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Treasury Releases New Anti-Inversion Guidance under Section 7874

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On November 19, 2015, the United States Treasury issued Notice 2015-79 (the Notice), which announces its intent to issue regulations which would (i) tighten the anti-inversion rules of Internal Revenue Code section 7874, and (ii) reduce the tax benefits of inversion transactions.

The Notice clarifies and expands on Notice 2014-52, which was issued on September 22, 2014 and had similar objectives. (For coverage of Notice 2014-52, see U.S. International Tax Alert dated September 23, 2014).

Treasury's announcement that it will issue regulations under section 7874 significantly restricts the ability to combine an existing U.S. company and an existing foreign corporation if the ultimate foreign parent is to be tax resident in a third jurisdiction (i.e., a jurisdiction other than the jurisdiction of formation or tax residency of the existing foreign company); under the announced rules, such business combinations are only possible if the ownership continuity percentage remains below 60 percent or the foreign parent does not acquire substantially all of the assets of the foreign target. Certain other changes could significantly increase or accelerate the U.S. tax costs for any post-expatriation restructurings designed to integrate the business operations of the foreign acquirer with the controlled foreign corporations (CFCs) of the expatriating U.S. group.

Background

Generally, for section 7874 to apply to a foreign acquisition of a U.S. corporation or partnership (the U.S. target), there must be a direct or indirect acquisition of substantially all the U.S. target's assets, ownership continuity by the former shareholders of the U.S. target of at least 60% of the foreign acquirer's stock by reason of equity in the U.S. target (the ownership continuity test), and lack of substantial business activities by the foreign acquirer's worldwide group (more specifically, the expanded affiliated group (EAG), which generally refers to the foreign acquirer and its direct and indirect greater-than-50% subsidiaries) in the country where the foreign acquirer is organized (the substantial business activities test). If the ownership continuity test is satisfied at the 60%-or-greater level, generally section 7874 denies the use of tax attributes to reduce U.S. tax attributable to transfers of assets by the U.S. target and U.S. members of the EAG to related foreign persons. If the ownership continuity test is satisfied at the 80%-or-greater level, generally section 7874 will, instead, treat the foreign acquirer as a U.S. corporation for all U.S. tax purposes.

Overview of Notice

A focus of the announced regulations is addressing acquisitions that would otherwise run afoul of section 7874. Thus, an impact of the regulations would be to generally limit the tax efficiencies that can be achieved in business-driven M&A transactions where owners of the U.S. target acquire at least 60% of the equity in the foreign acquirer by reason of their equity in the U.S. target. The Notice also clarifies and expands on prior guidance provided in Notice 2014-52.

Anti-inversion standard and foreign parent tax residency requirement

In applying the substantial business activities test, Treas. Reg. §1.7874-3 generally looks to the country in which the foreign acquirer is created or organized, even if the foreign acquirer is not a tax resident of such country (e.g., because it is treated as fiscally transparent under the laws of such country or is managed and controlled in a third country). The Notice announced that Treasury and the IRS intend to issue regulations under section 7874 to provide that an EAG cannot satisfy the substantial business activities exception unless the foreign acquirer is tax resident in the foreign country of its creation or organization.

Anti-inversion standard and "third country" foreign acquirers

For purposes of section 7874, ownership continuity is generally determined without regard to the country in which the foreign acquirer is created or organized. Accordingly, if a U.S. target and a foreign corporation (foreign target) are combining business operations, ownership continuity is generally the same whether (i) the foreign target directly acquires the U.S. corporation, or (ii) the foreign target and the U.S. target are acquired by a newly-formed foreign corporation that is tax resident in a third jurisdiction (i.e., a jurisdiction other than the jurisdiction of formation or tax residency of the foreign target).

Using asserted authority under sections 7874(c)(6) and (g), the Notice announced that Treasury and the IRS intend to issue regulations disregarding certain stock of a foreign acquirer that is issued to the shareholders of a foreign target for purposes of determining whether the 80-percent ownership continuity threshold is met. Such regulations would apply to an acquisition that satisfies the following requirements:

- The foreign acquirer directly or indirectly acquires substantially all of the properties held directly or indirectly by the foreign target (foreign target corporation) in a transaction related to the acquisition of a U.S. target (referred to as the "foreign target acquisition");

- The gross value of all property directly or indirectly acquired by the foreign acquirer in the foreign target acquisition exceeds 60 percent of the gross value of all foreign group property (i.e., not including property held directly or indirectly by the U.S. target and other assets that would be double counted), excluding foreign group nonqualified property (i.e., cash, marketable securities, certain obligations of related persons, and property acquired with a principal purpose of avoidance);

- The tax residence of the foreign acquirer is not the same as that of the foreign target, as determined before the foreign target acquisition and any transaction related to the foreign target acquisition; and

- Not taking into account these rules, the ownership continuity percentage would be at least 60% but less than 80%.

