Section 7874
Inversion Transactions

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Washington, DC

June 15, 2006

CIRCULAR 230

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Overview

- Background to inversion transactions:
  - What are they?
  - Reasons for enactment of section 7874.
- Detailed review of section 7874, including:
  - December 2005 temporary regulations (applicable to taxable years ending after March 4, 2003); and
  - June 2006 temporary regulations (generally applicable to acquisitions completed on or after June 6, 2006).
- Future legislative changes?

WHAT IS AN "INVERSION"?

- "An inversion is a transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces the existing U.S. parent corporation as the parent of the corporate group." *Corporate Inversion Transactions: Tax Policy Implications*, Office of Tax Policy, Department of the Treasury (May 2002).

- An inversion typically involves shifting the corporate group's foreign operations outside U.S. taxing jurisdiction.

- "File folder" transaction: The business operations of the inverted company remain in the U.S.

- The transactions are generally taxable either to the company's shareholders or to the company itself.

INTRODUCTION - WHY WERE THEY HAPPENING?

• Mainly to ***save taxes*** in the future (*e.g.*, Stanley Works* Proxy Statement/Prospectus, April 2, 2002):

  • Non-U.S. earnings (*i.e.*, reduce subpart F income).

  • U.S. earnings (*i.e.*, earnings stripping/base erosion techniques).

• ***Depressed stock prices*** decreased the impact of section 367 at the shareholder level because there was little, if any, inherent gain in stock. At the company level, net operating losses (in conjunction with other tax attributes) could be used to offset any gain.

• Increased access by foreign corporations to U.S. capital markets.

* On August 1, 2002, Stanley Works announced that it had abandoned its plans to invert.

INVERSION TRANSACTION STRUCTURES

Inversion transactions take the form of:

(1) A "***stock transaction***" - the most common form (*e.g.*, Helen of Troy, Triton Energy, ADT, Fruit of the Loom, Stanley Works);

(2) An "***asset transaction***"; or

(3) A "***drop down transaction***."

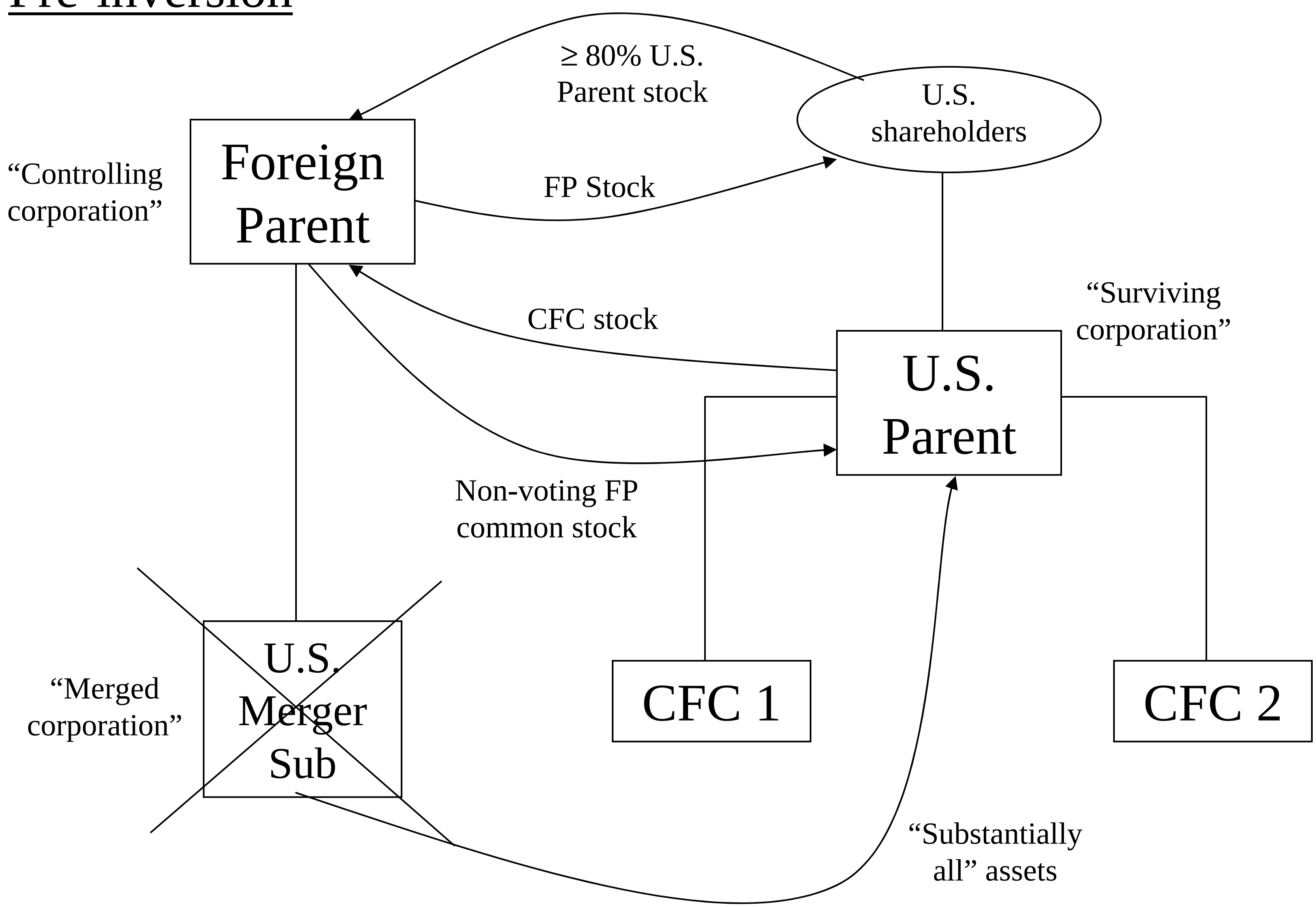
“STOCK TRANSACTION”

• Public shareholders of U.S. Parent exchanged their stock for stock in Foreign Parent, a newly formed foreign holding company incorporated in a tax haven jurisdiction such as Bermuda, either directly (pursuant to section 368(a)(1)(B)) or through a reverse subsidiary merger (pursuant to section 368(a)(2)(E)) with the U.S. Parent surviving as a subsidiary of Foreign Parent.

