



BDO Seidman, LLP  
Accountants and Consultants

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## Subject:

### IRS Issues Additional Guidance on Section 7874 (“Inversions”)

# International Tax Alert

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**Section 7874** was enacted in 2004 in order to combat certain expatriations of U.S. companies to foreign (and presumably low tax) jurisdictions, hereafter referred to as “inversions.” The Treasury Department and the Internal Revenue Service continue to expand the guidance with respect to this Code provision.<sup>1</sup> New proposed and temporary regulations (REG-112994-06, T.D. 9265) provide welcome clarifications as to what constitutes a “surrogate foreign corporation.”

The new temporary and proposed regulations that were released on June 5, 2006 address the exception regarding “substantial business activities” in the foreign country for purposes of determining whether the foreign entity is treated as a surrogate foreign corporation under Section 7874(a)(2)(B). The new rules also attempt to clarify the meaning of “indirect acquisition” of properties and the ownership “by reason of” holding stock in the domestic corporation (or an interest in the domestic partnership). In addition, the new regulations contain anti-abuse provisions to target the use of publicly traded foreign partnerships and the use of options and similar interest to avoid Section 7874.

The following provides a brief overview of these new regulations.

#### **A. Inversions-General Principles:**

In accordance with Sec. 7874(a)(2)(B), a corporate inversion may generally occur when three requirements are met:

1. A foreign corporation acquires directly **or indirectly** substantially all of the properties of a domestic corporation (or the trade or business of a domestic partnership);

2. After the acquisition, at least 60 percent of such foreign corporation's stock (determined by vote or value) is held by former shareholders of the domestic corporation (or former partners of the domestic partnership) **"by reason of"** holding stock in the domestic corporation or an interest in the domestic partnership; and
3. After the acquisition, the expanded affiliated group (which includes the foreign acquirer) does not have **substantial business activities in the acquirer's country of incorporation**, when compared to the total business activities of such expanded affiliated group.

The result of such an "inversion" is that the foreign acquiring company becomes a "surrogate foreign corporation" with respect to the domestic corporation or partnership as the expatriated entity. The tax treatment of the surrogate foreign corporation varies depending on the level of shareholder continuity. If the percentage of stock (by vote or value) in the surrogate foreign corporation held by former shareholders is 60 percent or more (but less than 80 percent), the entity is treated as a foreign corporation, but any applicable corporate level income or gain required to be recognized by the expatriated entity (Section 311(b), 304, 1248, etc.) or any income or gain recognized by the reason of the transfer or license of property other than inventory or similar property, cannot be offset by net operating losses or credits of the expatriated entity. The treatment of the expatriated entity will apply for a 10-year period following the completion of the acquisition. Perhaps more significantly, where the former shareholders or partners of the domestic entity hold at least 80 percent of the foreign surrogate corporation, that foreign corporation shall be treated as a domestic corporation for all purposes of the Internal Revenue Code under Sec. 7874(b).

## **B. Indirect Acquisition of Properties:**

Under Section 7874, a foreign corporation is deemed to have indirectly acquired the properties of a domestic corporation if it acquires the stock of such domestic corporation, either (a) directly or (b) indirectly through the acquisition of another domestic corporation or of a domestic or foreign partnership owning the respective shares.<sup>2</sup>

In contrast, the acquisition of a **foreign** corporation which, in turn, owns a domestic corporation does not constitute an indirect acquisition of such domestic corporation for purposes of Section 7874. In other words: the acquisition of a foreign corporation (X) by a foreign corporation (Y) will typically not trigger an inversion, even if X owns shares in U.S. corporations or interests in U.S. partnerships. This exception seems reasonable since the acquired U.S. corporation has been under foreign control already, and continuing such foreign control under a different structure should have no adverse effect.

However, an indirect acquisition is possible if the domestic entity's stock or assets are acquired in exchange for shares of a foreign controlling corporation.<sup>3</sup> Consider the following scenario: Foreign parent (FP) forms a new foreign subsidiary (FS). FS acquires the shares of U.S. Co. in exchange for FP shares. In that case, FP (rather than FS) would be deemed to have acquired indirectly the shares of U.S. Co. and could thus become a surrogate corporation (to be treated as a U.S. corporation).

## **C. Former Shareholders Owning Stock of the Acquiring Foreign Corporation "By Reason Of" Holding Stock or an Interest in the Domestic Activity:**

For purposes of determining the 60 percent ownership threshold in the foreign acquiring corporation, the former shareholders need only count the (foreign) stock they own as a result of the transfer of their domestic interests.

