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# New Temporary Regulations Introduce a Welcome De Minimis Rollover-Shareholder Exception to US Anti-Inversion Rules


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**On January 16, 2014, the Treasury Department and the Internal Revenue Service released new temporary regulations on one aspect of corporate inversions under Section 7874 (the "Regulations") that altered and clarified the "Exclusion Rule" first announced by the IRS in Notice 2009-78 (the "Notice").[1] The Exclusion Rule had the potential of causing transactions that were primarily cash acquisitions to be subject to the inversion rules and causing a foreign acquiring corporation to be deemed a US corporation. The new Exclusion Rule, while in some ways broader than the Notice's version, does contain a welcome de minimis exception. The de minimis exception will make it easier for a foreign corporate acquiror to acquire a US corporation or US partnership for cash consideration while allowing management or other shareholders to roll-over into an equity interest in the foreign corporate acquiror without causing the foreign corporate acquiror to be deemed a US corporation.**

[1] Notice 2009-78, 2009-40 I.R.B. 452 (September 17, 2009). Unless otherwise noted, all section references herein are to the Internal Revenue Code of 1986, as amended (the "Code").

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## Background

Under Section 7874, a foreign corporation may be treated as a US corporation for US federal income tax purposes even though the foreign corporation is organized under the laws of a foreign jurisdiction. In the case of an "inversion" of a US corporation, Section 7874 may apply to a foreign corporation that acquires "substantially all" of the properties of the US corporation (including indirectly through a stock acquisition) if shareholders of the US corporation exchange, or are deemed to exchange, their interests in the US corporation for sufficient stock in the foreign corporation. Specifically, Section 7874(b) will apply to an inversion transaction to treat a foreign corporation as a US corporation for US federal income tax purposes if, pursuant to a plan or a series of related transactions: (i) the foreign corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by the US corporation, (ii) after the acquisition at least 80 percent of the stock of the foreign corporation (by vote or by value) is held, or deemed held, by former shareholders of the US corporation by reason of the former shareholders holding stock in the US corporation and (iii) after the acquisition, the expanded affiliated group that includes the foreign corporation does not have substantial business activities in the foreign country in which the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group.[2] For purposes of measuring the ownership by former shareholders of the US corporation, an option on the stock of an acquiring foreign corporation will be treated as stock of the corporation, with a value equal to the holder's claim on the equity of the corporation.[3] If an inversion meets the three conditions above, or would meet those conditions but for the fact that less than 80 percent, but at least 60 percent, of the stock of the foreign corporation is held, or deemed held, by former shareholders of the US corporation by reason of the former shareholders holding stock in the US corporation, then the income and gain recognized by the US corporation in connection with the inversion (including certain licensing transactions) is subject to US federal income tax regardless of whether any deductions (such as NOL carryovers) or current year losses would otherwise be available to be used by the US corporation to offset such income or gain. Similar rules apply to a foreign acquiring corporation that acquires

[2] See also, Section 7874(a)(2)(B). The term "expanded affiliated group" means an affiliated group as defined in Section 1504(a) but without regard to Section 1504(b)(3), except that Section 1504(a) shall be applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears. Section 7874(c)(1). In general, the an expanded affiliated group will have "substantial business activities" if least 25 percent of the expanded affiliated group's employees (by number and compensation), business assets and business income are located or derived in the foreign country in which the foreign corporation is created or organized. See Treas. Reg. §1.7874-3T(b).

[3] Treas. Reg. §1.7874-2(h)(1).

substantially all of the assets of a trade or business of a US partnership and the income or gain recognized by partners in the partnership in connection with the inversion.

## Public Offering Rule

Under Section 7874(c)(2)(B), stock of the foreign acquiring corporation that is sold in a "public offering" related to the inversion is not taken into account for purposes of calculating the ownership fraction that is held, or deemed held, by former shareholders of the US corporation by reason of the former shareholders holding stock in the US corporation (the "ownership fraction"). The effect of this rule is that public offerings are not treated as diluting continuing former shareholder ownership for purposes of the 80 percent test or the 60 percent test. The Code does not provide a definition of "public offering" for these purposes.

The statutory public offering rule created uncertainty as to the scope of "public offering" and whether it included private placements or non-SEC registered public offerings as well as other issues.

## Notice 2009-78

In Notice 2009-78, the Treasury Department stated its intention to alter the statutory public offering rule by essentially doing away with the "public offering" criterion and introducing a new rule (the Exclusion Rule). The Notice provided that, under guidance that would apply to transactions that occur on or after September 17, 2009, the issuance of stock of a foreign corporation for cash or other "nonqualified property"[4] in any transaction that is related to the acquisition of substantially all of the properties of a US corporation is not to be taken into account for the purpose of determining the ownership fraction.

