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Legal Update
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IRS and Treasury Issue Long-Awaited Guidance on Corporate Inversions and "Disqualified Stock"

On January 16, 2014, the Internal Revenue Service (the "IRS") and the Treasury Department (the "Treasury") issued long-awaited temporary and proposed regulations under Code section 7874[1] relating to corporate inversions (the "Regulations").[2]

The Regulations incorporate, with certain modifications, the rules previously set forth in Notice 2009-78 (the "Notice"), which provided that, under certain conditions, the stock of a foreign acquiring corporation issued in exchange for cash, marketable securities and certain other assets should be disregarded for purposes of the "ownership test" of Code section 7874(a)(2)(B)(ii).

Although the Regulations include a new and welcome *de minimis* exception, they also expand in some respects the reach of the rules contained in the Notice. The preamble to such Regulations (the "Preamble") also raises some unsettling questions about common transactions that many practitioners may not have previously viewed as raising the inversion specter.

Brief Background on Code Section 7874 and the Notice

Code section 7874 was enacted under the American Jobs Creation Act of 2004[3] as a response to what Congress perceived to be a wave of high-profile redomiciliations by major US corporations.

Code section 7874 applies when, pursuant to a plan or a series of related transactions:[4]

(i) A foreign corporation acquires (directly or indirectly) substantially all of the properties held directly or indirectly by a domestic corporation (or substantially all of the properties constituting a trade or business of a domestic partnership) (the "Assets Test");

(ii) At least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by the former shareholders of the domestic corporation (or by the former partners of the domestic partnership) *by reason of* holding stock in such domestic corporation (or holding an interest in such domestic partnership) (the "Ownership Test"); and

(iii) The expanded affiliated group which includes the foreign acquiring corporation does not have "substantial business activities" in the foreign country in which the entity is organized, when compared to the total business activities of the group (the "Business Activities Test").

If these three prongs are met, the following adverse tax consequences result: (i) if the former shareholders of the domestic entity hold at least 60 percent, but less than 80 percent, of the stock of the foreign acquiring corporation, then the domestic acquired entity is limited in its ability to use certain tax attributes, including net

operating losses, to reduce tax on income resulting from certain transactions with related persons (e.g., gain or income resulting from post-acquisition restructurings, such as "out-from-under" tax planning),[5] and (ii) more drastically, if the former shareholders of the domestic entity hold 80 percent or more of the stock of the foreign acquiring corporation, the foreign acquiring corporation is treated as a domestic corporation for all US income tax purposes (thereby likely thwarting tax benefits sought for such transaction).[6]

Code section 7874(c)(2)(B) provides that stock of the foreign acquiring corporation that is sold in a public offering related to the acquisition is not taken into account for purposes of calculating the Ownership Test (the "Statutory Public Offering Exclusion"). Congress included this anti-stuffing type provision to prevent taxpayers from, for instance, avoiding the application of Code section 7874(b) by launching an initial public offering of 21 percent of a recently migrated foreign corporation.

In 2009, the IRS and the Treasury issued the Notice stating that they had become aware of transactions that, while not technically involving a sale of stock in a public offering, had similar effects that were also inconsistent with the purposes of Code section 7874. To address this concern, the Notice provided that stock of the foreign acquiring corporation issued in exchange for "nonqualified property" in a transaction related to the acquisition would not be taken into account for purposes of the Ownership Test, without regard to whether such stock was publicly offered or not.

The Regulations

The Regulations incorporate the rules set forth in the Notice with certain significant modifications. The following discussion provides a general description of the most salient aspects of the Regulations.

THE DISQUALIFIED STOCK EXCLUSION

As anticipated in the Notice, the Regulations revamp and replace the Statutory Public Offering Exclusion of Code section 7874(c)(2)(B).[7]

Notwithstanding the statutory language, under the Regulations it is irrelevant whether or not the stock of the foreign acquiring corporation is sold in a public offering for purposes of determining if such stock is excluded from the Ownership Test. Rather, the key determination is whether the stock meets the definition of "disqualified stock" (the "Disqualified Stock Exclusion").[8]

Stock subject to the Disqualified Stock Exclusion is not included in the denominator of the Ownership Test fraction, thereby generally increasing the ownership percentage of the former shareholders of the domestic corporation (and increasing the likelihood of an adverse application of Code section 7874).

The Disqualified Stock Exclusion may be triggered by two rules: the "Nonqualified Property Rule" and the "Associated Property Rule."

