INVERSIONS UNDER SIEGE: NEW TREASURY REGULATIONS ISSUED

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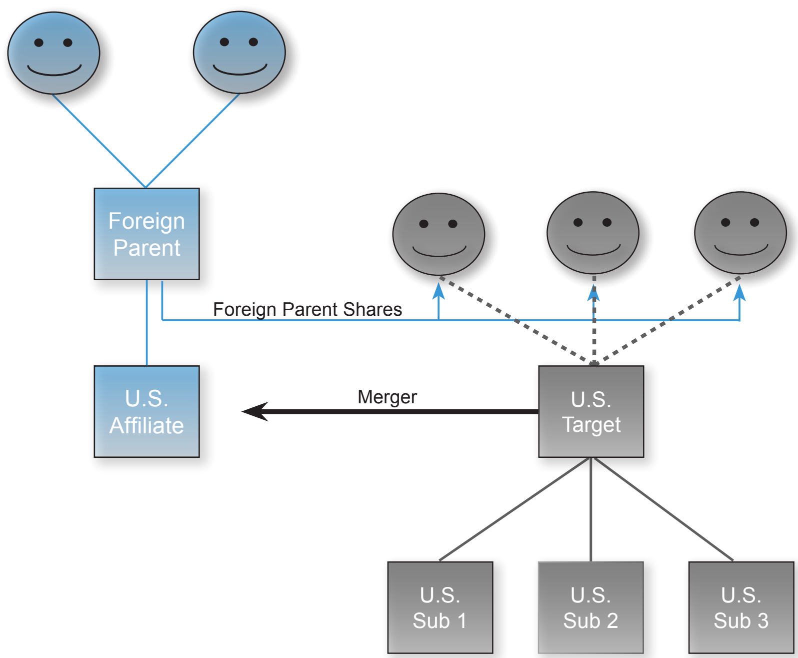
IN GENERAL

On April 4, 2016, the Treasury Department issued a third round of new rules under Code §7874 aimed at halting the wave of inversions that have allowed U.S.-owned multinational groups to restructure their global organization in order to lower U.S. taxes.[1] In an inversion, a U.S. parent corporation of a multinational group is replaced with a foreign parent corporation; the inversion is often structured as a merger of the U.S. parent into an affiliate of the foreign parent corporation with the shareholders of the U.S. parent getting stock of the foreign parent in that merger.



Notice 2014-52, issued on September 22, 2014, and Notice 2015-79, issued on November 19, 2015, created rules under §7874[2] aimed at stopping inversions. Those earlier efforts did not totally stop inversions, as illustrated by the recently-announced $160 billion Pfizer-Allergan merger that was set to close later this year. In this latest

1 On the day of the release, Treasury Secretary Jacob J. Lew announced, "Today, we are taking further action to make it more difficult to invert." U.S. Department of the Treasury, "Remarks by Treasury Secretary Jacob J. Lew on a Press Conference Call Regarding Announcement on Corporate Tax Inversions," press release, April 4, 2016.

2 References to a section are to a section of the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise indicated.

action, the Treasury issued regulations under these two notices and also made some changes aimed at bolstering their impact.[3] This recent action also expanded upon the earlier efforts, and within 24 hours of its release, Pfizer and Allergan announced their merger was scuttled due to these new rules.[4]

A major change adopted to halt inversions was the addition of a rule that disregards certain stock that is attributable to prior acquisitions of other U.S. companies (the "Multiple Domestic Entity Acquisition Rule") in computing whether a current transaction is subject to §7874.[5] The Multiple Domestic Entity Acquisition Rule will thwart efforts to increase the value of the foreign corporation (such as Allergan) by acquisitions of other companies made within three years of the signing of an agreement to participate in an inversion transaction. In a potential merger of a U.S. corporation (such as Pfizer) into a foreign corporation (such as Allergan), this new rule requires the enhanced value of the foreign corporation arising from these prior acquisitions to be removed from the calculation of the percentage interest acquired by the former shareholders of the U.S. corporation in the combined company. The result of this new rule is to increase the percentage ownership interest of the shareholders of the target, which makes the transaction more likely to be subject to §7874. In addition, the Treasury added the "Multiple-Step Acquisition Rule" aimed at halting multiple-step transactions that were designed to circumvent the inversion rules.[6]

Apart from these inversion rules, the Treasury also took extra steps that can have an impact on *any* international tax planning where related-party debt is involved.[7] In an unexpected move, the Treasury ignored Code §163(j), the earnings stripping provision,[8] and issued proposed regulations under Code §385.[9] While Code §385 directly addresses debt-equity classification issues, this section was dormant for decades with no regulations issued under it apart from a set of regulations that were withdrawn in 1983.[10] The proposed regulations target debt issued as a dividend to a foreign shareholder as well as related-party debt that was not issued to finance an acquisition. The Code §385 proposed regulations permit the I.R.S. to bifurcate a debt instrument into part debt and part equity, and add certain documentation requirements for large corporate groups. These proposed regulations can apply to any transaction and are not limited to inversions.

"Within 24 hours of [the Treasury] release, Pfizer and Allergan announced their merger was scuttled due to these new rules."

