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CORPORATE EXPATRIATION TRANSACTIONS AND THE ANTI-INVERSION RULES,
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INVERSIONS

CORPORATE EXPATRIATION TRANSACTIONS AND THE ANTI-INVERSION RULES

Section 7874 *contains rules designed to stop potentially abusive corporate inversions, and do not apply to mergers where the combined companies have substantial business activities in the country of the new foreign parent.*

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Corporate tax inversions are amongst the "hottest" topics in Washington this year, with President Obama and other congressional Democrats, including members of the tax-writing committees in both houses, threatening action to stem the use of cross-border mergers by U.S. corporations to escape taxes by taking up tax residence overseas. The inversion issue controversy has recently been reported by the financial press with respect to large U.S. pharma companies expressing interest in inverting, and Burger King's unexpected announcement that it plans to move its headquarters to Canada. **1** Economist Paul Krugman referred to inversions as the "tax avoidance du jour" in an op-ed piece published by the *New York Times.* **2**

In fact, several anti-inversion bills have been filed with Congress this year in an effort to curtail, if not prevent, the exodus of expatriating U.S. multi-nationals. Many members of Congress share the view that inversions are paper-shuffling enterprises whereby the former U.S. domestic parent merely has to set up an office in a tax haven or low-tax jurisdiction to substantially reduce its U.S. income tax liability. On

5/20/2014 Senator Carl Levin (D-Mich.) introduced the Stop Corporate Inversions Act of 2014 which would, for two years, lower the stock ownership threshold from 80% to 50% for surrogate foreign corporations to be treated as an inverted *domestic* corporation under Section 7874(b). Senator Levin's bill reflects the Obama Administration's position on the subject as well as its view that anti-inversion legislation is presently needed.

Senator Levin's brother, Sander (D-Mich.), a ranking minority member of the House Ways and Means Committee, introduced a similar bill in the House but his version does not contain a two-year sunset date. In addition, on 04/11/2014, Senator Grassley (R-Iowa) and then Senate Finance Committee Chair, Max Baucus (D-Mont.), introduced the Reversing Expatriation of Profits Offshore Act (REPO). **3** The concern expressed by the President, the IRS, and certain members of Congress over the inadequacy of current law to stop inversions is the continued erosion of the U.S. corporate tax base. A short comment recently made by Senate Finance Committee Chair, Ron Wyden (D-Ore.) on whether anti-inversion legislation would be enacted by Congress this term and carry an early effective date is worth noting: "I don't approach retroactivity in legislation lightly, but corporations must understand that they won't profit from abandoning the U.S." **4**

While Congress, in enacting anti-inversion legislation in 2004, may have believed it had completed its work on the subject, the increasing list of U.S. multi-nationals moving off-shore over the past ten years has proven that its prior work was only a first effort and did not achieve its intended effect. Arguably much more is needed at this time besides congressional and administrative bantering about "toughening up" the anti-inversion rules. As part of such effort, Congress must also address and enact further reforms that will substantially reduce the corporate tax rate to be competitive with other countries, provide dividend repatriation relief to incentivize reinvestments of capital and labor in the U.S., as well as eliminate certain rules pertaining to U.S.-based intangibles and controlled foreign corporations that will effectively broaden the corporate tax base. Now, on to a summary of this controversial area of U.S. corporate tax laws.

A Wide-Angle View of Section 7874

The rules under Section 7874 are designed to prevent U.S. companies from moving their tax residence overseas in an effort to substantially reduce their current and overall exposure to U.S. income taxation, and thereby realize a substantial reduction in worldwide tax rate. Section 7874 does not apply to all corporate expatriations, only those with respect to which shareholders of the former U.S. domestic parent corporation have a substantial continuing ownership interest. Indeed, the determination of which of the two major rules in Section 7874 apply is based on retention of certain levels of stock ownership in the surrogate foreign corporation. The inversion rules do not apply to a corporate expatriation where the combined companies, including certain members of an affiliated group which include the foreign parent corporation, already have substantial business activities in the country of organization of the new foreign corporation.

As to this substantial business exception to Section 7874, the Service has been engaged in efforts to

increase the level of activity required for companies to fall within the exception. As discussed further below, temporary regulations issued in 2012 increased the threshold level of employees, assets, and sales of the "expanded affiliated group" (EAG) from a 10% worldwide factor to 25%. This narrowing of the substantial (foreign) business activities test effectively limits if not precludes single-company inversions. **5**

Taxation of Domestic vs. Foreign Corporations.

A domestic corporation, including a domestic parent of a consolidated group of corporations having foreign subsidiaries or affiliates, is currently subject to U.S. income tax on its worldwide income at a federal maximum rate of 35%. Double taxation of a domestic corporation's foreign source income is substantially mitigated through use of foreign tax credits, subject to applicable limitation, as well as the application of income tax treaties designed to prevent or eliminate double taxation, including through access to mutual cooperation provisions or through the successful negotiation of advanced pricing agreements. Generally, a domestic corporation's income derived from business operations conducted through one or more foreign subsidiaries is deferred for U.S. income tax purposes until repatriated in the form of a dividend or possible investment in the U.S. **6** There are also anti-deferral of foreign source income provisions contained in the controlled foreign corporation rules under Subpart F as well as the passive foreign investment company provisions. **7**

In contrast to a U.S. domestic corporation, a foreign corporation is generally subject to U.S. tax on a gross basis (without the benefit of deductions) on certain passive sources of income at a flat 30% rate (and applicable withholding), subject to certain exceptions. A foreign corporation is also subject to a net tax at rates applicable to domestic corporations on income "effectively connected" with the conduct of a trade or business conducted in the U.S., or, attributable to business operations conducted through (and affiliated with) a "permanent establishment" in the U.S. under applicable tax treaty. Therefore a foreign parent corporation of a group of subsidiary corporations and affiliates generally is not subject to U.S. income taxation on its foreign source income.