THE NONQUALIFIED PROPERTY RULE[9]

Under the Regulations, stock transferred by the foreign acquiring corporation will be considered disqualified stock if, in a transaction related to the acquisition, such stock is transferred to a person (other than the domestic entity) in exchange for (i) cash,[10] (ii) "marketable securities," (iii) property acquired with a principal purpose of avoiding the purposes of Code section 7874, or (iv) certain "disqualified obligations" ((i) through (iv), collectively, "nonqualified property"). The paradigm example of this would be where the foreign acquiring corporation issues stock to a shareholder in exchange for cash.

The Regulations clarify that this rule is intended to apply only to transactions that have the effect of increasing the foreign acquiring corporation's

net assets.[11] As such, even stock transferred by a shareholder of the foreign acquiring corporation to another person for cash would not be eliminated from the denominator in the Ownership Test, so long as the stock was not disqualified property in the hands of the transferor.

Conversely, the inclusion of "disqualified obligations" represents an expansion of the concept of "nonqualified property" introduced in the Notice. A disqualified obligation is an obligation of a member of the expanded affiliated group of the foreign acquiring corporation, of a former shareholder or partner of the domestic entity, or of a person that, before or after the acquisition, is related to any such persons.[12] The IRS and the Treasury believe that such transfers also increase the net assets of the foreign acquiring corporation and thereby present opportunities to inappropriately reduce the fraction of the Ownership Test.

In response to comments received to the Notice, the Preamble clarifies that the specific use given by the foreign acquiring corporation to the received "non-qualified" property is irrelevant for purposes of determining the applicability of the Nonqualified Property Rule (i.e., there is no exception from the technical application of the rule for stock of the foreign acquiring corporation issued in exchange for nonqualified property where such corporation uses the nonqualified property to acquire assets unrelated to the domestic target).

In addition, the Regulations maintain the rule provided in the Notice that the term "marketable securities" does not include stock of a corporation (or interest in a partnership) that becomes a member of the foreign acquiring corporation's expanded affiliated group in a transaction related to the acquisition, unless a principal purpose for acquiring such stock is the avoidance of Code section 7874.[13] Such provision is necessary to ensure that a valid business combination of a foreign corporation and a domestic corporation can be effectuated under a new foreign corporation (e.g., via a "double dummy" structure involving a public foreign company).

THE ASSOCIATED PROPERTY RULE[14]

In addition to the Nonqualified Property Rule, the Regulations introduce a new scenario, not contemplated in the Notice, in which stock of the foreign acquiring corporation will also be disregarded for purposes of the Ownership Test.

Under the Associated Property Rule, stock of the foreign acquiring corporation will be disregarded if it is transferred in exchange for property that is not nonqualified property and, subsequently, the transferee (e.g., the domestic target) transfers such foreign acquiring corporation stock in exchange for the satisfaction or the assumption of that transferee's obligations associated with the exchanged property.[15] The IRS and the Treasury understand that, in the absence of this rule, these transactions would also present opportunities to inappropriately decrease the fraction of the Ownership Test (e.g., transfers of foreign acquiring corporation stock to creditors of the domestic target would not be disregarded because such creditors would not be considered as owning such stock by reason of holding stock in the domestic target).

THE *DE MINIMIS* EXCEPTION FOR OUTRIGHT STOCK PURCHASES WITH A SMALL ROLLOVER

Prior to the publication of the Regulations, some practitioners were concerned that, under a technical reading of the Notice, a typical outright stock purchase with a small management rollover could constitute an inversion transaction subject to Code section 7874. More specifically, the concern was that all stock issued by a foreign acquiring corporation in exchange for cash raised to pursue the acquisition of a domestic target would be excluded from the Ownership Test and, to the extent a few shares of the foreign acquiring corporation were issued to the target's management, such shares would be the only shares counted in both the

numerator and the denominator of the Ownership Test. As a result, the foreign acquiring corporation could be an inverted corporation.

In a rational, and much requested,[16] amendment to the Notice, the Regulations provide that the Disqualified Stock Exclusion does not apply if (i) the former shareholders of the US corporation own less than 5 percent (by vote and value) of the foreign acquiring corporation (determined without regard to the Disqualified Stock Exclusion), and (ii) after the transaction, the former shareholders of the US corporation own, in aggregate, less than 5 percent (by vote and value) of the stock of each member of the expanded affiliated group of the foreign acquiring corporation.[17]

This exception should prevent the application of the Code section 7874 rules to certain purchases by foreign companies that involve a rollover of the shareholders of the US target, to the extent such shareholders' interest is limited to the *de minimis* 5 percent threshold. This is certainly a welcome exception, although practitioners would have generally hoped for a higher *de minimis* threshold.