• U.S. Parent could transfer its foreign subsidiaries to Foreign Parent immediately before the inversion in a section 351(a) transaction in exchange for a second class of Foreign Parent common stock that was non-voting but that carried dividend rights (“***hook stock***”). The exchange did not qualify as a section 368(a)(1)(B) reorganization because the stock received by U.S. Parent was non-voting.

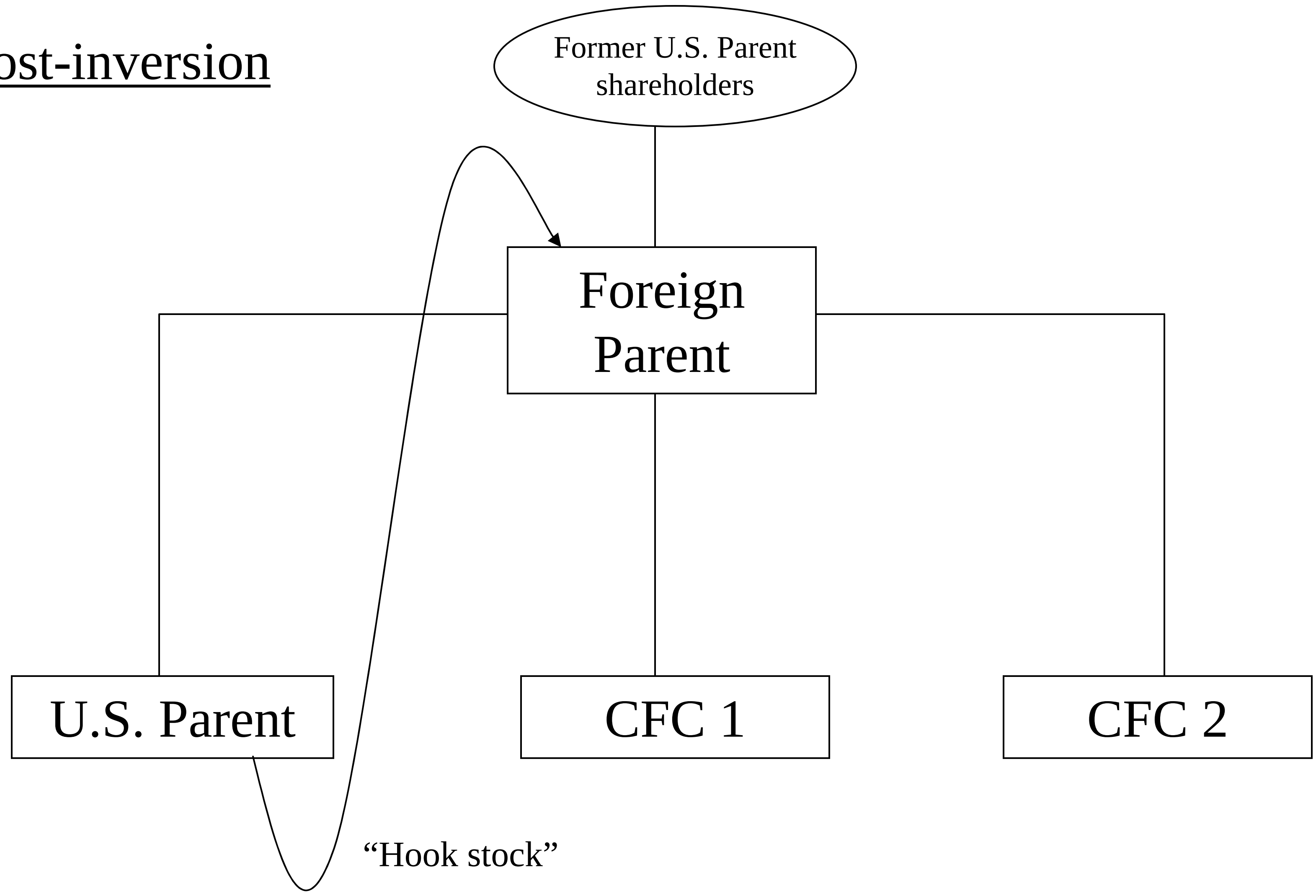
"STOCK TRANSACTION"

Pre-inversion



“STOCK TRANSACTION”

Post-inversion



"STOCK TRANSACTION" - TAX CONSEQUENCES

- To former U.S. shareholders of U.S. Parent:
  - Must recognize gain (but not loss) upon the exchange equal to the excess, if any, of the fair market value of the FP stock over its adjusted basis. I.R.C. § 367(a); Treas. Reg. § 1.367(a)-3(a).
    - The transaction does not qualify for the exception to gain recognition provided in the regulations because the U.S. shareholders of U.S. Parent receive more than 50% of Foreign Parent stock (vote and value) in the exchange. Treas. Reg. 1.367(a)-3(c).
  - To the extent that U.S. Parent's share value has declined, and/or it has many tax-exempt shareholders, the impact of the section 367(a) "toll charge" is reduced.

"STOCK TRANSACTION" - TAX CONSEQUENCES

- To U.S. Parent:
  - U.S. Parent not subject to tax with respect to the reincorporation transaction.
  - BUT U.S. Parent was subject to tax under section 367 with respect to the section 351 exchange *(i.e*., the transfer of the CFC stock):
    - Section 1248 did not apply directly because U.S. Parent could enter into a 5-year GRA, precluding any gain recognition under section 367(a). Treas. Reg. § 1.367(a)-3(a), (b)(1) & -8.
    - However, U.S. Parent was required to include, as a deemed dividend, the "***section 1248 amount***" attributable to its CFC stock (*i.e.*, the amount it would have been required to include under section 1248 if it had sold its CFC stock in a taxable transaction). I.R.C. 367(b); Treas. Reg. § 1.367(b)-2(b), (c)(1), -3(b)(2) & -4(a), (b)(1).

