Donmoyer, *Microsoft, P&G Seek U.S. Tax Break for Global Profits*, BLOOMBERG, Nov. 9, 2001.

4 The DLC was essentially a merger of equals, with no premium. Following the announcement of the transaction, Royal Caribbean's share price rose by 7.3 percent and Princess's share price rose by 16.7 percent.

5 In addition, in the DT transaction, large lock-ups further exacerbated the flowback problem.

6 Interestingly, Daimler Chrysler has traded as a "global share" since 1998 in the United States, Germany, Japan and other countries. Unlike ADRs and ADSs, which are indirect holdings in foreign companies and do not always possess the same rights as ordinary shares, a global share is the same in every country, distinguished only by currency. To date, global shares have rarely been used. *See* Karmin, *What in the World? Global Shares May Leave Obscurity*, WALL ST. J., Aug. 20, 2001, at C1.

7 By contrast, the estimated flowback in Daimler Chrysler was roughly $36 billion out of a combined market capitalization of $101 billion pre-announcement, but including the premium to Chrysler's shareholders, or $100 billion market capitalization six months after closing.

8 One reason, reportedly, was that it would make the company a more attractive merger candidate. *See Carreyrou, Fortis Will Merge Stock Listings By Late 2001 in Move to Simplify Listings,* WALL ST. J., Aug. 29, 2001, at A23.

9 The partial imputation works by giving U.K. individuals a nonrefundable tax credit equal to one-ninth of the dividend and then subjecting the aggregate of the dividend and the tax credit to special rates of tax (referred to as the Schedule F ordinary rate, 10 percent—for those with income up to £29,400). This results in no further tax to pay for lower and basic rate taxpayers. The incremental tax for higher rate taxpayers is 25 percent of the cash dividend.

10 Thus, if there is a dividend of 100 declared by USP, a U.K. Corporate that holds less than 10 percent of the shares in USP will suffer a 15-percent withholding tax, and so will receive a cash payment of 85. It will include 100 in its taxable profits (giving a pre-credit tax of 30) and will have a tax credit of 15, thus leaving 15 of tax to pay. If a U.K. corporate has 10 percent or more of the voting power in a foreign (that is non-U.K.) company, it is entitled to an underlying tax credit.

11 "Disposal" is defined very widely and includes part-disposals and the receipt of a capital sum in relation to an asset in addition to actual sales or transfers. If it were not for the share-for-share exchange relief (described below), U.K. shareholders would be subject to CGT on the difference between their basis in the UKP shares and the value of the consideration received by them. U.K. individuals are entitled to "taper relief" whereby the amount of the gain reduces by five percent for each whole year that the UK individual has held the shares from the third whole year up to the tenth whole year. Thus, if the shares have been held for 35 months and 29 days, 100 percent of the gain is taxable. If the shares have been held for three whole years, 95 percent is taxable, and if they have been held for 10 whole years or more, 60 percent is taxable. The rate and extent of taper relief is greater where the asset in question is a so-called "business asset," but a holding in UKP will not be a business asset.

12 The share-for-share exchange rules apply to a U.K. taxpayer where one company (Company A) issues shares or debentures to the U.K. taxpayer who holds shares in a company (Company B) in exchange for shares in Company B, and Company A holds, or as a result of the exchange will hold, one-quarter or more of the ordinary shares (common stock) in Company B, or Company A will, as a result of the exchange, control Company B. When the rules apply, the U.K. taxpayer is treated as having acquired the Company A shares at the same time and for the same cost as they in fact acquired the Company B shares. The share-for-share exchange rules do not apply to U.K. taxpayers who hold more than five

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percent of Company B unless the exchange is effected for *bona fide* commercial reasons and does not form part of a scheme or arrangement the main purpose or one of the main purposes of which is to avoid capital gains tax or corporation tax. There is an advance clearance procedure on this motive test and clearance is sought on the vast majority of transactions. There is some debate as to whether "corporation tax" in the motive test is limited to corporation tax on chargeable gains or extends also to corporation tax on income. In addition, the government has published draft legislation, which will apply to treat certain disposals of substantial shareholdings by corporates on or after Apr. 1, 2002, as exempt from CGT.