The *de minimis* exception does not apply, however, when the stock was issued with the principal purpose of avoiding Code section 7874.[18]

A QUESTION MARK ON CERTAIN PUBLIC OFFERINGS

A troubling subsection of the Preamble indicates that the IRS and the Treasury are aware that the newly introduced *de minimis* exception may facilitate certain transactions that compromise the policies underlying Code section 7874. The Preamble refers to certain buyout transactions that, over time, could result in the conversion of a publicly traded domestic corporation into a publicly traded foreign corporation. More specifically, the Preamble mentions a relatively common situation where a publicly traded domestic corporation is acquired for cash in a "going private" transaction with a less than 5 percent rollover. "After a period of time," the Notice speculates, the buyer may sell its stock of the foreign acquiring corporation in a public offering. Further, the Preamble states that the IPO of the foreign acquiring corporation "may have been one of the intended exit strategies" of the buyer when it organized the foreign corporation to acquire the stock of the domestic public company.

For now, the IRS and the Treasury have requested comments and have indicated that they are studying the application of Code section 7874 to such transactions. However, this statement could give many practitioners pause in implementing acquisition planning.

Effective Date

The Regulations provide that the rules that were already contemplated in the Notice apply to acquisitions completed on or after September 17, 2009.[19] All other rules introduced by the Regulations apply to acquisitions completed on or after January 16, 2014. However, a taxpayer may elect to apply all the rules of the Regulations to acquisitions completed between September 17, 2009 and January 16, 2014, if the taxpayer applies the rules consistently to all acquisitions completed before such date.[20]

Conclusion and Takeaways

The Regulations provide some much needed guidance as to the proper application of the concepts contained in the Notice. We expect that such guidance will give comfort to taxpayers engaging in business combination transactions in which a US target is acquired (as well as to practitioners advising on such transactions).

While the Regulations are generally consistent with the Notice, some concepts have been expanded and certain tests have been refined to better address the potentially abusive fact patterns that the IRS and the Treasury were concerned about. In addition, the new and

welcome de minimis exception for transactions that are more accurately viewed as outright stock purchases should also provide taxpayers and practitioners with greater certainty in tax planning. This new guidance does, however, leave some potentially perplexing uncertainties. In particular, the Preamble poses some unsettling questions about common transactions that many practitioners may not have previously viewed as raising the inversion specter. Hopefully, more guidance on that particular topic will be forthcoming.

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Endnotes

1 All "Code" references are to the Internal Revenue Code of 1986, as amended, and all "Treas. Reg." references are to the U.S. Treasury regulations promulgated under the Code.

2 T.D. 9654. The text of the temporary regulations also serves as the text of proposed regulations pursuant to a notice of proposed rulemaking issued on the same date.

3 P.L. 108-357.

4 Code section 7874(a)(2)(B).

5 Code sections 7874(a)(1), 7874(e)(1).

6 Code section 7874(b).

7 Treas. Reg. section 1.7874-4T(a).

8 In this regard, there could be stock of the foreign acquiring corporation sold in a public offering that would not be excluded under the Disqualified Stock Exclusion (Treas. Reg. section 1.7874-4T(b)) while, conversely, stock could be excluded under the Disqualified Stock Exclusion despite not being sold in a public offering (Treas. Reg. section 1.7874-4T(c)).

9 Treas. Reg. section 1.7874-4T(c)(1)(i).

10 Expanding on the Notice, the Regulations provide that the transfer of stock in exchange for the satisfaction or the assumption of one or more obligations of the transferor shall be treated as a transfer for cash. Treas. Reg. section 1.7874-4T(e).

11 Treas. Reg. section 1.7874-4T(c)(2).

12 Treas. Reg. section 1.7874-4T(i)(7)(iii).

13 Treas. Reg. section 1.7874-4T(i)(6).

14 Treas. Reg. section 1.7874-4T(c)(1)(ii).

15 An obligation is considered "associated" with the exchanged property if, for example, the obligation arose from the conduct of a trade or business in which the exchanged property had been used, regardless of the recourse or non-recourse nature of the obligation.

16 *See* New York State Bar Association Tax Section, *Report on Certain Issues under Section 7874*, May 3, 2010, IV.B.

17 Treas. Reg. section 1.7874-4T(d)(1).

18 Treas. Reg. section 1.7874-4T(d)(2).

19 Treas. Reg. section 1. 1.7874-4T(k)(1) and (2).

20 Treas. Reg. section 1. 1.7874-4T(k)(3).

taxpayer should seek advice based on the taxpayer's particular circumstances from an independent tax advisor.