Deloitte.

International Tax

United States Tax Alert

April 6, 2016

Anti-Inversion Guidance: Treasury Releases Temporary and Proposed Regulations

Contacts

Jeff O'Donnell
jodonnell@deloitte.com

Paul Crispino
pcrispino@deloitte.com

Jason Robertson
jarobertson@deloitte.com

On April 4, 2016, the United States Treasury and the IRS issued temporary regulations under Internal Revenue Code sections 304, 367, 956, 7701(l) and 7874 to address certain inversion and post-inversion transactions (collectively the "temporary regulations").[1]

Overview

The temporary regulations include rules previously described in Notice 2014-52 (the "2014 Notice"), issued on September 22, 2014 (see U.S. International Tax Alert dated September 23, 2014) and Notice 2015-79 (the "2015 Notice"), issued on November 19, 2015 (see U.S. International Tax Alert dated November 20, 2015). The temporary regulations also provide: (i) rules for identifying a foreign acquiring corporation when a domestic entity acquisition involves multiple steps; (ii) rules that disregard stock of the foreign acquiring corporation that is attributable to certain prior domestic entity acquisitions; (iii) rules that require a controlled foreign corporation (CFC) to recognize all realized gain upon certain transfers of assets described in section 351 that shift the ownership of those assets to a related foreign person that is not a CFC; and (iv) rules clarifying the definition of group income for purposes of the substantial business activities test.

In particular, the temporary regulations:

- Clarify the definition of "non-qualified property" as announced in the 2015 Notice at Temp. Reg. §1.7874-4T;
- Add the "Passive Assets Rule" announced in the 2014 Notice at Temp. Reg. §1.7874-7T;
- Add a "Multiple Domestic Entity Acquisitions Rule" at Temp. Reg.

[1] Unless otherwise indicated, all "section" references are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg. §" references are to the Treasury Regulations promulgated thereunder. On April 4, 2016, the United States Treasury and the IRS also issued proposed regulations under section 385 to address a broader range of transactions, which include certain financing transactions arising in the context of inversion and post-inversion transactions (the "proposed regulations"). These proposed regulations will be addressed in a separate U.S. International Tax Alert.

§1.7874-8T;

- Add the “Third-Country Rule” announced in the 2015 Notice at Temp. Reg. §1.7874-9T;
- Add the “Non-Ordinary Course Distribution Rule” announced in the 2014 Notice and modified in the 2015 Notice at Temp. Reg. §1.7874-10T and Temp. Reg. §1.367(a)-3T;
- Add the “Carve-Back of the Internal Restructuring Exception” announced in the 2014 Notice at Temp. Reg. §§1.7874-1T and -6T;
- Add the “Foreign Parent Tax Residency Requirement” announced in the 2015 Notice at Temp. Reg. §1.7874-3T;
- Clarify the definition of Group Income for purposes of the substantial business activities test at Temp. Reg. §1.7874-3T;
- Add a “Multi-Step Transactions Rule” at Temp. Reg. §1.7874-2T
- Add the “Expanded Inversion Gain Rule” announced in the 2015 Notice at Temp. Reg. §1.7874-11T
- Add the “Deemed U.S. Property Rule” announced in the 2014 Notice at Temp. Reg. §1.956-2T
- Add the “Specified Transactions Recharacterization Rule” announced in the 2014 Notice at Temp. Reg. §1.7701(l)-4T;
- Add the “Stock Dilution Rule” announced in the 2014 Notice and modified in the 2015 Notice at Temp. Reg. §1.367(b)-4T; and
- Clarify the application of section 304(b)(5)(B) as announced in the 2014 Notice at Temp. Reg. §1.304-7T.

Please note that the temporary regulations exceed 200 pages and should be studied carefully to assess their impact on particular transactions and taxpayers.

Inversion transactions

Section 7874

Section 7874 provides an exception to the generally applicable rule that a corporation is considered to be tax resident in the jurisdiction of its organization or incorporation (i.e. its home country). More specifically, under section 7874, a foreign corporation (or, in certain cases, a publicly-traded foreign partnership)[2] will be treated as a U.S. corporation if: (i) the foreign corporation, directly or indirectly, acquires substantially all of the properties held directly or indirectly by a U.S. corporation or partnership (“U.S. target”); (ii) the foreign corporation’s expanded affiliated group (EAG) does not have substantial business activities in its home country relative to the group’s worldwide activities; and (iii) after the acquisition, the former owners of the U.S. target hold at least 80% (by vote or value) of the foreign acquiring corporation’s shares by reason of holding an equity interest in the U.S. target (“80% ownership continuity test”).

