Deloitte.

International Tax

United States Tax Alert

May 21, 2014

Bills Extend Scope of Section 7874

Contacts

Jeff O'Donnell
jodonnell@deloitte.com

Richard Castanon
rcastanon@deloitte.com

Gretchen Sierra
gretchensierra@deloitte.com

Jonathan Traub
jtraub@deloitte.com

Dustin Coscarart
dcoscarart@deloitte.com

On Tuesday, May 20, 2014, House Ways and Means Committee Ranking Member Sander Levin (D-Mich.) introduced the "Stop Corporate Inversions Act of 2014" (the Bill). In addition, similar legislation was introduced in the Senate by Senate Permanent Subcommittee on Investigations Chairman Carl Levin, (D-Mich.). Both bills would make changes to the anti-inversion rules in Internal Revenue Code section 7874.

This alert highlights and summarizes the bills.

Background

Under current law, a foreign corporation (or a foreign publicly traded partnership, in either case a foreign acquirer) is treated as a surrogate foreign corporation under section 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 section 7874, an EAG is an affiliated group under section 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

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

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, section 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 Bills

Both bills would tighten the anti-inversion rules of section 7874 in several ways:

- All "inverted domestic corporations" (the new term would describe an entity captured by the new tests of the bills, while leaving the current definition of "surrogate foreign corporation" in place) as defined in the revised section 7874 would be treated as domestic for U.S. tax purposes (i.e., the "inversion gain" rules would be effectively repealed with respect to "inverted domestic corporations").
- The acquisition of substantially all of the assets of a domestic partnership, notwithstanding whether such assets would constitute a trade or business, could trigger "inverted domestic corporation" status
- The definition of an inverted domestic corporation would generally be based on a greater-than-50%, rather than present law's 60% (or 80%), continuity of ownership test with respect to an expatriated entity.
- An inverted domestic corporation would include a foreign corporation, notwithstanding lack of greater-than-50% continuity of ownership, if the management and control of the EAG occurs within the United States and the expanded affiliated group has "significant domestic business activities."
- An EAG would have significant domestic business activities if at least 25% of:
    - the employees of the group are based in the United States,
    - the employee compensation incurred by the group is incurred with respect to employees based in the United States,
    - the assets of the group are located in the United States, **<u>or</u>**
    - the income of the group is derived in the United States.
- The determination of significant domestic business activities would be made under rules similar to those contained within Treas. Reg. § 1.7874-3T applicable to the substantial business activities exception to section 7874. However, it should be noted that to qualify for the substantial business activities exception to section 7874, the EAG must satisfy the 25% threshold for each of the assets, employees and income tests, while the significant domestic business activities threshold will be crossed if any of the assets, employees or income tests pass the 25% threshold.

[4] Section 7874(a) and (e).

- Regulations would provide that the management and control of an EAG would be treated as occurring primarily in the United States if substantially all of the executive officers and senior management of the expanded affiliated group are based or primarily located in the United States.

The bills, as drafted, have a retroactive effective date that would apply to tax years ending after May 8, 2014 and the more stringent rules that apply with respect to "inverted domestic corporations" would apply to acquisitions occurring after May 8, 2014. The bills differ in one important aspect: the Senate version of the bill sunsets for transactions effective after May 8, 2016 (presumably to allow, or perhaps force, Congress to revisit the issue by May 8, 2016); the House version, by contrast, contains no sunset date.

Discussion

The prospects for enactment of the bills are uncertain. House and Senate Republicans have so far shown little appetite for addressing inversions outside the context of a fundamental tax reform plan that lowers corporate tax rates and embraces a territorial system for taxing income of U.S. multinationals. Earlier this month, Senate Finance Committee Chairman Ron Wyden (D-Ore.) published an op-ed in *The Wall Street Journal* in which he called for changes to Section 7874 that would be retroactive to May 8, 2014.[5] Although he clarified to reporters on May 20 that these changes were not likely to be enacted outside of tax reform, he indicated that he remained in favor of making them effective retroactively.[6] For his part, Ways and Means Committee Chairman Dave Camp (R-Mich.) has not embraced the notion of a retroactive effective date, and Senate Finance Committee Ranking Member Orrin Hatch (R-Utah) has rejected it outright.

Moreover, Congress has a mixed record when it comes to proposing and approving legislation with a retroactive effective date. When that happens, it is generally in a circumstance in which the chairmen of both tax writing committees are committed to that approach, a consensus that does not exist at this time. However, this is an issue that needs to be followed closely. An increase in the number of companies inverting could put additional political pressure on Congress to act. Further, Congress has two must-pass tax bills this year (the highway trust funds will need to be replenished this summer and the extenders bill is expected to be addressed later in 2014), and Senate Democrats may seek to force votes on the issue of inversions by concurrently proposing anti-inversion legislation as a revenue raiser to offset the cost of these two must-pass tax bills.

[5] See Wyden, Ron (2014, May 8). We Must Stop Driving Businesses Out of the Country. *The Wall Street Journal*. Retrieved from http://online.wsj.com.
[6] See Velarde, Andrew and McPherson, Lindsey. Inversion Rule Tightening to Wait for Tax Reform, Wyden Says. 2014 TNT 98-1.