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Hon. Mark W. Everson
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, DC 20224

Re: Comments Regarding the Proposed Regulations under Section 7874

Dear Commissioner Everson:

Enclosed are comments under Internal Revenue Code Section 7874. These comments represent the views of the American Bar Association Section of Taxation. They have not been approved by the Board of Governors or the House of Delegates of the American Bar Association and should not be construed as representing the policy of the American Bar Association.

Sincerely,

Dennis B. Drapkin
Chair, Section of Taxation

Enclosure

cc: Donald L. Korb, Chief Counsel, Internal Revenue Service
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AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

Comments Concerning Code Section 7874 and
Proposed and Temporary Regulations Thereunder

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by Giovanna Sparagna of the Foreign Activities of U.S. Taxpayers Committee (“FAUST”). Substantive contributions were made by Peter Blessing, Dirk Suringa, Joseph Caliano, and Robert Stack. The Comments were reviewed by Peter Blessing, Chair of the Committee, Stephen E. Shay, of the Section’s Committee on Government Submissions, and N. Susan Stone, Council Director for the Committee.

Although the members of the Section of Taxation who participated in preparing these Comments have clients who would be affected by the federal tax principles addressed by these Comments or have advised clients on the application of such principles, no such member (or the firm or organization to which such member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: May 12, 2006

I. Executive Summary of Requested Guidance under Section 7874

The American Jobs Creation Act of 2004 added section 7874 to the Internal Revenue Code of 1986 (the “Code”) to curtail inversion transactions. In December of 2005, the Treasury Department issued proposed and temporary regulations setting forth rules for disregarding affiliate owned stock in determining whether an inversion subject to section 7874 has occurred (the “2005 Regulations”).¹ The legislative history describes the paradigm transaction, which was the focus of the legislation - “[a] U.S. corporation may reincorporate in a foreign jurisdiction and thereby replace the U.S. parent corporation of a multinational corporate group with a foreign parent.”² The legislation was drafted to capture both stock inversions and asset inversions including various combinations of, and variations to, such transactions. Congress believed that inversion transactions resulting in minimal business presence in a foreign country were primarily designed to avoid U.S. tax.³ Accordingly, section 7874 identifies inversion transactions *deemed* motivated primarily for U.S. tax avoidance purposes and imposes harsh sanctions.

In general, the most urgent request of these Comments is for guidance with respect to numerous technical issues raised by the statute. Part II of these Comments sets forth a description of the Congressional concerns, expressed in the legislative history of section 7874 that led to the enactment of the anti-inversion provisions. Part III describes the key operational aspects of the inversion provisions. Part IV provides our comments with respect to the 2005 Regulations. In general, we welcome the clarification provided in the 2005 Regulations as to how stock of the expanded affiliated group is excluded under section 7874(c)(2) in determining the former shareholders’ “post-inversion” ownership percentage in the foreign acquiring entity.

¹ T.D. 9238 (Dec. 27, 2005); Treas. Reg. § 1.7874-1T.

² General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05, May 2005) (“Gen. Explanation”) 341, 342.

³ Gen. Explanation, *supra* n. 2 at 343.

Such clarification, in our view, appropriately excludes from the scope of section 7874 transactions that clearly (as contemplated by Congress) do not present an inversion abuse. However, we believe that further rules may be necessary to define the term “stock” solely for applying the exclusion rules provided in the 2005 Regulations.

Finally, Part V identifies areas in which we request additional guidance and where appropriate, suggests proposals for consideration. One significant open issue is the legal standard to be applied for combining seemingly separate steps as part of a single “plan.” We do not recommend relying solely on judicial principles for defining the term “plan” since such case precedent will not yield a definable standard and given the potential high stakes of any disagreement between the taxpayer and the Internal Revenue Service (the “IRS”), the lack of a clear standard will likely lead to significant controversy on the issue. In adopting a definition for what constitutes a plan, fairness would be promoted by adopting a single definition which would permit taxpayers as well as the IRS to affirmatively link interrelated steps which are part of a single plan. Clarification is also requested with respect to whether there has been an acquisition within the meaning of section 7874(a)(2)(B)(i). For example, we urge the issuance of (i) a bright-line test or safe harbor for determining whether there has been a transfer of “substantially all” the assets of the domestic corporation (or substantially all the trade or business of a partnership) and (ii) guidance as to how to determine the amount of assets acquired in a “direct or indirect” acquisition. These concepts should be amply demonstrated in examples. Moreover, despite the much-needed “scope-narrowing” rules provided in the 2005 Regulations, other unresolved questions can also result in the inappropriate application of the inversion provisions to transactions that present no “inversion abuse.” Specifically, technical guidance is requested (i) in the form of examples demonstrating which stock in the foreign acquiring corporation