13 It is possible to avoid the SDRT charge by effecting the take-over by way of a court-sanctioned scheme of arrangement under which existing UKP shares are cancelled and new shares issued to USP which will, in consideration, issue shares to UKP shareholders. However, the problem with a court-sanctioned scheme is that shareholders are unlikely to obtain share-for-share exchange relief for CGT purposes. The relief only applies where one company issues shares in exchange for shares in another company. It is generally thought (and importantly, it is understood that the Inland Revenue thinks) that a cancellation and issue does not involve the required exchange. Accordingly, the court-sanctioned scheme would only be used where there otherwise would be no CGT issue for the majority of UKP shareholders.

14 An asset acquisition of a U.K. company is uncommon.

15 If the UKP shares are not in ADR form, USP should be liable for SDRT at the rate of 0.5 percent of the value of the USP shares given in the exchange.

16 For example, a stock-for-stock reorganization that fails to qualify as a "B" reorganization because of boot, and fails to qualify as tax-free under other nonrecognition provisions.

17 However, the effect of obtaining a fair market value basis in UKP stock on the allocation of interest expense of the acquiring U.S. group must be considered. Obtaining full basis in UKP may increase the allocation of interest expense to foreign-source income and reduce USP's foreign tax credit. *See* Temporary Reg. §1.861-9T.

18 The U.K. is one of the more liberal taxing jurisdictions in terms of permitting U.K. shareholders to exchange U.K. stock for non-U.K. stock on a tax-free basis. Certain countries, such as Canada, do not permit tax-free exchanges of resident for nonresident shares. The United States takes a middle-ground approach, permitting tax-free exchanges of U.S. for non-U.S. stock in certain instances.

19 When the new U.S.-U.K. treaty is in effect, U.S. withholding generally will be at the rate of 15 percent. However, if the U.K. shareholder owns at least 10 percent of the U.S. stock but less than 80 percent, the rate will be five percent. U.S. withholding is eliminated if the U.K. shareholder owns at least 80 percent of the stock of the U.S. company.

20 Even if the U.S. tax rate were no higher than the U.K. rate, incremental U.S. tax still could be due as a result of the expense allocation rules (particularly interest expense allocation) under Code Sec. 864(e).

21 Other transactions that are more common in stock acquisitions between two U.S. companies (*e.g.*, a reverse merger) are not possible under U.K. law. In a reverse merger, a subsidiary (typically, a transitory company) of the acquiror is merged into the target, and the target shareholders receive stock in the acquiror in exchange for target stock. The transaction may contain a boot component to the target shareholders, and yet qualify as tax-free under Code Sec. 368(a)(2)(E) as long as sufficient voting stock was given for control of the target. (It also may qualify as tax-free under other provisions of the Code.) A direct acquisition of stock is the simpler approach in the context of a controlling shareholder exchanging stock in a controlled corporation. In the context of an acquisition of a target that has public shareholders, an acquisition of stock in public tender may be more cumbersome than a reverse merger.

22 Even if the foreign acquiror is larger than the U.S. target, taxpayers must be careful to navigate a broad anti-stuffing rule that reduces the value of the foreign acquiror by certain assets acquired by such company in the 36 months preceding the acquisition. Reg. §1.367(a)-3(c)(3)(iii)(B)(1)(i).

23 Any U.S. shareholder of USP that owns at least five percent of the vote or value of UKP stock after the exchange must enter into a "gain recognition agreement" (GRA) to preserve tax-free treatment. Reg. §1.367(a)-8. Under the GRA, the five-percent shareholder's deferred gain will be triggered if UKP sells USP in the five years after the acquisition.

24 The cost to U.S. shareholders is the same regardless of whether a single U.S. company expatriates (*e.g.*, *via* the formation of a new foreign holding company, such as the Fruit of the Loom transaction), or the stock of a larger U.S. company is acquired by a smaller foreign company in a cross-border business combination (such as the Tyco-ADT transaction).

