# Federal Bar Association
# March 6, 2015

# Notice 2014-52: Selected Issues


*Private Sector*

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# Agenda

- Section 7874 General Rules
- Notice 2014-52: Rules Increasing the Likelihood that Section 7874 Applies
  - Passive Asset Look-Through Rule
  - Slim Down Distribution Rule
  - Spinversions and other Subsequent Transfers of Stock Rules
- Notice 2014-52: Rules Decreasing the Tax Benefits of Inverting
  - Hopscotch Loan Rule
- Other Aspects of Notice 2014-52
  - Future Guidance
  - Treaty Policy
  - Timing, Legislation, Bold Predictions
- 2016 Greenbook Proposal

# Section 7874 General Rules

- Under section 7874(a)(1), if the three conditions below are satisfied, then the DE (defined below) will be fully taxed on its Inversion Gains (meaning certain inversion-based gains and income will be taxed without the use of certain offsetting deductions and credits) unless section 7874(b) applies:
  - *Substantially all* of the assets of a Domestic Entity ("DE") are acquired (directly or indirectly) by a Foreign Acquiror ("FA") (generally, 100 percent stock acquisitions satisfy this requirement);
  - Shareholders of DE own, *by reason of* their ownership in DE, 60 percent or more of the stock (vote or value) of FA (the "Ownership Fraction"); and
  - After the acquisition, FA, in conjunction with the members of its Expanded Affiliated Group ("EAG"), does not have substantial business activities in FA's country of organization (generally 25-percent employee, asset, and gross income tests, *see* Treas. Reg. sec. 1.7874-3T).
    - The term EAG generally means 1 or more chains of corporations (including foreign corporations) connected through more than 50 percent stock ownership (by vote and value) with a common parent corporation.
- Section 7874(b) – if the 3 conditions above are satisfied, and the Ownership Fraction is 80 percent or more, then FA will be treated as a U.S. corporation for U.S. federal income tax purposes.

# Section 7874 General Rules

- Under section 7874(c)(2)(A), FA stock owned by members of the EAG of which FA is a member is not included in the numerator or the denominator of the Ownership Fraction.
- Treas. Reg. sec. 1.7874-1 provides guidance addressing two situations where FA stock that is owned by members of the EAG of which FA is a member is nonetheless included in the denominator, but not the numerator, of the Ownership Fraction.
  - **Internal Group Restructurings** – where before the acquisition, 80 percent or more of the DE was owned (directly or indirectly) by the common parent of the EAG after the acquisition, and after the acquisition, 80 percent or more of FA is owned (directly or indirectly) by the same common parent.
  - **Loss of Control** – where after the acquisition, former DE shareholders do not hold, directly or indirectly, more than 50 percent of any member of the EAG.
- Treas. Reg. sec. 1.7874-2 provides guidance addressing, among other issues, multiple acquisitions to which section 7874 applies.
- Treas. Reg. sec. 1.7874-3T provides guidance addressing the "substantial business activity" threshold.
- Treas. Reg. sec. 1.7874-4T provides guidance under section 7874(c)(2)(B) addressing when certain FA stock is disregarded for purposes of calculating the Ownership Fraction.
- Treas. Reg. sec. 1.7874-5T provides guidance addressing subsequent transfers by the former shareholders of DE stock of FA stock received in the acquisition.

# Stock Attributable to Passive Assets

- Under existing rules, the total amount of stock in the foreign acquiring corporation (the denominator of the ownership fraction) can be reduced to account for certain stuffing transactions
  - Statutory public offering rule (Section 7874(c)(2)(B))
  - Stock received for certain "non-qualified property"
  - Non-qualified property is
    - passive assets (cash, cash equivalents, marketable securities, certain related person debt), and
    - property acquired in a related transaction and with a principal purpose to avoid section 7874 (Treas. Reg. sec. 1.7874-4T) ("avoidance assets")
      - Can an F reorganization of the foreign acquiror as part of an inversion transaction cause the foreign acquiror's assets to be treated as non-qualified property under Treas. Reg. section 1.7874-4T? Should it?

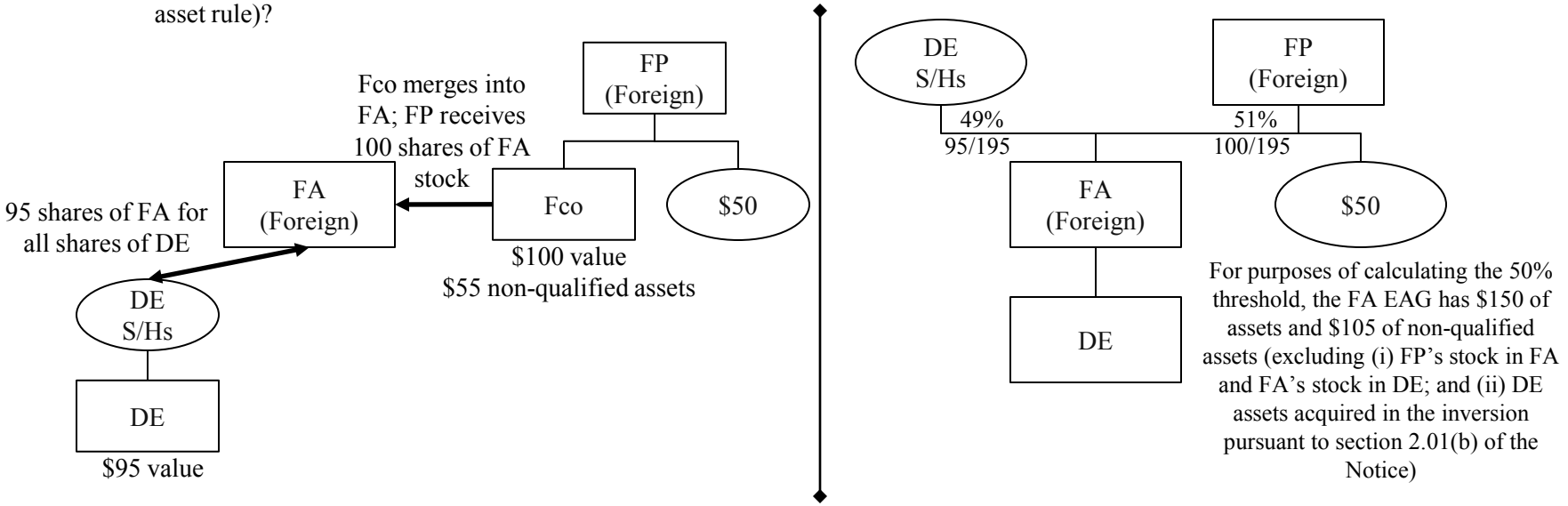
- New regulations would apply similar rules to foreign acquiring corporations that simply **hold** substantial liquid assets (passive assets),
  - Expanded rules would apply ***even if*** such assets are not contributed as part of the acquisition
  - Apply the same definition of non-qualified property
  - Application to avoidance assets

# Stock Attributable to Passive Assets (cont'd)

- If more than 50 percent of the gross value of all ***foreign group property*** is ***foreign group nonqualified property***, then the denominator of the ownership fraction will be reduced according to a formula
  - **Foreign Group Property:** Any property (including property that gives rise to disqualified stock under Treas. Reg. § 1.7874-4T) held by the EAG after the acquisition and related transactions are completed other than:
    - Property that is directly or indirectly acquired in the acquisition and that, at the time of the acquisition, was held directly or indirectly by the domestic entity, and
    - Stock or a partnership interest in a member of the EAG and an obligation of a member of the EAG (described in Treas. Reg. § 1.7874-4T(i)(7)(iii)(A))
  - **Foreign Group Nonqualified Property:** Foreign group property described in Treas. Reg. § 1.7874-4T(i)(7) (cash, marketable securities, certain obligations, etc.) other than property that gives rise to income described in section 1297(b)(2)(A) or section 954(h) or (i) (certain active banking and insurance income)
    - This also includes "substitute property" — property acquired, in a transaction related to the acquisition, in exchange for property that would have been foreign group nonqualified property
- Is it appropriate to include the non-qualified assets of the parent of the foreign acquiring corporation in this calculation, given that the former domestic entity shareholders have no access to such assets?

# Stock Attributable to Passive Assets (cont'd)

- How does the Notice's passive asset rule interact with Treas. Reg. section 1.7874-4T? Should non-qualified assets be counted against the ownership fraction twice (i.e., once in the Treas. Reg. section 1.7874-4T calculation and once in the Notice's passive asset rule)?