Many jurisdictions in which a foreign corporation is deemed to be resident have significantly lower corporate income tax rates than the U.S. **8** Some do not impose an income tax on a resident corporation's worldwide income opting instead for a territorial-based system. **9** This substantial, if not at times overwhelming, advantage of organizing a corporate business enterprise outside of the United States has led to an exodus of various U.S. parents by engaging in a corporate expatriation or inversion transaction to limit its tax base subject to U.S. income tax simply to its U.S. source income and effectively achieve a lower effective rate of corporate income tax on a worldwide basis. It has also produced an enormous if not unprecedented build-up of unrepatriated earnings of foreign subsidiaries of companies headquartered and resident in the U.S. **10** The Internal Revenue Service recently issued Notice 2014-32 **11** which limits a domestic corporation's ability to engage in a tax-free repatriation of foreign earnings of a foreign subsidiary under Section 367(b).

Corporate Expatriation Transactions Including Inversions

Corporate expatriation transactions, including a corporate "inversion," are reflected by one or a series of transactions designed to effect a readjustment or reorganization of the corporate structure of a U.S.-based multinational corporation (i.e., a U.S. parent corporation with domestic and foreign subsidiaries) into a structure which has a new foreign parent corporation. The U.S. parent may re-arrange its stock so that a new foreign corporation, conveniently located in a tax haven or jurisdiction with a low corporate tax rate, essentially steps in the shoes of the U.S.-based holding company, relegating the U.S. holding company to a first-tier subsidiary. Inversions can be effectuated by either stock or asset transfers although most reported corporate inversions are in the form of stock transfers.

In stock inversions, the U.S. corporation's shareholders exchange their shares of U.S. parent (pre-inversion) stock (or securities) for shares of the new parent, foreign corporation, either in a Section 351 transaction or a Type B reorganization. An asset inversion is effectuated by merger of the U.S. holding company with a new foreign corporation organized and managed outside of the U.S. as part of a Type C, D, or F reorganization. Other asset or stock transfers moving down the corporate chain of subsidiaries may also be part of the prearranged plan.

Tax Objectives

The intended tax objective of the corporate inversion is essentially to shift all or a substantial portion of the U.S. multinational's business operations overseas so that foreign source income of the affiliated group of corporations is not currently taxed in the U.S. Only U.S. source income, including income generated from the conduct of a trade or business through a permanent establishment in the U.S., would be taxable in the U.S. In many instances, the strategy is consistent with the expansion of the business operations into foreign markets and at more competitive tax rates. A corporate expatriation will also result in elimination of the application of the controlled foreign corporation rules under Subpart F. **12** Additional transactional elements of the restructuring may include setting forth debt **13** or other transactions between related parties to generate deductions such as royalties, management fees, or rents, or otherwise reduce U.S.-source income. In many instances the new foreign parent corporation may have limited activities in the selected foreign jurisdiction of incorporation.

Treatment Under Section 367

In an "expatriation" transaction, a consolidated/affiliated corporate group which had a domestic parent is restructured so that an existing or new foreign corporation becomes the parent of the group. There are several means by which such expatriation could be effectuated. The shareholders of the former U.S. parent corporation may contribute their stock to a foreign corporation in exchange for its stock in a Section 351 or Section 354 and Section 368(a)(1)(B) reorganization. **14** The tax consequences at this

point may appear to be somewhat benign subject to application of Section 367. **15** Another inversion method involves the U.S. parent corporation to transfer all of its assets, including subsidiary stock, both domestic and foreign, to a new or existing foreign corporation in exchange for shares of its stock as part of a non-taxable reorganization, including a triangular merger under Section 361(a)(2)(D) (forward triangular merger) or Section 361(a)(2)(E) (where former U.S. parent corporation survives the merger) again subject to Section 367. **16**

Where outbound transfers of domestic stock or securities are deemed to occur under Section 367(a)(1), gain recognition may result in the shareholders being treated as having exchanged their stock and securities in the former U.S. parent corporation for stock of the new foreign parent corporation. **17**

Prior to the enactment of Section 7874, an outbound exchange of domestic stock for stock of a foreign corporation generally resulted in gain (not loss) to a U.S. person in accordance with Section 367(a). **18** Where foreign subsidiaries or other assets were transferred to the "new" foreign corporation, the transfers may have resulted in taxable dispositions under Sections 311(b), 367, 1248, or other realization provisions.

Inversion transactions may give rise to immediate U.S. tax consequences at the shareholder or the corporate level, depending on the type of inversion. In stock inversions, the U.S. shareholders generally recognize gain (but not loss) under Section 367(a)(1), based on the difference between the fair market value of the foreign corporation shares received and the adjusted basis of the domestic corporation stock exchanged. **19** This gain is triggered where the U.S. shareholder-transferors of the stock of the domestic (parent) corporation in the aggregate receive stock in the transferee foreign corporation that is more than 50% by voting or value of the transferee foreign corporation. **20** Alternatively, gain recognition is required if more than 50% (by vote or value) of the stock of the foreign corporation (transferee) is owned in the aggregate, immediately after the transaction, by U.S. persons who are either 5% shareholders (by vote or value) or officers or directors of the transferred domestic corporation under the so-called "control group" rule. **21** To the extent that a U.S. parent corporation's share value has declined, or it has many foreign or tax-exempt shareholders, the effect of shareholder gain recognition under Section 367(a)(1) will be less costly.

Exception.