In determining whether a foreign acquirer has directly or indirectly acquired substantially all of the properties held directly or indirectly by a foreign target corporation, the principles of section 7874(a)(2)(B)(i) and Treas. Reg. §1.7874-2(c) (each pertaining to acquisitions of the properties of a domestic corporation) apply, modified so as to apply to a foreign, rather than a domestic, target.

When the four requirements are satisfied, stock of the foreign acquirer will be excluded from both the numerator and denominator of the section 7874 ownership continuity fraction to the extent the stock is held by former owners of the foreign target by reason of holding stock in the foreign target corporation. Consistent with Treas. Reg. §1.7874-2(e) (related to acquisitions of multiple domestic entities), the Notice will treat acquisitions of multiple foreign corporations that are residents of the same foreign country as a single corporation.

By excluding stock of the foreign acquirer held by the former owners of the foreign target from the denominator of the ownership continuity fraction, it is highly likely that in such business combinations involving a third country foreign acquirer the ownership continuity fraction would become 100%, rendering the foreign acquirer a U.S. corporation for all purposes of the Code in accordance with section 7874(b).

Anti-inversion standard and nonqualified property

In applying the ownership continuity test, Treas. Reg. §1.7874-4T generally disregards (in both the numerator and denominator) shares of the foreign acquirer issued for cash, cash equivalents, marketable securities, and obligations of related persons (collectively, specified nonqualified property), as well as any other property acquired in a transaction (or series of related transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874 (avoidance property). The Notice announces that Treasury and the IRS intend to issue regulations that will clarify that "avoidance property" means any property (other than specified nonqualified property), and not just passive-type property, acquired with a principal purpose of avoiding the purposes of section 7874.

Inversions and indirect transfers and licenses of property

As noted above, if the ownership continuity test is satisfied at the 60% level, section 7874 generally denies the use of tax attributes to reduce tax attributable to sales, licenses or other transfers of property by the U.S. target and other U.S. members of the EAG to related foreign persons. Under section 7874(a)(1) and (d)(2), this includes tax attributable to any income or gain from the transfer or license of property (i) as part of the acquisition of the U.S. target, or (ii) to a related foreign person during the 10-year period beginning on the date the U.S. target is acquired by the foreign acquirer. However, section 7874 generally does not deny the use of tax attributes to reduce tax attributable to *indirect* transfers of assets; for example, tax on subpart F income resulting from a transfer of assets by a CFC of the U.S. target.

Using asserted authority under section 7874(g), the Notice announces that Treasury and the IRS intend to issue regulations that will deny use of tax attributes to reduce tax attributable to such *indirect* transfers of property (other than inventory) by the target to related foreign persons. With respect to transfers or licenses of property by a partnership that is a foreign related person with respect to the U.S. target, the regulations will apply an aggregate theory of partnerships to such transfers. It is noted that such indirect inversion gains may not be limited to subpart F income inclusions by a U.S. target arising from transfers or license of property by a CFC, but might also include subsequent distributions received by a U.S. target (or other U.S. members of the EAG) of non-subpart F income derived from the transfer or license of property to related foreign persons by any non-U.S. member of the EAG. In essence, the announced regulations would expand the inversion gain rules to the non-U.S. members of the EAG.

Inversions and decontrolling transactions

Without regard to regulations described in Notice 2014-52, Treas. Reg. §1.367(b)-4(b) requires a shareholder that exchanges stock of a foreign corporation in an exchange subject to section 367(b) to include in income as a deemed dividend the section 1248 amount (as defined in §1.367(b)-2(c)(1)) with respect to the stock exchanged if the exchange results in either a loss of CFC status of the foreign corporation whose stock is exchanged or a loss of section 1248 shareholder status of the exchanging shareholder (or of a shareholder of the exchanging shareholder when there is an exchange of stock of a lower-tier CFC).

The Notice announced that Treasury and the IRS intend to issue regulations under section 367(b) that would require such an exchanging shareholder to recognize all built-in gain in exchanged stock of an expatriated foreign subsidiary under Treas. Reg. § 1.367(b)-4(b), even in cases that do not result in loss of CFC status but only dilute the exchanging shareholder’s interest. For this purpose, an expatriated foreign subsidiary is defined as a CFC for which an expatriated entity is a U.S. shareholder, and then only for the 10-year inversion gain period of section 7874. Thus, the announced regulations would modify the section 367(b) regulations only for CFCs of a U.S. corporation that has otherwise participated in an expatriation transaction resulting in at least a 60% ownership continuity for purposes of section 7874.