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3 Treas. Reg. §§1.304-7T, 1.367(a)-3T(c)(3)(iii)(C), 1.367(b)-4T, 1.956-2T(a)(4), 1.7701(l)-4T(h), 1.7874-1T(h)(2), 1.7874-2T(l)(2), 1.7874-3T(f)(2), 1.7874-4T(k)(1), 1.7874-6T(h), 1.7874-7T(h), 1.7874-8T(i),1.7874-9T(g), 1.7874-10T(i), 1.7874-11T(f), and 1.7874-12T(b).

4 Jonathan D. Rockoff, Liz Hoffman, and Richard Rubin, "Pfizer Drops Allergan Takeover," *Wall Street Journal*, April 6, 2016, A1.

5 Treas. Reg. §1.7874-8T.

6 Treas. Reg. §1.7874-2T(e).

7 This will be the subject of a future *Insights* article.

8 Earnings stripping occurs when a foreign shareholder of a U.S. corporation lends money to the U.S. corporation and the interest paid to the shareholder is not subject to 30% U.S. withholding tax. The goal is to create an interest deduction for the U.S. corporation and allow U.S. earnings to totally escape U.S. taxation. Code §163(j) is targeted toward earnings stripping, and if it is applicable, no deduction will be allowed to the U.S. corporation for interest paid on that loan.

9 Prop. Treas. Reg. §§1.385-1, 2, 3 & 4.

10 T.D. 7920, 1983-2 C.B. 69.

CODE §7874 FRAMEWORK TO CHALLENGE INVERSIONS

In 2004,[11] Congress enacted Code §7874 in order to halt abuses associated with inversion transactions. An inversion occurs when a U.S. corporation (or partnership) becomes a subsidiary of a foreign acquiring corporation ("F.A."),[12] and the shareholders of the U.S. corporation (or partners in the U.S. partnership) continue to own an interest in F.A. Among other post-acquisition planning techniques, the foreign subsidiaries previously owned by the U.S. parent can then be transferred to F.A., which eliminates potential U.S. tax on dividends and the impact of the controlled foreign corporation ("C.F.C.") rules.

The key factor under Code §7874 is whether F.A. will be treated as a surrogate foreign corporation, which will activate several limitations (*e.g.*, any "inversion gain" will be fully taxable from the date the acquisition begins until ten years after its completion, with only limited offset by losses and tax credits). Code §7874(a) provides that F.A. will be a surrogate foreign corporation if, pursuant to a plan or series of related transactions, the following conditions are met:

- F.A. acquires, directly or indirectly, substantially all of the properties held directly or indirectly by a domestic corporation or substantially all the properties constituting a trade or business of a domestic partnership.
- After the acquisition, at least 60% of the stock (by vote or value) of F.A. is held by former shareholders or partners of the domestic entity ("D.E.") by reason of their former ownership of D.E. (the "ownership percentage test").
- After the acquisition, F.A.'s "expanded affiliated group" ("E.A.G.") fails to meet the substantial business activities test, which works as an overall exception to Code §7874.

In determining the ownership percentage, the "ownership fraction" is referred to in the regulations and commentary. The ownership fraction has as its numerator the value (or vote) of the stock of F.A. acquired by the former shareholders of D.E. (the target U.S. corporation or partnership), and the denominator is the value (or vote) of all the stock of F.A. after the acquisition of D.E. is completed. For purposes of this computation, stock issued in a "public offering" is excluded from computation of this ownership fraction.[13] In addition, §7874(c)(4) provides that "[t]he transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of [§7874.]"

Code §7874(b) further provides that if the first and second conditions above are met and at least 80% of the stock of F.A. (by vote or value) is held by former own

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[11] Pub. L. 108-357, 118 Stat. 1418 (2004).

[12] Prior to adoption of Code §7874, an inversion could also occur if the U.S. parent corporation reincorporated into a foreign country with all its shareholders continuing to own stock in the reincorporated company. Code §7874, as discussed above, did away with this planning technique by treating the reincorporated company as a U.S. corporation. Code §7874(b).

[13] Code §7874(c)(2)(B).

ers of D.E. by reason of their historic ownership, F.A. will be treated as a domestic corporation for all Federal tax purposes.

NEWLY-ADOPTED MULTIPLE DOMESTIC ENTITY ACQUISITION RULE

Reason for Action

The Treasury wanted to close down a planning strategy, used by some foreign companies, in which multiple acquisitions of unrelated U.S. target corporations are made over time. This strategy allowed the foreign companies to avoid application of §7874, since each acquisition was analyzed on its own.[14] The major factor for determining if an inversion occurs is the ownership percentage that the shareholders of the U.S. target have in the foreign acquiring company. That ownership percentage is based on the ownership fraction noted above:[15] The numerator of this fraction is the value of the stock in the foreign company owned by the former shareholders of the U.S. target company, and the denominator is the value of all the stock in the foreign company owned by all shareholders after the acquisition.[16]

In a typical situation, the value of the stock of first U.S. target corporation to be acquired is small enough such that the shareholders of that first U.S. target do not own 60% or more of the foreign company. After that acquisition, the value of the foreign company is increased. As a result, the foreign company can acquire a larger U.S. target company, in a separate undertaking at a later time, without causing Code §7874 to apply.

After this second acquisition, the value of the foreign company stock owned by the shareholders of the second target would be less than 60% (or 80%). However, that percentage of interest would exceed 60% (or 80%) if the first acquisition is either disregarded or collapsed together with the second acquisition. There is a regulation that can collapse the two acquisitions into a combined transaction if they are part of a *plan* to acquire both companies. However, such a plan may not exist or, if it does, finding that plan can be very difficult, so this regulation has not been as useful as initially anticipated.[17]

The Treasury has now decided that certain prior acquisitions of U.S. corporations should be backed out of the computation of the denominator of the ownership fraction. This revised computation can push an acquisition into being an inversion subject to §7874.