should be treated as received “by reason of” an inversion transfer, (ii) for identifying stock issued (and ultimately excluded) pursuant to a “public offering” by relying on SEC registration rules or the foreign law analog of such rules, and (iii) for providing certain technical guidance relating to the definition of “former partners” where the transferring partnership has not liquidated. Finally, it is expected that significant rules will be required to determine when stock should be treated as a “non-stock” interest and when a non-stock interest should be considered as stock. Subject to a narrowly targeted anti-abuse rule, we would recommend that stock rights not be accorded equity status for purposes of testing the former shareholders’ post-transaction ownership in the acquiring entity. In the narrow circumstances when stock rights will be deemed to represent an equity interest, such rule should apply for all purposes (*i.e.*, to dilute or augment the former shareholders’ post-transaction ownership percentages in the acquiring corporation). In this regard, specific guidance is requested as to the treatment of non-stock rights packaged as part of a single investment unit such as a Canadian income deposit security. There are numerous additional requests for guidance with respect to other portions of the inversion provisions, the most significant of which is a request that future regulations define the presence of “substantial business activities” under section 7874(a)(2)(B)(iii) by reference to the 1996 U.S. Model Treaty, Article 23(3)(c) thresholds for determining whether the trade or business of a resident is “substantial.” A more complete discussion of the above comments is contained below in Part V.

II. Background

The primary objective of an inversion transaction is to shift control of a U.S. corporate group or a domestic partnership from U.S. persons to a foreign corporation. An inversion transaction may take many forms. To illustrate one paradigmatic form, assume an acquiring foreign corporation is incorporated in a low-tax foreign jurisdiction and forms a wholly owned

U.S. subsidiary that merges into the U.S. parent of a multinational group. The shareholders of the U.S. parent company exchange their U.S. parent company stock for stock in the acquiring foreign corporation. As a result, the former U.S. parent company becomes a wholly owned subsidiary of the acquiring foreign corporation. The ownership structure of the U.S. corporate group is referred to as “inverted” in that, after such transaction, the U.S. corporate group is placed at the bottom of the corporate chain *below* a foreign corporation, which becomes the new controlling shareholder.

The principal tax benefit of an inversion transaction is that a foreign controlled corporate group can create tax avoidance opportunities by sheltering U.S. profits of the U.S. corporate group with deductible payments made to foreign related parties. Moreover, tax benefits are enhanced to the extent that foreign subsidiaries held by the U.S. group (and thereby subject to the U.S. subpart F rules) are restructured or their operations are otherwise transferred to related foreign corporations that are outside the scope of the U.S. subpart F regime because the new foreign parent’s widely held stock places it outside the definition of a controlled foreign corporation.⁴

Many inversions were subject to full taxation at the shareholder level (and sometimes at the corporate level) under prior law. The absence of gain or availability of losses or other income-sheltering tax attributes, however, often mitigated the tax cost in consummated transactions. Notwithstanding the “toll charge” on inversions under prior law, Congress concluded that corporate inversion transactions should be further deterred because of the

⁴ “In particular, these transactions permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversions, but with the result that the inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on domestic operations.” Gen. Explanation, *supra* n. 2 at 343.

significant opportunities to strip earnings out of the United States.⁵ Congress also believed that similar benefits could be achieved from inversion transactions involving U.S. businesses conducted in partnership form.

As described more particularly in Part III, section 7874 operates to effectively disregard the inversion (*i.e.*, in the case where former shareholders own at least 80 percent of the acquiring foreign corporation)⁶ or limit the benefits of an inversion (*i.e.*, in the case where the former shareholders own less than 80 percent but at least 60 percent of the acquiring foreign corporation).