- Under Treas. Reg. section 1.7874-4T, $55 of FP's FA stock is eliminated from the denominator of the ownership fraction as disqualified stock and the DE shareholders are treated as owning approximately 68% (95/140 shares) of the FA stock.
- Under the Notice, another $23 of FA stock is excluded from the denominator of the ownership fraction, calculated as $45 of FA stock that is not (i) already disqualified under Treas. Reg. section 1.7874-4T (i.e., $55); (ii) described in Treas. Reg. section 1.7874-1(b) (none because the loss of control exception applies); or (iii) described in section 7874(a)(2)(B)(ii) (i.e., $95 of FA stock owned by former DE shareholders), multiplied by the 50/95 ratio of EAG non-qualified assets to all EAG assets (not counting solely for this purpose non-qualified FA assets that gave rise to disqualified stock), causing the DE shareholders to be treated as holding 81% (95/117 shares) of the FA stock. *Cf.* Treas. Reg. section 1.7874-4T(h).

# Slim Down Distribution Rule

- Section 7874(c)(2) disregards stock of the foreign corporation that is sold in a public offering related to the acquisition (described in section 7874(a)(2)(B)(i)). *See* Treas. Reg. section 1.7874-4T for guidance addressing this provision.

- Section 7874(c)(4) disregards transfers of properties (including distributions) or assumption of liabilities "if such transfers are part of a plan a *principal purpose* of which is to avoid the purposes" of section 7874.

- Section 7874(c)(6) provides the Secretary with authority to issue regulations "as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations (A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and (B) to treat stock as not stock."

- Section 7874(g) provides the Secretary with authority to issue regulations "as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section."

# Slim Down Distribution Rule—Notice Language

- **Non-ordinary course distributions** (defined below) made by the Domestic Entity (including a predecessor) during the 36-month period ending on the acquisition date (within the meaning of Treas. Reg. sec. 1.7874-3T(d)(1)) will be ***treated as part of a plan a principal purpose of which is to avoid the purposes of section 7874***. (A *per se* principal purpose test.) Accordingly, such distributions will be disregarded for purposes of section 7874.

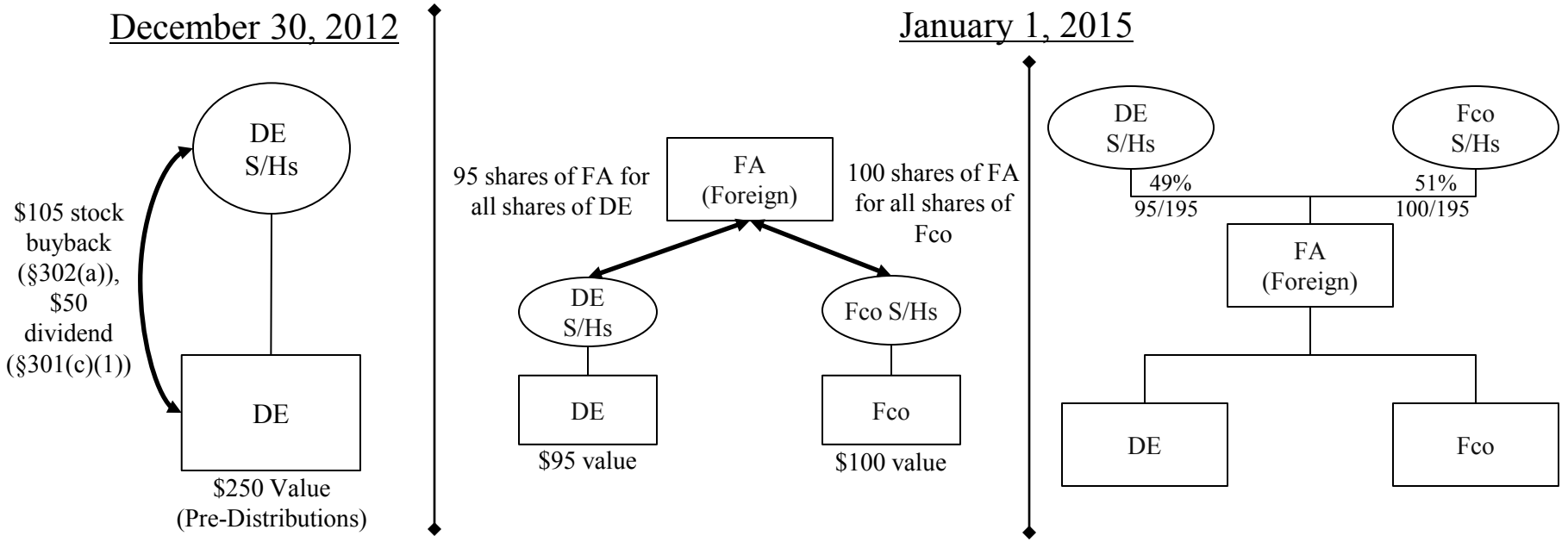
- A non-ordinary course distribution means—the excess of all distributions made during a taxable year by the domestic entity with respect to its stock (or partnership interests), over 110 percent of the average of such distributions during the 36-month period immediately preceding such taxable year.

- What distributions count? A distribution for this purpose includes any distribution, regardless of whether it is treated as a dividend, a section 355 distribution, a section 302(a) distribution, or a section 356(a) distribution. Basically any distribution sourced directly or indirectly from the Domestic Entity (or its predecessor).

# Slim Down Distribution Rule (cont'd)

- The Notice states that taxpayers have entered into transactions such as those where "a domestic entity may distribute property to its former shareholders . . . *in order to* reduce the ownership fraction by reducing the numerator."
- Using its authority under the provisions on the prior slide, the Notice disregards *all* non-ordinary course distributions during the 36-month period ending on the inversion date *without regard to their purpose*.
  - In other words, section 7874(c)(4) creates a "purpose"-based test that certain distributions or contributions in connection with an inversion should be disregarded, but the Notice eliminates the subjective "purpose"-based test in certain circumstances.
- The Notice does not explain the consequence of disregarding such a distribution.
- The Notice provides that a similar rule using the same principles will be added to the Treas. Reg. sec. 1.367(a)-3(c) "substantiality" test, thereby preventing the use of "slim down" distributions to avoid section 367(a) outbound domestic stock treatment.
  - Note that Treas. Reg. sec. 1.367(a)-3(c)(3)(iii)(B) has a subjective "principal purpose" test in its 36-month anti-stuffing rule, but a *per se* "principal purpose" test in the case of contributions of passive-income-producing property, made outside the ordinary course of business and within the 36-month period ending on the date of the exchange.

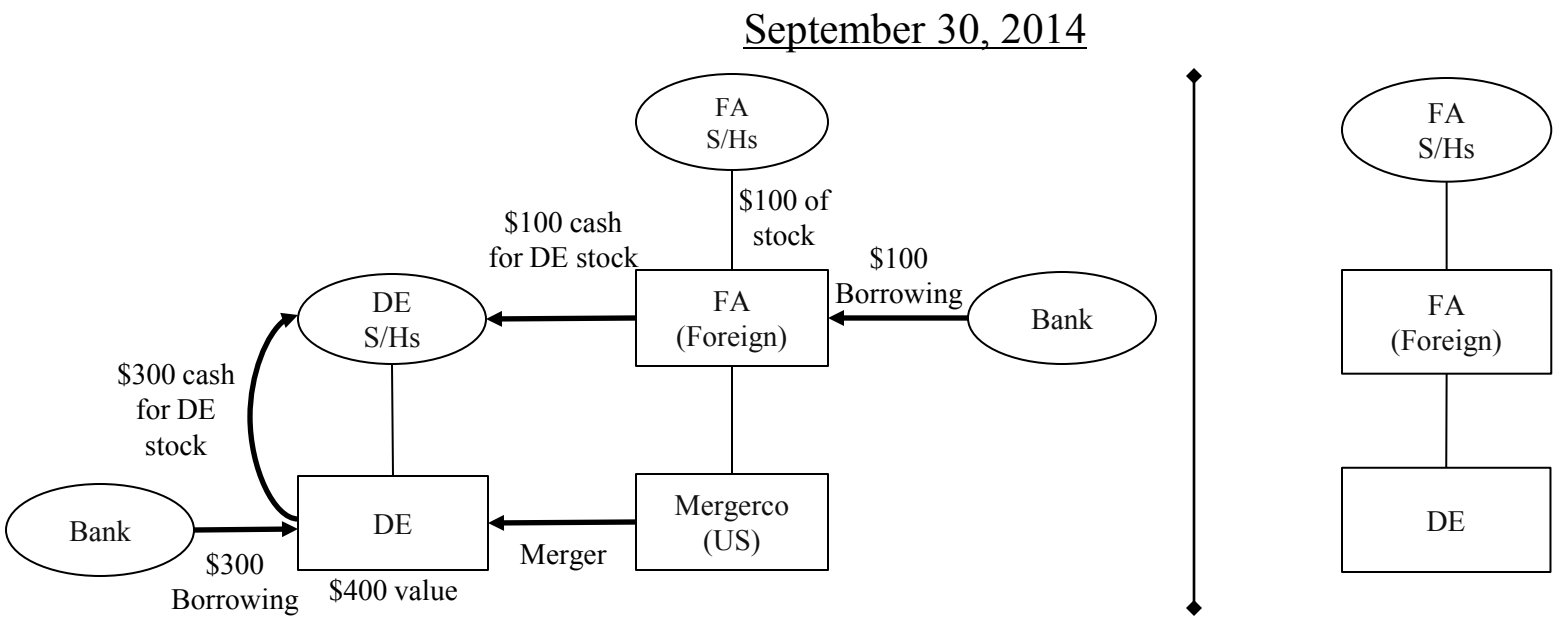
# Slim Down Distribution Rule—Example 1 (Dividend and Redemption)




| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| **Total DE Distributions** | $50 | $50 | $50 | $155 | $50 | $50 |
| **110% of Prior 36-Month Average** | - | - | - | $55 | $93.50 | $93.50 |
| **Excess over 110% of Prior 36-Month Average** | - | - | - | $100 | $0 | $0 |

**Under the Notice, are the DE shareholders treated as receiving $100 of additional FA stock so that they own 66% of FA (195/295 shares) for section 7874 purposes? What if 2011 was the first year of DE's existence so there is no 36-month look-back available?**

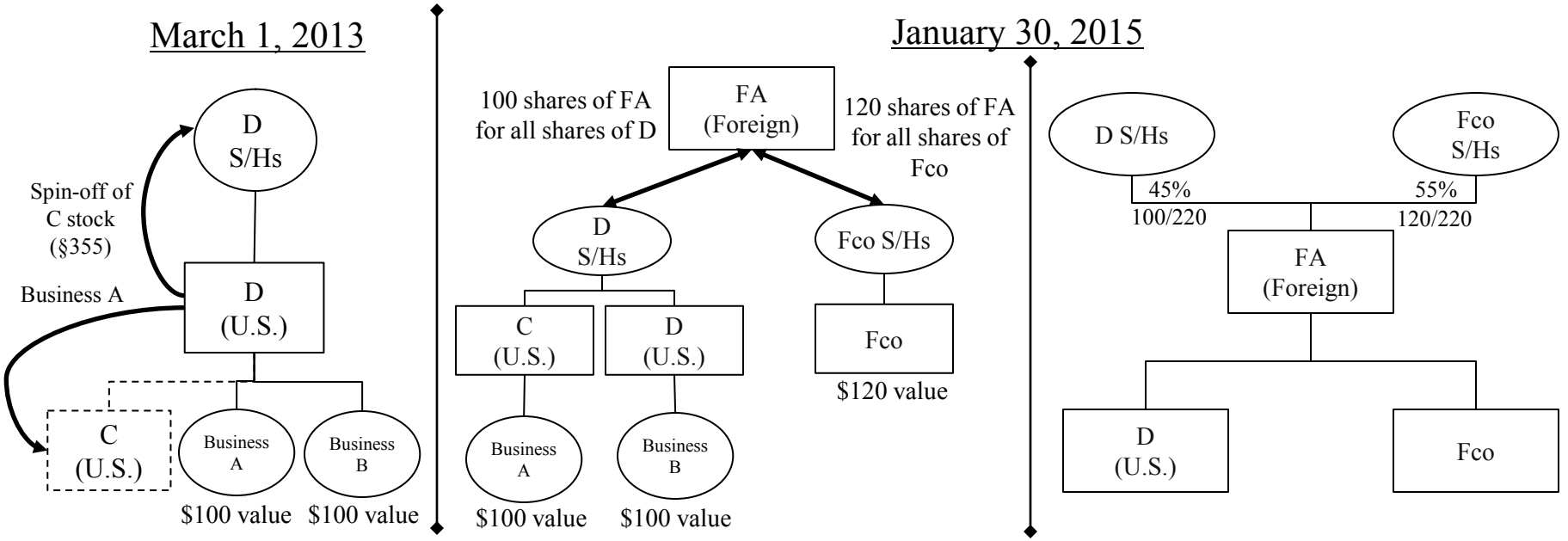
# Slim Down Distribution Rule—Example 2 (All-Cash LBO)




| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| **Total DE Distributions** | $0 | $100 | $0 | $0 | $0 | $300 |
| **110% of Prior 36-Month Average** | - | - | - | $36.67 | $36.67 | $0 |
| **Excess over 110% of Prior 36-Month Average** | - | - | - | $0 | $0 | $300 |

**Under the Notice, are the DE shareholders treated as receiving $300 of FA stock so that they own 75% of FA (300/400 shares) for section 7874 purposes? What if 10% (i.e., managers or founders) stay in? 20%? At what level of continuity of interest should section 7874 apply?**

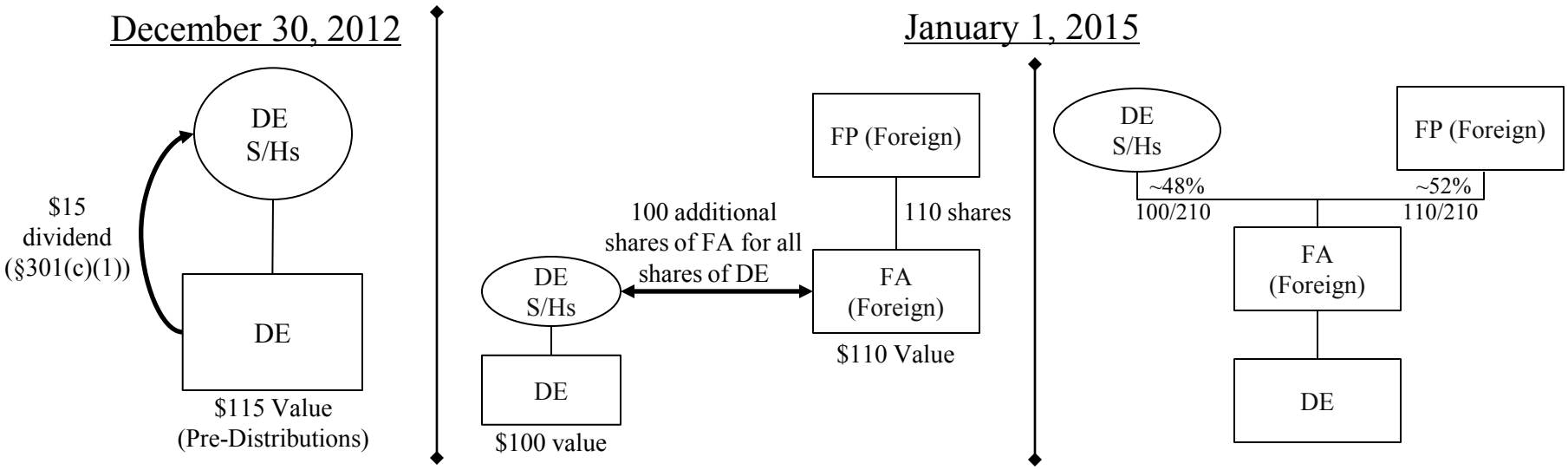
# Slim Down Distribution Rule—Example 3 (Spin-Off)




| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| **Total DE Distributions** | $5 | $5 | $5 | $5 | $100 | $5 |
| **110% of Prior 36-Month Average** | - | - | - | $5.50 | $5.50 | $40.33 |
| **Excess over 110% of Prior 36-Month Average** | - | - | - | $0 | $94.50 | $0 |

**Under the Notice, are the D shareholders treated as receiving $94 of additional FA stock so that they own 62% of FA (194/314 shares) for section 7874 purposes? Does newly-formed C inherit D's 36-month history of slim-down distributions? Does the answer depend on how much of D's historical assets are transferred to C? What about the relative values of D and C?**