Action Taken

The Multiple Domestic Entity Acquisition Rule is set forth in Treas. Reg. §1.7874-8T.

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14 T.D. 9761, Explanation of Provisions, I(B)(3). (April 8, 2016).

15 Treas. Reg. §1.7874-12T(a)(17).

16 The ownership percentage also has an alternate test based on vote, as previously discussed. Since the vote test can be more easily manipulated to prevent an inversion, practitioners have put greater focus on the value test when trying to avoid an inversion. As a result, the balance of this article will only refer to the value test for ease of presentation.

17 Treas. Reg. §1.7874-2(e).

This new rule will exclude from the denominator of the ownership fraction 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."[18]

A prior domestic entity acquisition is any acquisition of a domestic corporation made within the 36-month period ending on the signing date for the acquisition unless an exception applies.[19] An exception to this rule applies if the shareholders of this acquired domestic entity consequently hold less than 5% (by vote and value) of the stock of the foreign company and the fair market value of the foreign company did not exceed $50 million on the date the domestic entity was acquired.[20]

The determination of each excluded amount is done by a three step process:[21]

- First, the total number of shares of F.A. stock, outstanding after the prior domestic entity acquisition, must be calculated ("total number of prior acquisition shares").
- Second, for each relevant share class, the total number of prior acquisition shares must be adjusted to account for redemptions in the period after the completion date of the prior domestic entity acquisition, ending on the day prior to the completion date of the relevant domestic entity acquisition ("the general redemption testing period").[22]
- Third, for each relevant share class, the total number of prior acquisition shares, as adjusted, is multiplied by the fair market value of a single share of stock of the relevant share class, as of the completion date of the relevant domestic entity acquisition (the product is "an excluded amount").[23]

The total amount of stock of F.A. that is excluded from the denominator of the ownership fraction is the sum of the excluded amounts computed separately with respect to each prior domestic entity acquisition and each relevant share class.[24] This change applies to transactions undertaken after April 4, 2016.[25]

Pfizer-Allergan Deal Terminated Due to New Rules

As noted earlier, Pfizer's $160 billion deal with Irish-based Allergan was materially impacted by these new rules, and within 24 hours of the Treasury's actions, the planned merger was scuttled.

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18 Treas. Reg. §1.7874-8T(b).

19 Treas. Reg. §1.7874-8T(g)(4)(i).

20 Treas. Reg. §1.7874-8T(g)(4)(ii).

21 Treas. Reg. §1.7874-8T(c).

22 Treas. Reg. §1.7874-8T(e)(1). The number of redeemed shares is then multiplied by the redemption fraction (the product is the "allocable redeemed shares"). The numerator of the redemption fraction is generally the total number of prior acquisition shares, and the denominator is the sum of: (i) the number of outstanding shares of F.A. stock as of the end of the last day of the redemption testing period and (ii) the number of redeemed shares during the redemption testing period.

23 Treas. Reg. §1.7874- 8T(c).

24 Treas. Reg. §1.7874-8T(b).

25 Treas. Reg. §1.7874-8T(i).

> *"The Treasury was concerned that certain taxpayers were targeting foreign corporations with a value that was attributable to substantial passive assets rather than business assets."*

Under the rules in effect before these latest changes, Pfizer's shareholders were expected to get approximately 56% of Allergan's stock as a result of the merger. This percentage would not have triggered application of the U.S. inversion rules since it is less than the 60% ownership threshold.[26] In determining the stock ownership percentage and related ownership fraction, transactions conducted by Allergan in the last three years served to increase its value. Thus, the stock ownership percentage was decreased, with respect to Pfizer shareholders, to a rate below the 60% threshold. However, the addition of the Multiple Domestic Entity Acquisition Rule changes the way ownership in the combined company would be computed by disregarding the enhanced value that Allergan achieved through those prior acquisitions.

Allergan did several major deals in the last three years, including the $66 billion merger of Allergan and Actavis Plc, the $25 billion acquisition of Forest Laboratories, and the $5 billion takeover of Warner Chilcott.[27] Application of the new rules was expected to remove these deals from the computation of Allergan's value and, thus, increase the post-merger ownership percentage of the Pfizer shareholders. That risk resulted in the decision to cancel the merger.

NEWLY ADOPTED MULTIPLE-STEP ACQUISITION RULE

Reason for Action

Treas. Reg. §1.7874-2(c)(2) provides that when a foreign corporation ("Foreign Parent") acquires stock of another foreign corporation ("Foreign Sub") and Foreign Sub owns stock of a U.S. corporation (or an interest in a U.S. partnership) then Foreign Parent is not treated as making an indirect acquisition of the assets of the U.S. corporation or partnership. This regulation is a taxpayer favorable rule that prevents Foreign Parent from getting caught under the inversion rules.