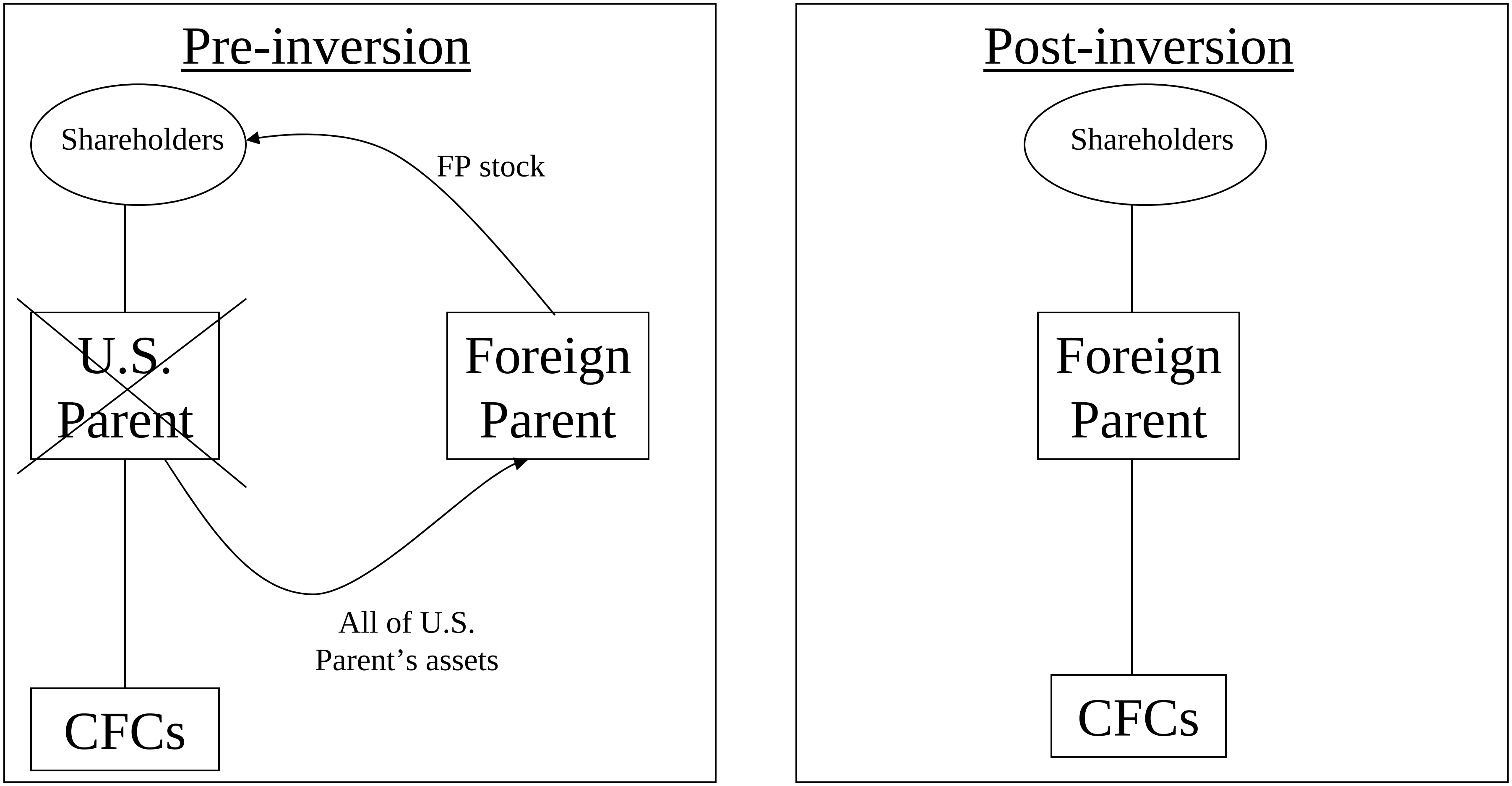
"STOCK TRANSACTION" - TAX CONSEQUENCES: MISCELLANEOUS ISSUES

- **Foreign tax credits, NOLs, etc.:** The tax on any income recognized may have been reduced or eliminated through the use of NOLs, foreign tax credits, and other tax attributes.
- U.S. Parent should have been entitled to the section 902 indirect foreign tax credit with respect to the taxes paid by its CFCs that were attributable to the "section 1248 amount."

- **Use of non-voting stock:** Foreign Parent avoided classification as a CFC of U.S. Parent because the latter was not a "U.S. shareholder" (*i.e.*, at least 10% ***voting*** power in a foreign corporation).

- **Valuation of non-voting stock:** Notice 94-93 valuation principles may have applied.

"ASSET TRANSACTION"



- U.S. Parent continues (under state corporate law conversion and continuance procedures) or reincorporates into a tax haven jurisdiction in a section 368(a)(1)(F) reorganization. Foreign Parent holds the corporate group previously held by U.S. Parent, and U.S. Parent's shareholders now hold Foreign Parent stock.

“ASSET TRANSACTION” - TAX CONSEQUENCES

- **Deemed steps:** The following steps are deemed to occur:

  (1) U.S. Parent transfers assets to Foreign Parent under section 361(a) in exchange for Foreign Parent stock and Foreign Parent’s assumption of U.S. Parent’s liabilities;

  (2) U.S. Parent distributes Foreign Parent stock to its shareholders; and

  (3) U.S. Parent’s shareholders exchange their U.S. Parent stock for Foreign Parent stock pursuant to section 354(a). Temp. Treas. Reg. § 1.367(a)-1T(f).

- **Taxability of U.S. Parent:** U.S. Parent was taxable upon the transfer of assets to Foreign Parent. I.R.C. § 367(a)(5).

- **Non-taxability of U.S. Parent’s shareholders:** U.S. shareholders recognized no gain or loss because the transaction constituted an F reorganization and did not involve any transfer of assets or stock by the U.S. shareholders to Foreign Parent under section 367(a)(5). Treas. Reg. § 1.367(a)-3(a) (third sentence) & -3(d)(3), ex.12.

POST-INVERSION EARNINGS STRIPPING/ BASE EROSION TRANSACTIONS

- **Intercompany indebtedness** was established either pre-inversion (U.S. Parent issued debt to Foreign Parent in exchange for a second class of non-voting common stock) or post-inversion (through a dividend of the debt or in exchange for property of equivalent value):

    - Subject to section 163(j), the interest expense was generally deductible for U.S. tax purposes and was subject to a reduced rate of withholding tax (*e.g.*, 12% if Foreign Parent is "managed and controlled" in Barbados). *See* Arts. 4(1)(a)(ii) & 11(1), U.S.-Barbados Treaty **(prior to 2004 Protocol – entered into force on 12/20/2004)**. Barbados subjects the income to tax at rate of between 1% and 2.5%.

- **Sale or other transfer of intangible property to Foreign Parent:**

    - Subject to sections 367(d) and 482: Treated as a sale of the intangible asset in exchange for deemed annual payments based on the productivity of the asset.