III. The Statutory Inversion Regime

Section 7874(a)(1) identifies “abusive” inversion transactions as those involving an “expatriated entity.” The term “expatriated entity” includes a domestic corporation or partnership with respect to which a foreign corporation is a “surrogate foreign corporation” (“SFC”).⁷ Thus, the key operative term in section 7874 is the definition of an SFC.

A foreign corporation becomes an SFC with respect to a domestic corporation or partnership if, pursuant to a plan or a series of related transactions, *all* of the following three requirements are met:

1. **Acquisition Requirement** – The “Acquisition Requirement” is satisfied if a foreign corporation “completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by [the]

⁵ *Id.*

⁶ Gen. Explanation, *supra* n. 2 at 343.

⁷ An expatriated entity also includes any U.S. person related (with the meaning of section 267(b) or 707(b)(1)) to an expatriated entity. I.R.C. § 7874(a)(2)(A)(ii). Thus, for example, if a subsidiary member of a U.S. affiliated group becomes an expatriated entity, then each member of the group becomes an expatriated entity.

domestic corporation or substantially all of the properties constituting a trade or business of [the] domestic partnership.”⁸

2. **Shareholder Continuity Requirement** – The “Shareholder Continuity Requirement” is met if former shareholders of the domestic corporation, or former partners of the domestic partnership, own at least 60 percent of the stock of the foreign corporation (by vote or value) after the acquisition.⁹ For this purpose, however, stock owned by members of the acquiring foreign corporation’s “expanded affiliated group” (“EAG”)¹⁰ is not counted.¹¹ Stock of the acquiring foreign corporation sold in a public offering *related* to the transaction is also disregarded.¹² Finally, section 7874(c)(5) provides that all partnerships under common control (within the meaning of section 482) are treated as one partnership in determining the level of post-transaction ownership held by former partners.
3. **No Substantial Business Activities** – The EAG will be found to have “No Substantial Business Activities” if after the acquisition, the EAG that includes the foreign corporation “does not have substantial business

⁸ I.R.C. § 7874(a)(2)(B)(i).

⁹ I.R.C. § 7874(a)(2)(B)(ii). (*But see*, The Tax Reform Act of 2005, S. 2020, section 541(a)(4), 109th Cong. (1st Sess. 2005) containing the Senate legislative proposal to lower the Shareholder Continuity Requirement, from 60 percent to “more than 50 percent.” Presumably this standard is being proposed so as to conform the scope of section 7874 to the section 367(a) regulatory standard for taxable transfers of domestic stock under Treas. Reg. §1.367(a)-3(c)(1).)

¹⁰ The term “expanded affiliated group” means an affiliated group under section 1504(a), with two modifications. First, foreign corporations are included in the group. Second, the required ownership threshold for group membership is reduced from *at least* 80 percent to *more than* 50 percent. For example, if two unrelated foreign corporations respectively owned 51 percent and 49 percent of a third foreign corporation, the 51-percent owner would be a member of the expanded affiliated group, but the 49-percent owner would not be. If the two corporations each owned 50 percent of the foreign corporation, neither of the two owners would be a member of the expanded affiliated group.

¹¹ I.R.C. § 7874(c)(2)(A).

¹² I.R.C. § 7874(c)(2)(B).

activities” in the country where the foreign corporation is organized, “when compared to the total business activities of such expanded affiliated group.”¹³

The adverse tax consequences for inversions subject to section 7874 depend on the level of ownership retained by the former owners of the expatriated entity. If the former owners of the expatriated entity own at least 80 percent of the acquiring foreign corporation’s stock, after taking account of the EAG and public offering ownership exclusions, section 7874(b) treats the foreign parent as a domestic corporation for all purposes of the Code.¹⁴ The harsh treatment accorded to “80 percent inversions” was based on the view that such “inversion transactions have little or no non-tax effect or purposes and should be disregarded.”¹⁵ If the former owners of the expatriated entity obtain at least 60 percent but less than 80 percent of the acquiring foreign corporation’s stock, the taxable income of the expatriated entity for any taxable year (which includes any portion of the “applicable period”) will be no less than the “inversion gain.”¹⁶ The inversion gain cannot be offset by any net operating loss carryovers or credits, including the foreign tax credit. Respecting this inversion case (*i.e.*, the 60 percent or greater but less than 80 percent case) was believed to be appropriate since the 60-percent inversion was deemed to “have sufficient non-tax effect and purpose to be respected.”¹⁷ Nevertheless, imposing a minimum level of tax on inversion gain was believed necessary to backstop section 367(a) and to prevent a potential erosion of the U.S. tax base.

