



United States Tax Alert

Anti-inversion guidance: Treasury finalizes expiring regulations and modifies “*de minimis*” exceptions

On January 13, 2017, the US Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) issued final regulations and revised temporary regulations under Internal Revenue Code section 7874. These regulations finalize expiring Temp. Reg. §§1.7874-4T and 1.7874-5T with modifications (the “Final Regulations”), including a modification to the *de minimis* exception to application of the disqualified stock rule of Treas. Reg. §1.7874-4 (“disqualified stock rule”). These regulations also revise existing temporary regulations to make conforming changes to the *de minimis* exceptions to application of the passive assets rule of Temp. Reg. §1.7874-7T (“passive assets rule”) and the non-ordinary distribution rule of Temp. Reg. §1.7874-10T (“non-ordinary course distribution rule”).

The Final Regulations and the revised temporary regulations generally adopt or modify, as appropriate, rules described in temporary regulations issued on January 16, 2014, or April 4, 2016 (the “Temporary Regulations”). For prior discussion of the Temporary Regulations, see United States Tax Alerts dated [January 18, 2014](#) and [April 6, 2016](#).¹

Summary of noteworthy changes

As compared to the Temporary Regulations, the Final Regulations and revised temporary regulations:

- exclude from the definition of nonqualified property an obligation of a member of the Foreign Acquirer’s expanded

affiliated group (EAG, defined below) if the holder (or a successor) of the obligation immediately before the domestic entity acquisition (and all related transactions) is a member of the EAG immediately after the Acquisition (defined below) and all related transactions;²

- exclude from the definition of nonqualified property obligations of former *de minimis* owners of the US Target (defined below);³
- exclude from the definition of nonqualified property obligations of persons that have a *de minimis* ownership in a member of the Foreign Acquirer's EAG or a Significant Shareholder (defined below);⁴
- expand the application of the "associated obligation rule";⁵
- clarify (or modify) the definition of "obligation" to include a contractual obligation to provide goods and services;⁶
- clarify that stock included in the numerator of the ownership continuity fraction is also included in the denominator (even if such stock would otherwise be disqualified stock);⁷
- clarify that an interest in a partnership is only nonqualified property if it is a marketable security or is transferred with a principal purpose of avoiding the purposes of section 7874;
- finalize Temp. Reg. §1.7874-5 without substantive modification; and
- modify the *de minimis* exceptions included in Treas. Reg. §1.7874-4T(d)(1), Temp. Reg. §1.7874-7T(c), and Temp. Reg. §1.7874-10T(d).

Inversion transactions – basic rules

A foreign corporation (or a foreign publicly-traded partnership, in either case a "Foreign Acquirer") generally will be treated as a US corporation⁸ under section 7874 if, pursuant to a plan or series of related transactions:

- the Foreign Acquirer acquires "substantially all" of the properties held directly or indirectly by a US corporation or held in a domestic partnership's trade or business (such domestic entity, the "US Target," and such acquisition, an "Acquisition");
- former owners of the US Target acquire 80% or more (by vote or value) of stock of the Foreign Acquirer in exchange for their interests in the US Target; and
- the Foreign Acquirer's EAG does not have substantial business activities in its home country relative to the group's worldwide activities.⁹ For purposes of section 7874, an EAG is an affiliated group under §1504(a), with a 50% threshold, attribution through partnerships and inclusion of foreign corporations.¹⁰

If former shareholders or partners hold less than 80%, but at least 60% (by vote or value) of the stock of the Foreign Acquirer by reason of holding an equity interest in the US Target, the Foreign Acquirer continues to be treated as a foreign corporation (or foreign publicly-traded partnership, as applicable) for US federal income tax purposes. However, certain rules can apply that prevent certain business integration transactions and that apply to deny the use of certain attributes to offset US tax of the US Target. This ownership continuity percentage, expressed as a fraction, is referred to as the "ownership fraction."

General disqualified stock rules

Subject to a *de minimis* exception, certain “disqualified stock” of a Foreign Acquirer is excluded from the denominator of the ownership fraction.¹¹ Disqualified stock generally includes stock of the foreign acquiring corporation that is (i) transferred to a person (other than the US Target) in exchange for “nonqualified property” (the “nonqualified property rule”), or (ii) transferred by a person (transferor) to another person (transferee) in exchange for property (exchanged property) if, as part of the same plan, the transferee subsequently transfers such stock in satisfaction of, or in exchange for the assumption of, one or more obligations of the transferee or a person related (within the meaning of section 267 or 707(b)) to the transferee (the “associated obligation rule”).¹² The term “nonqualified property” generally means (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations described below, or (iv) any other property acquired in a transaction (or series of transactions) related to the Acquisition with a principal purpose of avoiding the purposes of section 7874.¹³

***De minimis* exception**

Prior to modification, the *de minimis* exception as contained in the Temporary Regulations applied if both:

- (i) the ownership of the Foreign Acquirer by the former owners of the US Target determined without regard to the disqualified stock rule, the passive assets rule, and the non-ordinary course distribution rule is less than 5% (by vote and value); and
- (ii) after the Acquisition and all related transactions, former owners of the US Target, in the aggregate, own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than 5% (by vote and value) of the stock of (or a partnership interest in) each member of the Foreign Acquirer’s EAG.