POST-INVERSION TAXATION OF U.S. OPERATIONS

• Foreign Parent was subject to tax with respect to its U.S. operations (*i.e.*, U.S. Parent was still subject to tax).

• Dividend distributions by U.S. Parent to Foreign Parent were generally subject to reduced U.S. withholding tax (*e.g.*, 5% if Foreign Parent is "***managed and controlled***" in Barbados (**prior to 2004 Protocol)**, even if it was incorporated in another foreign jurisdiction). I.R.C. § 894(a); Arts. 4(1)(a)(ii) & 10(2)(a). Barbados subjected Foreign Parent to tax at a rate of between 1% and 2.5% with respect to such payments.

POST-INVERSION TAXATION OF FOREIGN OPERATIONS

• Certain foreign-source earnings of Foreign Parent's non-U.S. subsidiaries (formerly CFCs of U.S. Parent) were no longer subject to U.S. tax, either immediately (subpart F) or upon a remittance of earnings.

• Even if the foreign subsidiaries were not transferred to Foreign Parent, there were still opportunities to reduce their income that was subject to U.S. taxation (*e.g.*, through various earnings stripping and related transactions that shift foreign-source income to Foreign Parent and its non-U.S. subsidiaries).

Section 7874(a)

- Taxable income of an expatriated entity for any taxable year which includes any portion of the applicable period shall in no event be less than the inversion gain of the entity for the taxable year.
  - Expatriated entity defined in section 7874(a)(2).
  - Applicable period defined in section 7874(d)(1).
  - Inversion gain defined in section 7874(d)(2).

Expatriated Entities – 7874(a)(2)

- An <u>expatriated entity</u> is a domestic corporation or partnership (or persons related to such corporation or partnership within the meaning of section 267(b) or 707(b)(1)) with respect to which a foreign corporation is a <u>surrogate foreign corporation</u>.

80% Inversions

- Requirements:
  - U.S. corporation becomes a subsidiary of a foreign incorporated entity or otherwise transfers substantially all of its properties to such entity (after 3/4/03)
  - 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, and
  - The foreign incorporated entity, considered together with all companies connected to it by a chain of greater than 50% ownership (the "expanded affiliated group" or "EAG") does not conduct substantial business activities in the entity's country of incorporation when compared to the total worldwide business activities of the EAG.
- Result:
  - Foreign corporation treated as a domestic corporation.
  - Removes any benefit from undertaking an inversion.

Consequences of conversion to Domestic Corporation

- If a surrogate foreign corporation is treated as a domestic corporation by reason of the 80% inversion rule, the conversion of the corporation from foreign to domestic is treated for all purposes of the Code as an "F reorganization."

60% Inversions

- Requirements:
  - Transaction would meet the requirements of an 80% inversion except that only a 60% ownership threshold is required.
- Result:
  - Surrogate foreign corporation is respected as a foreign corporation but:
    - Loss of certain tax credits (but not FTCs).
    - Loss of NOLs.

Partnership Inversions

- Requirements:
  - Foreign incorporated entity acquires substantially all the properties constituting a trade or business of the partnership, and
  - After the acquisition at least 60% of the stock of the foreign incorporated entity is owned by former partners of the partnership (by reason of holding their domestic partnership interests),
  - Provided the other terms of the definition of a 60% inversion are satisfied (e.g., no substantial business activities in country of incorporation).
- Special rules:
  - All partnerships that are under common control, within the meaning of section 482, are treated as one partnership (except to the extent provided in regulations).
- Results:
  - The limitation in section 7874 on the use of tax attributes to offset gain or other income related to the transaction applies at the partner level.
  - Similar domestication result if 80% of former partners receive stock in foreign incorporated entity.

Surrogate Foreign Corporation 7874(a)(2)

- Three tests:
  - – Acquisition test – 7874(a)(2)(B)(i).
  - – Stock ownership test – 7874(a)(2)(B)(ii).
  - – Business activities test – 7874(a)(2)(B)(iii).

“Pursuant to a plan”

- An inversion transaction may occur over time, pursuant to a plan.
- If a foreign corporation acquires directly or indirectly substantially all of the properties of a domestic corporation or partnership during the 4 year period beginning on the date which is 2 years before the ownership requirements are met, the creeping acquisition is treated as having occurred pursuant to a plan.
- Transfers of property or liabilities that have a principal purpose to avoid section 7874 are disregarded.
- Exception: If the foreign entity acquired 50% or more of the domestic corporation before March 4, 2003.
  - Accenture exception.

Acquisition Test

- A foreign corporation is a “surrogate foreign corporation if the entity completes, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation.
  - Direct or indirect acquisition – Treas. Reg. § 1.7874-2T(b).

Direct or Indirect Acquisition

- Indirect acquisition:
  - In general, an indirect acquisition means stock of a domestic corporation acquired by foreign corporation.
- Special rules:
  - An acquisition by a foreign corporation of a partnership interest in any partnership (foreign or domestic) that holds stock of a domestic corporation is considered an indirect acquisition of the proportionate amount of properties held directly or indirectly by the domestic corporation.
  - A foreign corporation that owns more than 50% of the stock of the acquiring foreign corporation is treated as having acquired a proportionate amount of the stock or assets of the acquired domestic corporation.
- Excludes:
  - Acquisition by a foreign corporation of stock of a second foreign corporation.
    - This means that a domestic sub of a foreign corporation is not indirectly acquired by a foreign corporation if a foreign corporation acquires the stock of the second foreign corporation.

Stock Ownership Test

- In the case of a domestic corporation, after the acquisition at least 60% (or 80%) of the stock (by vote or value) of the entity is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation.
  - Former shareholders – Treas. Reg. § 1.7874-2T(c)(2).
  - By reason of – Treas. Reg. § 1.7874-2T(c).

Former Shareholders

- Former shareholders are persons who held stock in the domestic corporation before the acquisition, including persons who held stock in the domestic corporation both before and after the acquisition.

Stock Held By Reason Of Holding Stock In the Domestic Corporation

- Stock of the foreign corporation which is received by a former shareholder of the domestic corporation in exchange for stock of the domestic corporation is considered stock held by reason of holding stock in the domestic corporation.
- Where a foreign corporation also issues stock in exchange for property (other than stock of the domestic corporation) the percentage of stock considered to be held by former shareholders by reason of holding stock in the domestic corporation is determined on the basis of the relative value of the property exchanged for the stock of the foreign corporation.