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This rule is best explained through an example<sup>4</sup>: A holds all the stock of a domestic corporation (DC) and all the stock of a foreign corporation (FC). DC's outstanding stock is worth \$30, and FC's stock is worth \$70. A contributes DC and FC to FP, a foreign holding company, in exchange for 100 percent of the FP stock (Section 351 transaction). For purposes of Section 7874, A is considered to hold 30 percent of the FP shares "by reason of" holding stock in DC because the remaining 70 percent of his FP shares are owned by reason of contributing other assets (FC shares) to the foreign corporation. No inversion would have occurred because A would not be deemed to own at least 60 percent of the foreign corporation (FP) for purposes of Section 7874.

#### **D. Substantial Business Activities of the Expanded Affiliated Group:**

As indicated, where the expanded affiliated group has substantial business activities in the foreign country where the acquiring corporation is organized, an inversion can generally be avoided, even if the former shareholders are deemed to own 60 percent or more of the acquiring foreign corporation. Three questions are crucial to determine whether the substantial business activities exception applies:

1. What constitutes the expanded affiliated group (EAG)?
2. Which factors determine the presence of substantial business activities in the foreign country of incorporation?
3. Can the safe harbor test be met?

The term "**expanded affiliated group**" is defined by reference to Sec. 1504(a) except that it includes foreign corporations and lowers the affiliation threshold to "more than 50 percent".<sup>5</sup> This is a very broad definition and – in the case of a multinational – will often include virtually the entire group.

The definition of "**substantial business activities**" constitutes the cornerstone of the new regulations. In order for the business activities in the foreign country where the acquiring corporation is organized to be substantial, they must be substantial when compared to the total business activities of the entire EAG. It is also important to note that the acquiring corporation itself does not necessarily have to have an active business. Any EAG member's business activity in that country counts. The regulations provide two tests for determining whether the EAG has substantial business activities in the acquiring foreign entity's country of incorporation.

The first test is a test based on **facts and circumstances** that have to be taken into account to determine substantial presence. Factors to consider include<sup>6</sup>:

- Historical continuous presence;
- Operational activities involving property, employees and sales in the foreign country;
- Management by officers or employees based in the foreign country;
- Owners and/or investors residing in the foreign country; and
- Strategic planning in the foreign country.

In contrast, assets or activities transferred or contributed to the foreign country for the purpose of avoiding the application of this Section 7874 cannot be considered.<sup>7</sup>

The second test is a **safe harbor test**, in which the EAG will be deemed to have substantial business activities in the foreign country if it meets all of the following conditions<sup>8</sup>:

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1. After the acquisition, the group employees based in the foreign country account for at least 10 percent (by headcount and compensation) of total group employees;
  2. After the acquisition, the group assets located in the foreign country represent at least 10 percent of the total value of the all group assets; **and**
  3. During the 12 months period surrounding the acquisition, the sales in the foreign country account for at least 10 percent of the total group sales.

The new regulations include detailed definitions with respect to the terms “employee”, “group asset”, and “group sales” which are not further discussed here. However, it appears that this safe harbor test can be particularly difficult to meet by large multinational corporations with a global presence. That is because these global players will often have such widespread operations that no single foreign country can ever come near the required 10 percent threshold, at least not in all three categories.

### **E. Other Issues:**

The regulations also target two structures that the IRS perceives as abusive. First, the use of publicly traded partnerships can generally not avoid the application of Section 7874 because such partnerships are treated as foreign corporations and members of the EAG for purposes of determining the existence of a surrogate foreign corporation.<sup>9</sup> Second, options or similar interests (e.g., warrants, convertible debt) in the foreign acquiring corporation held by a former shareholder or partner of the expatriated entity must be treated as exercised<sup>10</sup>. Thus, the option holder will be taken into account for purposes of determining the 60 percent/80 percent continued ownership threshold.

### **E. Effective Date:**

The temporary regulations apply to acquisitions completed on or after June 6, 2006. In addition, taxpayers may choose to apply the regulations before the June 6, 2006 date; however, the regulations must be applied consistently to all covered acquisitions.

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<sup>1</sup> Earlier in 2006, Treasury published regulations outlining the rules on when and how stock held by members of the expanded affiliated group may be disregarded for purposes of determining the continuity of ownership. See Treas. Reg. § 1.7874-1T

<sup>2</sup> Treas. Reg. § 1.7874-2T(b)(1), (2), (3)

<sup>3</sup> Treas. Reg. § 1.7874-2T(b)(4)

<sup>4</sup> See Treas. Reg. § 1.7874-2T(c)(3)

<sup>5</sup> See Sec. 7874(c)(1).

<sup>6</sup> Treas. Reg. § 1.7874-2T(d)(1)(i), (ii)

<sup>7</sup> Treas. Reg. § 1.7874-2T(d)(1)(iii)

<sup>8</sup> Treas. Reg. § 1.7874-2T(d)(2)

<sup>9</sup> Treas. Reg. § 1.7874-2T(e)

<sup>10</sup> Treas. Reg. § 1.7874-2T(f)

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