¹³ I.R.C. § 7874(a)(2)(B)(iii).

¹⁴ I.R.C. § 7874(b).

¹⁵ Gen. Explanation, *supra* n. 2 at 343.

¹⁶ I.R.C. § 7874(a)(1).

¹⁷ Gen. Explanation, *supra* n. 2 at 343.

An important interpretive issue is discerning the intended scope of section 7874. Although the historic “inversion” transaction was generally thought to encompass transfers by U.S. persons,¹⁸ the statutory definition of an inversion was broadly drafted so as to include transfers by foreign persons. Accordingly, transfers of stock in a foreign controlled domestic entity could be described as an inversion subject to section 7874 even though foreign control of the domestic entity (or its assets) was not occasioned by the “inversion” transaction. In this context, the application of section 7874 to foreign controlled transactions becomes more of a trap for the unwary given that a foreign controlled domestic entity could engage in “stripping activities” without the inversion transaction. Moreover, there are challenges in applying the statute to transactions that involve solely foreign shareholders of the claimed “inverted” domestic entity. For example, what are the consequences of treating a foreign controlled SFC as a domestic entity for purposes of withholding taxes and the application of treaties?

On the other hand, the broader legislative scope could be viewed as an attempt to stem all direct and indirect acquisitions of assets of a domestic entity by foreign shareholders (as well as U.S. shareholders of a domestic entity) since the statute *presumes* that engaging in an inversion transaction by a foreign shareholder will facilitate post-transaction “stripping” transfers. Although admittedly, as noted above, the broader scope of the statute will likely catch the “uninformed,” those foreign controlled groups that are well advised will be able to restructure without triggering the inversion statute. Conversely, the Treasury and the IRS will need to

¹⁸ There is evidence of the outbound focus in legislative history. For example, there is a discussion that U.S. shareholders will generally recognize gain under section 367(a) in stock inversions. Compare this with the legislative history explicit recognition of the “unfair” advantages our tax laws convey on foreign ownership. Gen. Explanation, *supra* n. 2 at 343. However, it is difficult to contend that the outbound focus was the sole focus of the legislation given the fact that the drafters of section 7874 chose not to limit the reference to former shareholders solely to “U.S. persons” that were former shareholders.

monitor situations in which the application of section 7874 confers a benefit on the foreign controlled group.¹⁹

It is against this backdrop that certain issues were addressed regarding the calculation of former shareholders' (foreign and U.S.) post-transaction stock ownership (*i.e.*, the Shareholder Continuity Requirement) in the promulgation of the 2005 Regulations. As more fully discussed below, simple computational questions regarding the application of the inversion statute lead to results that do not appear to make sense, in some circumstances removing any content from the statute and in other circumstances unnecessarily triggering the inversion statute in an internal restructuring.

IV. Comments on the 2005 Regulations

The 2005 Regulations provide guidance for computing post-transactional ownership levels involving EAG stock (including "Hook Stock").²⁰ The need for such guidance was urgent in that the post-transaction ownership calculation effectively determines the scope of section 7874. In particular, there was uncertainty as to how to apply the broad statutory requirement to disregard EAG stock in the computation of post-transaction ownership levels of the former shareholders in the acquiring foreign corporation. If the EAG stock were disregarded completely (*i.e.*, in the numerator and the denominator), certain anomalies resulted. Without such guidance, for example, the Shareholder Continuity Requirement could be met in the context of a transfer of

¹⁹ Compare I.R.C. § 269B with Prop. Treas. Reg. § 1.269B-1 (REG-101282-04, 9/7/2004) (status of stapled foreign entity as domestic was reversed for purposes of section 1504(b) (Notice 89-94) and later guidance respected the U.S. status of a stapled entity solely for purposes of section 904(i) and the section 861 interest allocation rules (Notice 2003-50)).