The Treasury became aware that some taxpayers have realized that they can do a multiple-step acquisition that relies on §1.7874-2(c)(2) so that the second step can avoid being subject to §7874.[28] In the first step, a foreign corporation (the "initial acquiring corporation") acquires substantially all of the properties held by a domestic entity in a transaction that does not result in the initial acquiring corporation being treated as a domestic corporation under Code §7874(b) because the ownership percentage is less than 80% (the "initial acquisition"). In the second step, pursuant to a plan that includes the initial acquisition or a series of related transactions, another foreign corporation (the "subsequent acquiring corporation") acquires substantially all of the properties of the initial acquiring corporation (the "subsequent acquisition"). In this case, the subsequent acquiring corporation is not treated as acquiring any of the assets of the domestic entity based on Treas. Reg. §1.7874-2(c)(2). It is essential to this planning that the first step does not make the initial acquiring corporation a domestic corporation, which would occur if 80% or more of its stock was acquired initially by the shareholders of the domestic corporation.

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[26] Lynnley Browning & Michelle Cortez, "Pfizer-Allergan Deal May Be Imperiled by U.S. Inversion Rules," *Bloomberg*, April 5, 2016.

[27] Lindsay Dunsmuir & Carl O'Donnell, "New U.S. Inversion Rules Threaten Pfizer-Allergan Deal," *Fiscal Times*, April 4, 2016.

[28] T.D. 9761, Explanation of Provisions, I(A). (April 8, 2016).

Action Taken

Treas. Reg. §1.7874-2 defines when a foreign corporation becomes a surrogate foreign corporation. The Treasury has adopted temporary regulations to incorporate the Multiple-Step Acquisition Rule into the definition of a surrogate foreign corporation.[29] This change applies to transactions undertaken after April 6, 2016.[30]

ADOPTION OF REGULATIONS DESCRIBED IN NOTICE 2014-52

Notice 2014-52 (the "First Notice") described regulations that the Treasury intended to issue to address transactions that would avoid the purposes of §7874, as well as to address tax avoidance by corporate groups that have completed certain transactions described in §7874. The adopted Code §7874 regulations incorporate these rules with some modifications. Significant modifications are discussed below.

Disregarded Stock Attributable to Passive Assets

The Treasury was concerned that certain taxpayers were targeting foreign corporations with a value that was attributable to substantial passive assets rather than business assets. That type of cashbox foreign corporation would serve as the foreign acquiring corporation with the goal of removing the transaction from the application of Code §7874.[31] Since the passive assets were already held by the foreign corporation, the full value of the foreign corporation, including the value attributable to the passive assets, would be reflected in the denominator of the ownership fraction. The First Notice indicated that regulations would be issued to halt the use of foreign cashbox corporations.

Treas. Reg. §1.7874-7T incorporates this rule and identifies certain foreign corporation stock, which has substantial value and is attributable to passive assets. That stock is disregarded in determining the ownership fraction. If more than 50% of the gross value of all "foreign group property" is "foreign group nonqualified property," a portion of the stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction.[32] When triggered, this rule will skew the ownership fraction in the direction of the former shareholders of the domestic acquired corporation so that Code §7874 may apply.

One comment received by the Treasury was concern that this passive assets rule could apply to a case where the former shareholders of the U.S. target company get only a *de minimis* amount of stock in the foreign acquiring company.[33] The regulations address this point by adding a *de minimis* rule that applies if (i) the ownership percentage of the former shareholders is less than 5% measured by vote or value and (ii) the former domestic entity shareholders own less than 5% of any member of the E.A.G. headed by the foreign acquiring company.[34]

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29 Treas. Reg. §§1.7874-2T(a), (b)(7) -(13), (c)(2), (c)(4), (f)(1)(iv).

30 Treas. Reg. §1.7874-2T(l)(2).

31 Notice 2014-52, 2014-42 I.R.B. 712, § 2.01(b).

32 Treas. Reg. §1.7874-7T(b).

33 T.D. 9761, Explanation of Provisions, I(B)(2)(c)(i) (April 8, 2016).

34 Treas. Reg. §1.7874-7T(c).

This regulation generally applies to transactions undertaken after September 22, 2014.[35]

Disregarded Pre-Transaction Distributions by a Domestic Target

The so-called anti-skinnying rule of the First Notice would disregard any non-ordinary course distribution ("N.O.C.D.") made by the domestic entity during the 36-month period ending on the acquisition date.[36] This rule applies to all distributions, regardless of whether they are treated as dividends for tax purposes.[37] For example, a spin-off described in Code §355 would be a distribution subject to this rule.

Treas. Reg. §1.7874-10T incorporates this rule and, in determining the ownership fraction, disregards certain N.O.C.D.'s made by a domestic entity in the 36-month period before the inversion.[38] This means that former shareholders (or former partners) of the domestic entity (or former domestic entity partners) are treated as receiving additional stock of the foreign acquiring corporation when the domestic entity has made one or more N.O.C.D.'s.

For this purpose, an N.O.C.D. is any distribution within a look-back year in excess of the N.O.C.D. threshold for that look-back year.[39] A look-back year is generally each 12-month period within the 36-month period ending on the completion date.[40] The distribution history period referred to below means, with respect to a look-back year, the 36-month period preceding the start of the look-back year.[41] In both instances, adjustments are made for corporations with a shorter period of existence.

The N.O.C.D. threshold is generally equal to 110% of the distributions made within the distribution history period, multiplied by a fraction in which the numerator is the number of days in the look-back year and the denominator is the total number of days in the distribution history period.[42]

The regulations incorporate comments regarding the effect of post-distributions fluctuation in value.