25 There is at least one exception to the IRS position on substantiality. If the foreign acquiror historically has been larger than the U.S. company prior to the date the deal is announced, but the U.S. company becomes the larger company because the foreign acquiror pays a premium to effect the acquisition, the IRS may rule favorably as to the substantiality test. See LTR 199929039 (Apr. 12, 1999). The transaction also must satisfy the "50-percent test" of Reg. §1.367(a)-3(c)(1)(i) to be tax-free (*i.e.*, the U.S. target company's U.S. shareholders may not receive more than 50 percent of the foreign acquiror's stock). Thus, where a premium makes the U.S. target the larger company, the acquiror must use a combination of boot and no more than 50 percent of its stock to satisfy this requirement.

26 Such "shrinkage" strategy may also be useful under Code Sec. 355(e). *See* D. Kevin Dolan and Philip Tretiak, *Cross-Border Business Combinations—Thinking About Spin-Offs, Globally*, J. TAX'N GLOBAL TRANSACTIONS, Fall 2001, at 5. However, a distribution by a U.S. target ordinarily would be taxable to its shareholders, and any pre-transaction distribution by the target company might also affect the tax-free nature of the transaction (*e.g.*, the "substantially all" requirement applicable to certain types of tax-free reorganizations).

27 The UK FTC rules generally will only take into account tax paid by a non-U.K. company on the profits out of which a dividend is paid, to a U.K. company, or through a chain of foreign companies and ultimately to a U.K. company up to the applicable U.K. corporation tax rate (currently 30 percent). Thus, even though USP is treated, for UK tax purposes, as having suffered 35-percent U.S. tax on the profits out of which it pays a dividend to UKP, UKP will only be able to obtain credit for 30-percent tax. However, the FTC rules contain an "on-shore pooling" system which will apply with the result that the tax paid by USP in excess of 30 percent but below 45 percent constitutes eligible underlying foreign tax (EUFT) which can be utilized by UKP offsetting it against certain other foreign dividends received by UKP which carry less than a 30-percent tax credit. The way in which these on-shore pooling rules work means that if USP has foreign (non-U.S.) subsidiaries, it may be necessary to consider a post-acquisition reorganization to avoid wasted FTCs.

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[28] Even if permitted by foreign law, the IRS view is that a "merger" between a U.S. company and a non-U.S. company does not qualify as an "A" reorganization (which has more liberal requirements than a "C" reorganization). Recently proposed regulations under Code Sec. 368 permit the merger of a U.S. company into an LLC to qualify as an "A" reorganization, but reserve on whether such transaction may qualify as an "A" reorganization if the LLC is owned by a foreign parent. *See* Preamble to REG-126485-01, Statutory Mergers and Consolidations, 66 FR 57400 (Nov. 15, 2001).

[29] Subject to the technical requirements generally applicable to reorganizations, if boot is received by USP, then the voting stock of UKP must constitute at least 80 percent of the total consideration given UKP in exchange for USP's assets (*i.e.*, boot may not exceed 20 percent of the total consideration given for the target's assets). For this purpose, any liabilities of USP that are assumed by UKP are treated as boot. As a result, if USP's shareholders receive any consideration other than UKP voting stock, then because of the treatment of assumed liabilities, it may be difficult for the transaction to qualify as a Code Sec. 368(a)(1)(C) reorganization.

[30] Code Secs. 367(a)(1) and (a)(5).

[31] See Reg. §1.367(a)-3(a).

[32] The "Transocean" structure refers to a transaction effected by Transocean Offshore, Inc., in 1999. *See* Prospectus/Proxy Statement (dated Apr. 12, 1999).

[33] Reg. §1.367(a)-3(d)(2)(vi).

[34] Reg. §1.367(a)-3(d)(1)(v).

[35] It is not at all clear that the IRS would agree with this characterization.

[36] Code Sec. 1441.

[37] The foreign transferee must satisfy an active trade or business test. However, Holdco can satisfy the test *via* an active "qualified subsidiary" (*i.e.*, an 80-percent-owned foreign subsidiary) such as UKP. *See* Reg. §1.367(a)-3(c)(3)(i)(A).