With respect to the second requirement of the *de minimis* exception, the Temporary Regulations required that the former shareholders or partners collectively own less than 5% (through attribution) of each member of the Foreign Acquirer’s EAG after the Acquisition and all related transactions. The Final Regulations modify the second requirement to provide that the *de minimis* rule is met only if after the Acquisition and all related transactions, each former owner of the US Target individually owns (through applying the section 318 attribution rules, as modified by section 304(a)(3)(B)) less than 5% (by vote and value) of the stock or partnership interest in each member of the Foreign Acquirer’s EAG.¹⁴ While this modification makes it somewhat easier for taxpayers to apply the exception in certain circumstances (*e.g.*, certain public deals), it continues to be difficult to apply in many other situations where investments in either a privately-held US Target or privately-held Foreign Acquirer are either (i) made through complex investment structures where ultimate ownership is unknown or (ii) held by investment funds.

As indicated above, the temporary regulations issued on January 13, 2017 similarly revise the *de minimis* exceptions to the passive asset rule and the non-ordinary course distribution rule of Temp. Reg. §§1.7874-7T and 1.7874-10T, respectively.

Special rules with respect to obligations

Treatment of certain obligations under the nonqualified property rule

Obligations owed by certain persons constitute nonqualified property under both the Final and Temporary Regulations. Generally, nonqualified property includes obligations of: (i) the Foreign Acquiring's EAG ("EAG Obligations"), (ii) former shareholders or partners of US Targets ("Shareholder Obligations"), and (iii) persons that own stock of or are related (under section 267 or 707(b)) to members of the Foreign Acquiring's EAG or former shareholders or partners of US targets ("Related Party Obligations"). The Final Regulations modify the definitions so as to exclude certain obligations from the definition of nonqualified property.

First, the Final Regulations modify part (i) of the definition to exclude from the definition of nonqualified property EAG Obligations where the holder of the obligation before the Acquisition is a member of the Foreign Acquirer's EAG immediately after the Acquisition and related transactions ("Excluded Intercompany Obligations").¹⁵

Second, the Final Regulations modify part (ii) of the definition to insert a *de minimis* rule with respect to Shareholder Obligations, and limit their scope to obligations where the former shareholder or partner actually or constructively (through section 318 attribution, as modified by section 304(c)(3)(B)) owns at least 5% (by vote or value) of the US Target before the Acquisition (a "Significant Shareholder").¹⁶

Third, the Final Regulations similarly modify part (iii) of the definition to insert a *de minimis* rule with respect to Related Party Obligations, and limit their scope to obligations where persons actually or constructively (through section 318 attribution, as modified by section 304(c)(3)(B)) own, before or after the Acquisition, at least 5% (by vote or value) either a member of the Foreign Acquirer's EAG or a Significant Shareholder.¹⁷ However, the Final Regulations retain the rule that obligations of persons that are related (under sections 267 or 707(b)) to a member of the Foreign Acquiring's EAG or former shareholders or partners of the US Target before or after the Acquisition constitute nonqualified property.¹⁸

It is important to note that the exception to Related Party Obligations does not carve out Excluded Intercompany Obligations, which could cause such obligations to fall within the definition of a Related Party Obligation even though such obligations clearly are intended to fall outside the scope of nonqualified property based on their exclusion from the definition of EAG Obligations. To give effect to the carve-out of Excluded Intercompany Obligations from EAG Obligations, taxpayers might construe the term "person" as used in the definition of Related Party Obligation as "person (other than an EAG member)". Nevertheless, Treasury and the IRS should issue further guidance to clarify the scope of Related Party Obligations.

Treatment of certain obligations under the associated obligation rule

As noted above, under the associated obligation rule, disqualified stock generally includes stock of the foreign acquiring corporation transferred by a person (transferor) to another person (transferee) in exchange for property (exchanged property) if, as part of the same plan, the transferee subsequently transfers such stock in satisfaction of, or in exchange for the assumption of, one or more obligations of the transferee or a person related (within the meaning of section 267 or 707(b)) to the transferee (the "associated

obligation rule"). In contrast to the Temporary Regulations, the Final Regulations apply to transfers of stock of the Foreign Acquirer to satisfy, or in exchange for the assumption of, any obligation of the transferee, rather than only those obligations associated with the exchanged property (*e.g.*, those obligations that arose from the conduct of a trade or business in which the exchanged property was used).¹⁹ However, the amount of disqualified stock cannot exceed the proportionate share of obligations associated with the exchanged property that are not assumed by the Foreign Acquirer (the "Proportionate Share Limitation"). Additionally, the rule in the Final Regulations now covers situations in which the transferee indirectly uses Foreign Acquirer stock to satisfy an obligation or have it assumed (subject to the Proportionate Share Limitation), such as where the transferee sells its stock of the Foreign Acquirer and uses the proceeds to repay an obligation.