> Accordingly, post-distribution fluctuations in the value of the stock or interests of the domestic entity, as applicable, or the value of the distributed property (for example, in the case of a spin-off), do not affect the amount of...stock that is deemed received.[43]

This regulation generally applies to transactions undertaken after September 22, 2014.[44]

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35 Treas. Reg. §1.7874-7T(h). Because it is a temporary regulation, this regulation expires in three years (*i.e.*, April 4, 2019). Treas. Reg. §1.7874-7T(i).

36 Notice 2014-52, 2014-42 I.R.B. 712, §2.02(b).

37 *Id.*

38 Treas. Reg. §1.7874-10T(a).

39 Treas. Reg. §1.7874-10T(h)(6).

40 Treas. Reg. §1.7874-10T(h)(5).

41 Treas. Reg. §1.7874-10T(h)(2).

42 Treas. Reg. §1.7874-10T(h)(7).

43 T.D. 9761, Explanation of Provisions, I(B)(5)(b)(i) (April 8, 2016).

44 Treas. Reg. §1.7874-10T(i).

Subsequent Transfers of Foreign Acquiring Corporation Stock

In determining the ownership percentage, Code §7874(c)(2)(A) and Treas. Reg. §1.7874-1 provide that certain stock held by members of the E.A.G. that includes the foreign acquiring company will not be taken into account in either the numerator or the denominator of the ownership fraction.[45]

To insure that these rules are not used as a device to avoid an inversion, Treas. Reg. §1.7874-5T, issued in 2012, indicates that stock that was acquired with the intent to carry out an inversion will not lose that status if it is subsequently transferred. As a result, the transferred stock will be included in the determination of the ownership percentage.

In the First Notice, the Treasury said it will supplement these rules by issuance of an additional rule applicable to stock of the foreign acquiring corporation that is (i) received by a former owner of the U.S. target company and (ii) later transferred in a transaction related to the inversion. That stock will be included in both the numerator and the denominator of the fraction, subject to two exceptions involving U.S.-parented groups and foreign-parented groups.[46]

Treas. Reg. §1.7874-6T incorporates these rules, but makes one helpful change by providing that the U.S.-parented group exception applies even if the common parent of the E.A.G. changes after the transaction.[47] The U.S.-parented group exception applies if (i) before and after the acquisition, the transferring corporation (or its successor) is a member of a U.S.-parented group; and (ii) after the acquisition, the person that holds the transferred stock, the transferor of such stock, and the foreign company that acquired the U.S. target company are all members of a U.S.-parented group headed by any of the following corporations: the original U.S. parent, another U.S. member of that group, or a new U.S. company formed in the overall transaction.[48]

The Treasury declined to accept a request for a change to the definition of a foreign-parented group to permit a restructuring. The foreign-parented group exception applies if (i) before the acquisition, the transferring corporation and the domestic entity are members of the same foreign-parented group and (ii) after the acquisition, the transferring corporation is a member of the E.A.G. or would be a member of the E.A.G. absent the subsequent transfer of any stock of the foreign acquiring corporation by a member of the foreign-parented group in an acquisition-related transaction.[49]

This regulation generally applies to domestic entity acquisitions completed on or after September 22, 2014.[50]

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45 However, such ownership will be taken into account in the denominator (but not the numerator) if the stock was acquired in an internal group restructuring, which can help to reduce the ownership percentage. Treas. Reg. §1.7874-1(c)(2).

46 Notice 2014-42, §2.03.

47 T.D. 9761, Explanation of Provisions, II(C)(3)(a) (April 8, 2016).

48 Treas. Reg. §1.7874-6T(c)(1).

49 Treas. Reg. §1.7874-6T(c)(2).

50 Treas. Reg. §1.7874-6T(h).

Application of Code §956

Code §956 provides that a U.S. shareholder of a C.F.C. recognizes income if the C.F.C. makes an investment in U.S. property. The Treasury expressed concern that an inverted domestic corporation could divert earnings from the U.S. group by having its foreign subsidiaries make loans to, or acquire stock of, a foreign affiliate outside the U.S.-parented chain. To prevent this money from bypassing the U.S. shareholder's tax return, the First Notice said that regulations will be adopted to require income inclusion under Code §956 in these situations.

Treas. Reg. §1.956-2T(a)(4)(i) incorporates this anti-hopscotch rule. If an expatriated foreign subsidiary (*viz.*, a C.F.C. subsidiary of a domestic corporation that was acquired in an inversion) acquires an obligation or stock of a non-C.F.C. related foreign corporation during the applicable period, the obligation or stock is treated as U.S. property under Code §956. The applicable period[51] is the ten-year period beginning on the date of acquisition of the domestic corporation.

The Treasury expanded the foregoing concept by including in the scope of the rule any obligation or stock of the related foreign corporation acquired in a "transaction related to the inversion transaction."[52] As a result, an obligation or stock acquired *before* the applicable period is covered by this rule if made in contemplation of the inversion.[53]

"An obligation or stock acquired before the applicable period is covered by this rule if made in contemplation of the inversion."

Consistent with the First Notice, the regulation provides that if the expatriated foreign subsidiary is a guarantor or pledger of debt of the non-C.F.C. related foreign person, then the C.F.C. is treated as holding an obligation of the non-C.F.C. person.[54] As a result, income recognition may then occur for the domestic corporation.

