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IRS Revises "Anti-Inversion" Regulations Under Code Section 7874

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On June 9, 2009, the IRS issued new final and temporary regulations (T.D. 9453) under the "anti-inversion" rules of Section 7874 of Internal Revenue Code of 1986, as amended (the "Code"). The new regulations (the "2009 Regulations") address the classification of a foreign corporation as a "surrogate foreign corporation" subject to adverse U.S. tax treatment, including potential U.S. taxation of the foreign corporation's worldwide income. The 2009 Regulations replace temporary regulations published in June 2006 (the "2006 Regulations"), and in many respects are more restrictive than the 2006 Regulations. The 2009 Regulations generally apply to acquisitions completed on or after June 9, 2009.

Related Practices:

- Federal Tax
- Tax

Background

Generally, Code Section 7874 targets certain inversion transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership) to an offshore jurisdiction. Under current law, a foreign corporation is generally treated as a "surrogate foreign corporation" for this purpose if, pursuant to a plan (or a series of related transactions), the following three conditions are satisfied:

(1) the foreign corporation directly or indirectly acquires substantially all of the properties of a domestic corporation;

(2) after the acquisition, at least 60% of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation; and

(3) after the acquisition, the expanded affiliated group ("EAG") (as defined in Code Section 7874(c)(1)) that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the EAG.

Similar provisions apply to transactions involving the acquisition by a foreign corporation of substantially all of the properties constituting a trade or business of a domestic partnership.

The U.S. tax consequences of surrogate foreign corporation status depend upon the degree of ownership of the surrogate foreign corporation by former shareholders of the domestic corporation. If the former shareholders own at least 60% but less than 80%, the inversion transaction is respected, but certain additional U.S. tax burdens are imposed on the acquired domestic corporation and its affiliates with respect to the inversion transaction itself, certain related restructuring steps and transactions during the 10 year period following the inversion. For example, the acquired corporation's gain on the inversion transaction cannot be offset by net operating losses or other otherwise available tax attributes. If the other elements for treatment as a surrogate foreign corporation are present, but former shareholders own at least 80%, then the foreign corporation is no longer treated as a surrogate foreign corporation. Rather, the inversion transaction is effectively disregarded by treating the foreign corporation as a domestic corporation for all purposes of the Code, resulting in U.S. taxation of its worldwide income.

Substantial Business Activities

As noted above, the anti-inversion rules will only apply if, among other things, an EAG does not have "substantial business activities" in the acquiring foreign corporation's country of organization. The 2009 Regulations significantly modify the rules for determining whether "substantial business activities" exist, and increase uncertainty in the application of that standard.

The 2006 Regulations provided a general rule that, with certain exceptions, determined the existence of substantial business activities based on all the facts and circumstances, including a non-exhaustive list of factors relevant to the determination. The 2006 Regulations illustrated the application of the general rule through several examples. Importantly, the 2006 Regulations also provided a safe harbor under which an EAG would be considered to have substantial business activities (and thus would be exempted from the anti-inversion rules) if at least 10% of the EAG's employees, assets and sales were situated in the acquiring foreign corporation's country of organization. Given the potentially enormous stakes involved in the typical inversion transaction, the safe harbor provided critical certainty to taxpayers considering such a transaction.

Significantly, the 2009 Regulations retain the general rule (in a modified form), but eliminate the examples illustrating the general rule and also eliminate the safe harbor altogether. The preamble to the 2009 Regulations expresses concern that certain transactions technically fitting within the safe harbor might nevertheless violate the purpose of the anti-inversion rules. As a result, Treasury expressly states that taxpayers cannot rely on the former safe harbor or the examples illustrating the general rule.

The 2009 Regulations also modify the rules regarding certain assets, activities and income not to be taken into account in determining whether the substantial business activities condition is met. Under the 2006 Regulations, assets, activities and income would be disregarded if they were the subject of a transfer a principal purpose of which was to avoid the anti-inversion rules. The 2009 Regulations retain this rule without material modification.

The 2006 Regulations also provided that assets would not be taken into account in assessing substantial business activities if the assets were only temporarily located in a foreign country as part of a plan a principal purpose of which was to avoid the anti-inversion rules. The 2009 Regulations expand on this restriction in a number of respects.

- First, under the 2009 Regulations it is clear that the restriction applies not only to assets, as was true under the 2006 Regulations, but also to business activities and employees.