[38] Dividend access shares, discussed below, could make the use of Holdco more tax efficient. To the extent that the U.S. public shareholders were to hold access shares in USP, then the need for distributions by USP to Holdco would be reduced, thereby avoiding U.S. withholding tax. Furthermore, U.S. corporate shareholders would qualify for a dividends-received deduction on distributions from USP. To the extent that the U.K. public shareholders were to hold access shares in UKP, the U.K. public shareholders would be entitled to U.K. imputation benefits that accompany distributions from a U.K. corporation—benefits they would otherwise lose by holding shares in (a non-U.K.) Holdco. Another option would be for a nontreaty parent to hold non-U.S. subsidiaries through an intermediate treaty country holding company, but to hold the U.S. subgroup directly and avoid making distributions.

[39] Another example of an acquisition using exchangeable shares is Microsoft's acquisition of SOFTIMAGE in 1994.

[40] The terms of the HBMS "special shares" were as follows:

Dividend rights: Dividends on the Canadian special shares were equivalent to dividends on U.S. common shares. IR agreed to provide sufficient funds to HBMS to ensure that dividends would be paid. IR was precluded from paying dividends unless HBMS could pay dividends.

Voting rights: The Canadian special shares had voting rights in IR equivalent to one common U.S. share; the special shares did not carry general voting rights in HBMS (although they did carry some special voting rights).

Exchange redemption/liquidation rights: The Canadian special shares were exchangeable into one share of IR common stock. On voluntary liquidation, the holders of special shares would receive one share of IR common stock or cash equivalent (at HBMS's option). HBMS could redeem the special shares for U.S. stock or cash equal to the trading value of IR common stock.

[41] Exchangeable shares, such as the HBMS shares, typically are publicly traded. However, if an exchangeable share is not publicly traded, the exchange right itself should provide liquidity to the holder.

[42] The Canadian target typically amends its articles of incorporation to authorize the issuance of the exchangeable shares. As in access share arrangements, target shareholders receive dividends in the home-country target and have voting rights in the parent. Under U.S. tax principles, the transaction should qualify as either an "E" recapitalization (if the exchangeable stock is respected as stock in the Canadian target) or stock-for-stock "B" reorganization (if the stock is treated as stock of the U.S. parent). *See also*, Code Sec. 351(g) ("nonqualified preferred stock"), although such section likely would not apply because the holder will have a significant participation in the growth of the company. Code Sec. 351(g)(3)(A).

[43] It likely would be difficult for a U.K. subsidiary to issue exchangeable stock and remain on an index in the U.K. Thus, flowback would be an issue.

[44] This transaction occurred before the Code Sec. 367(a) inversion regulations were promulgated, but presumably would qualify for tax-free treatment if it occurred today. Even if the transaction failed to satisfy one or more of the requirements of the inversion regulations (*e.g.*, because SmithKline was larger by value than Beecham), the gain to the former SK shareholders would be negligible (*i.e.*, the value of the voting right in U.K. Newco) assuming that the access shares were respected as stock in SmithKline, a U.S. company.

[45] The rights of the stapled shares were as follows:

Dividend rights: The SK preferred shares had a cumulative preference of $0.35 per share (about 25 percent of the anticipated dividend rate on UK Newco common shares) and the right to additional discretionary dividends as declared by the SK board. UK Newco did not have to pay dividends on ordinary shares, but if it did, it first had to declare and pay a make-up distribution on the Class A ordinary shares equal to amounts paid on the SK preferred shares before dividends were made *pro rata* on both the Class A and the Class B ordinary shares.

Voting rights: The SK preferred shareholders could elect one-sixth of the directors in SK. In addition, the SK preferred shareholders had one-fifth of a vote per share on mergers and certain other issues requiring shareholder approval. The Class B ordinary shares in UK Newco had normal voting rights.

Liquidation/redemption rights: The SK Preferred shares had a $2.25 liquidation preference (about 25 percent of anticipated liquidation value). The issuer had a redemption right after two years or at any time if there was a change in U.S. tax law. The Class A ordinary shares had a liquidation preference over the Class B ordinary shares equal to the liquidation preference on the SK preferred shares plus other amounts distributed on the preferred shares in excess of amounts previously distributed on the Class A ordinary shares.