If the 80% ownership continuity test is not met, but the former owners of the U.S. target hold at least 60% (by vote or value) of the shares of the foreign acquiring corporation by reason of holding an equity interest in the U.S. target corporation,

[2] For convenience, this Alert refers to the acquirer as a corporation.

the foreign corporation will be respected as foreign for U.S. tax purposes, *provided however*, that section 7874 will apply to limit the ability of the U.S. target and its U.S. affiliates to use certain U.S. tax attributes, such as net operating losses (NOLs) and tax credits, to offset U.S. taxable income resulting from certain transactions ("60% ownership continuity test"). In such case, the foreign acquiring corporation is treated as a "surrogate foreign corporation," and the taxable income of the U.S. target (and any U.S. person related to the U.S. target, each of which, including the U.S. target, is an "expatriated entity") for any given year, within a period beginning on the first date the U.S. target's properties were acquired directly or indirectly by the foreign acquiring corporation and ending 10 years after the last date the U.S. target's properties were acquired, will be no less than the expatriated entity's "inversion gain" for that taxable year. An expatriated entity's inversion gain includes, among other items, gain from the transfer of shares or any other property (other than property held for sale to customers) and income from the license of any property that is either transferred or licensed as part of the acquisition or after the acquisition to a non-U.S. related person.

Calculating ownership continuity

Disqualified Stock – Generally

Under section 7874(c)(2)(B) (statutory public offering rule), stock of a foreign acquiring corporation that is sold in a public offering related to the acquisition of a U.S. target is excluded from the denominator of the ownership fraction. Temp. Reg. §1.7874-4T modifies the statutory public offering rule to further exclude certain "disqualified stock" from the denominator of the ownership fraction. Disqualified stock generally includes stock of the foreign acquiring corporation that is transferred to a person (other than the U.S. target) in exchange for "nonqualified property." Prior to the clarification set forth below, the term "nonqualified property" generally meant (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations, or (iv) any other property acquired in a transaction (or series of transactions) related to the acquisition of the U.S. target with a principal purpose of avoiding the purposes of section 7874. The preamble to the temporary regulations, the 2014 Notice, and the 2015 Notice refer to property described in clauses (i), (ii), and (iii) as "specified nonqualified property" and to the property described in (iv) as "avoidance property."

Clarification of "Nonqualified Property" Definition

Consistent with previously announced guidance in the 2015 Notice, Temp. Reg. §1.7874-4T now provides that "avoidance property" means any property (other than specified nonqualified property) acquired with a principal purpose of avoiding the purposes of section 7874, regardless of whether the transaction involves an indirect transfer of specified nonqualified property.

Effective date: The clarification of the definition of avoidance property applies to acquisitions of U.S. targets completed on or after November 19, 2015.

Passive Assets Rule

Temp. Reg. §1.7874-7T disregards stock of a foreign acquiring corporation for purposes of calculating ownership continuity if such stock is attributable to certain passive assets (the "passive assets rule"). This rule generally incorporates guidance announced in the 2014 Notice and the 2015 Notice, with modifications, and includes an exception in the case of *de minimis* ownership continuity. More specifically, if more than 50% of the gross value of all "foreign group property" constitutes “foreign group nonqualified property,” stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the product of (1) the value of the stock of the foreign acquiring corporation, other than stock that is (a) received by former shareholders of the U.S. target by reason of ownership stock in the U.S. target, (b) excluded from the denominator of the ownership fraction by reason of being held by a member of the foreign acquiring corporation’s EAG, or (c) excluded from the denominator by reason of being disqualified stock, and (2) the “foreign group nonqualified property fraction.”

In applying this rule:

- The term “foreign group nonqualified property” means foreign group property that is specified nonqualified property and avoidance property (as such terms are defined above), other than certain financial assets of companies engaged in financing, banking and insurance activities, including specifically: (i) certain property that gives rise to income described in 954(h), (ii) certain property that gives rise to income described in section 954(i), (iii) property that gives rise to income described in section 1297(b)(2)(A) or (B), and (iv) certain property held by a domestic corporation that is subject to tax as an insurance company under subchapter L.

- The term “foreign group property” means any property held on the date the U.S. target is acquired, other than (i) property that is directly or indirectly acquired in the U.S. target, (ii) stock or a partnership interest in a member of the modified EAG, and (iii) an obligation of a member of the modified EAG.

- The term “foreign group nonqualified property fraction” means a fraction, the numerator of which is the gross value of all foreign group nonqualified property, other than property received by the EAG that gives rise to disqualified stock, and the denominator of which is the gross value of all foreign group property, other than property received by the EAG that gives rise to disqualified stock.

- The term “modified expanded affiliated group” (or “modified EAG”) means an EAG determined as if the foreign acquiring corporation were the common parent corporation.

For purposes of the passive assets rule, if one or more members of the modified EAG own, in the aggregate, more than 50% (by value) of the interest in a partnership, the partnership is treated as a corporation that is a member of the EAG.

