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AN ALERT FROM THE BDO INTERNATIONAL TAX PRACTICE

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SUBJECT

TREASURY ISSUES LATEST ROUND OF ANTI-INVERSION GUIDANCE

SUMMARY

On April 4, 2016, the Internal Revenue Service (the "Service") and Treasury ("Treasury") issued temporary regulations relating to inversion transactions, as well as final regulations that revise and add cross-references to the temporary regulations. As discussed below, these regulations incorporate rules relating to inversions and post-inversion transactions included in prior notices, and include certain new rules relating to such transactions.

DETAILS

Background

A foreign corporation ("foreign acquiring corporation") generally is treated as a surrogate foreign corporation under Internal Revenue Code ("IRC") Section 7874(a)(2)(B) if pursuant to a plan (or a series of related transactions):

1. The foreign acquiring corporation completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation ("acquisition test") after March 4, 2003;
2. After the acquisition, at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation ("ownership test"); and
3. After the acquisition, the expanded affiliated group ("EAG") that includes the foreign acquiring corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized (relevant foreign country), when compared with the total business activities of the EAG ("substantial business activities test").

CONTACT:

ROBERT PEDERSEN, Partner and International Tax Practice Leader
(212) 885-8398 / rpedersen@bdo.com

JOE CALIANNO, Partner and International Technical Tax Practice Leader
National Tax Office
(202) 904-2402 / jcalianno@bdo.com

ROBERT M. BROWN, Partner
(412) 281-6018 / rmbrown@bdo.com

SCOTT HENDON, Partner
(214) 665-0750 / shendon@bdo.com

MONIKA LOVING, Partner
(404) 979-7188 / mloving@bdo.com

CHIP MORGAN, Partner
(310) 557-7517 / cmorgan@bdo.com

BRAD RODE, Partner
(312) 233-1869 / brode@bdo.com

WILLIAM F. ROTH III, Partner,
National Tax Office
(616) 776-3761 / wfroth@bdo.com

JERRY SEADE, Principal
(713) 986-3108 / jseade@bdo.com

Similar provisions apply if a foreign acquiring corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

The level of ownership in the foreign acquiring corporation by former shareholders of the domestic corporation (or former partners in the domestic partnership) under the ownership test determines the treatment of the transaction when the above three conditions are satisfied, thereby making the foreign acquiring corporation a surrogate foreign corporation. If the ownership percentage is at least 60 but less than 80, the foreign acquiring corporation is respected as a foreign corporation, but the domestic entity and certain related United States persons are treated as expatriated entities under IRC Section 7874(a)(2)(A). In such case, IRC Sections 7874(a)(1) and (e) prevent the use of certain tax attributes to reduce the United States tax owed with respect to certain income or gain recognized by an expatriated entity regarding certain transfers or licenses of property that occur as part of, or after, the inversion transaction. In contrast, if the ownership percentage is 80 or greater, IRC Section 7874(b) provides that a foreign corporation will be treated as a domestic corporation.

There are certain statutory anti-avoidance provisions in IRC Section 7874 (e.g., IRC Sections 7874(c)(4) and (g)) for which Treasury has previously issued guidance relating to the application of such provisions.

The 2014 and 2015 Notices

On September 22, 2014, Treasury issued Notice 2014-52, 2014-42 , I.R.B. 712 (the "2014 notice"), which announced its intention to issue regulations described therein to address certain transactions structured to avoid the purposes of IRC Section 7874 and Treasury Regulations Section1.367(a)-3(c), as well as certain post-inversion tax avoidance transactions. Some of the rules contained in the 2014 notice included the passive asset rule and the non-ordinary course distributions rule. Subsequently, on November 19, 2015, Treasury issued Notice 2015-79, 2015-49 I.R.B. 775 (the "2015 notice"), which announced its intention to issue regulations described therein to address certain additional transactions structured to avoid the purposes of IRC Section 7874 and Treasury Regulations Section 1.367(a)-3(c), as well as certain additional post-inversion tax avoidance transactions. The third country rule and the tax residency rule relating to the substantial business activities test were also included in the 2015 notice. The notices included rules relating to the application of IRC Sections 304, 367, 956, 7701(l), and 7874.

The New Temporary Regulations

The temporary regulations address the rules described in the two notices with certain modifications. In addition, the temporary regulations set forth new rules addressing issues that were not previously discussed, including:

1. Rules for identifying a foreign acquiring corporation when a domestic entity acquisition involves multiple steps;
2. Rules that disregard stock of the foreign acquiring corporation that is attributable to certain prior domestic entity acquisitions;
3. Post-inversion rules that require a controlled foreign corporation ("CFC") to recognize all realized gain upon certain transfers of assets described in IRC Section 351, which shift the ownership of those assets to a related foreign person that is not a CFC; and
4. Rules clarifying the definition of group income for purposes of the substantial business activities test.