- Second, the 2009 Regulations eliminate the requirement that the assets, business activities or employees in question have been only "temporarily" located in the foreign country pursuant to a plan to avoid the anti-inversion rules. The preamble to the 2009 Regulations does not elaborate on this change. Particularly because the regulations require only "a" principal purpose (versus "the" principal purpose) to avoid the anti-inversion rules, if broadly construed the elimination of the "temporarily" requirement could create considerable uncertainty for many taxpayers having any meaningful increase in their foreign country assets, business activities or employees in conjunction with the migration of their corporate parent, even if that increase is largely motivated by non-tax considerations and is maintained indefinitely following the inversion transaction.

- Third, the 2009 Regulations disregard any assets, business activities, or employees located in the foreign corporation's country of organization if such assets, business activities or employees are transferred to another country pursuant to a plan that existed at the time of the inversion transaction. Although again the preamble does not explain this change, it appears to eliminate the prior requirement of a plan to avoid the anti-inversion rules. Instead, any assets, business activities or employees apparently will be disregarded as long as the subsequent movement of those items out of the relevant foreign country was planned at the time of the inversion transaction, even if Section 7874 avoidance was not at all a factor in the planned movement of the assets.

Despite the enhanced uncertainty created by the elimination of the safe harbor and the other changes to the substantial business activities standard, the preamble expressly provides that satisfaction of the substantial business activities standard will remain an issue on which the IRS ordinarily will not issue private letter rulings. As a result, in all but very clear-cut situations, the 2009 Regulations leave taxpayers with no opportunity to achieve certainty on this important issue.

Other Provisions

The 2009 Regulations also clarify, modify, and/or provide a number of other rules relating to the determination of "surrogate foreign corporation" status in ways that will in many cases expand the scope of Section 7874, including, for example:

- Clarifying that stock held by a partnership is treated as held proportionately by its partners only for purposes of testing ownership of the foreign corporation by former owners of the domestic entity;

- Adding other partnership look-through rules, including for purposes of determining the business activities of the expanded affiliated group;

- Expanding the rule on indirect acquisition of assets using a controlled subsidiary to reach an acquisition of properties of a partnership and acquisitions by controlled partnerships;

- Providing that if, pursuant to a plan or series of related transactions, two or more foreign corporations, in the aggregate, directly or indirectly acquire substantially all of the properties of a domestic corporation, then each foreign corporation is treated as having completed the acquisition for purposes of assessing that corporation's surrogate foreign corporation status;

- Providing that if, pursuant to a plan or series of related transactions, a single foreign corporation acquires multiple domestic corporations (or partnerships), then the acquisitions will be treated as a single acquisition of a single entity for purposes of testing ownership of the foreign corporation by former owners of the domestic entity. This rule was foreshadowed in the preamble to the 2008 final Section 1.7874-1 regulations and is described as a clarification rather than a change in law;

- Clarifying that stock of a foreign corporation will be considered to be received "by reason of" holding stock in the domestic corporation not only if received in "exchange" for domestic corporation stock (as is clear under the 2006 Regulations), but also if otherwise received "with respect to" domestic corporation stock, including, for example, foreign corporation stock received as a taxable or non-taxable distribution on domestic corporation stock;

- Expanding the rules on acquisitions by publicly traded partnerships to apply to partnerships that become publicly traded after the acquisition pursuant to a plan that existed at the time of the acquisition, and deeming a plan to exist if publicly traded status occurs within two years after the acquisition;

- Modifying and expanding the rules regarding the circumstances and manner in which options will be treated as stock ownership in the domestic corporation or foreign acquiring corporation, as applicable;

- Creating a new rule treating any interest (including stock or a partnership interest) that is not otherwise treated as stock of a foreign corporation as stock of a foreign corporation if the interest provides the holder with distribution rights that are substantially similar in all material respects to the distribution rights provided by stock in the foreign corporation, but only if treating the interest as stock in the foreign corporation results in surrogate foreign corporation status;

- Clarifying that, for all purposes of Section 7874, including determining ownership of a foreign corporation by former owners of a domestic entity, a creditor's claim against an insolvent or bankrupt domestic corporation or partnership is treated as an equity interest. This rule was also anticipated in the preamble to the 2008 final Section 1.7874-1 regulations; and

- Providing notice of an intent to issue future regulations, which may apply to acquisitions completed on or after June 9, 2009, that would prevent the special rule for computing the ownership fraction of former owners in the case of internal group restructurings from applying to certain divisive transactions.