Example

- A holds all the issued and outstanding stock of DC, FC1, FC2 and FC3. DC is a domestic corporation and FC1, FC2 & FC3 are foreign corporations. DC's stock is worth $40, FC1's stock is worth $25, FC2's stock is worth $20, and FC3's stock is worth $15.
- In a section 351 transaction, A contributes the stock of DC, FC1, FC2, and FC3 to FP, a foreign corporation, in exchange for all the issued stock of FP.
- Result: A is considered to hold 40% of the stock of FP by reason of holding stock in DC.
  - 40% = $40 (domestic corporation value exchanged for foreign stock) / $100 (total property exchanged for foreign stock).

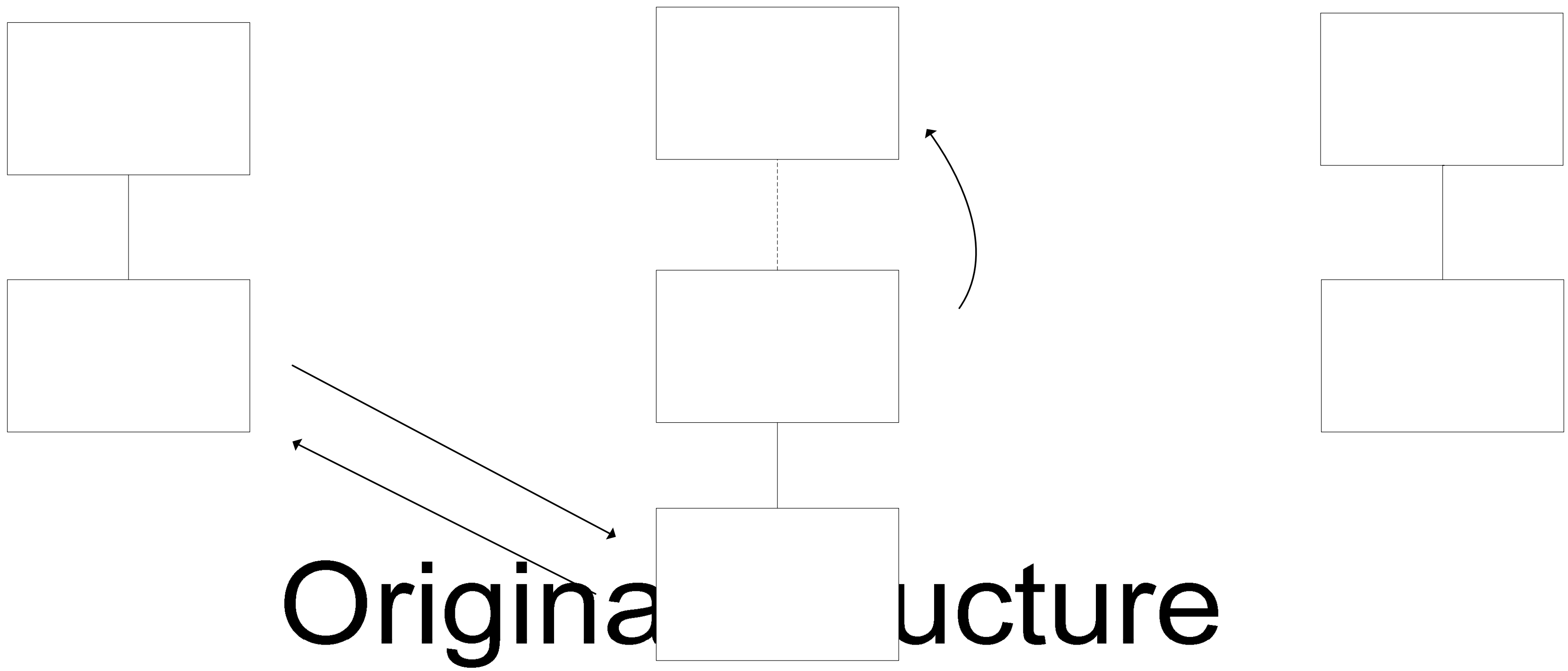
Disregard certain stock

- Stock held by members of the EAG that includes the foreign corporation is disregarded.
  - Hook stock (stock of the parent held by the subsidiary) is disregarded.
  - For purposes of determining whether the 60 or 80% threshold is met, stock will be disregarded as part of the numerator and/or the denominator.
    - Generally, affiliate owned stock is excluded from both the numerator and denominator of the fraction that determines stock ownership percentage.
    - Depending on the circumstances, this may make it easier or harder to avoid inverted status.
- Stock sold in a public offering related to the transaction is disregarded.