Definition of obligations

The Final Regulations remove the reference to Treas. Reg. §1.752-1(a)(4)(ii) that was provided in the Temporary Regulations for the definition of an "obligation". Instead, the Final Regulations define an obligation as:

[A]ny fixed or contingent obligation to make a payment or provide value without regard to whether the obligation is otherwise taken into account for purposes of the Internal Revenue Code. An obligation includes, but is not limited to, a debt obligation, an environmental obligation, a tort obligation, a contract obligation (including an obligation to provide goods or services), a pension obligation, an obligation under a short sale, and an obligation under derivative financial instruments such as options, forward contracts, and swaps. An obligation does not include any obligation treated as stock for purposes of section 7874 (see, for example, §1.7874-2(i), which treats certain interest, including certain creditor claims, as stock).²⁰

The preamble to the Final Regulations states the reason for this change was to avoid confusion when applying Treas. Reg. §1.752-1(a)(4)(ii) outside of the partnership context. However, some taxpayers may view the new definition as expanding the definition of an obligation to cover obligations to make payment or provide value, including contractual obligations to provide goods and services.

Certain clarifications

In response to comments, the Final Regulations clarify that a partnership interest is treated as nonqualified property only to the extent that it is a marketable security or is transferred with a principal purpose of avoiding section 7874.

Additionally, the Final Regulations clarify that stock included in the numerator of the ownership fraction (*i.e.*, stock of the Foreign Acquirer that former equity owners of the US Target receive by reason of owning equity of the US Target) is also included in the denominator of this fraction.²¹ This clarifies that stock included in the numerator is also included in the denominator even if the stock in the numerator would otherwise be disqualified stock.

Finalization of Temp. Reg. §1.7874-5T

The Final Regulations also finalize Temp. Reg. §1.7874-5T without substantive modification.²³

Effective dates

The rules described in the Final Regulations and the revised temporary regulations have a variety of effective dates, which reflect the dates on which they were first introduced in published guidance. Taxpayers may elect to apply a provision in the Final Regulations or the revised temporary regulations to Acquisitions occurring before such provision is published (but after the provision was first introduced in published guidance), provided that the taxpayer applies it consistently to all Acquisitions completed during such period.

¹ T.D. 9654, 79 F.R. 3100 (Jan. 17, 2014); T.D. 9761, 81 F.R. 20897 (Apr. 8, 2016). The rules were first announced in part on September 17, 2009 in Notice 2009-78 (2009-40 I.R.B. 452).

² Treas. Reg. §1.7874-4(i)(2)(iii)(A).

³ Treas. Reg. §1.7874-4(i)(2)(iii)(B).

⁴ Treas. Reg. §1.7874-4(i)(2)(iii)(C).

⁵ Treas. Reg. §1.7874-4(c)(1).

⁶ Treas. Reg. §1.7874-4(i)(3).

⁷ Treas. Reg. §1.7874-4(c)(1).

⁸ Section 7874(b). Section 7874 overrides any conflicting provisions contained in current or future treaties. Section 7874(f).

⁹ Section 7874(a)(2)(B).

¹⁰ Section 7874(c)(1).

¹¹ Treas. Reg. §1.7874-4(b).

¹² Treas. Reg. §1.7874-4(c).

¹³ Treas. Reg. §1.7874-4(i)(2).

¹⁴ Treas. Reg. §1.7874-4(d)(1).

¹⁵ Treas. Reg. §1.7874-4(i)(2)(iii)(A).

¹⁶ Treas. Reg. §1.7874-4(i)(2)(iii)(B).

¹⁷ Treas. Reg. §1.7874-4(i)(2)(iii)(C).

¹⁸ Id.

¹⁹ Treas. Reg. §1.7874-4(c)(1)(ii).

²⁰ Treas. Reg. §1.7874-4(i)(3).

²¹ Treas. Reg. §1.7874-4(c)(1).

²² Treas. Reg. §1.7874-4(c)(1).

²³ The changes are primarily to use and cross-reference the definitions introduced by Temp. Reg. §1.7874-12T as part of T.D. 9761, 81 F.R. 20897 (Apr. 8, 2016).

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