²⁰ In general, Hook Stock involves circular stock ownership within an EAG. The 2005 Regulations effectively define Hook Stock to include stock of an issuing corporation held by an entity that is at least 50-percent owned by vote or value directly or indirectly by such issuing corporation. Treas. Reg. § 1.7874-1T(d).

a 99-percent stock interest in a domestic corporation to a foreign corporation (*i.e.*, potentially triggering application of section 7874).²¹

In providing differing treatments of EAG stock in different circumstances, we believe that the regulations reached an appropriate balance in discerning between those transactions clearly subject to, and those transactions clearly beyond, the scope of the statute. The adoption of a general rule whereby EAG stock will be eliminated completely from the numerator and the denominator of the post-transaction ownership fraction²² accomplishes the Congressional intent to prevent “Hook Stock” from “diluting” former shareholder ownership in the acquiring foreign corporation. For situations that do not involve Hook Stock and are not otherwise eligible for the exception to the general rule (as described below), the general statutory scheme is preserved, and if the Shareholder Continuity Requirement is met in a particular transaction, the acquiring foreign corporation will have to demonstrate the presence of substantial business activities in its country of incorporation in order to avoid section 7874.

On the other hand, certain transactions are carved out from the general rule in circumstances where completely disregarding the EAG stock would have produced results inconsistent with Congressional intent and the tax objectives underlying section 7874. Accordingly, under a “special rule” applicable in two circumstances, EAG stock (except Hook Stock) is excluded from the numerator and not the denominator of the post-transaction ownership fraction. First, the special rule will apply if the common parent owns directly or indirectly at least 80 percent of the domestic entity (or partnership) before the transaction, and

²¹ Completely disregarding the EAG stock in the numerator and denominator of the ownership fraction caused the one-percent non-EAG former shareholder’s post-transaction ownership fraction to equal 100 percent (*i.e.*, effectively treating such one-percent former shareholder as the only former shareholder of the domestic entity and its continuing interest in the acquiring foreign corporation as the sole interest therein).

²² Treas. Reg. §1.7874-1T(b).

non-EAG former shareholders hold no more than 20 percent of the acquiring foreign corporation after the transaction (the “80-20 Limit”).²³ The carve out from the general rule under these circumstances will ensure that reshuffling within an affiliated group, for example, of the stock interest in a 80-percent owned domestic entity will fall outside section 7874 (*i.e.*, the post-transaction percentage ownership of former non-EAG shareholders will constitute 20 percent when excluding, from the numerator but not the denominator, the 80-percent ownership block under the special rule). Second, the special rule will apply where the former shareholders or partners of the domestic entity do not own, in the aggregate, directly or indirectly, more than 50 percent of the stock (by vote or value) of any member of the EAG.²⁴

The most controversial aspect of the 2005 Regulations is in limiting “computational” relief only to those transactions meeting the 80-20 Limit. For example, assume that a corporate shareholder owns 79 percent and an unrelated minority shareholder holds 21 percent of a domestic entity. Applying the general rule, the Shareholder Continuity Requirement will be met in the case where all the stock of the domestic entity is transferred by both former shareholders to an acquiring foreign corporation in exchange for stock in proportion to such shareholders’ pre-transaction ownership percentages (*i.e.*, 79 percent to the former corporate shareholder and 21 percent to the former non-EAG shareholder). Considering only the stock held by the 21-percent non-EAG shareholder in both the numerator and the denominator of the ownership fraction, the non-EAG shareholder’s post-transaction ownership percentage of the foreign acquiring entity would be 100 percent. In this and other similar cases falling outside the 80-20 Limit, relief from the statute will occur, if at all, by having substantial business activities in the country where the acquiring foreign corporation is organized.

²³ Treas. Reg. §1.7874-1T(c)(1).

²⁴ Treas. Reg. §1.7874-1T(c)(2).