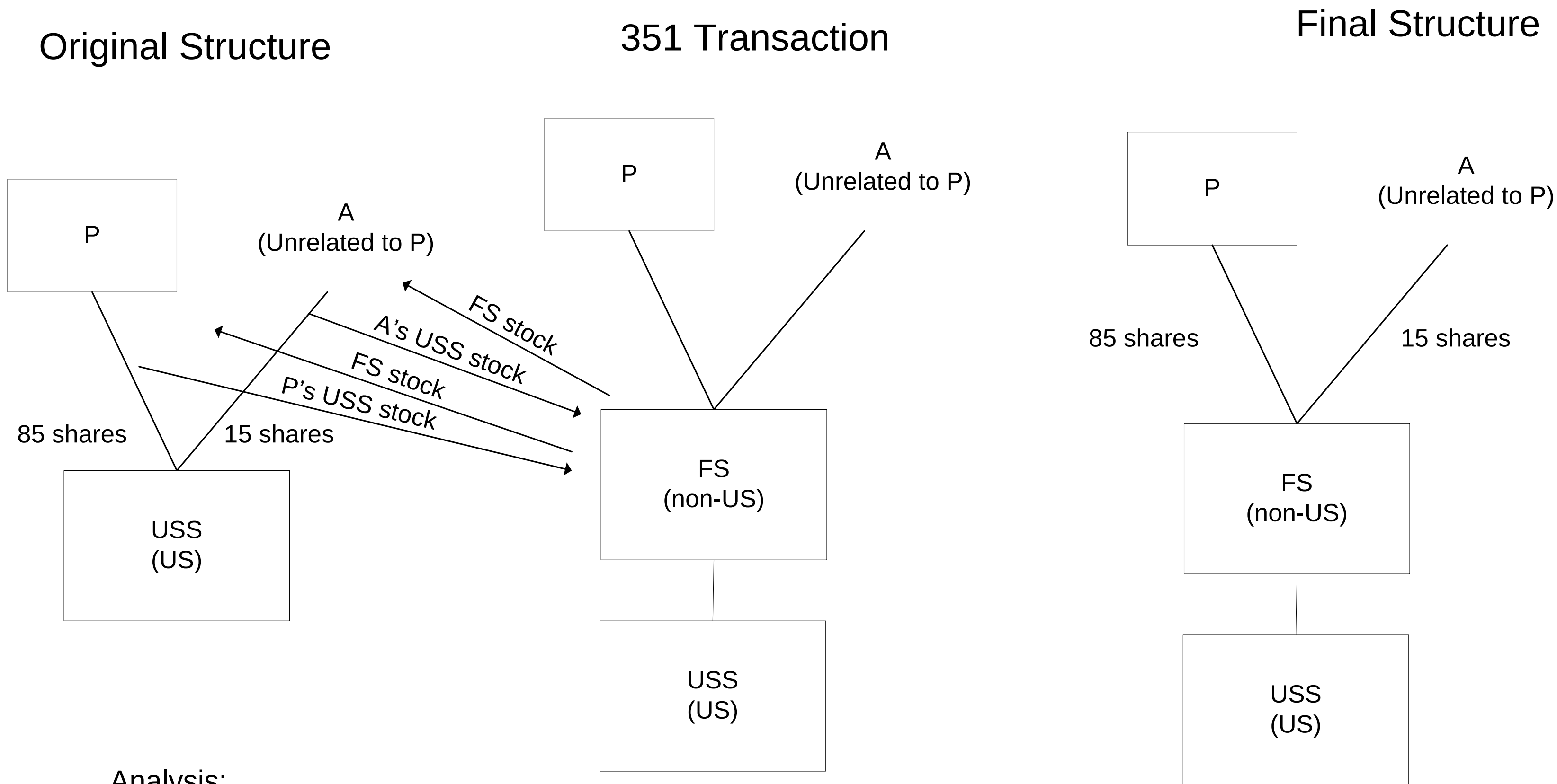
Exceptions to Disregard Rule

- Exception for certain internal group restructurings involving domestic entities.
  - Common parent must own at least 80% of the domestic entity before the transaction and continuing owners that are not members of the EAG hold no more than 20% of the stock of the acquiring foreign corporation after the transaction.
- Exception for certain acquisitive business transactions between unrelated parties where the former shareholders of the domestic entity have a minority interest in the acquired properties after the acquisition.
  - Applies where the foreign owners of the domestic entity do not own, in the aggregate, directly or indirectly, more than 50% of the stock of any member of the EAG that includes the acquiring foreign corporation.