As noted above, a *de minimis* exception applies when: (i) the ownership percentage—determined without regard to the application of the passive assets rule, disqualified stock and the non-ordinary course distribution rule (described below)—is less than 5% (by vote and value), and (ii) on the date that the acquisition of the U.S. target and all related transaction are complete, former owners of the U.S. target 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 EAG.

Effective date: The passive assets rule generally applies to acquisitions of a U.S. target completed on or after September 22, 2014. Certain aspects, such as the *de* *minimis* exception, the modified EAG rule, and the treatment of partnerships as a corporation that is a member of the EAG, apply to acquisitions completed on or after April 4, 2016. Further, the rule excluding certain financial assets of companies engaged in financing, banking and insurance activities from the definition of foreign group nonqualified property applies to acquisitions completed on or after November 19, 2015. For acquisitions completed before April 4, 2016, a taxpayer may elect to retroactively apply all the rules of Temp. Reg. §1.7874-7T.

Multiple Domestic Entity Acquisitions Rule

While not addressed in either the 2014 Notice or 2015 Notice, Temp. Reg. §1.7874-8T disregards stock of a foreign acquiring corporation for purposes of calculating ownership continuity if such stock is attributable to certain prior domestic entity acquisitions (the “multiple domestic entity acquisitions rule”). The rule effectively deflates the size of a foreign acquiring corporation in the context of serial acquisitions of U.S. targets.

More specifically, the rule applies to a domestic entity acquisition (“relevant domestic entity acquisition”) when the foreign acquiring corporation (including a predecessor) has completed one or more prior domestic entity acquisitions. Subject to a *de minimis* exception, a “prior domestic entity acquisition” generally means a domestic entity acquisition that occurred within the 36-month period ending on the first date on which the contract to effect the relevant domestic entity acquisition is a binding contract. In such a situation, stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the sum of the “excluded amounts” computed separately with respect to each prior domestic entity acquisition and each relevant share class.
For this purpose, an “excluded amount” is the product of (i) the total number of shares issued to former owners of a U.S. target by reason of their ownership of such U.S. target (“prior acquisition shares”), adjusted to account for share splits (and similar transactions) and redemptions; and (ii) the fair market value of a single share of stock of the relevant share class on the completion date of the relevant domestic entity acquisition. A “relevant share class” means, with respect to a domestic entity acquisition, each separate legal class of shares in the foreign acquiring corporation from which prior acquisition shares were issued.

Effective date: The multiple domestic entity acquisitions rule applies to domestic entity acquisitions completed on or after April 4, 2016, regardless of when a prior domestic entity acquisition was completed.

Third-Country Rule

For purposes of section 7874, ownership continuity generally is determined without regard to the country in which the foreign acquiring corporation is created or organized. Accordingly, if a U.S. target and a foreign corporation (acquired foreign target) are combining business operations, ownership continuity generally is the same whether (i) the acquired foreign target directly acquires the U.S. target, or (ii) the acquired 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 acquired foreign target).

If an acquisition of a U.S. target occurs in the context of a “third-country transaction,” as announced in the 2015 Notice, Temp. Reg. §1.7874-9T disregards stock of the foreign acquiring corporation for purposes of calculating ownership continuity if the stock is held by former shareholders of an acquired foreign corporation by reason of holding certain stock in that foreign corporation. As compared to guidance previously announced in the 2015 Notice, the "third country rule" now operates when stock held by former shareholders of the acquired foreign corporation exceeds a certain ownership percentage, rather than when gross value of the properties of the foreign acquiring corporation acquired from the acquired foreign corporation exceeds a certain percentage. More specifically, an acquisition of a U.S. target occurs in the context of a third-country transaction if:

- The foreign acquiring corporation completes a covered foreign acquisition pursuant to a plan (or series of related transactions that includes the U.S. target acquisition);

- After the covered foreign acquisition and all related transactions are complete, the foreign acquiring corporation is not subject to tax as a resident in the foreign country in which the acquired foreign corporation was subject to tax as a resident before the covered foreign acquisition and all related transactions; and

- The ownership percentage, determined without regard to the third-country rule, is at least 60.

The term "covered foreign acquisition" means a transaction in which (i) a foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by an acquired foreign corporation, and (ii) after the acquisition and all related transactions are complete, the foreign ownership percentage is at least 60%. For purposes of determining whether a covered foreign acquisition occurs, the principles of section 7874 generally apply, modified to take into account that the acquisition is of a foreign corporation rather than a U.S. target. Although not so treated in the 2015 Notice, it appears that a foreign corporation's migration of tax residency prior to the acquisition of a U.S. target is treated as a covered foreign acquisition for all purposes of the provision.

By excluding stock of the foreign acquiring corporation held by the former owners of the acquired 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 be 80% or more, rendering the foreign acquirer a U.S. corporation for all purposes of the Code in accordance with section 7874(b).