# Slim Down Distribution Rule—Example 4 (Loss of Control)




| | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|---|---|---|---|---|---|---|
| **Total DE Distributions** | - | - | - | $15 | - | - |
| **110% of Prior 36-Month Average** | - | - | - | - | $5.50 | $5.50 |
| **Excess over 110% of Prior 36-Month Average** | - | - | - | $15 | - | - |

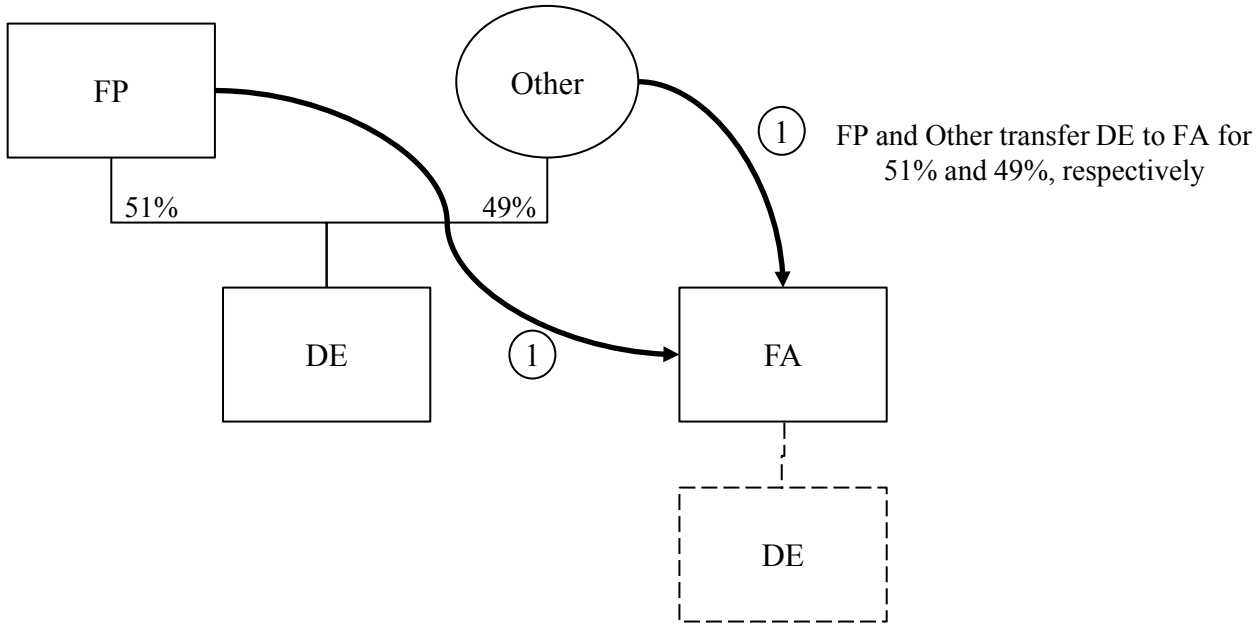
# Slim Down Distribution Rule—Example 4 (Loss of Control) (cont'd)

- Under the Notice, the $15 pre-inversion distribution causes the DE shareholders to be treated as owning 51% of the FA stock (115/225 shares) for ownership percentage test purposes.
- Does the "slim down" rule under the Notice apply for purposes of determining whether the "loss of control" exception under Treas. Reg. section 1.7874-1(c)(3) is available?
  - This would result in a 100% inversion—is that the appropriate result? What if the distribution occurred in order to satisfy the loss of control exception?
- The preamble to T.D. 9238, the introduction of the loss of control exception in then Treas. Reg. section 1.7874-1T, provides that:

> [T]he IRS and Treasury Department believe that the affiliate-owned stock rule was not intended to cause section 7874 to apply to certain acquisitive business transactions, such as the acquisition of stock or assets of a domestic corporation by an unrelated foreign corporation where after the acquisition the former owners of the domestic entity do not own more than 50 percent (by vote or value) of the stock of any member of the expanded affiliate group. For example, the contribution of a domestic entity or its assets to a foreign joint venture corporation in exchange for a minority interest in the joint venture corporation should not result in the joint venture corporation's being treated, for purposes of the ownership percentage test, as wholly owned by the former owners of the domestic entity by operation of the affiliate-owned stock rule. . . . Congress intended the section to apply to transactions (other than internal group restructurings, as discussed previously) that effectively replace a domestic corporation or partnership with a foreign corporation at least 60 percent of which is held by former owners of the domestic entity.

# Subsequent Transfers & EAG Rules: Overview

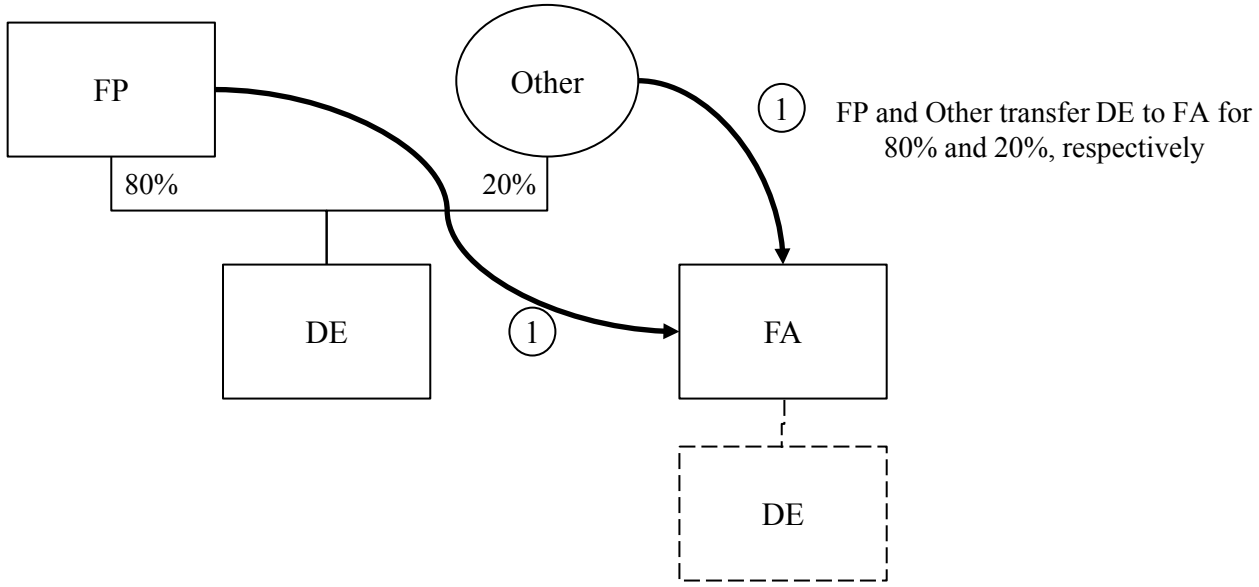
- Statutory EAG Rule (section 7874(c)(2)(A)): stock held by members of the EAG that includes the foreign acquiring corporation is disregarded, i.e., excluded from the numerator and denominator for purposes of calculating the Ownership Fraction




- Result: FP's stock of FA is excluded from the denominator and numerator, and the Ownership Fraction is 49/49