This regulation generally applies to obligations or stock acquired after September 22, 2014.[55]

Preventing De-Control of C.F.C. Stock

U.S. companies that are targets of inversions usually have many foreign corporate subsidiaries that are C.F.C.'s. The First Notice described certain specified transactions that may be undertaken, after the inversion, to de-control an expatriated foreign subsidiary so that it no longer is a C.F.C. The First Notice also indicated that regulations will be adopted to stop any tax benefits that such de-control may afford.[56]

Treas. Reg. §1.7701(l)-4T adopts these de-control rules.[57] Under these rules, the C.F.C. status of an expatriated foreign subsidiary is preserved despite a later stock issuance by that expatriated foreign subsidiary to a related non-C.F.C. foreign person. For example, a transaction by which an expatriated foreign subsidiary issues

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[51] Treas. Reg. §1.7874-12T(a)(2).

[52] Treas. Reg. §1.956-2T(a)(4)(i)(C)(2).

[53] T.D. 9761, Explanation of Provisions, II(A)(2)(a) (April 8, 2016).

[54] Treas. Reg. §1.956-2T(c)(5).

[55] Treas. Reg. §1.956-2T(i).

[56] Notice 2014-52, §3.02.

[57] T.D. 9761, Explanation of Provisions, II(B)(1)(b) (April 8, 2016).

stock to a related foreign person for cash will generally be re-characterized so that (i) the cash is deemed contributed by the related foreign purchaser of the stock to the U.S. inverted company and then (ii) the U.S. inverted company contributes the cash to the expatriated foreign subsidiary in exchange for a deemed issuance of stock.[58] As a result, the U.S. ownership of the expatriated foreign subsidiary is not reduced and it continues to be a C.F.C. Similar rules are adopted to prevent loss of C.F.C. status due to the transfer of stock in the expatriated foreign subsidiary to a related person.[59]

The regulation adopts two exceptions to the rules set forth in the First Notice.[60] The regulations add a new *de minimis* rule that can apply if at least 90% of the pre-transaction ownership in the expatriated foreign subsidiary is maintained, excluding the percentage of stock owned by non-C.F.C. related persons.[61] The regulations also contain a special rule that can unwind the impact of C.F.C. status if the disregarded stock in the expatriated foreign subsidiary is later transferred to an unrelated person.[62]

This regulation generally applies to specified transactions occurring on or after September 22, 2014, but only if the inversion was *completed* on or after such date.[63]

Preventing Dilution of Ownership Under Code §367 Regulations

Code §367(b) provides that a shareholder that exchanges stock of a foreign corporation for stock of another foreign corporation in certain tax-free transactions must include the Code §1248 amount in income as a deemed dividend, if the exchange results in (i) loss of C.F.C. status for the foreign corporation that issued the exchanged stock or (ii) loss of Code §1248 shareholder status for the shareholder involved in the exchange.[64] The Code §1248 amount is the portion of the C.F.C.'s non-previously taxed earnings and profits.[65] The First Notice provided that a stock dilution rule would be adopted, which would extend this deemed dividend treatment to certain nonrecognition transactions that occur after an inversion even if the transaction does not result in loss of C.F.C. status or Code §1248 shareholder status.

This stock dilution rule is adopted in Treas. Reg. §1.367(b)-4T(e)[66] with two new exceptions.[67] The first exception is built into the definition of specified exchanges and provides that this new rule does not apply if the exchanging shareholder is neither

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58 Treas. Reg. §1.7701(l)-4T(c)(2) (assuming the stock issuance is made within the 10-year period after the inversion).

59 Treas. Reg. §1.7701(l)-4T(c)(3).

60 Notice 2014-52, §3.02(e)(i)(C) adopted in Treas. Reg. §§1.7701(l)-4T(b)(2)(i), (ii). The two exceptions are for fast pay stock or a case in which a person pays full U.S. tax on the transfer of the stock.

61 Treas. Reg. §§1.7701(l)-4T(b)(2)(i), (iii).

62 Treas. Reg. §1.7701(l)-4T(d)(3).

63 Treas. Reg. §1.7701(l)-4T (h).

64 Treas. Reg. §1.367(b)-4(b).

65 Treas. Reg. §1.367(b)-2(c).

66 T.D. 9761, Explanation of Provisions, II(B)(2) (April 8, 2016).

67 T.D. 9761, Explanation of Provisions, II(B)(2)(c)(ii) (April 8, 2016).

an expatriated entity nor an expatriated foreign subsidiary.[68] The second exception is a *de minimis* rule.[69]

The temporary regulations also adopt a rule that can require income recognition for any unrealized gain if an expatriated foreign subsidiary transfers specified property to a foreign transferee corporation in a Code §351 transaction.[70]

This income recognition rule is generally applicable to exchanges completed after November 19, 2015, but only if the inversion was completed on or after September 22, 2014. However, the new Code §351 rule and certain other changes apply to transfers occurring on or after April 4, 2016.[71]

<u>Preventing the Repatriation of Untaxed Earnings Under Code §304 Regulations</u>

The First Notice addressed certain transactions that taxpayers are thought to engage in after an inversion in order to reduce a C.F.C.'s earnings and profits to facilitate a subsequent repatriation of cash or other property of the C.F.C. in a tax-free manner.[72] Treas. Reg. §1.304-7T addresses this concern, effective for transactions completed on or after September 22, 2014.[73]

An example in the regulations illustrates when this rule applies.[74] In the example, F.A., a foreign corporation that is not a C.F.C., owns 100% of a domestic corporation ("D.T.") that has $51 of earnings and profits. D.T. owns 100% of a C.F.C. ("F.S.1") that has $49 of earnings and profits. F.A. sells the D.T. stock to F.S.1 for $100. Code §304(a)(2) applies to the sale, so the $100 cash is treated as a distribution in redemption of D.T. stock owned by F.A. Under prior law, the $49 of F.S.1's earnings and profits would have been eliminated and the $100 cash would have been treated as a foreign-source dividend, not subject to U.S. tax. Under the temporary regulations, F.S.1's earnings and profits are not eliminated and the $100 of cash is treated as a U.S.-source dividend to the extent of D.T.'s $51 of earnings and profits.