The regulations provide an active trade or business exception to the recognition of gain rules under Section 367(a)(1). Several requirements must be satisfied. First, the transferee foreign corporation or any "qualified subsidiary" or "qualified partnership" must have been engaged in an active trade or business outside the U.S. for the entire 36-month period preceding the transfer. **22** A second requirement is that neither the transferors of the stock nor the transferee foreign corporation, including as well any qualified subsidiary or qualified partnership, intend to substantially dispose of or discontinue the trade or business used to meet the three-year test. **23** A third requirement is that the transferee foreign corporation must satisfy a "substantiality test," i.e., its fair market value at the time of the transfer is at least equal to the fair

market value of the transferred domestic corporation. **24**

The transfer of foreign subsidiaries or other assets to the foreign parent corporation also may give rise to U.S. tax consequences at the corporate level (e.g., gain recognition and earnings and profits inclusions under Sections 1001, 311(b), 304, 367, 1248, or other provisions). The tax on any income recognized as a result of these restructurings may also be reduced or eliminated through the use of U.S. parent corporation's available net operating losses, foreign tax credits, and other tax attributes. In asset inversions prior to Section 7874, the U.S. corporation generally recognized gain (but not loss) under Section 367(a) as though it had sold all of its assets, but the U.S. shareholders generally did not recognize gain or loss, assuming the transaction satisfied the requirements of a reorganization. Congress, by passing Section 7874 and the special excise tax on "corporate insiders" under Section 4985 as discussed below, recognized that the application of Section 367 to corporate expatriations was insufficient to provide disincentives to engage in an inversion transaction.

Enactment of Section 7874

The legislative history of the tax treatment of expatriated entities and their foreign parents, i.e., Section 7874, enacted into law as part of the American Jobs Creation Act of 2004 (AJCA), evidenced Congress' concern that corporation inversion legislation was required to offset foreign countries, by use of lower tax rates and territorial-based tax systems, created an unfair advantage in the global economy. This unfair advantage needed had to be met with a disincentive to expatriate, and that was the purpose Section 7874 was intended to serve, i.e. to turn-off further erosion of the U.S. corporate income tax base and consequential revenue loss. **25** While Section 7874's purpose may have been laudable, it has not lived up to its intended goal and this is reflected by the continuing number of corporate expatriations, including inversions of U.S. companies.

Section 7874 sets forth two categories of inversion transactions which have distinct and separate outcomes. The two categories are based on continued stock ownership by the shareholders of the domestic corporation, i.e., the 80% continued stock ownership inversion and the 60% stock ownership inversion. There are three general factors used in determining whether an inversion transaction is within the scope of Section 7874. First, the transferee foreign corporation must acquire, directly or indirectly, substantially all of the properties held, directly or indirectly, by a domestic corporation. The second requirement is the "stock ownership test." A third test determines whether the transaction is within or without the scope of Section 7874, i.e., the "substantial business activities test." In order for Section 7874 to apply, after the transferee foreign corporation's acquisition, the expanded affiliate group, which includes the transferee foreign corporation, must not have "substantial business activities" in the jurisdiction in which the transferee foreign corporation is created or organized as compared to the expanded affiliate group's worldwide business activities. **26** So, if the substantial business activity test is satisfied, Section 7874 is inapplicable.

Definitions.

There are several important defined terms under Section 7874. An "expatriated entity," defined under Section 7874(a)(2), is any domestic corporation or domestic partnership substantially all of its properties have been acquired, directly or indirectly, by a "surrogate foreign corporation" over a four-year period beginning two years before the stock ownership test is satisfied as part of a plan of expatriation. **27** A "foreign surrogate corporation," defined in Section 7874(a)(2)(B), is a foreign corporation where, pursuant to a plan or series of related transactions, such foreign entity acquires substantially all of the properties held, directly or indirectly, of a U.S. corporation or substantially all of the properties constituting a trade or business of a U.S. partnership and after the acquisition at least 60% of the stock of the foreign transferee corporation (by vote or value (but not including stock sold in a related public offering or held by members of its expanded affiliated group)) of the entity is held by former shareholders of the domestic corporation or former partners of the domestic partnership (by capital or profits interest) and further provided that after the acquisition the EAG, which includes the foreign transferee corporation, does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared with the total business activities of such EAG. **28** In determining whether a transaction meets the definition of an inversion under the provision, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded.

For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. Stock sold in a public offering related to the transaction also is disregarded for these purposes. An exception is provided in Section 7874(a)(3) which provides that a corporation required to be treated as a "domestic corporation" under Section 7874(b) is not treated as a surrogate foreign corporation.

Section 7874(a) provides that any "expatriated entity," as well as any U.S. person deemed related to such "expatriated entity," must include its "inversion gain" in taxable income for any taxable period commencing with the date of its first property acquisition and ending 10 years after the date of such last related acquisition of property. The term "inversion gain," defined in Section 7874(d)(2), is income recognized by an expatriated entity during the applicable recognition period by reason of the transfer during such period of stock or other properties by an expatriated entity and any income received or accrued during the recognition period by reason of a license of any property (other than inventory type property described in Section 1221(a)(1)) by the expatriated entity.

Section 7874(b) treats certain inversion transactions (involving 80% or greater identity of prior stock ownership based on vote or value of such stock) as disregarded for U.S. tax purposes.In other words, an inverted corporate structure which has a foreign parent corporation which is owned by 80% or more of the

prior shareholders, both domestic and foreign, then the "foreign" corporation is for U.S. federal income tax purposes a domestic corporation and is subject to worldwide tax as a U.S. domestic corporation. As mentioned, current anti-inversion legislation pending before Congress would reduce the stock threshold for Section 7874(b) from 80% to 50%.