The temporary regulations also contain the rules described in Notice 88-108, 1988-2 C.B. 445; Notice 2008-91, 2008-43 I.R.B. 1001; Notice 2009-10, 2009-5 I.R.B. 419; and Notice 2010-12, 2010-4 I.R.B. 326, concerning the short-term obligation exception from United States property for purposes of IRC Section 956. In addition, the temporary regulations provide a new definitions section under Treasury Regulations Section 1.7874-12T that defines terms commonly used in certain of the regulations under IRC Sections 367(b), 956, 7701(l), and 7874.

New rules (i) and (ii) mentioned above are discussed in more detail below.

Identifying a foreign acquiring corporation when a domestic entity acquisition involves multiple steps

In discussing rules for identifying a foreign acquiring corporation when a domestic entity acquisition is made, Treasury stated in the preamble to the temporary regulations that it is concerned that taxpayers may take the position that certain transactions are not domestic entity acquisitions, even if the transactions give rise to the policy concerns that motivated Congress to enact IRC Section 7874. Treasury provided the example of a foreign corporation ("initial acquiring corporation") that acquires substantially all of the properties held by a domestic entity ("initial acquisition") in a transaction that does not result in the initial acquiring corporation being treated as a domestic corporation under IRC Section 7874(b) (e.g., the ownership percentage is less than 80 or the EAG purports to meet the substantial business activities exception in Treasury Regulations Section1.7874-3). Furthermore, pursuant to a plan that includes the initial acquisition (or a series of related transactions), another foreign corporation ("subsequent acquiring corporation") acquires substantially all of the properties of the initial acquiring corporation ("subsequent acquisition"). In this case, Treasury indicated that a taxpayer may take the position that the form of the transactions is respected for U.S. federal income tax purposes and that Treasury Regulations Section 1.7874-2(c)(2) prevents the subsequent acquiring corporation from being considered to have indirectly acquired the properties of the domestic entity pursuant to the subsequent acquisition. Under this position, although the initial acquisition would be a domestic entity acquisition and the initial acquiring corporation would be a foreign acquiring corporation, the subsequent acquisition would not be a domestic entity acquisition, and the subsequent acquiring corporation would not be a foreign acquiring corporation. Moreover, for purposes of computing the ownership percentage, a taxpayer may assert that former domestic entity shareholders do not hold stock of the subsequent acquiring corporation by reason of holding stock in the domestic entity and, instead, hold stock of the subsequent acquiring corporation only by reason of holding stock in the initial acquiring corporation.

In certain cases, Treasury noted that these positions are contrary to the purposes of IRC Section 7874, including the purposes of (i) the third-country rule if the subsequent acquiring corporation and the initial acquiring corporation are subject to tax as residents of different foreign countries, or (ii) the substantial business activities exception if the EAG has substantial business activities in the foreign country in which, or under the laws of which, the initial acquiring corporation is created or organized but does not have substantial business activities in the foreign country in which, or under the laws of which, the subsequent acquiring corporation is created or organized.

To address these concerns, the temporary regulations provide the multiple-step acquisition rule that treats the subsequent acquisition as a domestic entity acquisition and the subsequent acquiring corporation as a foreign acquiring corporation. When the multiple-step acquisition rule applies, the temporary regulations treat stock of the subsequent acquiring corporation received, pursuant to the subsequent acquisition, in exchange for stock of the initial acquiring corporation (that is, stock of the initial acquiring corporation that, as a result of the initial acquisition, is by-reason-of stock) as stock of the subsequent acquiring corporation held by reason of holding stock in the domestic entity.

Further, if pursuant to the same plan (or a series of related transactions), a foreign corporation directly or indirectly acquires substantially all of the properties held by a subsequent acquiring corporation in a transaction that occurs after the subsequent acquisition, the principles of the multiple-step acquisition rule apply to also treat the further acquisition as a domestic entity acquisition and the foreign corporation that made such acquisition as a foreign acquiring corporation.

For example, if pursuant to a plan, a foreign corporation ("F1") acquires substantially all of the properties held by a domestic corporation, followed by another foreign corporation ("F2") acquiring substantially all of the properties held by F1, followed in turn by another foreign corporation ("F3") acquiring substantially all of the properties held by F2, then the multiple-step acquisition rule also would treat F3's acquisition of F2's properties as a domestic entity acquisition and F3 as a foreign acquiring corporation. In such a case, the principles of the multiple-step acquisition rule would apply in a similar manner to treat stock of F3 as by-reason-of stock to the extent the F3 stock is received in exchange for F2 stock that is itself treated as by-reason-of stock under the multiple-step acquisition rule.

The multiple-step acquisition rule applies in a similar manner when the domestic entity is a domestic partnership.

These rules do not affect the application of IRC Section 7874 to the initial acquisition and may also apply to the subsequent acquisition. As a result, IRC Section 7874 may apply to both the initial acquisition and the subsequent acquisition. In addition, the multiple-step acquisition rule applies solely for IRC section 7874 purposes. Accordingly, this rule does not modify general tax principles (such as the step-transaction doctrine) or other rules or guidance that may apply to related transactions.