As noted above, this new rule was adopted based on transactions undertaken following an inversion. However, this temporary regulation is not limited to transactions that are a part of an inversion transaction. As a result, it can have greater impact.

ADOPTION OF REGULATIONS DESCRIBED IN NOTICE 2015-79

Notice 2015-79 (the "Second Notice") described regulations that the Treasury intended to issue to address transactions that would avoid the purposes of Code §7874, as well as to address tax avoidance by corporate groups that have completed certain transactions described in Code §7874. The adopted Code §7874

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68 Treas. Reg. §1.367(b)-4T(e)(2).

69 Treas. Reg. §1.367(b)-4T(e)(3).

70 Treas. Reg. §1.367(b)-4T(f).

71 Treas. Reg. §1.367(b)-4T(h).

72 T.D. 9761, Explanation of Provisions, II(B)(4) (April 8, 2016).

73 Treas. Reg. §1.304-7T(e).

74 Treas. Reg. §1.304-7T(d), Ex. 1.

regulations incorporate these rules with some modification. Significant modifications are discussed below.

The "Third Country Rule"

The Second Notice addressed adoption of a Third Country Rule,[75] and it is incorporated in Treas. Reg. §1.7874-9T. The Third Country Rule involves a case in which a domestic entity is combined with an existing foreign corporation under a new foreign parent corporation that is a tax resident of a "third country."[76] The likely impact of this rule is to cause the new foreign parent company to be treated as a U.S. corporation unless the former shareholders of the domestic entity own less than 60% of the foreign parent company.

Some background is needed to understand the reason for this new rule. A foreign corporation may want to acquire a U.S. target corporation in exchange for its stock, but at the same time, the foreign corporation may want to restructure by establishing a new foreign parent holding company for the group with a tax residence that is different from that of the existing foreign corporation. In these circumstances, a new third-country parent acquires the stock of the existing foreign corporation, and the shareholders of the existing foreign corporation receive more than 20% of the stock of the new third-country parent. At the same time, the new third-country parent acquires the stock of the domestic entity, and the shareholders of the domestic entity receive less than 80% of the stock of the new third-country parent.

In the Second Notice, the I.R.S. said that such a "third-country transaction" is:

> Generally driven by tax planning including the facilitation of U.S. tax avoidance following the acquisition. For example, the third country may have a more favorable income tax treaty…with the result that U.S. withholding taxes on dividends, interest, and royalties paid by the domestic entity may be reduced or eliminated.[77]

Under this rule, if a third-country transaction occurs, this rule ignores the stock issued to the old shareholders of the existing foreign company in determining the ownership percentage of the former shareholders of the U.S. target in the new foreign parent.[78] A third-country transaction will generally occur if

- the former shareholders of the U.S. target company get 60% or more of the stock of the new foreign parent company ("share ownership test"),
- the new foreign parent company also acquired a foreign target company in the same transaction, and
- the foreign parent company is subject to tax in a country other than the country in which the foreign target company is taxed.[79]

The regulations adopt a share ownership (or continuity of interest) test rather than a

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75 Notice 2015-79, §2.02(b).

76 T.D. 9761, Explanation of Provisions, I(B)(4)(a) (April 8, 2016).

77 Notice 2015-79, §2.02(b).

78 Treas. Reg. §1,7874-9T(b).

79 Treas. Reg. §1,7874-9T(c). See also Treas. Reg. §1.7874-9T(f), Example.

test based on gross value of assets, which was set forth in the Second Notice. As a result, the new parent company will generally be classified as a domestic company if the former shareholders of the U.S. target company now own 80% or more of the shares of the new parent company.

This regulation generally applies to transactions undertaken on or after November 19, 2015. However, for transactions completed on or after November 19, 2015 but before April 4, 2016, taxpayers can elect to determine whether there has been a third-country transaction by use of the gross asset test in the Second Notice rather than the continuity of interest test in the regulations.[80]

"Nonqualifie property includes cash, marketable securities as well as any other property 'acquired with a principal purpose of avoiding the purposes of Code §7874.'"

Ownership Percentage Exclusions

A key factor in determining whether an inversion occurs is the ownership percentage. This invites planning to try to either increase the denominator or decrease the numerator to lower the ownership percentage. Code §7874(c)(2)(B), the "statutory public offering rule," provides that stock issued in a public offering that is related to the acquisition of a U.S. target company (*viz.*, the funds raised in the public offering are used by the company to finance the acquisition of the U.S. target company) is excluded from the denominator.