At a lower threshold of retained continuity of stock ownership, i.e. greater than 60% but less than 80% ownership in the new foreign parent corporation, Congress was willing to concede, in enacting Section 7874(a), that such change in stock ownership may be reflective, at least in part, of a transaction that had a sufficient nontax effect. Still, heightened scrutiny and other limitations would be applied to such transactions to avoid the erosion of the U.S. tax based through related-party transactions. In such a case, any applicable corporate-level tax on items of "inversion gain", required to be recognized under Sections 304, 311(b), 367, 1001, 1248, or any other provision with respect to the transfer of controlled foreign corporation stock or the transfer or license of other assets by a U.S. corporation as part of the inversion transaction may not be reduced or eliminated by the domestic corporations net operating losses, foreign tax credits, or other tax attributes which is not the case under the Section 367(a) regime. The rule does not apply to certain transfers of inventory and similar property. These measures generally apply for a ten-year period following the inversion transaction.

Corporate Inversion Transaction Type 1: 80% or More Stock Ownership Identity

The first type of inversion subject to **Section 7874(b)** is a transaction in which, pursuant to a plan or a series of related transactions:

> (1) A U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity in a transaction completed after 3/4/2003.
> (2) The former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 80% or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction.
> (3) The foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50% ownership (i.e., the "expanded affiliated group" or EAG), does not have substantial business activities in the entity's country of incorporation, compared to the total worldwide business activities of the expanded affiliated group.

In such case, the surrogate foreign corporation is treated as a domestic corporation for U.S. income tax purposes. Based on the "domestic" status of the new foreign parent corporation, the shareholder-level "toll-charge" rules in Section 367(a) do not apply to Section 7874(a) inversions.

Except as otherwise provided in the regulations, Section 7874(a) also does not apply to a direct or indirect acquisition of the properties of a U.S. corporation no class of the stock of which was traded on an established securities market at any time within the four-year period preceding the acquisition. In determining whether a transaction would meet the definition of an inversion under the provision, stock

held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. Where, for example, a former U.S. parent corporation receives stock of the foreign incorporated entity (e.g., so-called "hook" stock), the stock would not be considered in determining whether the transaction meets the definition. Stock sold in an initial or secondary public offering or private placement related to the transaction also is disregarded. Acquisitions with respect to a domestic corporation or partnership are deemed to be "pursuant to a plan" if they occur within the four-year period beginning on the date which is two years before the ownership threshold under the provision is met with respect to such corporation or partnership.

The Service published temporary regulations in 2012 addressing the requirements for a foreign corporation to meet the "substantial business activities" test under Section 7874(a)(2)(B)(iii). **29** The temporary regulations adopt a bright line test requiring that at least 25% of the expanded affiliated group's employees, assets, and gross income be located or derived in the relevant foreign country. This bright line test replaces the facts-and-circumstances test for determining substantial business activities, which applied under the immediately preceding temporary regulations. The Preamble to the temporary regulations states that the bright line rule will provide more certainty in applying **S**ection 7874 to particular transactions and will improve the administrability of the provision.

Where applicable, **Section 7874** treats the foreign corporation for all purposes of the Code as a domestic corporation. In such instance, there will be no shareholder gain recognition since **Section 367(a)** will not be applicable to Section 7874(b) transactions.

In testing for the requisite ownership percentage, stock held by members of the expanded affiliated group that includes the foreign incorporated entity is disregarded. For example, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded. **30** Stock sold in a public offering related to the transaction also is disregarded for these purposes. Stock held by members of an expanded affiliated group (EAG) that includes the surrogate foreign corporation is not taken into account for purposes of the ownership percentage test. Under Section 7874(c)(1), stock owned by members of an EAG is excluded from both the numerator and denominator of the ownership fraction. Still, affiliate owned stock is excluded from the numerator but not the denominator with respect to: (1) certain transactions that are part of an internal group restructuring involving a domestic entity; or (2) certain acquisitive business transactions between unrelated parties where the former shareholders or partners of the domestic entity have a minority interest in the acquired properties after the acquisition. **31**

Transfers of properties or liabilities as part of a plan, a principal purpose of which is to avoid the purposes of **Section 7874** , are disregarded. In addition, Congress, as reflected in the Senate Report to the provision, granted the Service authority to prevent the avoidance of the purposes of the proposal, including avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries, and through transactions designed to qualify or disqualify a person as a related person or a member of an expanded affiliated group. Similarly, the IRS is granted authority to treat certain non-stock instruments as stock, and certain stock as not stock, where necessary to carry out the

purposes of **Section 7874** .

Type 2: Greater Than 60% But Less Than 80% Stock Ownership Identity

The second, generic type of inversion transaction is described in Section 7874(a)(1) and occurs if 60% (but less than 80%) of vote or value stock ownership of stock acquired in the foreign corporation by the shareholders of the "expatriated entity" test is met. In such instance, Section 7874(a)(1) provides that the taxable income of an "expatriated entity" will, during the recognition period of ten years, be at least equal to the "inversion gain " of the entity for the tax year. **32** The foreign entity in this context is referred to as a surrogate foreign corporation. **33** Section 7874(a)(1) also applies to the transfer by a U.S. partnership of substantially all of its properties constituting a trade or business to a surrogate foreign corporation provided, again, that at least 60% of the foreign corporation's stock (by vote or value) after the acquisition is held by former partners of the domestic partnership by reason of holding a capital or profits interest. A domestic corporation or partnership with respect to which a foreign corporation is a surrogate foreign corporation is also defined as an expatriated entity under Section 7874(a)(2)(A).

In either a Type 1 or Type 2 inversion, the inversion rules will not apply where after the acquisition, the EAG has substantial business activities in the foreign country in or under the law of which the foreign corporation is created or organized, when compared to the total business activities of the EAG. **34** The regulations set forth when the EAG will satisfy the substantial business activity test; to-wit: (i) number of group employees in the relevant foreign country must be 25% or more of the total number of group employees; (ii) the compensation of group employees in the relevant foreign country must be at least 25% of total compensation of all group employees; (iii) the value of group assets located in the relevant foreign country must be 25% or more of the value of all group assets; and (iv) group income derived in the relevant foreign country must be 25% or more of the total group income. **35**

Taxation of Expatriated Entity's Inversion Gain.