# Subsequent Transfers & EAG Rules: Overview (cont'd)

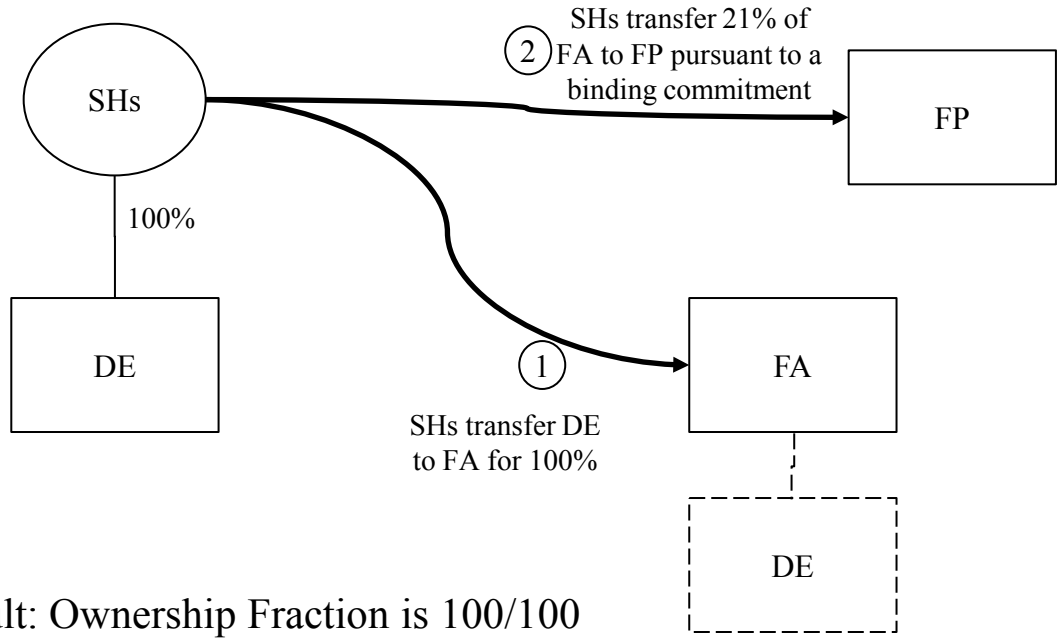
- Internal group restructuring exception to the statutory EAG rule (Treas. Reg. § 1.7874-1(c)(2)) results in EAG-owned stock included in the denominator, but not the numerator, of the Ownership Fraction
  - Common parent of the EAG owns at least 80% of Domestic Target prior to transaction and at least 80% of Foreign Acquiring after transaction




- Result: FP's stock of FA is included in the denominator, but not the numerator, and the Ownership Fraction is 20/100

# Subsequent Transfers & EAG Rules: Overview (cont'd)

- Subsequent transfers of stock (Treas. Reg. § 1.7874-5T)
  - For purposes of the Ownership Fraction (i.e., numerator of the Ownership Fraction), stock that is held "by reason of" ownership in the domestic target shall not cease to qualify as such by virtue of a subsequent disposition by the former shareholder(s)/partner(s) of such stock/interest, even if the subsequent transfer is related to the acquisition




- Result: Ownership Fraction is 100/100

# Subsequent Transfers & EAG Rules: Notice 2014-52 General Rule

- General rule under the Notice: If stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) (that is, stock of the foreign acquiring corporation held by reason of) is received by a former corporate shareholder or former corporate partner of the domestic entity (transferring corporation), and, in a transaction (or series of transactions) related to the acquisition, that stock (transferred stock) is subsequently transferred, the transferred stock is not treated as held by a member of the EAG for purposes of applying the EAG rules
  - Under general rule, therefore, stock held by the EAG is included in both the numerator and denominator
  - No definition of "related to"

- U.S.-parented group exception and foreign-parented group exception (next slide) – if exceptions apply, stock held by the EAG is excluded from the numerator and, unless the internal group restructuring exception applies, excluded from the denominator

- Except as provided under the foreign-parented group exception, all transactions related to the acquisition are taken into account for purposes of determining an EAG, a U.S.-parented group, and a foreign-parented group

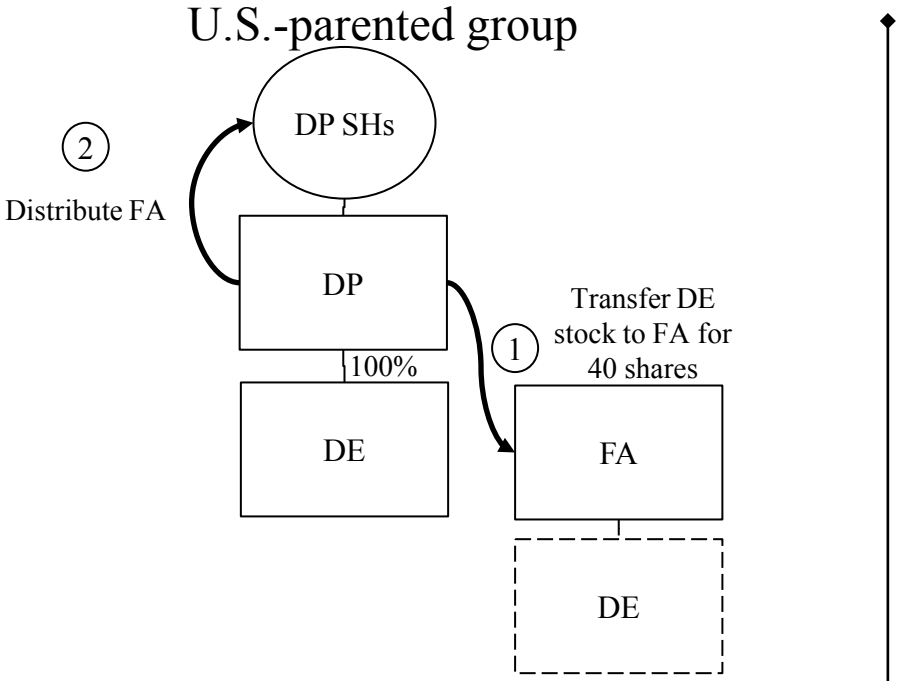
# Subsequent Transfers & EAG Rules: Notice 2014-52 Exceptions

- U.S.-parented group ("USPG") exception: Transferred stock is treated as held by a member of the EAG for purposes of the EAG rules if (i) before and after the acquisition, the transferring corporation (or its successor) is a member of a USPG; and (ii) after the acquisition, both the person that holds the transferred stock (after all related transfers of the transferred stock are completed) and the foreign acquiring corporation are members of the USPG

- Foreign-parented group ("FPG") exception: Transferred stock is treated as held by a member of the EAG for purposes of the EAG rules if (i) before the acquisition, the transferring corporation and the domestic entity are members of the same FPG; and (ii) after the acquisition, the transferring corporation is a member of the EAG or would be a member of the EAG absent the subsequent transfer of any stock of the foreign acquiring corporation by a member of the FPG in a transaction related to the acquisition (but taking into account all other transactions related to the acquisition)

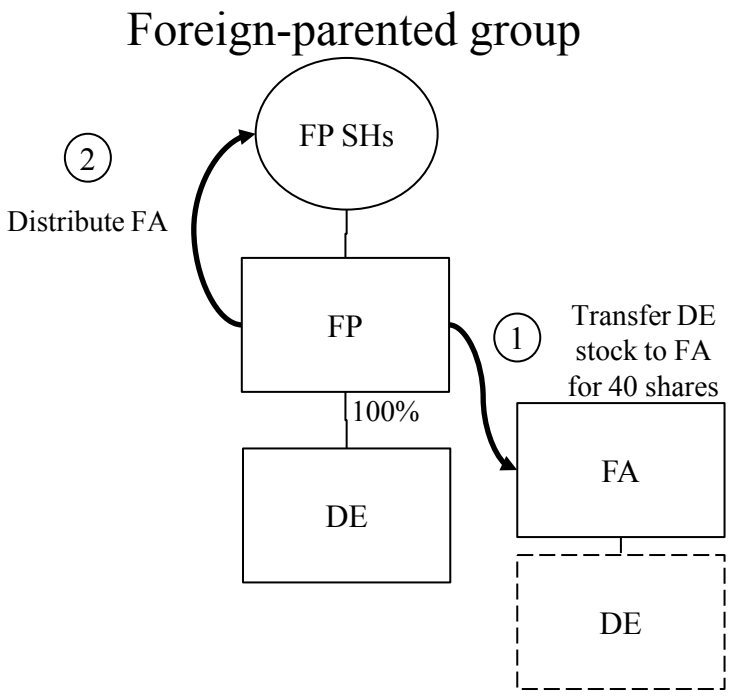
- U.S. [Foreign]-parented group = affiliated group (section 1504(a)) that has a domestic [foreign] corporation as the common parent corporation, applying a >50% standard and including foreign corporations in the group
- Notice confirms that a 0/0 Ownership Fraction does not result in an inversion (*see also* PLR 201432002)

# Subsequent Transfers & EAG Rules: Notice 2014-52 "Spinversions"




Result: USPG exception does not apply because (i) before and after the acquisition, DP (the transferring corporation) is a member of a USPG, *but* (ii) after the acquisition, DP SHs (persons that hold transferred stock) and FA are not members of the DP USPG, therefore EAG rules do not apply and Ownership Fraction is 40/40 (*see* Example 1 in the Notice)

Transaction might be unattractive for other reasons (e.g., section 367)