Effective date: The third-country rule generally applies to acquisitions of U.S. targets completed on or after November 19, 2015. For acquisitions completed between November 19, 2015 and April 4, 2016, taxpayers may elect to apply a rule that generally reflects the rule articulated in the 2015 Notice.

Non-Ordinary Course Distribution Rule

Temp. Reg. §1.7874-10T treats former owners of the U.S. target as receiving additional stock of the foreign acquiring corporation when the U.S. target has made non-ordinary course distributions (NOCDs). In other words, the regulations generally change the calculation of the ownership percentage by increasing the numerator and denominator of the ownership fraction. This NOCD rule expands on and clarifies guidance previously announced in the 2014 Notice and the 2015 Notice.

More specifically, for purposes of calculating the ownership percentage by value (but not vote), former owners of the U.S. target are treated as receiving, by reason of owning an interest in such U.S. target, stock with a fair market value equal to the amount of the NOCDs, determined as of the date of the distributions, made by the U.S. target during the 36-month period ending on the date of acquisition of the U.S. target (completion date) or, if shorter, the entire period starting with the formation date of the U.S. target (or a predecessor) and ending on the completion date (the "look-back period"). The temporary regulations set forth five steps for determining the amount of NOCDs:

1. Identify the look-back period.

2. Divide the look-back period into look-back years. Although the 2014 Notice contemplated using a taxable-year convention to determine a look-back year, the temporary regulations generally provide that a look-back year means any of the three consecutive 12-month periods that comprise the look-back period.

3. Identify the distribution history period for each look-back year. The distribution history period for a look-back year generally means the 36-month period preceding the start of the look-back year. When a look-back year is preceded by less than 12 months of history, then the look-back year is considered to not have a distribution history period.

4. Calculate the NOCD threshold for each look-back year. Generally, the NOCD threshold means 110% of the sum of the distributions made during the distribution history period for that look-back year, multiplied by a fraction the numerator of which is the number of days in the look-back year at issue, and the denominator of which is the number of days in the distribution history period for that look-back year.

5. Calculate, for each look-back year, the excess, if any, of all distributions made during the look-back year over the NOCD threshold for the look-back year. Such excess amounts constitute NOCDs.

To facilitate application of these rules, the temporary regulations include a "predecessor rule" by which a U.S. target inherits distributions made by a predecessor (and such predecessor could also inherit distributions made by a predecessor to it). In addition, pursuant to a *de minimis* exception, the NOCD rule does not apply if (i) the ownership percentage determined without regard to application of the NOCD rule, the disqualified stock rules under Temp. Reg. §1.7874-4T, and the passive assets rule, is less than 5% (by vote and value), and (ii) after acquisition of the U.S. target, former owners of the U.S. target 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 EAG.

To prevent perceived abuse, Temp. Reg. §1.7874-10T also provides that if a domestic corporation (distributing corporation) distributes stock of another domestic corporation (controlled corporation) pursuant to a transaction described in section 355 and, immediately before the distribution the fair market value of the stock of the controlled corporation represents more than 50% of the fair market value of the stock of the distributing corporation, the controlled corporation is deemed, on the date of the distribution, to have distributed the stock of the distributing corporation. This rule generally prevents taxpayers from avoiding application of the NOCD rule by causing a foreign acquiring corporation to acquire the controlled corporation (which, without this rule, would not have a distribution history).

Further, Temp. Reg. §1.7874-10T explicitly provides that if only a portion of a distribution is a NOCD, section 7874(c)(4) (disregarding the transfer of properties or liabilities (including by contribution or distribution) that are part of a plan a principal purpose of which is to avoid the purposes of section 7874) may apply to the remainder, but does not create a presumption that section 7874(c)(4) applies. For distributions that do not fall within the scope of the NOCD rule, this provision authorizes a "second bite at the apple" to re-inflate the U.S. target for purposes of determining ownership continuity under section 7874(c)(4), but provides no guidance as to when such re-inflation would be appropriate or inappropriate.

Note – see below under "Section 367 – Substantiality Test" for similar changes to the substantiality test of Treas. Reg. §1.367(a)-3(c).

Effective date: The NOCD rule generally applies to acquisitions of a U.S. target occurring on or after September 22, 2014. The *de minimis* exception applies to acquisitions occurring on or after November 19, 2015, and the rules applicable to section 355 distributions apply to acquisitions occurring on or after April 4, 2016. For acquisitions completed prior to November 19, 2015, taxpayers may elect to apply the *de minis* exception, and for acquisitions completed prior to April 4, 2016, taxpayers may elect to determine NOCDs on the basis of taxable years in lieu of 12-month periods, in a manner consistent with the principles of the temporary regulation.

