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International Tax

United States Tax Alert

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§7874 Temporary Regulations re: Stock Acquired for Cash or Other Disqualified Property

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On January 16, 2014, the IRS and Treasury issued temporary regulations under §7874 (Temporary Regulations), providing guidance on determining whether a foreign corporation is treated as a surrogate foreign corporation. (The content of the Temporary Regulations was also issued in proposed form for finalization.) The Temporary Regulations provide rules to disregard certain stock of a foreign acquirer in analyzing its ownership continuity percentage (disqualified stock), as announced in Notice 2009-78, issued September 17, 2009 (the Notice). The regulations are effective for acquisitions on or after September 17, 2009; for acquisitions completed on or after September 17, 2009 but before January 16, 2014, absent an affirmative election, certain portions of the Temporary Regulations not addressed by the Notice do not apply (e.g., creating protection for certain *de minimis* acquisitions with less than 5% equity rollover and treating any stock issued for an obligation of a member of the foreign acquirer's expanded affiliated group as disqualified stock).

This alert highlights and summarizes the Temporary Regulations.

Background

A foreign corporation (or a foreign publicly traded partnership, in either case a "foreign acquirer") is treated as a surrogate foreign corporation under §7874 if pursuant to a plan or series of related transactions:

i. the foreign acquirer acquires "substantially all" (a still-undefined term) of the properties of a U.S. corporation or of a domestic partnership with a trade or business (an "acquisition");
ii. former owners of the U.S. corporation or partnership acquire 60% or more (by vote or value) of stock of the foreign acquirer in exchange for their interests in the U.S. corporation or partnership (disregarding certain stock discussed below); and
iii. the expanded affiliated group (EAG) that includes the foreign acquirer does not have substantial business activities in its country of

incorporation.[1] For purposes of §7874, an EAG is an affiliated group under §1504(a), with a 50% threshold, attribution through partnerships and inclusion of foreign corporations.[2]

If former shareholders or partners hold at least 80% (by vote or value) of a surrogate foreign corporation by reason of having held interests in the domestic entity, the surrogate foreign corporation is treated as a domestic corporation for all U.S. federal income tax purposes.[3] If former shareholders or partners hold at least 60% but less than 80% of a surrogate foreign corporation by reason of having held stock in the domestic entity, the surrogate foreign corporation is treated as a foreign corporation (or foreign publicly traded partnership, as applicable) for U.S. federal income tax purposes. However, §7874 restricts the use of deductions and credits to shelter "inversion gain" and may impose minimum U.S. taxable income thresholds upon the domestic entity acquired by the surrogate foreign corporation or upon the former partners in the context of an acquisition of a U.S. partnership.[4]

The Temporary Regulations

The Temporary Regulations provide the following factors in determining the 60% (or 80%) ownership continuity percentage:

- In applying the ownership requirement of §7874 to an acquisition by a foreign corporation (or foreign publicly traded partnership), generally, "disqualified stock" is not taken into account. Disqualified stock is stock of the foreign acquirer that is:

    1) transferred to a person other than the U.S. target in exchange for "nonqualified property"; or
    2) transferred to a person in exchange for property, and pursuant to the same plan (or series of related transactions) the transferee subsequently transfers such stock in an exchange for the satisfaction or the assumption of one or more obligations associated with the property exchanged.

    However, stock is disqualified stock only to the extent that the transfer of the stock in the exchange increases the fair market value of the foreign acquirer's assets or decreases its liabilities. In the case of such an obligation being assumed or satisfied, the transferee is treated as acquiring its foreign acquirer stock for cash equal to the fair market value of the stock.

- A transfer means, with respect to stock of the foreign acquirer, an issuance, sale, distribution, exchange, or any other disposition of such stock.

[1] §7874(a)(2)(B).
[2] §7874(c)(1).
[3] §7874(b). Section 7874 overrides any conflicting provisions contained in current or future treaties. §7874(f).
[4] §7874(a) and (e).

- The rules disregarding disqualified stock do not apply if a *de minimis* exception applies. Such an exception has two requirements:

    1) there is less than 5% (by vote and value) ownership continuity in the foreign acquirer (i.e., the ownership percentage described in §7874(a)(2)(B)(ii) determined without regard to the disqualified stock rule); and
    2) after the acquisition and all related transactions are completed, former equity owners of the U.S. target in aggregate own less than 5% by vote and value (taking into account §318, as modified by §304(c)(3)(B)) in the equity of any member of the foreign acquirer's EAG.

    This *de minimis* exception does not apply to disqualified stock that is transferred in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the application of §7874.

    Also, it should be noted that factor (2) above for this *de minimis* exception will require the foreign acquirer to measure indirect ownership by any overlapping ownership between the foreign acquirer and the domestic entity, even if that overlapping shareholding is "old and cold" in a U.S. tax sense.

    Note: in the preamble to the Temporary Regulations, the IRS has requested comments on whether this *de minimis* exception should apply if "one of the intended exit strategies" of the foreign acquirer (or its shareholders) was to sell the shares of the foreign acquirer in a public offering. No such rule presently exists in the Temporary Regulations, and any subsequent adoption of such rule should, presumably, have only prospective effect.

- In applying the ownership requirement for §7874 to an acquisition by a foreign corporation (or foreign publicly traded partnership), equity issued by the foreign acquirer generally will be disregarded in the denominator of the ownership continuity percentage if it is issued for:

    1) cash or cash equivalents;
    2) "marketable securities" as defined in §453(f)(2) (except as noted below);
    3) an obligation of a member of the foreign acquirer's EAG, a former equity owner of the U.S. target, or a person that (before or after the acquisition) holds equity in such a former equity owner or is related to such a person; and
    4) any other property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of §7874.

    This will be the case even if the cash and marketable securities (including from the disposition of such instruments) are to be used in the active conduct of the continuing business of EAG.

    For this purpose, the meaning of the term "marketable securities" under §453(f)(2) is modified to exclude equity in an entity that becomes a member of the foreign acquirer's EAG in a transaction (or series of transactions) related to the acquisition, unless a principal purpose for acquiring such equity is to avoid the purposes of §7874. However, for this purpose, marketable securities generally shall not include equity issued by a member of the EAG that, after the acquisition being tested, includes the foreign acquirer unless a principal purpose of the issuance of the stock was the avoidance of the application of §7874.

Also for this purpose, the term “obligation” is defined in Treas. Reg. §1.752-1(a)(4)(ii), provided that the obligation is not otherwise treated as stock for purposes of §7874 (for example under Treas. Reg. §1.7874-2(i), which treats certain interests as stock).

Note: these provisions would cause §7874 to apply to a foreign corporate joint venture formed between a U.S. and a foreign multinational where the U.S. multinational contributes a U.S. subsidiary and the foreign multinational contributes primarily cash (or other disqualified property), unless the U.S. multinational receives more than 50% (by vote and value) of the joint venture corporation (and can otherwise qualify under the internal restructuring rules of Treas. Reg. §1.7874-1).

Further, these provisions would cause §7874 to apply when shareholders transfer the shares of a domestic corporation to a foreign corporation (i.e., the foreign acquirer) when a new investor concurrently contributes cash to that foreign acquirer, even if the new investor obtained a greater than 20% equity interest in the foreign acquirer (or even a 94% equity interest, i.e., just over the threshold of the *de minimis* exception), and even if the cash is required for the business needs of the EAG that includes the domestic corporation.