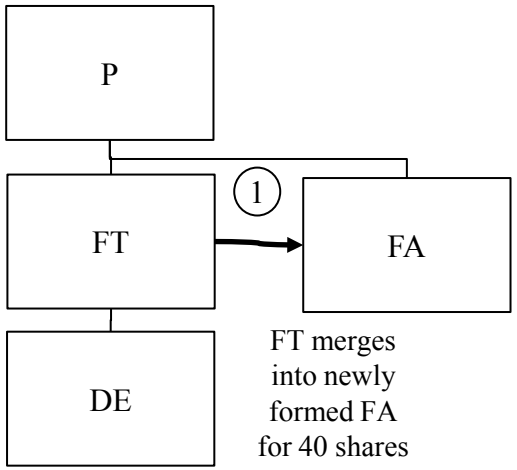



Result: FPG exception applies because (i) before the acquisition, FP (transferring corporation) and DE (domestic entity) are members of the same FPG, and (ii) FP (transferring corporation) would be a member of the EAG but for the subsequent transfer (i.e., the distribution); the transaction qualifies as an internal group restructuring, and the Ownership Fraction is 0/40 (*see* Example 1(iii) in the Notice)

# Subsequent Transfers & EAG Rules: Notice 2014-52 "F" Reorganizations (Ex. 1)

Basic "F" reorganization

*Key assumption in examples: FT owns no assets other than the stock of DE and has no liabilities

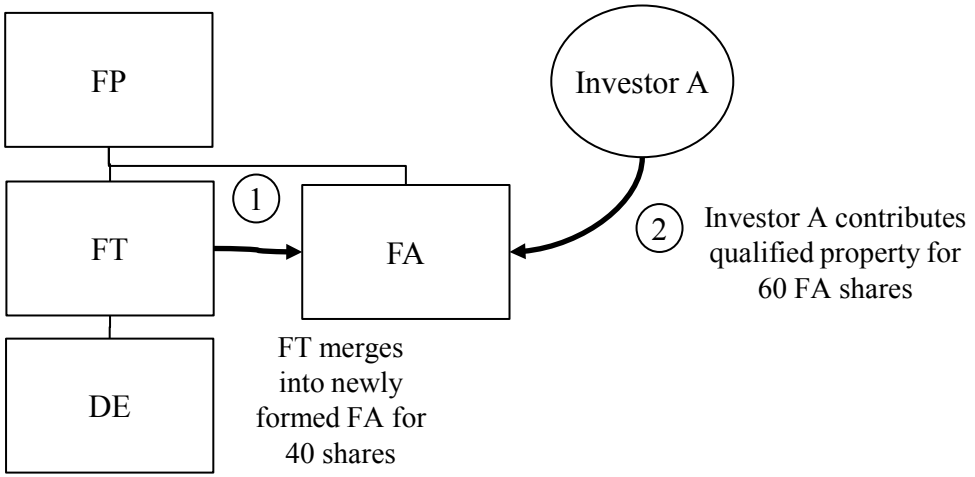



Results:

- If P is domestic: USPG exception applies because (i) before and after the acquisition, FT (or its successor) (the transferring corporation) is a member of a USPG, and (ii) after the acquisition, P (person that holds transferred stock) and FA are members of the P USPG; internal group restructuring (0/40 Ownership Fraction)
- If P is foreign: FPG exception applies because (i) before the acquisition, FT (transferring corporation) and DE (domestic entity) are members of an FPG, and (ii) FT (transferring corporation) would be a member of the EAG but for the subsequent transfer (i.e., the section 361(c) distribution of FA stock); internal group restructuring (0/40 Ownership Fraction)
- *See* Example 2 in the Notice

# Subsequent Transfers & EAG Rules: Notice 2014-52 "F" Reorganizations (Ex. 2)

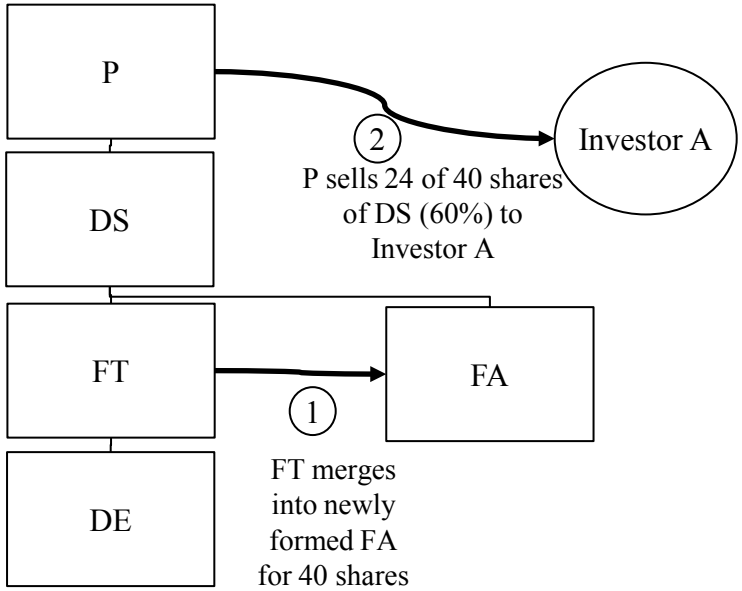
"F" reorganization with new investment




- Under the Notice, except as provided in the FPG exception, all transactions related to the acquisition are taken into account in determining an EAG, USPG, or FPG.
- The FPG exception does not apply because (i) before the acquisition, FT (transferring corporation) and DE (domestic entity) are members of an FPG, but (ii) FT (transferring corporation) would *not* be a member of the EAG absent the subsequent transfer (i.e., the section 361(c) distribution of FA stock) because of the issuance of FA stock to Investor A; 40/100 Ownership Fraction (See Example 2(iii) in the Notice).
- What if Investor A contributed "nonqualified property" (generally, cash or cash equivalents, marketable securities, related-party debt, and certain other property) under Treas. Reg. § 1.7874-4T? Why is a contribution of nonqualified property problematic when DE is already foreign-owned?

# Subsequent Transfers & EAG Rules: Notice 2014-52 "F" Reorganizations (Ex. 3)

"F" reorganization with upper-tier sale




If P is domestic (USPG exception):

-Is it true that before and after the acquisition, FT (or its successor) is a member of a USPG?

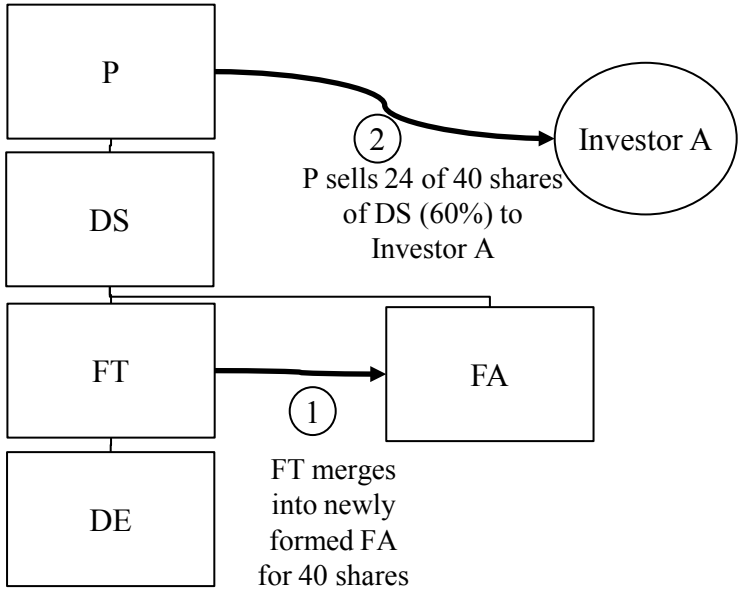
-Yes, if it doesn't have to be the same USPG

-No, if it has to be the same USPG in which P is the parent

-Is it true that after the acquisition and all related transfers of the transferred stock, DS (person that holds the transferred stock) and FA are both members of the USPG? If the answer is No, then the ownership fraction would be 40/40—is this result appropriate? (Note: reference to "the" suggests that the first requirement above must be referring to the same group)

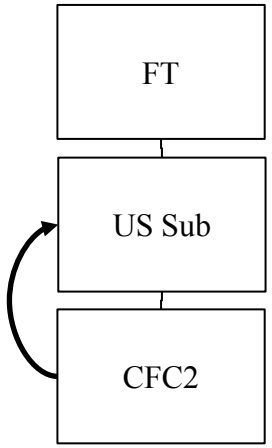
# Subsequent Transfers & EAG Rules: Notice 2014-52 "F" Reorganizations (Ex. 4)