Carve-Back of the Internal Restructuring Exception

Generally, section 7874(c)(2)(A) and Treas. Reg. §1.7874-1 apply the ownership continuity test by disregarding shares of the foreign acquiring corporation held by members of the EAG (the EAG rule), subject to two exceptions created by Treasury and the IRS. Shares of the foreign acquiring corporation held by an EAG member generally are included in the denominator but not the numerator (i.e. diluting the testing fraction to facilitate business combinations without application of section 7874) in (i) internal group restructurings where the common parent of the EAG owns at least 80% of the U.S. target before the acquisition and at least 80% of the foreign acquiring corporation afterward (the internal restructuring exception) and (ii) transactions where there is a loss of control (i.e. where the former owners of the U.S. target do not hold in the aggregate directly or indirectly more than 50% of any member of the foreign acquiring corporation's EAG).

Temp. Reg. §§1.7874-1T and -6T carve back the internal restructuring exception, providing that if stock of the foreign acquiring corporation received by a former owner of the U.S. target by reason of such person's ownership of the U.S. target is re-transferred in a transaction related to the acquisition of the U.S. target ("transferred stock"), such stock is not treated as held by members of the EAG and, accordingly, is included in the numerator and the denominator of the ownership fraction. This carve-back of the internal restructuring exception rule loosens the U.S.-parented group exception (described below) previously articulated in the 2014 Notice and otherwise generally is consistent with the guidance previously announced in such Notice.

The carve-back does not apply in the case of a U.S.-parented group if (i) before and after the acquisition the transferring shareholder is a member of the EAG and (ii) after the acquisition each of the transferring shareholder (or its successor), any person that holds transferred stock, and the foreign acquiring corporation are members of a U.S.-parented group the common parent of which (A) before the acquisition of the U.S. target was a member (including the parent) of the U.S.-parented group described in the first requirement, or (B) is a corporation that was formed in a transaction related to the acquisition of the U.S. target, provided that, immediately after the corporation was formed (and without regard to any related transactions), the corporation was a member of the U.S.-parented group described in the first requirement. The carve-back does not apply in the case of a foreign parented group if (i) before the acquisition the target and transferor of the re-transferred stock are members of the same EAG and (ii) after the acquisition the re-transferor is a member of the EAG or would be absent the transfer of stock in the foreign acquirer by a member of the EAG in a transaction related to the acquisition.

The carve-back is subject to a special “fungible stock” rule, which provides that if the transferring shareholder receives stock by reason of the acquisition of the U.S. target that has the same terms as other stock of the foreign acquiring corporation held by such transferring shareholder (fungible stock), and if the transferring shareholder re-transfers less than all of such fungible stock, a pro rata portion of the stock re-transferred is treated as consisting of the stock of the foreign acquiring corporation acquired by reason of the acquisition of the U.S. target. Further, similar to the passive assets rule, if one or more members of an affiliated group own, in the aggregate, more than 50% (by value) of the interest in a partnership, the partnership is treated as a corporation that is a member of the affiliated group.

The carve-back has the effect of denying use of the EAG rule and internal group restructuring exception in situations where a U.S. subsidiary of a U.S. multinational transfers substantially all its assets to a new foreign subsidiary and the shares of the new foreign subsidiary are distributed to the public in a section 368(a)(1)(D) reorganization and section 355 spin-off (i.e. a so-called “spinversion” transaction). As a result, the new foreign acquirer could be treated as a U.S. corporation by application of the general rules of section 7874.

Effective date: The carve-back of the internal restructuring exception rule is generally applicable to acquisitions of a U.S. target occurring on or after September 22, 2014. The fungible stock rule and the treatment of partnerships as a corporation that is a member of the affiliated group are generally applicable to acquisitions occurring on or after April 4, 2016. Taxpayers may elect either to apply the foreign-parented group exception to acquisitions completed before September 22, 2014 or to consistently apply the foreign-parented group exception, the fungible stock rule and the treatment of partnerships as a corporation that is a member of the affiliated group to acquisitions completed before April 4, 2016.

Substantial business activities

Generally

Under Treas. Reg. §1.7874-3, an EAG is considered to have substantial business activities in the country of organization or incorporation of the foreign acquiring corporation (the “relevant foreign country”) only if at least 25% of its group employees, group assets and group income are located or derived in the relevant foreign country.

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 acquiring corporation is created or organized, even if the foreign acquiring corporation 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). Temp. Reg. §1.7874-3T provides that an EAG cannot satisfy the substantial business activities exception unless the foreign acquiring corporation is also tax resident in the foreign country of its creation or organization. This foreign parent tax residency requirement rule is consistent with guidance previously announced in the 2015 Notice.

Effective date: The foreign parent tax residency requirement rule generally is applicable to acquisitions of a U.S. target occurring on or after November 15, 2015.