The issue is whether the 80-20 Limit is too restrictive. We support the Treasury and the IRS in providing relief for those cases meeting the 80-20 Limit. Although one might argue whether 80 percent is the appropriate place to draw the line, it strikes a reasonable balance since the legislative history describes a clear intent to exclude internal restructurings.²⁵ An 80-percent pre- and post-transaction ownership limit is certainly *consistent* with the level of ownership typically considered to be an “internal restructuring.” Given the breadth and rigidity of the statute, we understand the difficulty of extending the “internal restructuring” protection beyond the 80-percent boundary. Although a 75-percent or even 66- $\frac{2}{3}$ -percent ownership threshold may comport more closely with corporate “supermajority” powers, the 80-percent ownership threshold is one that has been distinguished under domestic law (e.g., provisions relying on the ownership thresholds of section 1504(a) such as consolidated filing and section 332) and in section 7874 itself (*i.e.*, considering an 80-percent level of ownership as so high as to warrant treating the SFC as a domestic entity and thereby ascribing no tax effect to the inversion transaction).²⁶

Given how pivotal the 80-20 Limit is in defining the scope of transactions subject to section 7874, future regulations should specify which stock will be included in determining whether the 80-20 Limit is met. For example, the amount of any pre-transaction ownership should be determined on an “actual” ownership basis. Thus, it may not be appropriate to consider unexercised stock options for determining the pre-transaction ownership levels since the 80-20 Limit will be an “after the fact” determination; and whatever rights could have been exercised, but were in fact not exercised prior to the transaction, should not be relevant.

²⁵ Gen. Explanation, *supra* n. 2 at 344. (The legislative history describes the conversion of a wholly owned U.S. subsidiary into a new foreign corporation as a transaction that would not be an inversion under the statute by reason of the EAG stock exclusion rule.)

²⁶ Gen. Explanation, *supra* n.1 at 343.

V. Request for Specific Guidance

a. Adopt Interpretations That Limit the Scope to True Inversions.

Guidance is urgently needed to limit an overly broad application of section 7874 to transactions that do not constitute *inversion* transactions as targeted in the legislative history. We believe Congress granted Treasury broad authority to draft regulations to define “whether a corporation is a surrogate foreign corporation.”²⁷ We strongly urge Treasury to exercise its regulatory authority to define a SFC in a manner that is consistent with the intended reach of section 7874. The following discussion considers first the overriding concept of a “plan” and then the issues raised by each of the three key required elements of a SFC – the Acquisition Requirement, the Shareholder Continuity Requirement and the Substantial Business Activities test.

b. What is a Plan?

Under section 7874(a)(2)(B), each of the SFC elements listed above must be determined taking into consideration all transactions that are “pursuant to a plan (or a series of related transactions).” The “plan” language serves a broad anti-abuse function so that seemingly separate, but related transactions could be combined in a manner akin to the judicially created step-transaction doctrine.²⁸ Moreover, for purposes of the Acquisition Requirement, this anti-abuse function is further enhanced by a special non-rebuttable presumption under section 7874(c)(3) which provides that the transfer of substantially all of the properties of a domestic corporation or partnership during a 4-year period beginning on the date which is two years before the Shareholder Continuity Requirement is met will be deemed to be pursuant to a plan.

²⁷ I.R.C. § 7874(c)(6).

²⁸ Compare *J.E. Seagram Corp. v. Commissioner*, 104 T.C. 75 (1995) with *Esmark, Inc. v. Commissioner*, 90 T.C. 171 (1988), *aff’d*, 886 F.2d 1318 (7th Cir. 1989).

Regulations should clarify the purpose and interaction of the “plan/related transaction” language with respect to each of the SFC elements. The implication of the “plan/related transactions” language is obvious in the context of creeping acquisitions whereby the Acquisition and the Shareholder Continuity Requirements might not be met if testing occurred separately with respect to each step in the plan but would be met if the steps were collapsed. Not as clear, however, is whether in determining the Shareholder Continuity Requirement, contemporaneous transactions that dilute the former shareholders’ stock interest in the acquiring foreign corporation below the 60-percent threshold would be considered. In general, we believe that regulations should make clear when the “linkage” of related transactions may be used affirmatively by taxpayers.²⁹