Example of Disregard Rule: Wholly-owned Corporation

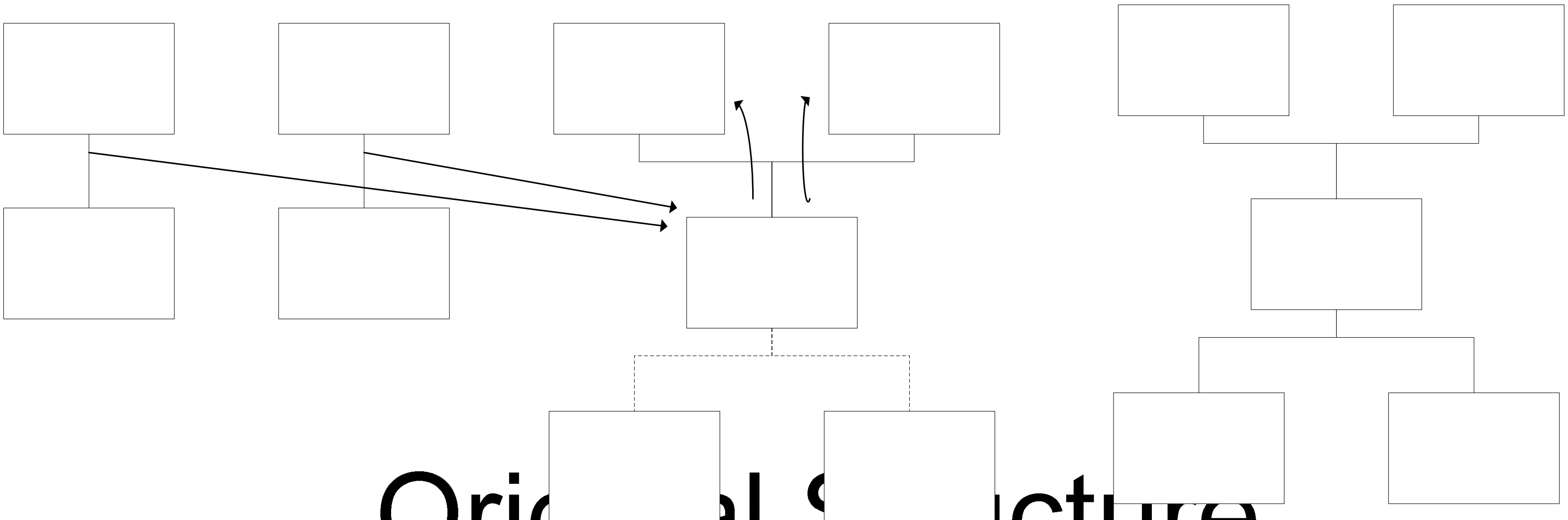


Example of Disregard Rule: Less Than Wholly-owned Corporation



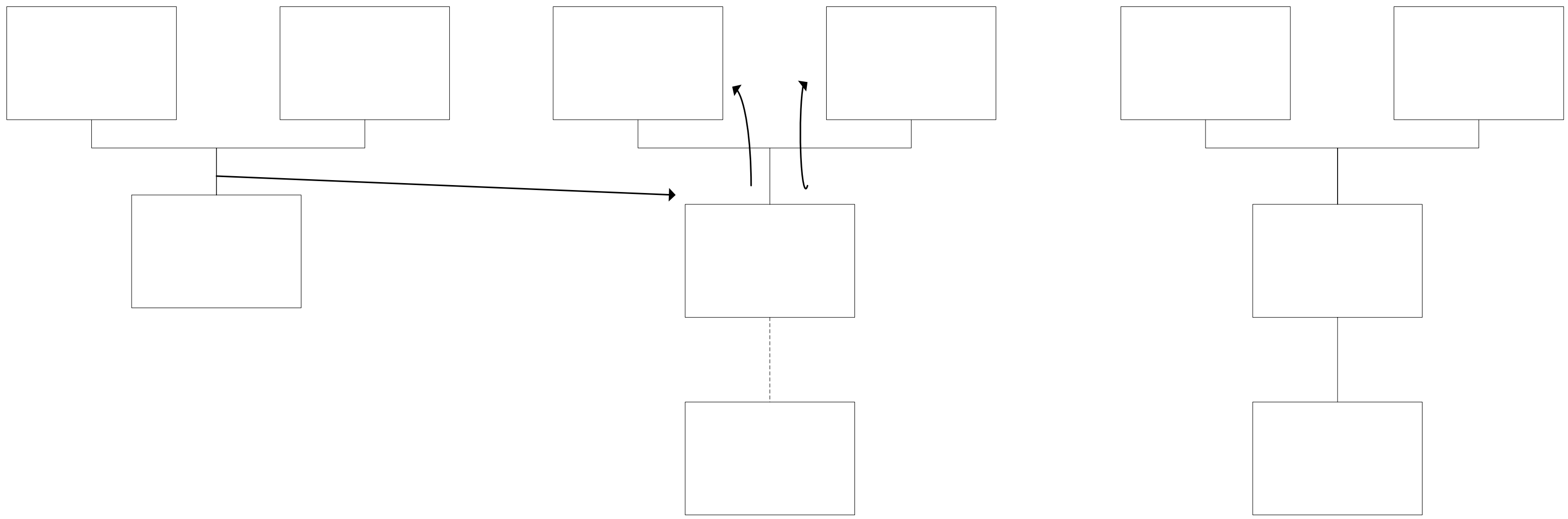
Analysis:
After the acquisition, P owns 85 shares of FS stock by reason of holding stock in USS, and A owns 15 shares of FS stock by reason of holding stock in USS. Before the acquisition, USS was more than 80% owned by P, which is the common parent of the EAG, and after the acquisition, less than 20% of the FS stock is owned by non-members of the EAG (*i.e.*, by A) by reason of holding stock in USS. The FS stock owned by P is included in the denominator but not in the numerator of the fraction that determines the percentage of FS stock owned by former shareholders of USS by reason of holding stock in USS. Accordingly the fraction is 15/100 and the percentage of ownership is 15%. FS is not a surrogate foreign corporation and is a CFC.

Example of Newly-formed Foreign Joint Venture



Original Structure

Example of Acquisition of Joint Venture



Original Structure

“Substantial Business Activities”

- After the acquisition, the expanded affiliated group which includes the entity (the tested foreign 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 to the total business activities of such expanded affiliated group. I.R.C. § 7874(a)(2)(B)(iii).

“Substantial Business Activities”

- Temporary regulations provide that the “substantial business activities” test of section 7874(a)(2)(B)(iii) may be satisfied in two ways:
  - The ***all-facts-and-circumstances*** test; or
  - A bright-line ***safe harbor*** test. Temp. Treas. Reg. § 1.7874-2T(d)(1).
- Both tests are intended to determine whether the EAG has “a meaningful and *bona fide* business presence” in the relevant foreign country.
- **Partnership attribution:** In applying both tests, a member of an EAG is attributed a proportionate amount of the activities, employees, assets, income, and sales of any partnership in which it has a capital or profits interest, as determined under the principles of sections 701 to 706. Temp. Treas. Reg. § 1.7874-2T(d)(3)(iv).

The All-Facts-And-Circumstances Test

- The all-facts-and-circumstances test – Temp. Treas. Reg. § 1.7874-2T(d)(1)(i):
  - The EAG is not required to have a minimum percentage of its total business activities in its country of incorporation.
  - The business activities of one EAG in a particular country may not be substantial even though identical business activities of another EAG in that country are considered to be substantial (*e.g.*, because the total business activities of the first EAG may be much more extensive than those of the first EAG).

The All-Facts-And-Circumstances Test

- Non-exhaustive list of potentially relevant factors – Temp. Reg. § 1.7874-2T(d)(1)(ii):
  - **Historical presence:** Activities conducted in the foreign country by the EAG prior to the acquisition.
  - **Operational activities:**
    - **Property** located in the foreign country owned by members of the EAG;
    - The **performance of services** by employees of EAG members in the foreign country; and
    - **Sales to customers** in the foreign country by EAG members.

The All-Facts-And-Circumstances Test

- **Management activities:** The performance in the foreign country of ***substantial managerial activities*** by EAG members' officers and employees based in the foreign country.
- **Ownership:** A substantial degree of ownership of the EAG by investors resident in the foreign country.
- **Strategic factors:** The existence of business activities in the foreign country that are ***material to the achievement of the EAG's overall business objectives***.

The All-Facts-And-Circumstances Test

- **Factors *not* to be considered in the all-facts-and-circumstances test – Temp. Treas. Reg. § 1.7874-2T(d)(1)(iii):**
  - Disregard any assets, liabilities, or activities in the foreign country that were transferred pursuant to a plan a principal purpose of which was to avoid section 7874. *See* I.R.C. § 7874(c)(4).
  - Assets temporarily located in the foreign country for the purpose of avoiding section 7874.
- Passive investment activities and related income and assets "normally would not be give any significant weight" (*e.g.*, intangible assets that are not exploited by any member of the EAG in the course of active business activities). 71 Fed. Reg. 32,437, 32,440 (June 6, 2006).

The Safe Harbor Test

- This is an ***alternative test*** for meeting the "substantial business activities" requirement of section 7874(a)(2)(B)(iii).
  - Even if an EAG does not meet the safe harbor test, it may still meet the all-facts-and-circumstances test. Treas. Reg. § 1.7874-2T(d)(2)(i).
- The EAG must satisfy three conditions relating to ***employees, assets, and sales*** after the acquisition.

The Safe Harbor Test

- **Employees:** "Group employees" based in the foreign country must account for ***at least 10 percent*** (by headcount ***and*** compensation) of total group employees. Temp. Treas. Reg. § 1.7874-2T(d)(2)(ii).
  - **"Group employees":** Common law employees of the EAG who work full time (35 hours or more per week) during the "***testing period***."
    - Independent contractors do not count.
    - A group employee is based in a country if he spends more time in that country than any other country during the testing period. Temp. Treas. Reg. § 1.7874-2T(d)(3)(i).
  - **"Testing period":** The 12-month period ending on the last day of the EAG's monthly or quarterly management accounting period in which the acquisition is completed. Temp. Treas. Reg. § 1.7874-2T(d)(3)(v).