On January 16, 2014,[81] the Treasury adopted Treas. Reg. §1.7874-4T(b), which provides that disqualified stock is not included in the denominator of the fraction, subject to a *de minimis* exception. Disqualified stock includes stock of a foreign acquiring company that is transferred for "nonqualified property" when that exchange is related to the inversion transaction. Nonqualified property[82] includes cash, marketable securities as well as any other property "acquired with a principal purpose of avoiding the purposes of Code §7874."[83]

The Second Notice expressed concern that some taxpayers "may be narrowly interpreting the definition of avoidance property."[84] To address those situations, the Second Notice indicated that the definition of avoidance property will be modified to add the words "regardless of whether the transaction involves an indirect transfer of property." This change was adopted in revised Treas. Reg. §1.7874-4T(i)(7)(4).[85]

Most importantly, the Treasury added an example to illustrate how this may apply.[86] In the new example, a foreign partnership transfers certain business assets to a new foreign corporation in exchange for 25 of its shares, and at the same time, the shareholders of U.S. target company transfer their stock in the domestic target to new foreign corporation in exchange for the remaining 75 shares of the foreign corporation. The example concludes that the 25 shares issued to the foreign partnership were issued for avoidance property and, thus, those 25 shares are disqualified stock. As a result, the former shareholders of the domestic target own 100% of the new foreign corporation, which is caught by the inversion rules and is treated as a

80 Treas. Reg. §1.7874-9T (g).

81 T.D. 9654 (Jan. 16, 2014).

82 Treas. Reg. §1.7874-4T(i)(7).

83 Treas. Reg. §1.7874-4T(i)(7)(iv) ("avoidance property").

84 Notice 2015-79, §2.03.

85 T.D. 9761, Explanation of Provisions, §II(B)(1) (April 8, 2016).

86 Treas. Reg. §1.7874-4T(j), Example 3.

U.S. corporation. This change is effective for acquisitions completed on or after November 19, 2015.[87]

Substantial Business Activities

Code §7874 does not generally apply if the E.A.G. that includes the foreign acquiring company conducts "substantial business activities" in the country where the foreign acquiring company is formed.[88] Treas. Reg. §1.7874-3, adopted on June 3, 2015,[89] sets forth rules for determining if substantial business activities are conducted. Substantial business activities will exist if at least 25% of the group's employees, assets, and income are derived in the relevant foreign country.[90]

The Second Notice indicated that this regulation will be modified so that the "subject to tax" rule will only be met if the foreign corporation is also a resident of that foreign country.[91] Treas. Reg. §1.7874-3T(b)(4) adopted this rule without making any substantive changes and is effective for acquisitions after November 19, 2015.[92]

Inversion Gain

If an inversion occurs, Code §7874(a)(1) provides that, for any taxable year during the the ten-year period after the inversion, the taxable income of the expatriated U.S. entity will not be less than the inversion gain for that year. This rule does not allow the expatriated entity to use a net operating loss carry forward to offset the inversion gain. Inversion gain includes the income or gain recognized by the expatriated entity on a direct transfer of stock or other property from the inversion transaction or a license by the expatriated entity that was entered into as part of the inversion transaction.[93]

The Second Notice indicated that the Treasury will issue regulations that will provide that income or gain attributable to "indirect" transfers of stock or property by an expatriated entity, or an "indirect" license, will also be included as part of inversion gain. The Treasury was concerned that such indirect transfers may also remove "foreign operations from U.S. taxing jurisdiction while avoiding current taxation contrary to the policy underlying [the inversion rules]."[94] For example, after an inversion, a C.F.C. owned by the expatriated U.S. entity may sell property to the foreign acquiring entity in a transaction that generates Subpart F income to the expatriated U.S. entity. This Subpart F income is not classified as inversion gain under the Code. Therefore, it may be sheltered from tax by use of a N.O.L. carry-forward unless this indirect transfer rule is adopted.

Treas. Reg. §1.7874-11T adopts rules for determining inversion gain. The definition of inversion gain includes gain attributable to the "direct or indirect transfer of stock or other properties or license of any property either as part of the [inversion

87 Treas. Reg. §1.7874-4T(k)(1).

88 Code §7874(a)(2)(B)(iii).

89 T.D. 7874 (June 3, 2014).

90 Treas. Reg. §1.7874-3(b).

91 Notice 2015-79, §2.02(a).

92 Treas. Reg. §1.7874-3T(f)(2).

93 Code §7874(d)(2).

94 Notice 2015-79, §3.01((b).

transaction], or after such acquisition if the transfer or license is to a specified related person."[95] In response to a comment,[96] Treas. Reg. §1.7874-11T(b)(1) provides that inversion gain includes amounts treated as dividends under Code §78 with respect to foreign taxes deemed to be paid by an expatriated entity under Code §902(a) or Code §960(a)(1).

This regulation generally applies to transfers or licenses of property completed on or after November 19, 2015, but only if the inversion transaction was completed on or after September 22, 2014.[97]

CONCLUSION

The latest attempt to close down inversions has seen its first success story in the termination of the pending Pfizer-Allergan merger. While they are not prone to the same public exposure, there are likely many other inversions in the planning stages that will never see the light of day as a result of these actions. As we have also mentioned, the Treasury opened up a whole new front on the battle against inversions with its release of proposed regulations under Code §385 that take aim at related-party debt.

95 Treas. Reg. §1.7874-11T(b).

96 T.D. 9761, Explanation of Provisions, §II(C)(2) (April 8, 2016).

97 Treas. Reg. §1.7874-11T (f).