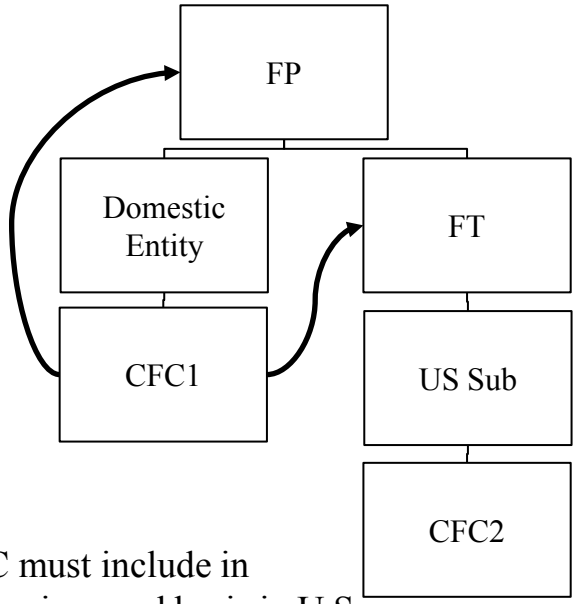
"F" reorganization with upper-tier sale




- If P is foreign: FPG exception applies because (i) before the acquisition, FT (transferring corporation) and DE (domestic entity) are members of an FPG, and (ii) FT (transferring corporation) *would* be a member of "the EAG" but for the subsequent transfer (i.e., the section 361(c) distribution of FA stock) because sale occurs above the FA/FT level
- Does internal group restructuring exception apply, or does the fact that the common parent of the EAG changes get taken into account?

# Section 956 Expansion: New Rules and Terms



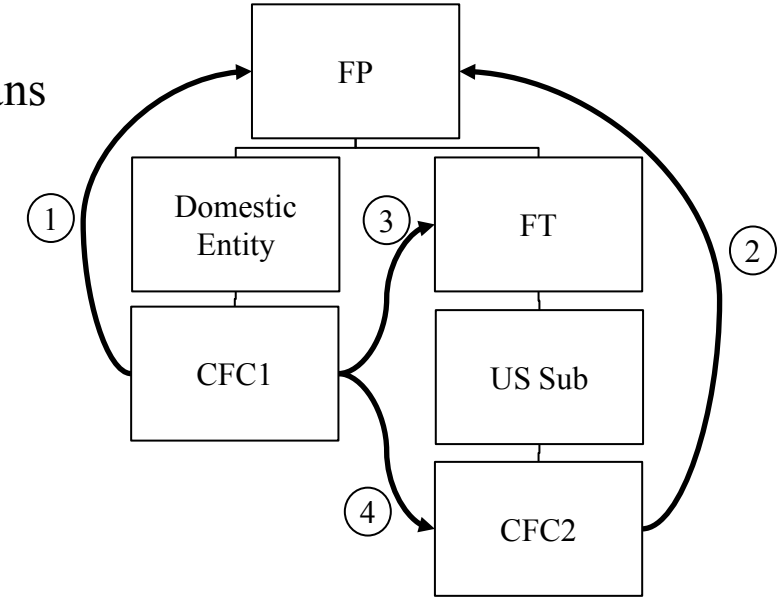

- Section 956/951(a)(1)(B): U.S. shareholder in a CFC must include in income currently pro rata share of lesser of CFC's earnings and basis in U.S. property
  - U.S. property
    - Obligation/stock of a related U.S. person
  - Quarterly determination

# Section 956 Expansion: New Rules and Terms (cont'd)

- Any obligation or stock of a foreign related person (as defined in section 7872(d)) other than an "expatriated foreign subsidiary" (a "non-CFC foreign related person") will be treated as U.S. property to the extent such obligation or stock is acquired by an expatriated foreign subsidiary during the applicable period (within the meaning of section 7874(d)(1)).
- Definitions:
  - "Expatriated foreign subsidiary" is a CFC with respect to which an expatriated entity (as defined in section 2.01(a) of Notice 2014-52, which refers back to section 7874(a)) is a U.S. shareholder
  - An "expatriated foreign subsidiary" does not include a CFC that is a member of the EAG immediately after the acquisition and all transactions related to the acquisition are completed (completion date) if the domestic entity is not a U.S. shareholder with respect to the CFC on or before the completion date
    - Intent here is to exclude any CFCs of a pre-existing U.S. subsidiary of foreign acquiring
    - It is not clear whether, if a foreign subsidiary of foreign acquiring becomes a CFC of the domestic entity, such CFC becomes an expatriated foreign subsidiary or remains a non-CFC foreign related person
    - To what extent do these definitions apply only after post-combination integration is completed (i.e., when is the completion date)?
- Aimed at shutting down source of financing for inversions and post-inversion planning

# Section 956 Expansion: Loan Examples

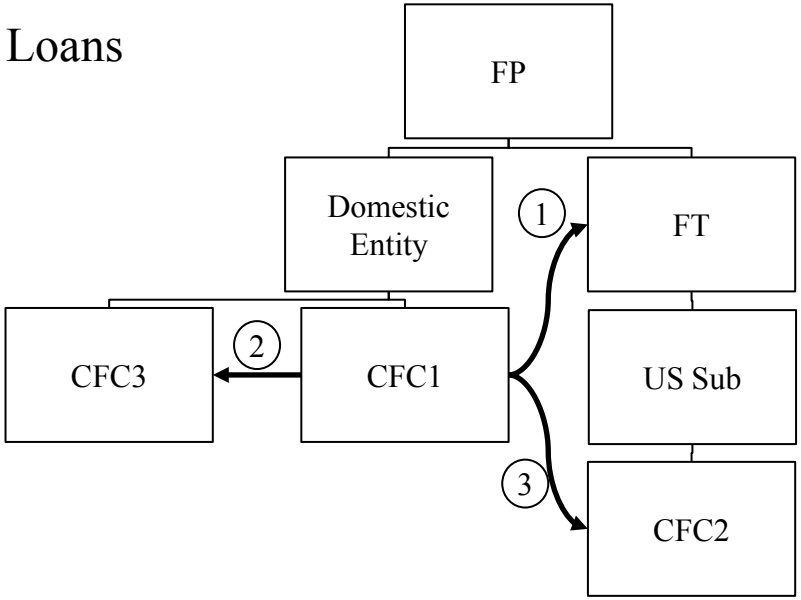
Intercompany Loans




- Domestic Entity is an "expatriated entity," CFC1 is an "expatriated foreign subsidiary"
- CFC2 is not an "expatriated foreign subsidiary"
- FP, FT, and CFC2 are "non-CFC foreign related persons" as to CFC1
- Loans 1, 3, and 4 are U.S. property (same result even if the borrower is an intercompany "cash pool")
- Loan 2 is not U.S. property

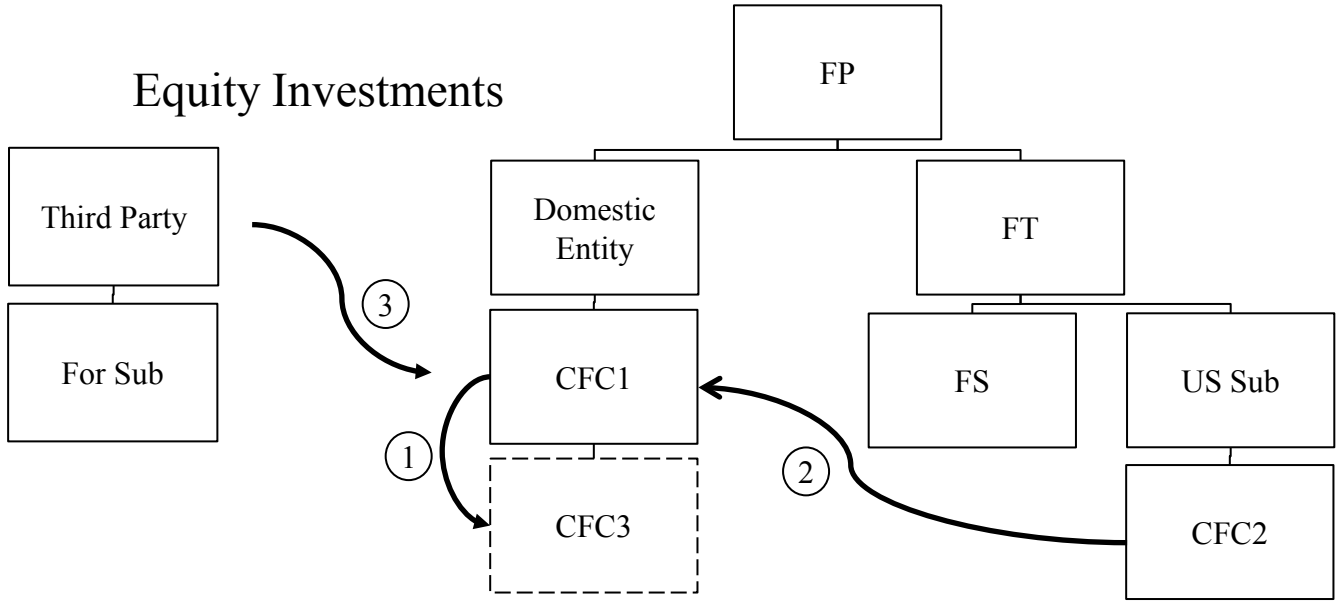
# Section 956 Expansion: Loan Examples (cont'd)