Clarification of Group Income

Treas. Reg. §1.7874-3 currently provides that group income is gross income from transactions occurring in the ordinary course of business with unrelated customers as determined consistently under either federal tax principles or as reflected in the EAG's financial statements. With respect to group income determined using the EAG's financial statements, Temp. Reg. §1.7874-3T clarifies that financial reporting principles are relevant only for determining the amount of items of income that are taken into account, as an EAG must take into account all items that its members recognized for financial accounting purposes.

Effective date: The clarification of group income rule generally is applicable to acquisitions of a U.S. target occurring on or after April 4, 2016. Taxpayers may elect to apply the rule to acquisitions completed on or after June 3, 2015 and before April 4, 2016.

Multi-step transactions rule

Treas. Reg. §1.7874-2(c)(2) provides that when a foreign corporation acquires stock of another foreign corporation, which in turn directly or indirectly owns stock of a U.S. entity, the acquisition by the foreign corporation does not constitute an indirect acquisition of any properties held by the domestic entity. The Treasury Department and the IRS expressed concern that application of the rule may facilitate transactions that are contrary to the purposes of section 7874. For example, Treas. Reg. §1.7874-2(c)(2) may allow taxpayers to avoid application of the third-country rule or to inappropriately take advantage of the substantial activities exception by causing a foreign acquiring corporation (the "initial acquiring corporation") that meets the substantial business activities exception or third-country rule to acquire a U.S. target, followed by an acquisition of the initial acquiring corporation by a foreign acquiring corporation (the "subsequent acquiring corporation") that would not meet such exception or test.

Temp. Reg. §1.7874-2T treats the subsequent acquisition of the initial acquiring corporation as an acquisition of a U.S. target and the subsequent acquiring corporation as a foreign acquiring corporation. For this rule, a "subsequent acquisition" means, with respect to an initial acquisition, a transaction occurring, pursuant to a plan that includes the initial acquisition (or series of related transactions), after the initial acquisition in which a foreign corporation directly or indirectly acquires substantially all of the properties of the initial acquiring corporation. In contrast with the multiple domestic entity acquisitions rule, this multi-step transactions rule does not include a deemed plan period. This rule applies solely for purposes of section 7874 and does not modify general tax principles (such as the step-transaction doctrine) or other rules of guidance that may apply to related transactions.

Effective date: The multi-step transactions rule generally applies to acquisitions of an initial acquiring corporation occurring on or after April 4, 2016.

Section 367 – Substantiality test

For purposes of determining whether a foreign acquiring corporation is substantial in relation to a U.S. target corporation, Temp. Reg. §1.367(a)-3T provides that the value of the U.S. target company includes the aggregate amount of NOCDs made by the U.S. target company, subject to application of a *de minimis* rule. In this regard, NOCDs and the *de minimis* exception are calculated in the same manner as provided under Temp. Reg. §1.7874-10T. (See the discussion of the "NOCD rule" above.)

Effective date: The section 367 – substantiality test rules generally apply for transfers completed on or after September 22, 2014. The *de minimis* exception applies on or after November 19, 2015, subject to an election to apply retroactively to September 22, 2014.

Post-inversion transactions

Expanded Inversion Gain Rule

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.

Temp. Reg. §1.7874-11T expands the application of the inversion gain rule to include 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. This rule generally is consistent with guidance previously announced in the 2015 Notice, but also includes amounts treated as a dividend under section 78 in inversion gain.

More specifically, Temp. Reg. §1.7874-11T denies the 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 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 also might 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.

Effective date: In general, the expanded inversion gain rule generally applies to transfers and licenses of property completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014.

Section 956: Deemed U.S. property rule

Generally, section 951(a)(1)(B), together with section 956, causes a U.S. shareholder of a CFC to have taxable income akin to a deemed dividend in respect of the U.S. shareholder's pro rata share of the CFC's investment in U.S. property. Over time, Congress has passed various rules to define what constitutes U.S. property to prevent repatriation of U.S. earnings without U.S. tax.

Temp. Reg. §1.956-2T modifies the statutory definition of "U.S. property" to include investments in stock or obligations of foreign related persons within the meaning of section 7874(d)(3) (or pledges or guarantees in respect of obligations of such persons), but only for CFCs for which an expatriated entity is a U.S. shareholder (i.e. an "expatriated foreign subsidiary"), and then only for stock, obligations, pledges, or guarantees acquired or entered into during the 10-year inversion gain period of section 7874 or in a transaction related to the acquisition of the U.S. target. Temp. Reg. §1.956-2T clarifies and expands upon rules previously articulated in the 2014 Notice.

For this purpose, a foreign related person is a foreign person that is related to or under common control with a U.S. target in an acquisition to which section 7874 applies (or a U.S. person related to the target), excluding expatriated foreign subsidiaries. Further, "U.S. property" does not include certain obligations of a non-CFC foreign related party arising in the ordinary course of business.