Under a Type 2 corporate (or partnership) inversion under Section 7874(a)(1), the expatriated entity's inversion gain is subject to federal income tax at the maximum corporate rate without reduction by any tax attribute such as a net operating loss or foreign tax credit. **36** The taxable income of an expatriated entity for any tax year which includes the portion of the "applicable period," e.g., ten years following the inversion transaction, must be at least the amount of the entity's inversion gain for the tax year. Inversion gain is treated as U.S. source income for foreign tax credit purposes but foreign tax credits will not, as mentioned, reduce the tax on inversion gain

Inversion gain is income or gains realized by reason of the expatriated entity's transfer during the applicable period of stock or other properties. It also includes any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity as part of the acquisition

which results in an expatriated entity, or after the acquisition if the transfer or license is to a "foreign related person" under the constructive ownership rules of **Section 267(b)** or **Section 707(b)** , or under common control per **Section 482** . Inversion gain does not include, however, dealer property as held by the expatriated entity. **37**

Example 1. On 12/1/2012, A, a U.S. corporation, transfers its assets to "Newco" foreign corporation organized in the Cayman Islands for 75% of Newco's stock. The stock is distributed to A's shareholders. A is an expatriated entity under Section 7874(a)(2)(i) and Newco is a foreign surrogate corporation under **Section 7874(a)(2)(B)** . The exchange is effectuated to meet the requirements of a Type D reorganization. Still, gain is recognized by A under **Section 367(a)(5)** and Section 367(a)95), without regard to Section 7874. Gain recognized as to the foreign subsidiary stock is taxed under Section 1248 whereby certain foreign earnings and profits are taxed as a dividend. This inversion gain is taxable under **Section 7874(d)(2)(A)** . As inversion gain, A is taxed at the maximum corporate rate without use of its losses or other tax attributes.

Example 2. In 2013, a subsidiary of ForeignCo, a Caymanian corporation, merges into A, a U.S. corporation. Foreign Co. is treated as the acquiring corporation and the former shareholders of A receive 70% of ForeignCo's stock. No substantial business operations are conducted by ForeignCo in the Grand Caymans. A is an expatriated entity (Type 2) under Section 7874(a)(2)(i) and ForeignCo is a surrogate foreign corporation. The shareholders of A corporation recognize any gain on the exchange of their A stock for Foreign Co stock. **38** A recognizes no gain on the inversion and has no inversion gain. In 2015 and 2016, assets of A's U.S. subsidiaries and stock of other A U.S. subsidiaries are transferred to ForeignCo. Assuming the assets and stock have appreciated in value, A is treated as receiving "inversion gain" per **Section 7874(d)(2)(B)** because there is a transfer to a related foreign person after the transfer, and the transfers are within the ten-year applicable period which begins in 2012. In Year 3 and Year 4, assets of certain of T's U.S. subsidiaries and stock of other T subsidiaries are transferred to ForeignCo.

The tax on the inversion gain recognized under **Section 7874(d)(2)(B)** is not reduced by tax credits (other than the foreign tax credit) except to the extent that the tax exceeds the amount obtained by multiplying the inversion gain by the maximum U.S. corporate income tax rate and the inversion gain is treated as U.S. source income in determining the foreign tax credit. **39** This U.S.-source income treatment also applies for purposes of taking foreign tax credits into account in computing **Section 1248** gain.

Example 3. After a 60%-80% corporate inversion, a pre-inversion, foreign subsidiary of the expatriated (U.S.) entity is sold for a gain under the applicable ten-year period. Gain recognized as to the expatriated entity's sale of a foreign subsidiary is tax under **Section 1248** and characterized as ordinary income (dividend) to the extent of accumulated earnings and profits. The gain recognized by the expatriated entity is inversion gain and is taxable at the highest corporate income tax rate under **Section 11** . The inversion gain or rate of tax on the inversion is not reduced by the expatriated entity's operating loss, loss carryforwards, or other tax credits, including foreign tax credits.

Where the expatriated entity is a partnership, i.e., a direct or indirect transfer of substantially all properties

constituting a trade or business of a domestic partnership with the former partners of the U.S. partnership acquiring 60% but less than 80% ownership (by vote or value) of the surrogate foreign corporation's stock and there are insufficient business activities in the foreign corporation's country of organization or creation, the inversion gain is realized and taxed at the partner level. **40** A partner's inversion gain for a particular year is the sum of such partner's distributive share of the partnership's inversion gain plus gain recognized by the partner for the tax year resulting from the partner's transfer during the applicable period (of any partnership interest in the partnership to the surrogate foreign corporation and is computed at the highest rate of tax on individuals. Special rules apply in computing the individual partner's tax on the inversion gain. **41**

Application to Certain Partnership Transactions

Section 7874 also applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60% of the stock of the entity is held by former partners of the partnership who received such shares in exchange for interests in the partnership and provided that the other terms of the basic definition are met. All partnerships that are under common control, as defined under **Section 482** , are a single partnership unless otherwise provided in regulations. Any inversion gain of the expatriated partnership is taxed at the partner level.

Grandfather Rule

A transaction otherwise meeting the definition of an inversion transaction is not treated as an inversion transaction if, on or before 3/4/2003, the foreign-incorporated entity had acquired directly or indirectly more than half of the properties held directly or indirectly by the domestic corporation, or more than half of the properties constituting the partnership trade or business.