Intercompany Loans




- What if Loan 1 is put in place the day before FP's acquisition of Domestic Entity? Is such loan "acquired" during the "applicable period"?
- Why does Loan 3 give rise to a section 956 investment but Loan 2 does not?
  - Is the concern an anti-abuse concern with CFC2 on-lending to FP? If so, why not governed by section 1.956-1T(b)(4)?

# Section 956 Expansion: Stock Examples (cont'd)




- Transaction 1: CFC1 forms CFC3 and transfers assets/cash for 100% of CFC3 equity
- Transaction 2: CFC1 buys 51% or more of the stock of CFC2
  - Is CFC2 prevented from becoming an expatriated foreign subsidiary by definition? If so, stock of CFC2 section 956 property but can make loans to FP, etc.
- Transaction 3: CFC1 buys all of the stock For Sub from Third Party for cash
  - For Sub becomes a CFC of an expatriated entity (Domestic Entity) and thus appears to be an expatriated foreign subsidiary. Stock of For Sub not section 956 property, but it cannot lend funds or make equity investments in related, non-CFCs without triggering section 956.

# Section 956 Expansion: New Rules and Terms (cont'd)

- Section 956 rules adapted to apply to these new situations:
  - CFC pledge/guarantee rules of section 956(d) and Treas. Reg. § 1.956-2(c) can apply
    - E.g., expatriated foreign subsidiary guarantees a third-party borrowing of a non-CFC related person
  - Request for comments on application of exceptions in section 956(c)(2) or Treas. Reg. § 1.956-2 (but will not apply the exception in Rev. Rul. 88-108 for certain obligations collected within 30 days)
  - Possibility of applying operative rule of section 956 with no exceptions? What is the basis for that cherrypicking?

# Section 956 Expansion: New Rules and Terms (cont'd)

- What is the policy for deeming a section 956 investment where the cash never touches any U.S. company?
  - At the time Section 956 was enacted, the Senate stated that the purpose of Section 956 was to tax U.S. shareholders of controlled foreign corporations ("CFCs") that invested in U.S. assets "on the grounds that this is substantially the equivalent of a dividend being paid to them." S. Rep. No. 87-1881, at 87 (1962).
  - Thus, Section 956 operates "to prevent the repatriation of income *to the United States* in a manner which does not subject it to U.S. taxation." H.R. Rep. No. 87-1447, at 51 (1962); S. Rep. No. 87-1881, at 87 (1962) (same). Emphasis added.
  - In keeping with this policy of preventing repatriation, Congress enacted several exceptions intended to prevent Section 956 from applying to "normal commercial transactions without intention to permit the funds *to remain in the United States* indefinitely." S. Rep. No. 87-1881, at 87 (1962); H.R. Rep. No. 87-1447, at 51 (1962) (same). Emphasis added.
  - The IRS has consistently applied section 956 to reflect the substance of the transaction as a repatriation to the United States: "[S]ection 956 is intended to prevent the tax-free repatriation of earnings even in circumstances that would not otherwise constitute a dividend distribution. The facts and circumstances of each case must be reviewed to determine if, in substance, there has been *a repatriation of the earnings* of the controlled foreign corporation." Rev. Rul. 89-73, 1989-1 C.B. 258 (emphasis added).
  - Notice 2014-52 reiterates the animating policy: "In the absence of section 956, a U.S. shareholder of a CFC could access the CFC's funds (untaxed earnings and profits) in a variety of ways other than by the payment of an actual taxable dividend, such that there would be no reason for the U.S. shareholder to incur the dividend tax."

# Section 956 Expansion: New Rules and Terms (cont'd)

- Why does Notice specifically target a U.S. corporation that falls within the "expatriated entity" definition (60% or greater but less than 80% Ownership Fraction, no substantial business activities)?
  - According to Notice 2014-52, the new foreign parent in the newly inverted group could avoid section 956 by accessing the untaxed earnings and profits of CFCs in the U.S. target group without a current tax on the U.S. shareholders.
  - This is a result that U.S. shareholders could not achieve before the inversion.
  - New foreign parent's ability to access deferred CFC earnings and profits eliminates the need to pay dividends to U.S. shareholders, "thereby circumventing the purposes of section 956."
  - How?
- What is the authority for this expansion of section 956?
  - Section 956(e) provides (without ellipses) that "[t]he Secretary shall prescribe such regulations as may be necessary *to carry out the purposes of this section*, including regulations to prevent the avoidance of the provisions of this section through reorganizations or otherwise." Emphasis added.
  - According to Notice 2014-52, an inversion permits the foreign parent and U.S. shareholders to avoid paying dividends to U.S. shareholders, thereby avoid section 956, and thus an inversion is reorganization identified in section 956(e).
  - But this is true for all cash inversions not subject to section 7874.

# Future Guidance

- "The Treasury Department and the IRS ***expect to issue*** additional guidance to further limit inversion transactions that are contrary to the purposes of section 7874 ***and*** the benefits of post-inversion tax avoidance transactions."
- "In particular, the Treasury Department and the IRS ***are considering*** guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or 'stripping' U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt."
- Other issues???
- "Future guidance ***will apply prospectively***; however, the Treasury Department and the IRS expect that, to the extent any tax avoidance guidance applies only to inverted groups, ***such guidance will apply to groups that completed inversion transactions on or after September 22, 2014***."

# Income Tax Treaty Policy

- The Treasury Department is also reviewing its tax treaty policy regarding inverted groups and the extent to which taxpayers inappropriately obtain tax treaty benefits that reduce U.S. withholding taxes on U.S. source income

- Inversion wave in late 1990s and early 2000s:
  - Renegotiation of the Barbados Treaty
  - Modifications to the Limitation on Benefits (LOB) provision

- Different destinations in the current transactions

# 2016 Greenbook Proposal

## *Limit The Ability Of Domestic Entities To Expatriate*

- To limit the ability of domestic entities to expatriate, the proposal would broaden the definition of an inversion transaction by reducing the 80-percent test to a greater than 50-percent test, and eliminating the 60-percent test.

- The proposal also would add a special rule whereby, regardless of the level of shareholder continuity, an inversion transaction would occur if (i) immediately prior to the acquisition, the fair market value of the stock of the domestic entity is greater than the fair market value of the stock of the foreign acquiring corporation, (ii) the EAG is primarily managed and controlled in the United States, and (iii) the EAG does not conduct substantial business activities in the country in which the foreign acquiring corporation is created or organized.

# 2016 Greenbook Proposal (cont'd)

## *Limit The Ability Of Domestic Entities To Expatriate*

- Additionally, the proposal would expand the scope of acquisitions described in section 7874 so that an inversion transaction could occur if there is a direct or indirect acquisition of substantially all of the assets of a domestic corporation or domestic partnership, substantially all of the trade or business assets of a domestic corporation or domestic partnership, or substantially all of the U.S. trade or business assets of a foreign partnership.

- In addition, the proposal would provide the IRS with authority to share tax return information with Federal agencies for the purpose of administering an agency's anti-inversion rules. Federal agencies receiving this information would be subject to the safeguarding and recordkeeping requirements under section 6103.

# 2016 Greenbook Proposal (cont'd)

## *Limit The Ability Of Domestic Entities To Expatriate*

- The proposals that would limit the ability of domestic entities to expatriate would be effective for transactions that are completed after December 31, 2015. The proposal providing the IRS with the authority to share information with other Federal agencies to assist them in identifying companies that were involved in an inversion transaction would be effective January 1, 2016, without regard to when the inversion transaction occurred.

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