Section 956(e) authorizes regulations to prevent avoidance of section 956; however, as noted, section 956 also contains a specific list of investments decided over time by Congress to represent investments in U.S, property. Thus, these regulations represent an expansive reading of Congress' intent for anti-abuse regulations, so as to treat an investment in non-U.S. property as "U.S. property" without the need to trace a CFC's investment in such non-U.S. property back to a U.S. person (such as under a conduit arrangement).

The temporary regulations also incorporate the principles of Notice 88-108, Notice 2008-91, Notice 2009-10 and Notice 2010-12 (generally allowing short-term quarter-end loans provided each loan does not exceed 30 (or 60) days, and the CFC does not hold such obligations for 60 (or 180) days in total during the calendar year), but do not extend such principles to obligations of a non-CFC foreign related party.

Effective date: The deemed U.S. property rule generally applies to obligations, stock, guarantees, and pledges acquired or entered into, as appropriate, on or after September 22, 2014, but only if the acquisition of the U.S. target was completed on or after that date; *provided however*, that specific aspects of the rules are only applicable to such property acquired after April 4, 2016.

Decontrolling transactions

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. The temporary regulations protect, and in certain cases significantly modify, the application of these principles.

Specified Transaction Recharacterization Rule

Temp. Reg. §1.7701(l)-4T recharacterizes certain specified transactions for all purposes of the Code. This specified transaction recharacterization rule generally is consistent with guidance previously announced in the 2014 Notice and the 2015 Notice. More particularly, a specified transaction is, with respect to an expatriated foreign subsidiary, a transaction in which stock of the expatriated foreign subsidiary is issued or transferred to a person that immediately before the issuance or transfer is a specified related person, provided the transaction occurs during the 10-year inversion gain period of section 7874(d). A specified related person generally is a non-CFC foreign related person, a U.S. partnership that has one or more partners that is such a foreign person or a U.S. trust that has one or more beneficiaries that is such a foreign person.

A specified transaction in which the specified stock is *issued* by an expatriated foreign subsidiary to a specified related person is recharacterized such that (i) the transferred property is treated as having been proportionately transferred by the specified related person to each person that was a section 958(a) U.S. shareholder of the expatriated foreign subsidiary immediately before the specified transaction in exchange for deemed instruments in such section 958(a) U.S. shareholders, and (ii) the transferred property that is treated as transferred to such section 958(a) U.S. shareholder is treated as having been contributed by such person (through intermediated entities, if any, in exchange for equity in the intermediate entities) to the expatriated foreign subsidiary in exchange for deemed issued stock in the expatriated foreign subsidiary.

A specified transaction in which the specified stock is *transferred* by a shareholder of the expatriated foreign subsidiary to a specified related person is recharacterized such that (i) the transferred property is treated as having been proportionately transferred by the specified related person to each person that was a section 958(a) U.S. shareholder of the expatriated foreign subsidiary immediately before the specified transaction in exchange for deemed instruments in the section 958(a) U.S. shareholder, and (ii) to the extent a section 958(a) shareholder is not a transferring shareholder, the transferred property treated as transferred to such section 958(a) U.S. shareholder is treated as having been contributed by such person (through intermediate entities, if any, in exchange for equity in the intermediate entities) to the transferring shareholder in exchange for equity in the transferring shareholder.

For the purpose of these rules, the “deemed instruments” have the same terms as the specified stock issue or transferred (and, likely, therefore treated as equity for U.S. tax purposes). When a distribution is made with respect to the disregarded specified stock, matching seriatim distributions with respect to the deemed issued stock are treated as made by the expatriated foreign subsidiary, through intermediate entities, if any.

Pursuant to a *de minimis* exception, the specified transaction recharacterization rule does not apply to a specified transaction in which (i) immediately after the specified transaction and any related transaction, the expatriated foreign subsidiary is a CFC, (ii) the post-transaction ownership percentage with respect to the expatriated foreign subsidiary is at least 90% of the pre-transaction ownership percentage with respect to the expatriated foreign subsidiary, and (iii) the post-transaction ownership percentage with respect to any lower-tier expatriated foreign subsidiary is at least 90% of the pre-transaction ownership percentage with respect to the lower-tier expatriated foreign subsidiary. The rule also does not apply to a transaction otherwise recharacterized under the fast-pay stock rules or pursuant to which income and/or gain, as appropriate, was recognized under principles of Temp. Reg. §1.367(b)-4T (see discussion of the stock dilution rule, below).

Temp. Reg. §1.7701(l)-4T also includes rules that take into account changes in the status of the parties to the deemed arrangements, which may result in an unwinding of the deemed arrangement.