The Notice created issues in M&A deals in which a foreign corporation acquired a US corporation for cash consideration but the foreign corporation wanted management or other shareholders to receive stock of the foreign corporation (or acquisition vehicle). This is common where the acquiror wants to retain the US corporation's management and motivate them by providing them rollover equity. The Exclusion Rule set forth in the Notice could cause Section 7874 to apply to acquisitions that are, in substance, sales of a US business for cash with little continuity of ownership by the historic owners of the US corporation. For example, assume a foreign acquiror formed a new foreign company (to which it contributed cash) in order to acquire a US target and wanted to give management 10% of the new foreign company's stock in exchange for their shares in the target company. The Exclusion Rule in the Notice would have resulted in the ownership fraction being 100% because the foreign acquiror received new foreign company stock in exchange for cash. The Exclusion Rule in the Notice would have caused this result even if only one target shareholder received a single share of stock in the new foreign company. This also would have been the result irrespective of whether the exchange of new foreign company stock for US target stock was tax-free or taxable.

[4] Nonqualified property, for these purposes, included: (i) cash and cash equivalents; (ii) marketable securities as defined in Section 453(f)(2), but, in the case of stock of a member of the expanded affiliated group that, after the acquisition, includes the foreign acquiring corporation, only if a principal purpose of issuing the stock of the foreign acquiring corporation in exchange for such stock was the avoidance of the purposes of Section 7874; and (iii) any other property acquired in a transaction with a principal purpose of avoiding the purposes of Section 7874.

## New Section 7874 Treasury Regulations

The Regulations set forth a modified version of the Exclusion Rule. The Regulations describe all situations in which stock will be excluded from the denominator of the ownership fraction under Section 7874(c)(2)(B). The Regulations expand the definition of nonqualified property to include certain obligations and exclude from the ownership fraction (i) stock of the foreign acquiring corporation transferred to any person (including the acquired US corporation) in exchange for property to the extent, pursuant to the same plan, the stock is later transferred in exchange for the satisfaction or the assumption of an obligation associated with the property exchanged and (ii) any stock of the foreign corporation transferred in exchange for nonqualified property by any person (including unrelated persons) in connection with the potential inversion transaction, but, in each case, only to the extent such transfers increase the fair market value of the assets or decrease the amount of liabilities of the foreign corporation.[5]

The Preamble of the Regulations indicates that the Treasury Department considered comments on the Notice recommending that Section 7874 should not apply to acquisitions of a domestic entity by a foreign corporation in exchange for mostly, but not exclusively, cash. The Treasury Department did not adopt those recommendations in general.

However, the Regulations provide an exception from the Exclusion Rule when the former owners of the US corporation own a de minimis equity interest in the foreign corporation after the acquisition. This exception applies if, (i) the ownership fraction determined without regard to the Exclusion Rule is less than five percent (by vote and value), (ii) after the acquisition and all transactions related to the acquisition, former shareholders of the US corporation, in the aggregate, own directly or indirectly, less than five percent (by vote and value) of the stock of any member of the expanded affiliated group that includes the foreign corporation, and (iii) stock of the foreign corporation which would otherwise be excluded from the denominator was not transferred in a transaction related to the acquisition with a principal purpose of avoiding the purposes of Section 7874.[6] In the example above, the foreign acquiring corporation would not be taxed as a US corporation if management received no more than 4.9% of the stock of the new foreign company.

The 5 percent threshold provides some relief as compared to the Notice, but because the threshold is still relatively low, the new Exclusion Rule may still cause Section 7874 to apply to transactions the predominant effect of which is not an inversion, but rather that of a sale or joint venture, due to the magnitude of the change in share ownership of the acquired US corporation.

The Regulations' changes to the Exclusion Rule are generally applicable to transactions completed on or after January 16, 2014. A taxpayer can elect to apply all of the Regulations retroactively, including the de minimis exception described above, to acquisitions completed on or after September 17, 2009, so long as the taxpayer applies the Regulations consistently to all such acquisitions.

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If you wish to receive more information on cross-border mergers and acquisitions generally or the Section 7874 regulations, you may contact your regular Shearman & Sterling contact person or any contact person listed in this publication.

[5] Treas. Reg. §1.7874-4T(c).

[6] Treas. Reg. §1.7874-4T(d).

## Circular 230 Disclosure

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