Anti-Avoidance Rules

Transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of **Section 7874** are disregarded. In addition, the IRS was authorized to issue regulations to prevent avoidance through the use of related persons, pass-through or other noncorporate entities, or other intermediaries. Similarly, Congress authorized the treatment of certain non-stock instruments as stock, and certain stock as not stock, where necessary, to carry out the purposes of the provision. **42**

Override of Tax Treaties

Congress specifically intended that the provisions of **Section 7874** would override any existing tax treaty

that would apply in a manner that is inconsistent with its rules and effects. 43

Barbados.

To further control the benefits of an inversion, the U.S. negotiated treaty changes with Barbados and the Netherlands, compressing the limitation of benefits provisions under the tax treaties with them. The protocols became effective beginning in 2005. Under the new Barbados limitation of benefits provision, a company can claim residence in Barbados only if it has regularly traded shares and those shares are primarily traded on the exchanges of Barbados, Jamaica, and Trinidad. In the case of a subsidiary, at least 50% of the shares must be owned by companies meeting the locus of trading test, and the subsidiary must further satisfy an earnings stripping limitation, designed to prevent profits from the subsidiary from being paid to persons who are not residents of Barbados. Under the earnings stripping limitation, less than 50% of the Barbados subsidiary's income may be paid or accrued in payments deductible for Barbados tax purposes to persons who are nonresident in Barbados.

The Netherlands.

The revised Dutch treaty limitations of benefits provision is less stringent. While a company's shares must be regularly traded, the trading may occur on several specified developed country exchanges besides the U.S. and the Netherlands. Nevertheless, the company will not be entitled to treaty benefits if it has "no substantial presence" in the Netherlands. In the case of a subsidiary, at least 50% percent of the shares must be owned by five or fewer companies that meet the trading test. In the case of a Dutch resident company, it has "no substantial presence" in the Netherlands if (1) the aggregate volume of trading in its shares is greater in the NAFTA region than in Europe or (2) the company's shares traded are either not traded in Europe or less than 10% of worldwide trading in its shares occurs in Europe, and the company's primary place of management and control is not in the Netherlands.

Other Related Changes Enacted With Section 7874

As discussed below, Congress also introduced an excise tax, per **Section 4985** , on the stock compensation of certain corporate insiders to the expatriated entity in cases where any shareholders are required to recognize gain on their stock as a result of the inversion. And new **Section 6043A** requires information reporting by acquiring corporations of potential inversions. 44

Transfers of Intangibles

A transfer by a U.S. person of U.S. based "intangibles" to a foreign (controlled) corporation or in a tax-free reorganization is governed by **Section 367(d)** . Intangibles are described in **Section 936(h)(3)(B)** and

include patents, trademarks, copyrights, franchises, licenses, methods, and similar items, but not goodwill. In such instance the U.S. transfer is treated as having sold the intangible property in exchange for a hypothetical series of payments which are contingent on the productivity, use, or disposition of the property. It is taxed at ordinary income rates, on amounts that reasonably reflect the amounts that would have been received over the useful life of the property or, in the case of certain dispositions, after the transfer at the time of such disposition. **45** The rule was enacted to police the transfer of valuable intangibles outside of the U.S. without imposition of a tax based on their projected value over their useful life. **46**

Manchester United IPO.

When the famous British professional soccer club Manchester United was taken public by its U.S. owners, a reorganization was apparently structured to fall with the treatment of an inversion transaction under the 80% or Type 1 inversion. The new parent corporation was a Cayman holding company, which may have been purposely designed to avoid application of **Section 367(d)** . While the popular team owned valuable intangible assets, where a Type 1 inversion occurs, the new Caymanian corporation is a domestic corporation for tax purposes, and **Section 367(d)** is completely avoided. While tax on the team's intangible assets was avoided, the Caymanian corporation would be taxed on its worldwide income in the U.S., and thus this transaction was not the type of tax exodus that has recently concerned commentators and politicians.

Imposition of Excise Tax on Stock Compensation

Under Section 4985(c), which was also enacted in 2004 in AJCA as part of the anti-inversion legislation, a "disqualified individual" is subject to a 15% excise tax under Section 4985(a) on the value of specified stock compensation held (directly or indirectly) by or for the benefit of a disqualified individual, or a member of such individual's family, at any time during the 12-month period beginning six months before the corporation's expatriation date. The excise tax applies to any such specified stock compensation previously granted to a disqualified individual but cancelled or cashed-out within the six-month period ending with the expatriation date, and to any specified stock compensation awarded in the six-month period beginning with the expatriation date. For example, where a corporation cancels outstanding options three months before the transaction and then reissues comparable options three months after the transaction, the tax applies both to the cancelled options and the newly granted options.

Specified stock compensation subject to the tax does not include a statutory stock option or any payment or right from a qualified retirement plan or annuity, tax-sheltered annuity, or simplified employee pension. In addition, under the provision, the excise tax does not apply to any stock option that is exercised during the six-month period before the expatriation date or to any stock acquired pursuant to such exercise, if income is recognized under Section 83 on or before the expatriation date with respect to the stock acquired pursuant to such exercise. The excise tax also does not apply to any specified stock

compensation that is exercised, sold, exchanged, distributed, cashed-out, or otherwise paid during such period in a transaction in which income, gain, or loss is recognized in full. The excise tax also applies to any payment by the expatriated corporation or any member of the expanded affiliated group made to an individual, directly or indirectly, in respect of the tax. Whether a payment is made in respect of the tax is determined under all of the facts and circumstances. Any payment made to keep the individual in the same after-tax position that the individual would have been in had the tax not applied is a payment made in respect of the tax. This includes direct payments of the tax and payments to reimburse the individual for payment of the tax. The excise tax is not deductible by the target corporation. . **47**