Congress enacted section 7701(l) in the wake of arrangements where three parties engaged in a chain of financing transactions (e.g., back to back loans from a Cayman company to a company resident in a country with a tax treaty with the U.S. and then in turn to a U.S. company, in hopes of obtaining treaty benefits for payments from the U.S. company). Congress specified that it intended to prevent tax avoidance by intermediate or conduit entities (even if not involving back to back loans). Thus, these regulations represent an expansive reading of Congress' intent for section 7701(l), given their impact on the integration of business assets of a U.S. target with a foreign acquirer (as opposed to shell intermediate companies), even when such arrangements do not include financing transactions.

Effective date: The specified transaction recharacterization rule generally applies to specified transactions completed on or after September 22, 2014, but only if the inversion transaction was completed on or after such date.

Stock Dilution Rule

In general, 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 Treas. Reg. §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). In the context of certain foreign-to-foreign transfers of stock or assets following an inversion transaction that would otherwise be governed by section 351 or 361, Temp. Reg. §1.367(b)-4T greatly expands the scope of Treas. Reg. §1.367(b)-4, generally requiring full gain recognition, including recharacterization of the section 1248 amount as a dividend if applicable.

First, pursuant to Temp. Reg. §1.367(b)-4T, if a foreign corporation (the transferee foreign corporation) acquires stock of a foreign corporation in an exchange described in section 351 or stock or assets of a foreign corporation in a reorganization described in section 368(a)(1) (in either case, the foreign acquired corporation), an exchanging shareholder must, if the exchange is a specified exchange: (i) include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges, and (ii) after taking into account the increase in basis resulting from the deemed dividend (if any), recognize all realized gain with respect to the stock that would not otherwise be recognized. For this purpose, an exchange is a "specified exchange" if (i) immediately before the exchange the foreign acquired corporation is an expatriated foreign subsidiary and the exchanging shareholder is either an expatriated entity or an expatriated foreign subsidiary; (ii) the stock received in the exchange is stock of a foreign corporation; and (iii) the exchange occurs during the 10-year inversion gain period under section 7874(d). An income inclusion under this rule does not qualify for the same country exception or section 954(c)(6) look-through treatment. Application of the rule is subject to a *de minimis* exception similar to the *de minimis* exception applicable under the specified transaction recharacterization rule.

Second, if an expatriated foreign subsidiary transfers specified property to a foreign corporation (the transferee foreign corporation) in an exchange described in section 351, the expatriated foreign subsidiary must recognize all realized gain with respect to the specified property transferred that would otherwise would not be recognized. As above, a *de minimis* exception similar to the *de minimis* exception applicable under the specified transaction recharacterization rule applies.

Effective date: The stock dilution rule generally applies to exchanges completed on or after September 22, 2014, but only if the inversion transaction was completed on or after that date. The requirement to fully recognize gain (rather than just the section 1248 amount) applies to exchanges completed on or after November 19, 2015, but only if the inversion was completed on or after September 22, 2014. The rule applicable to transfers of specified property by an expatriated foreign subsidiary in a section 351 exchange applies to transfers completed on or after April 4, 2016. Further, certain aspects of the foregoing rules apply only to exchanges or transfer completed on or after April 4, 2016, provided that taxpayers may elect to apply such aspect retroactively.

Section 304(b)(5)(B)

Generally, section 304(b)(5)(B) prevents the acquisition of stock in a section 304 transaction from resulting in a deemed dividend from the foreign acquiring corporation's earnings and profits unless more than 50% of the deemed dividend resulting from the acquisition is subject to U.S. tax or is includible in the earnings of a CFC. Consistent with guidance announced in the 2014 Notice, Temp. Reg. §1.304-7T expands the scope of section 304(b)(5)(B). More specifically, Temp. Reg. §1.304-7T(b) provides that only the earnings and profits of a foreign acquiring corporation (and none of the earnings and profits of a domestic issuing corporation) are taken into account in determining whether more than 50% of the dividends arising from the acquisition (determined without regard to section 304(b)(5)(B)) would neither be subject to U.S. federal income tax nor be includible in the earnings and profits of a controlled foreign corporation.

As an anti-abuse rule, Temp. Reg. §1.304-7T(c) disregards a partnership, option (or similar interest), or other arrangement that is used with a principal purpose of avoiding the application of Temp. Reg. §1.304-7T (e.g., by causing the selling shareholder to be treated as a controlled foreign corporation).

Effective date: Temp. Reg. §1.304-7T applies to acquisition that are completed on or after September 22, 2014.

Request for comments

The Treasury Department and the IRS request comments as to whether it is appropriate to treat other amounts included by a CFC in gross income as a dividend under section 964(e) as dividends from a related person to which section 954(c)(6) may apply.

Effect on other documents

The temporary regulations obsolete the following prior guidance: Notice 88-108, Notice 2008-91, Notice 2009-10, Notice 2010-12, Notice 2014-52, and Notice 2015-79.