Similarly, how will the “plan/related transaction” concept apply to the determination whether there are no substantial business activities in the incorporating jurisdiction of the acquiring foreign corporation? A scenario where this issue may arise is in the case where the acquiring foreign corporation is in the start-up phase in its country of incorporation. Assume, for example, that the acquiring foreign corporation is newly incorporated in Country X and has plans to complete the transfer of its “substantial business activities” from Country Z to Country X by the end of November 2006. However, in June 2006, when that plan has not yet been executed, the acquiring foreign corporation acquires the stock of a domestic corporation and at that time, substantially all of its business activities are in Country Z. We believe that the former shareholders should be permitted to demonstrate that the acquiring foreign corporation would

²⁹ Compare *Zenz v. Quinlivan*, 213 F.2d 914 (6th Cir. 1954) and Rev. Rul. 75-447, 1975-2 CB 113 (post-redemption control determination includes related transactions that dilute ownership).

satisfy the Substantial Business Activities test based on the facts that actually exist by the end of 2006.³⁰

Moreover, additional guidance is needed as to what constitutes a plan or what facts will be viewed as establishing a “series of related transactions” that will be treated as part of the plan. The regulations should include an example illustrating transactions that are not related, such as transactions occurring after unforeseen, intervening events.

c. Clarification with respect to the Acquisition Requirement.

(1) *Defining the Substantially All Threshold* – The Acquisition Requirement of section 7874(a)(2)(B)(i) is met if the SFC acquires directly or indirectly “substantially all” of the properties held directly or indirectly by a domestic corporation or “substantially all” the properties constituting a trade or business of a domestic partnership. Guidance is requested regarding both the quantitative (*i.e.*, the threshold level percentage) and qualitative aspects (*i.e.*, which assets should be considered in computing the threshold ratio) of the term “substantially all.”

A variety of definitions for the term “substantially all” are provided in case law and other relevant authority. The term “substantially all” is most commonly used in the context of certain section 368(a) reorganizations.³¹ Given the similar purposes of the provisions, it is likely that Congress had a similar meaning in mind for purposes of section 7874, although the legislative

³⁰ Compare Treas. Reg. §1.351-1(c)(2). (The determination of whether a corporation is an investment company is ordinarily made by reference to the circumstances in existence immediately after the transfer in question, but “where circumstances change thereafter pursuant to a plan in existence at the time of the transfer, this determination shall be made by reference to the later circumstances.”)

³¹ IRC § 368(a)(1)(C); §§ 368(a)(1)(D)/354(b)(1)(A); § 368(a)(2)(D); § 368(a)(2)(E).

history makes clear that Treasury and the IRS are not bound by the interpretations under those provisions or elsewhere.³²

In the reorganization context, a “safe harbor” level of “substantially all” enunciated for advance ruling purposes (i.e., not the minimum level as a matter of law) is 70 percent of the gross value and 90 percent of the net value of a corporation’s assets.³³ In the reorganization context, particularly in cases in which a “liquidation/reincorporation” fact pattern was presented and reorganization treatment was sought by the government, the term substantially all “has been subjected to [a] construction which in effect applies a continuity test rather than mere blind percentages.”³⁴ In such context, the “substantially all” ratio generally has been determined by reference to the portion of transferred operating assets as a percentage of the total operating assets of the transferring corporation (resulting in a percentage of total assets that is much lower than the ruling threshold).³⁵ Given the purpose of section 7874 (i.e., to prevent the offshore movement of *valuable* operating businesses), the term “substantially all” similarly could appropriately be limited to operating assets (including working capital) rather than by reference to passive assets, and more generally, to gross assets. The “operating asset” approach would be consistent with the test as applied to partnerships, which determines “substantially all” by reference to the trade or business of a partnership.³⁶ Such a focus also would provide protection

³² American Jobs Creation Act of 2004, P.L. 108-357, H. Rept. 108-755 (Oct. 7, 2004) (the “Conf. Rept.”) 554, 558 (fn. 429) (“It is expected that the Treasury Secretary will issue regulation applying the term “substantially all” in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code.”).

³³ See Rev. Proc. 77-37, 1977-2 CB 586.

³⁴ *James Armour v. Commissioner*, 43 T.C. 295, 308 (1965) (citing *John G. Moffat v. Commissioner*, 42 T.C. 558, 578, aff’d, 363 F.2d 262 (9th Cir. 1966)).

