



International Tax

United States Tax Alert

June 4, 2015

Treasury Releases Final Substantial Business Activities Regulations under Section 7874

Contacts

Jeff O'Donnell
jodonnell@deloitte.com

Matthew Ettl
metzl@deloitte.com

On June 3, 2015, Treasury and the Internal Revenue Service (IRS) released final regulations (T.D. 9720) under section 7874 of the Internal Revenue Code addressing when an expanded affiliated group (EAG) is considered to satisfy the substantial business activities exception in a foreign country for purposes of determining whether a foreign corporation is a surrogate foreign corporation under section 7874(a)(2)(B), and thus whether the anti-inversion rules apply. The new final regulations under Treas. Reg. §1.7874-3 replace former temporary regulations issued on June 7, 2012 (T.D. 9592) (the 2012 temporary regulations).

In short, Treasury and the IRS have retained the 25-percent, three-part substantial business activities test found in the former 2012 temporary regulations, with the final regulations continuing to require at least 25 percent of an EAG's group employees, group assets, and group income to be located in the foreign country in which, or under the laws of which, the acquiring foreign corporation was created or organized (the relevant foreign country). Although substantially the same as the former 2012 temporary regulations, the final regulations contain several clarifying changes.

Partnership Look-Through for Determining EAG Members

The final regulations clarify that a partner must look through the partnership in which the partner has an interest to the corporate stock held by the partnership in determining whether the partner, lower-tier corporations, or the partnership is an EAG member. The rule specifically provides that each partner in a partnership is treated as holding its proportionate share of stock held by the partnership under the principles of sections 701 through 777. Following application of the partnership look-through rule, and similar to the 2012 temporary regulations, partnerships owned more than 50 percent, in the aggregate, by members of the EAG are deemed corporations and members of the EAG.

Measuring Group Employees and Group Income

For purposes of determining the number of EAG employees in a relevant foreign jurisdiction, the final regulations permit the use of either (i) U.S. federal tax principles alone or (ii) local foreign country tax principles for employees performing services in the relevant foreign country and U.S. federal tax principles

for those employees performing services in the U.S.

Rules for measuring gross income under the group income test are also modified to permit the use of either (i) U.S. federal tax principles or (ii) financial statements prepared in accordance with U.S. GAAP or International Financial Reporting Standards (IFRS).

Modification to the Anti-Abuse Rule

The final regulations contain a slight modification to the anti-abuse rule found in the former 2012 temporary regulations. This basic rule excludes items disregarded under section 7874(c)(4), among other things, from the numerator (and not the denominator) of the ratio used in the group employees, group assets, and group income tests.¹ Under the final regulations, items associated with the transfer of property *to the EAG* that are disregarded under section 7874(c)(4) are now excluded from both the numerator *and* the denominator.

Relief for Mobile Assets

The former 2012 temporary regulations generally provide that a group asset is considered located in a relevant foreign country only where the asset is (i) physically present at the close of the acquisition date and (ii) predominantly located during the testing period. The final regulations provide relief for group assets that are “mobile in nature” and used in “transportation activity, such as a vessel, an aircraft, or a motor vehicle,” by looking only to where the mobile asset is predominantly located during the testing period.

Effective Date

The final regulations under Treas. Reg. §1.7874-3 apply to acquisitions completed on or after June 3, 2015.

¹ Section 7874(c)(4), in general, disregards “the transfer of properties or liabilities (including by contribution or distribution) . . . if such transfers are part of a plan a principal purpose of which is to avoid the purposes of [section 7874].”

Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a UK private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see <http://www.deloitte.com/about> for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms. Certain services are not available to attest clients under the rules and regulations of public accounting.

Deloitte provides audit, tax, consulting, and financial advisory services to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and deep local expertise to help clients succeed wherever they operate. Deloitte's approximately 200,000 professionals are committed to becoming the standard of excellence.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, its member firms, or their related entities (collectively the "Deloitte Network") is, by means of this publication, rendering professional advice or services. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

© 2015 Deloitte Global Services Limited