Anti-inversion standard and passive assets of foreign acquirer (change to Notice 2014-52 to exclude certain active banking, financing, and insurance property from “nonqualified property”)

As noted above, in applying the ownership continuity test, Treas. Reg. §1.7874-4T generally disregards (in both the numerator and denominator) shares of the foreign acquirer issued for cash, cash equivalents, obligations of related persons, and property acquired with a principal purpose of avoidance (defined as nonqualified property). Using the asserted broad authority to modify the anti-inversion rules under section 7874(c)(6), Notice 2014-52 announced that Treasury and the IRS intend to issue regulations expanding the reach of Treas. Reg. §1.7874-4T in the case of acquisitions where over 50% of the foreign acquirer’s EAG constitutes nonqualified property (i.e., so-called cash boxes) by reducing the denominator of the ownership continuity percentage’s testing fraction; generally, the reduction is akin to reducing the denominator (equity in the foreign acquirer) by the fraction equal to the ratio of the group’s nonqualified property to its total property.

Notice 2014-52 specifically excludes from nonqualified property any property that gives rise to income described in section 1297(b)(2)(A) (PFIC banking exception) or section 954(h) or (i) (subpart F exceptions for qualified banking or financing income and for qualified insurance income, respectively).

The Notice announced that Treasury and the IRS will expand the exception to nonqualified property to include property that gives rise to income described in section 1297(b)(2)(B) (PFIC insurance exception); provided, however, that other property received by the foreign corporation in exchange for property described in section 1297(b)(2)(B) in a transaction related to the acquisition of the U.S. target will be substitute property (as defined in Notice 2014-52), and therefore treated as nonqualified property.

The Notice further announced that Treasury and the IRS intend to expand the exception to nonqualified property to include property held by a domestic corporation that is subject to tax as an insurance company under subchapter L (provided that the property is required to support, or is substantially related to, the active conduct of an insurance business), as well as property held by a domestic corporation that gives rise to income described in section 954(h). In both cases, other property received by the foreign corporation in exchange for such property in a transaction related to the acquisition of the U.S. target will be substitute property, and therefore treated as nonqualified property.

Anti-inversion standard and distributions by U.S. target (change to Notice 2014-52 to implement a de minimis exception)

Pursuant to the asserted broad anti-avoidance rule of section 7874(c)(4), Notice 2014-52 announced that Treasury and the IRS intend to issue regulations expanding the reach of section 7874 by disregarding non-ordinary course distributions by the U.S. target during the 36-month period ending on the acquisition date, as well as cash or other property received by shareholders of the U.S. target in connection with the acquisition. In other words, the regulations generally would change the application of the ownership continuity test by increasing the numerator and denominator of the ownership continuity's testing fraction. Non-ordinary course distributions generally are those in excess of 110% of the average during the 36-month period preceding the year of the acquisition. (Notice 2014-52 also announced that a comparable look-back rule will be added to tighten the testing for substantiality for purposes of the limited exception to gain recognition under Treas. Reg. §1.367(a)-3(c).)

The Notice announced that Treasury and the IRS intend to exclude all distributions from the U.S. target from the definition of non-ordinary course distributions if former shareholders of the U.S. target own only a de minimis amount of stock in the foreign acquirer after the acquisition. The exception will apply when (i) the ownership continuity percentage (determined without application of Treas. Reg. § 1.7874-4T) is less than 5% (by vote and value), and (ii) after the acquisition and all related transactions, former owners of the U.S. target directly, indirectly and constructively own, in the aggregate, less than 5% (by vote and value) of members of the EAG that includes the foreign acquirer.

Inversions and business integration (change to Notice 2014-52 to clarify "small dilution exception")

Generally, sections 367 and 1248 operate to allow for taxation of a CFC's untaxed earnings on various dispositions of shares in the CFC by a U.S. shareholder. Using the asserted authority under section 7701(l) (which addresses multiple party financing transactions), Notice 2014-52 announced that Treasury and the IRS intend to issue regulations to prevent avoidance of sections 367 and 1248 by recharacterizing specified transactions. Generally, a specified transaction is one in which stock in an expatriated foreign subsidiary is transferred to a specified related person, or a U.S. target's share ownership in the expatriated foreign subsidiary is diluted. For this purpose, a specified transaction does not include (among other transactions) a transaction where the expatriated foreign subsidiary is a CFC after all related transactions, and the *amount of* stock (by value) in the expatriated foreign subsidiary (and any lower tier expatriated foreign subsidiary) that is owned in aggregate by U.S. shareholders does not decrease by more than 10% as a result of the specified transaction and any related transactions.

Expressing concern that taxpayers may be comparing the value of the stock of an expatriated foreign subsidiary owned by a section 958(a) U.S. shareholder immediately before a specified transaction with the value of the stock owned by that U.S. shareholder immediately after the specified transaction, the Notice announced that the future regulations will clarify that it is the change in the *percentage* of stock as measured by value held by the section 958(a) U.S. shareholder that is the relevant measure.

Effective dates of the new rules

The Notice announced the intent that future regulations issued thereunder will apply to inversion transactions completed on or after November 19, 2015. However, the regulations governing: (i) *indirect* transfers or licenses of property, (ii) full recognition of built-in stock gain in certain decontrolling transactions, and (iii) the clarification of the small dilution exception regarding transactions to decontrol or significantly dilute CFCs, will apply to such transactions and specified exchanges completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014.