Specified stock compensation is treated as held for the benefit of a disqualified individual if such compensation is held by an entity, e.g., a partnership or trust, in which the individual, or a member of the individual's family, has an ownership interest. A disqualified individual generally includes officers, e.g., president, CFO, principal accounting officer or controller, any vice-president in charge of a principal business unit or any officer who performs a policy-making function. A disqualified individual also includes directors and 10% or greater owners of private and publicly held corporations. The legislative history to Section 4985 provides that stock compensation subject the excise includes any payment (or right to payment) granted by the expatriated corporation (or any member of the corporation's expanded affiliated group) to any person in connection with the performance of services by a disqualified individual for such corporation (or member of the corporation's expanded affiliated group) if the value of the payment or right is based on, or determined by reference to, the value or change in value of stock of such corporation (or any member of the corporation's expanded affiliated group). In determining whether such compensation exists and valuing such compensation, all restrictions, other than a non-lapse restriction, are ignored. Specified stock compensation includes compensatory stock and restricted stock grants, compensatory stock options, and other forms of stock-based compensation, including stock appreciation rights, phantom stock, and phantom stock options. Specified stock compensation also includes nonqualified deferred compensation that is treated as though it were invested in stock or stock options of the expatriating corporation (or member). For example, the provision applies to a disqualified individual's deferred compensation if company stock is one of the actual or deemed investment options under the nonqualified deferred compensation plan. The excise tax does not apply where is triggered by a target value of the corporation's stock or where a payment depends on a performance measure other than the value of the corporation's stock. Similarly, the tax does not apply if the amount of the payment is not directly measured by the value of the stock or an increase in the value of the stock.

Conclusion

The anti-inversion rules of **Section 7874** prevent companies from avoiding U.S. taxes by merely reincorporating abroad. However companies have found that they can avoid the application of the rules through inversions that take the form of a merger with an existing foreign company, if the combined companies have substantial business activities in the country of organization of the new foreign parent. Such inversions may become subject to tougher rules, as Congress reacts to a wave of tax-motivated

mergers.

1

See Ward, "Pfizer Refuses to Rule Out Tax Inversion Deals," Financial Times, 7/29/2014; Farrell, "Saliz Pharmaceuticals: The Newest Inversion Play," Wall St. J., 7/9/2014 at http://blogs.wsj.com/moneybeat/2014/07/09/saliz-pharaceuticals; Healey, "The Inversion Virus Spreads as Burger King Seeks to Flee to Canada," Los Angeles Times, 08/25/2014.

2

Krugman, "Corporate Artful Dodgers: Tax Avoidance du Jour: Inversion," New York Times, 7/27/2014.

3

U.S.-based corporations that are considering inversions are reported to be busy lobbying against new legislation as well as accelerating their plans to engage in expatriation transactions.

4

Sullivan, "Lessons From the Last War on Inversions," 143 Tax Notes 861 (5/26/2014).

5

TD 9592, 6/7/2012 (temporary regulations on meaning of "substantial business activities" of foreign corporations under Section 7874). See also TD 9654, 1/16/2014 (temporary regulations on determining stock ownership for determining whether foreign corporation is a "surrogate foreign corporation" under Section 7874). See also Section 7874(c)(2)(B) (statutory public offering rule). See Herzfeld, "Inversions-Why Now?," 144 Tax Notes 653 (8/11/2014).

6

See Sections 902, 960, and 957.

7

Sections 951 through 964 (CFC rules); 1291-1298 (PFIC rules).

8

For the effect of varying tax rates on decision-making of U.S. multinationals see International Monetary Fund Policy Paper, "Spillovers in International Corporate Taxation," 5/9/2014, at http://www.imf.org/external/np/pp/eng/2014/050914.pdf.

9

See the House Ways & Means Committee report on the Tax Reform Act of 2014, which would lower corporate and individual tax rates, and shift more to a territorial-based system among other proposals.

10

A U.S. domestic corporation with a substantial level of unrepatriated foreign earnings may be substantially motivated to engage in an inversion.

11

2014-20 IRB 1006.

12

See Sections 951 through 959, 1248.

13

See, however, Section 163(j) which disallows certain earnings stripping deductions for interest paid, at the time the interest accrues, by a corporation to a related person, as defined under Sections 267(b) and 707(b)(1), where: (1) the corporation-debtor has a debt-equity ratio of greater than 1.5 to 1; (2) the lender is not subject, in general, to U.S. taxation; and the corporation-debtor's interest expense exceeds 50% of its pre-interest income. The amount of "excess interest expense" that is disallowed is carried over as "disqualified interest" to the following year. Section 163(j)(1)(B). See also Section 7701(l) (conduit regulations proscribing multiple party financing transaction to prevent tax avoidance).

14

See GCM 39820, 6/22/90 (Service viewed some types of inversions as Section 304 redemptions). But see Bhada, 892 F.2d 39 (CA-6, 1989); Caamano, 879 F.2d 156 (CA-5, 1989).

15

An additional concern was whether the former U.S. parent corporation must recognize (unrealized) gain resulting from the dilution of its ownership of a former foreign subsidiary now becoming the parent corporation. See Notice 94-93, 1994-2 CB 563. See also Section 1248(i) (potential deemed taxable distribution of wholly owned foreign subsidiary becoming new parent of the group).

16

A domestic acquisition subsidiary could be used in effectuating the triangular merger to avoid having the foreign parent corporation directly acquire the transferred assets.

17

See TD 8702, 12/30/1996; TD 8638, 12/16/1995. In Notice 94-46, 1994-1 CB 356 the Service stated that anti-expatriation rules would be incorporated in the Section 367(a) regulations requiring gain recognition when U.S. person(s) transfer domestic corporate stock or securities to a foreign corporation, provided all U.S. transferors own, in the aggregate, at least 50% of the total voting power or value of the stock of the transferee foreign corporation immediately after the exchange. The gain recognition provision in the regulations would not be applicable. The temporary regulation adopting Notice 94-46 was effective for transfers made after 4/17/1994 while the final regulations were generally effective for transfers made after 01/29/1997.