[46] Until it was abolished in 1999, ACT was payable by a company on dividends paid by that company at the basic rate of income tax / (1 – the basic rate of income tax) of the cash dividend (thus where the basic rate was 30 percent, the ACT rate was 3/7). The company could then offset that ACT against its mainstream corporation tax liability up to a maximum of the basic rate of income tax applied to its profits (thus where the basic rate was 30 percent and the corporation tax rate was 40 percent, the maximum ACT which could be used against 100 of profit would be 30, leaving 10 tax to pay.) A company was said to have "surplus ACT" if the amount

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of ACT that a company paid exceeded its ability to use that ACT against its mainstream corporation tax liability. Typically, a company would have a surplus ACT problem where its accounting profit exceeded its taxable profits or where the company received overseas income on which overseas tax had been paid and sourced dividends to its shareholders from that overseas income. In the latter case, a company would have surplus ACT because the overseas tax paid by the company could be offset against the company's mainstream corporation tax liability in respect of its overseas income. This reduced the company's mainstream corporation tax liability against which ACT could be offset. If a company was in a surplus ACT position, then ACT, which was normally only a timing issue, would have a more serious impact. It resulted in the company paying an increased effective rate of tax on its profits. This problem was alleviated in the SK Beecham structure because SK would pay dividends directly to former SK shareholders rather than pay dividends to UK Newco (which in turn would have paid dividends to the former SK shareholders). The surplus ACT problem was eliminated by the so-called foreign income dividend (FID) legislation, which was introduced in 1994, and under which a company could reclaim ACT that was surplus because it had credit for overseas tax.

47 A 1991 article noted that there was significant price divergence between the A ordinary shares and the stapled unit from inception (the A ordinary shares were often 10 percent higher). The article stated that (1) Beecham was a better company than SmithKline, (2) the company was traded on the FTSE 100 in London (targeted by institutional investors) but traded as an ADR in the United States, not part of the S&P 500 (so that institutions felt less compelled to buy the stock), and (3) investors would typically arbitrage the stock only when the discount in the U.S. shares reached 10–12 percent. *See Doctoring Shares*, THE ECONOMIST, Nov. 2, 1991, at 76.

48 In a virtual merger, both companies should be able to retain their listings and their local indices, but this should be confirmed. This article does not address the corporate and securities law issues relating to DLCs. For a survey of transactions that have used DLC structures, see D. Kevin Dolan, U.S. TAXATION OF INTERNATIONAL MERGERS, ACQUISITIONS AND JOINT VENTURES (Warren, Gorham and Lamont 1995); Code Sec. 8.04[4][f].

49 It is not fully clear how UKP would be taxed if it were treated as a domestic corporation under Code Sec. 269B, but perhaps it would resemble the taxation of a dual incorporated company (DINC). If UKP was a holding company that received minimal dividends, then the tax bite should not be onerous. There would, however, be many complexities in terms of reporting, dealing with two sets of CFC regimes, withholding tax and foreign tax credit issues.

50 However, the parties should ensure that, as a result of the DLC structure, USP is not considered to be "managed and controlled" in the United Kingdom, and thus is subject to U.K. tax. The parties should also examine any impact on UKP's U.K. tax residency.

51 Code Secs. 957(a) and 951(b).

52 *See* H.R. Rep. No. 432, pt. 2 (1984); H.R. Conf. Rep. No. 861(1984); *General Explanation of the Deficit Reduction Act of 1984*, prepared by the Staff of the Joint Committee on Taxation, at 454. The technique of stapling and distributing a CFC would likely be taxable under current law (even without Code Sec. 269B). A distribution of CFC stock is taxable to the U.S. distributing company if the distributee is (1) foreign, or (2) a U.S. individual. *See* Code Sec. 367(e)(1) and Reg. §1.367(b)-5(b)(1)(ii). Proposed Reg. §1.367(b)-5(b)(1)(ii) would tax the distributing company on a distribution of CFC stock to a tax-exempt entity. *See also*, Code Sec. 1248(f) with respect to foreign companies that lose their CFC status.