The Safe Harbor Test

- **Assets:** The total value of the "group assets" located in the foreign country must be ***at least 10 percent*** of the total value of all group assets. Temp. Treas. Reg. § 1.7874-2T(d)(2)(iiii).
  - **"Group assets":** Tangible personal property used or held for use in the active conduct of a trade or business.
    - ***Intangible assets*** not taken into account (in either the numerator or the denominator).
    - An asset is considered to be located in a country only if it was physically present in that country for more time than in any other country during the testing period.
    - Total value determined on a gross basis (*i.e.*, no reduction for liabilities), and is measured by either tax book value or fair market value, but not both. Temp. Treas. Reg. § 1.7874-2T(d)(3)(ii).

The Safe Harbor Test

- **Sales:** During the testing period, the “group sales” made in the foreign country accounted for ***at least 10 percent*** of total group sales. Temp. Treas. Reg. § 1.7874-2T(d)(2)(iv).
  - **“Group sales”:** Sales and the provision of services by members of the EAG, measured by gross receipts from such sales and services.
    - A group sale is considered to be made in a country only if the services, goods, or other property transferred by such sale are sold for use, consumption, or disposition in such country. Temp. Treas. Reg. § 1.7874-2T(d)(3)(iii).

Example: All-Facts-And-Circumstances Test

- ***Financial services group; real estate in foreign country*: EAG is a financial services company:**
  - EAG employees regularly perform back office functions in Country A, the acquiring foreign corporation's country of incorporation.
  - During the testing period:
    - < 5% of group employees are based in Country A;
    - < 3% of group sales are made in Country A; and
    - > 10% of group assets are located in Country A (because EAG purchased a substantial amount of real estate in Country A during the 24-month period preceding the acquisition).
  - Management of real estate undertaken by an unrelated independent agent.
  - Most of EAG's senior managers are based outside Country A.
  - None of EAG's activities in Country A are material to the achievement of EAG's business objectives.
- ***Conclusion:*** The EAG fails the all-facts-and-circumstances test. Temp. Treas. Reg. § 1.7874-2T(d)(4), ex. 3.

Example: All-Facts-And-Circumstances Test

- ***Foreign group merging with larger U.S. group*: Former shareholders of an acquired publicly-traded domestic corporation received more than 60% of EAG parent company stock (also publicly-traded):**
  - Country A based EAG group employees perform all of the functions involved in EAG's overall business activities (*e.g.*, HQ and senior management functions);
  - During the testing period:
    - 11% of group employees are based in Country A;
    - 10% of the total value of group assets are located in Country A; and
    - 7% of group sales are made in Country A.
- ***Conclusion*: The EAG meets the all-facts-and-circumstances test. Temp. Treas. Reg. § 1.7874-2T(d)(4), ex. 4.**

Example: All-Facts-And-Circumstances Test

- ***Relocation of business to foreign country*:** An advanced technology company (DC) with substantial U.S. business activities and assets transferred all of such activities and assets to a newly-formed Country A FP (including the stock of FS, DC's wholly-owned Country A corporation).
- As a result of the relocation, substantially all group employees are based in Country A, and substantially all group assets are located there.
- ***Conclusion*:** The EAG meets the all-facts-and-circumstances test. Temp. Treas. Reg. § 1.7874-2T(d)(4), ex. 5.

Anti-abuse provisions

- Grant of regulatory authority to issue regulations to prevent avoidance of this section through:
  - the use of related persons or other intermediaries, or
  - Transactions designed to have persons cease to be (or not become) members of the EAG or related persons.

Publicly traded Partnerships

- Generally, PTPs are treated as corporations under section 7704.
- Certain PTPs that receive 90% or more of their income in the form of passive income (*e.g.*, dividends) are treated as partnerships for U.S. federal income tax purposes under 7704.
- Treas. Reg. § 1.7874-2T(e) contains an anti-abuse rule that treats foreign PTPs that are treated as partnerships under section 7704 as corporations for purposes of applying the section 7874 inversion rules.

Options and similar interests

- Options and similar instruments (*e.g.*, warrants, convertible debt instruments and other instruments that are convertible in to stock) are treated as exercised to the extent that the effect is to treat the acquiring foreign entity as a surrogate foreign corporation.

Treaty Issues

- **Section 7874(f):** An expatriated entity may not rely on any treaty to override the application of section 7874 to such entity.
- **Eligibility of expatriated entity for treaty benefits?**
  - **Interaction of sections 7874(b) and 7701(a)(4):** A surrogate foreign corporation that meets the 80% test is deemed to be a domestic corporation for all purposes of the Code "notwithstanding section 7701(a)(4)," which defines a domestic corporation as one that is "created or organized in the United States."

Treaty Issues

- **Application of treaty tie-breaker rules:** It appears that an expatriated entity that is deemed to be a domestic corporation under section 7874(b) generally will not be eligible to receive treaty benefits without competent authority relief (where available):
  - The expatriated entity would be considered a resident of both contracting states under the definition of "resident of a contracting state" (*i.e.*, either because its place of incorporation would be in both states or because of the "any criterion of a similar nature" language).
  - **Analogous issues under sections 269B and 1504(d)?**
    - Paragraph II of the MOU to the U.S.-Netherlands treaty explains that a foreign corporation subject to section 269B must obtain competent authority relief under the Article 4(4) tie-breaker rule. According to the JCT report, "the competent authorities would not ordinarily agree to treat [the stapled corporation] as a Dutch company." *See also* Notice 89-94, 1989-2 C.B. 416.

Legislative Developments?

- Proposed amendment to section 7874 in October 2005:
  - Would have narrowed the scope of section 7874 to companies whose stock was "readily tradeable on an established securities market at any time during the 4-year period ending on the date of the acquisition."
  - Would have expanded the application of section 7874 in other respects:
    - Retroactive to March 20, 2002; 50% test instead of 60% test; special earnings stripping rule under section 163(j); increased penalties.
- **2005 JCT Report:** Would redefine a domestic corporation to include a ***publicly-traded*** foreign corporation whose ***"primary place of management and control"*** is in the United States.
  - Much broader than section 7874 (*e.g.*, it could apply to newly-formed corporations or to certain pre-existing foreign multinational corporations).
  - Similar, but even broader, proposal in the President's Tax Reform Panel Report (*e.g.*, not limited to publicly-traded corporations).