18

See Reg. 1.367(a)-3(c) (actual or deemed outbound transfers of stock or securities of a domestic corporation).

19

See Notice 94-46, 1994-1 CB 356, obsoleted by Rev. Rul. 2003-99, 2003-34 IRB 388 ("anti-expatriation or inversion rules to be incorporated in §367 regulations for transfers occurring after April 17, 1994 which will, in general, require a U.S. person to recognize gain under §367(a) where all U.S. transferors in the aggregate own at least 50% of the total voting rights or total value of the transferee foreign corporation immediately after the exchange, determined with application of §958 attribution rules, regardless of the GRA rules in the regulations). Under the gain recognition agreement (GRA) rule, an otherwise taxable exchange described in Section 367(a)(1) will not be immediately taxable provided the U.S. person files an amended return and recognize the gain realized on the exchange if the transferee corporation disposes of the transferred stock within a specific period of time. See, in general Reg. 1.367(a)-3(c)(1)(iii). Regulations, both temporary and final, rejecting application of the GRA rule as announced in Notice 94-46, supra, were issued shortly thereafter. See TD 8702, 12/30/96. Exception was provided in the regulations where an active trade or business was conducted outside of the U.S. for the preceding three-year period by the transferee foreign corporation or any "qualified subsidiary" or "qualified partnership." See Regs. 1.367(a)-3(c)(1)(iv) and (c)(3).

20

Reg. 1.367(a)-3(c)(1)(i). See Reg. 1.367(a)-3(c)(7) (ownership statement provision).

21

Reg. 1.367(a)-3(c)(1)(ii).

22

Reg. 1.367(a)-3(c)(3)(i)(A). See also Temp. Regs. 1.367(a)-2T(b)(2), (b)(3). Alternatively, if the three-year requirement is not satisfied, the taxpayer could file for a favorable private letter ruling based on "substantial compliance" with the active trade or business test. Reg. 1.367(a)-3(c)(9)(i).

23

Again, a ruling request could be submitted based on "substantial compliance." Reg. 1.367(a)-3(c)(9)(i).

24

Regs. 1.367(a)-3(c)(3)(i)(C), and (iii). Again the regulations allow for a ruling to be granted on demonstration of "substantial compliance."

25

As detailed further below, Section 7874 applies to "inversion" transactions in which, pursuant to a plan or a series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity after 3/4/2003; (2) the former shareholders of the U.S. corporation hold (by reason of holding stock in the U.S. corporation) 60% or more (by vote or value) of the stock of the foreign-incorporated entity after the transaction; and (3) the foreign-incorporated entity, considered together with all companies connected to it by a chain of greater than 50% ownership (i.e., the "expanded affiliated group") does not conduct substantial business activities

in the entity's country of incorporation compared to the total worldwide business activities of the expanded affiliated group. Section 7874 applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60% of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of Section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified "toll charge" provisions apply at the partner level. See the disregarded stock rules in Temp. Reg. 1.7874-4T(c).

26

Section 7874(a)(2)(B)(iii). See use of term "substantially all" used in Section 368(a)(1)(C). The question arises as to whether passive assets should be eliminated or given less weight in testing for "substantially all" the assets of the expatriated entity. See James Armour, Inc., 43 TC 295 (1965) ; Arctic Ice Machine. Co., 23 BTA 1223 (1931). The "substantially all" test is also applicable to stock in a subsidiary. Presumably stock value should be greater than 50% for this purpose.

27

Section 7874(c)(3).

28

The definition of an EAG is provided in Section 7874(c)(1) and underlying regulations. See, e.g., Reg. 1.7874-1(a) .

29

TD 9592 , 6/7/2012, promulgating Temp. Reg. 1.7874-3T. Earlier guidance for determining whether a corporation is a "surrogate foreign corporation" was provided in **TD 9265** , 6/6/2006, and in **TD 9453** , 6/9/2009.

30

See Temp. Reg. 1.7874-1T(d) ("treatment of hook stock in inversion transactions"). Rizzi, "Hook Stock and the Scope of IRS Ruling Policy," 41 J. Corp. Tax'n, 39 (July/August 2014).

31

See TD 9399, 5/19/2008 (final regulations relating to the disregard of certain affiliate-owned stock in determining whether a corporation is a surrogate foreign corporation under Section 7874(a)(2)(B)).

32

Section 7874(d)(1). Where the expatriated entity is a partnership, the tax on "inversion gain" is applied at the partner level. Section 7874(e)(2).

33

Proposed regulations (REG-121534-12, 1/16/14) and final and temporary regulations (TD 9654, 1/16/14) provide guidance under Section 7874 for identifying certain stock of a foreign corporation that is

disregarded in calculating ownership of the foreign corporation for purposes of determining whether it is a surrogate foreign corporation as defined in Section 7874(a)(2)(B).

34

Section 7874(a)(2)(B)(iii). See Rev. Proc. 2014-7, 4.01(31), 2014-4 IRB 238 (no ruling policy on "substantial business activities" in the applicable foreign country). See Temp. Reg. 1.7874-3T(d)(4).

35

See Temp. Reg. 1.7874-3T(c).

36

See **Section 7874(a)** .

37

Section 1221(a)(1) .

38

Section 367(a)(1).

39

Section 7874(e)(1) .

40

Section 7874(e)(2)(A).

41

Section 7874(e)(3).

42

See Section 7874(g).

43

See **Sections 7874(f)** and **7852(d)** .

44

See **Notice 2005-7, 2005-3 IRB 340** .

45

See **Notice 2012-39, 2012-31 IRB 95** .

46

See **Reg. 1.482-7** (cost-sharing regulations pertaining to intangibles).

47

Sections 4985(f)(2), 275(a)(6).