53 The stapling technique addressed by Code Sec. 269B was perhaps the first well-publicized structure used by taxpayers to avoid the onerous subpart F regime. In 1984, Congress also enacted Code Sec. 1248(i) to combat "flip" transactions, such as the McDermott transaction in which McDermott International (a CFC of McDermott) issued its own stock to acquire its U.S. parent, McDermott. *See*, David R. Tillinghast, *Recent Developments in International Mergers, Acquisitions and Restructurings*, TAXES, Dec. 1994, at 1061. More recently, companies such as Helen of Troy have sought to minimize exposure to subpart F by expatriating to a tax haven. Notice 94-46, 1994-1 CB 356 and subsequent "inversion" regulations under Code Sec. 367(a) were in response to Helen of Troy, with a goal of protecting the subpart F regime. *See* Williard B. Taylor, *Corporate Expatriations—Why Not?* TAXES, Mar. 2000, at 146.

54 Code Secs. 269B(c)(2) and (3); Code Sec. 269B(c)(1) defines an "entity" as any corporation, partnership, trust, association, estate or other form of carrying on a business or activity.

55 Although the topic below, whether DLC Structure I should be treated as a partnership for U.S. tax purposes, is a separate topic, one may conclude that affirmatively treating the structure as a partnership may further minimize the risk that Code Sec. 269B will apply. In that case, two public companies have arguably only formed a large joint venture.

56 The partnership should not be treated as an investment company. Code Sec. 721(b); Reg. §1.351-1(c). USP should ensure that the transfer of liabilities to the partnership does not trigger any tax to USP. *See*, *e.g.*, Code Secs. 752, 731 and 707(a)(2)(B). If UKP has U.S. real property interests, the deemed transfer of those assets (or stock) to a partnership should not trigger tax under the FIRPTA rules. *See* Code Sec. 897(g); Temporary Reg. §§1.897-1T(c), (e), -6T(a) and -7T.

57 Certain other considerations should be addressed. For example, USP will be deconsolidated from its U.S. subsidiaries as a result of the deemed transfer to a partnership, potentially triggering deferred intercompany gains. Code Sec. 904(f)(3) should be considered. In addition, USP will not be taxed if, as a result of the transfer of stock of a CFC to a foreign partnership, the CFC loses its CFC status. By contrast, if USP were to transfer stock of a CFC to a joint venture foreign corporation and, as a result of the transfer, the CFC lost its CFC status, USP would be taxed on its Code Sec. 1248 amount with respect to the CFC stock. Reg. §1.367(b)-4(b). Conversely, if the DLC is treated as a U.S. partnership or is treated as a foreign partnership, but USP owns more than 50 percent of the vote or value of such partnership, then UKP's non-U.S. subsidiaries will also be subject to the subpart F regime. Finally, if the partnership is considered to be foreign, USP would be subject to additional reporting requirements. *See*, Code Secs. 6038, 6038B and 6046A.

58 The Code Sec. 704(b) regulations permit source-based allocations provided that the economic effect of such allocations is substantial. *See* Reg. §1.704-1(b)(5), Example 10. If the partnership has losses, the Code Sec. 1503(d) rules would need to be considered.

59 The manner in which withholding is accomplished depends upon whether the partnership is domestic or foreign. *See* Reg. §1.1441-5.

60 A conversion of USP's wholly-owned subsidiary to a disregarded entity is treated as a tax-free liquidation if done prior to the formation of the virtual merger. *See* Reg. §1.7701-3. For conversions of U.S. subsidiaries of UKP, the application of Code Sec. 367(e)(2) needs to be considered.

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[61] See Code Secs. 875(1) and 884 (the branch profits tax, which is five percent under the new treaty unless UKP is grandfathered and qualifies for an exemption from the tax).

[62] See Code Secs. 704(c)(1)(B) and 737.

[63] See the often-criticized Rev. Rul. 91-32, 1991-1 CB 107, with respect to taxable dispositions of a partnership interest by a foreign person.

[64] The transfer may qualify as tax-free in the United Kingdom if the assets consist solely of shares of other companies. U.K. tax legislation effective Apr., 1, 2002, should also be considered, together with potential U.K. de-grouping issues.

[65] In such case, Code Sec. 894(c) should be considered.

[66] The parties should also consider the impact of the DLC structures on existing debt covenants.

[67] The United Kingdom apparently does not have the U.S. concept of special allocations of partnership income, thus, separately-owned opcos or access shares would be necessary to achieve the same effect as special allocations of partnership income.

[68] The allocation of U.S. Opco distributions to UKP's U.S. subsidiary raises issues that are beyond the scope of this discussion.