Disregarding stock of the foreign acquiring corporation that is attributable to certain prior domestic entity acquisitions

Treasury noted in the preamble to the temporary regulations that it is concerned that a single foreign acquiring corporation may avoid the application of IRC Section 7874 by completing multiple domestic entity acquisitions over a relatively short period of time, in circumstances where IRC Section 7874 would otherwise have applied if the acquisitions had been made at the same time or pursuant to a plan (or series of related transactions). In these situations, the value of the foreign acquiring corporation increases to the extent it issues stock in connection with each successive domestic entity acquisition, thereby enabling the foreign acquiring corporation to complete another, potentially larger, domestic entity acquisition to which IRC Section 7874 will not apply. The preamble to the temporary regulations states that in some cases, a substantial portion of the value of a foreign acquiring corporation may be attributable to its completion of multiple domestic entity acquisitions over the span of just a few years, with that value serving as a platform to complete still larger subsequent domestic entity acquisitions that avoid the application of IRC Section 7874. That is, the ownership percentage determined with respect to a subsequent domestic entity acquisition may be less than 60, or less than 80, if the shares of the foreign acquiring corporation issued in prior domestic entity acquisitions are respected as outstanding (thus, included in the denominator but not the numerator) when determining the ownership fraction.

Treasury has concluded that it is not consistent with the purposes of IRC Section 7874 to permit a foreign acquiring corporation to reduce the ownership fraction for a domestic entity acquisition by including stock issued in connection with other recent domestic entity acquisitions. Moreover, Treasury further stated that it does not believe that the application of IRC Section 7874 in these circumstances should depend on whether there was a demonstrable plan to undertake the subsequent domestic entity acquisition at the time of the prior domestic entity acquisitions. Therefore, Treasury has issued regulations addressing this scenario by providing that the stock of the foreign acquiring corporation that was issued in connection with certain prior domestic entity acquisitions occurring within a 36-month look-back period should be excluded from the denominator of the ownership fraction. The temporary regulations provide under IRC Sections 7874(c)(6) and (g) that, for purposes of calculating the ownership percentage by value with respect to a domestic entity acquisition, (the relevant domestic entity acquisition), stock of the foreign acquiring corporation attributable to certain prior domestic entity acquisitions is excluded from the denominator of the ownership fraction. This rule (the multiple domestic entity acquisition rule) applies if, within the 36-month period ending on the signing date with respect to the relevant domestic entity acquisition, the foreign acquiring corporation (or a predecessor) completed one or more other domestic entity acquisitions that are not excluded under an exception (each such other domestic entity acquisitions, a prior domestic entity acquisition). In general, a domestic entity acquisition is excluded from the definition of a prior domestic entity acquisition if (i) the ownership percentage with respect to such domestic entity acquisition was less than five, and (ii) the fair market value of the by-reason-of stock received by the former domestic entity shareholders or former domestic entity partners did not exceed $50 million. The temporary regulations provide details relating to the application and operation of this rule, including rules relating to the calculation of the ownership percentage when applying this rule.

Applicability Dates

The applicability dates for the rules that were previously announced in the 2014 notice and the 2015 notice are consistent with the dates announced in the new temporary regulations Thus, the rules described in the 2014 notice address transactions that are structured to avoid the purposes of IRC Section 7874 apply to acquisitions completed on or after September 22, 2014, and the rules described in the 2015 notice that address transactions that are structured to avoid the purposes of IRC Section 7874 apply to acquisitions completed on or after November 19, 2015. Furthermore, the rules described in the 2014 notice that reduce the tax benefits of inversion transactions apply to post-inversion tax avoidance transactions completed on or after September 22, 2014. and the rules described in the 2015 notice that reduce the tax benefits of inversion transactions apply to post-inversion tax avoidance transactions completed on or after November 19, 2015. The rules apply only if the inversion transaction was completed on or after September 22, 2014, with one exception: consistent with the 2014 notice, the rule regarding the application of IRC Section 304(b)(5) is a generally applicable rule that applies without regard to whether there was an inversion transaction.

The new rules included in the temporary regulations, including any changes to rules described in the 2014 notice and the 2015 notice, generally apply to acquisitions or post-inversion tax avoidance transactions completed on or after April 4, 2016. In addition, the new rule in the temporary regulations that reduces post-inversion tax benefits (by requiring a CFC to recognize all realized gain upon certain IRC Section 351 transfers) applies only if the inversion transaction was completed on or after September 22, 2014. However, Treasury indicated in the preamble to the temporary regulations that no inference is intended as to the treatment of transactions described in the temporary regulations and the preamble under the law that applied before the applicability date of these regulations. The Service, where appropriate, may challenge transactions, including those described in the temporary regulations and this preamble, under applicable IRC or regulatory provisions or judicial doctrines.

BDO INSIGHTS

The rules contained in the new regulations represent Treasury's heightened focus on inversions and post-inversion transactions. The professionals in BDO's International Tax Services Group can assist you in navigating through the complexities of these rules.