³⁵ See e.g., *American Mfg. Co. v. Commissioner*, 55 T.C. 204 (1970) (20 percent of total assets represented *all* of the operating assets); *Smothers v. U.S.*, 642 F.2d 894 (5th Cir. 1981) (“substantially all” found where 15 percent of the total assets represented *all* the operating assets); *James Armour* at 309, *supra* n. 34 (51 percent found to constitute substantially all).

³⁶ I.R.C. §7874(a)(2)(B)(i).

against the use of passive/non-operating assets for avoidance purposes such as “stuffing” assets into the domestic corporate parent (in order to avoid meeting the “substantially all” threshold by leaving non-operating assets behind). The retention of non-active assets should not prevent the application of the inversion provision.

There is a paucity of analogous authority for determining a minimum percent threshold for “substantially all.”³⁷ However, if the definition of “substantially all” were limited solely to the ratio of transferred operating assets to total operating assets of the domestic corporation, a high quantitative threshold would be warranted since the retention of any operating asset by the domestic transferor would more directly affect the value of the transferred business and reduce the opportunity to remove value from the United States.

The calculation of “substantially all” generally would be based on the fair market value of assets. Although testing on the basis of asset fair market value is sometimes difficult for taxpayers from a compliance point of view, that should not be the case where the transaction presumably would require a valuation of the transferred stock or assets (because of the existence of unrelated parties) to determine the issuance of the acquiring foreign corporation’s stock.³⁸ Moreover, a fair market value reference point would be more consistent with the basis for testing continuing ownership (*i.e.*, on a vote or *value* basis) under the Shareholder Continuity Requirement.

Finally, the calculation of “substantially all” may have to account for shifts in value or asset base when asset transfers occur over time (*e.g.*, “pursuant to a plan” or related

³⁷ See *e.g.*, *National Bank of Commerce of Norfolk v. U.S.*, 158 F. Supp 887 (ED Va. 1958) (the retention of 19 percent of operating assets (*i.e.*, the transfer to the acquiring corporation of only 81 percent of operating assets) did not satisfy the substantially all threshold).

³⁸ As discussed more fully at Part IV., *supra*, in the case of an 80-percent controlled internal restructuring where requiring a fair market valuation may be a burden, SFC status will not result since the Shareholder Continuity Requirement will not be met.

transactions). For example, assume in Year 1, the domestic corporation transfers less than substantially all of its assets at the time of the transfer. Assume in Year 2 that, as part of the same plan, another portion of the domestic corporation's assets are transferred. What if the assets acquired by the acquiring foreign corporation have substantially increased or decreased in value since Year 1, or if the retained assets have substantially increased or decreased in value since Year 1? What if the domestic corporation has disposed of a large portion of its operating assets between Year 1 and Year 2 or has significantly augmented its operating assets between Year 1 and Year 2? One approach would be to measure the asset base of the domestic corporation by taking into account any acquisitions from, or dispositions to, third parties planned at the time of the initial transfer to the acquiring foreign corporation and to measure the values of assets transferred and retained by reference to their values at the time of the initial transfer.

Although the Treasury and the IRS have flexibility to choose a "substantially all" threshold, the primary concern among taxpayers is that there be a clearly defined and administrable threshold. An objective standard for the term "substantially all" seems justified for two reasons. First, given the significant punitive ramifications of falling within section 7874, taxpayers and IRS examiners should have clear guidance for applying such a key provision. Second, providing a bright-line test for the definition of "substantially all" would not facilitate abuse given that section 7874(c)(4) (disregarding transfers of property or liabilities that are part of a plan to avoid section 7874) provides an additional backstop against tax-avoidance transfers.

(2) ***Substantially All Test for Partnerships*** -- Additional guidance may be required in the case of domestic partnerships. As described above, the Acquisition Requirement will be met if the foreign corporation (directly or indirectly) acquires "substantially all of the properties constituting a trade or business" of the partnership. The same considerations discussed

above will apply to determine whether “substantially all” is met with respect to the transfer of assets by a domestic partnership. However, an operating asset focus is imposed in the case of a transfer of domestic partnership assets since only the “properties constituting a trade or business” can satisfy the Acquisition Requirement.

In this context, guidance regarding the definition of a “trade or business” of the partnership would be helpful. There are numerous existing provisions that define the term “trade or business.” The comprehensive definition provided in Treas. Reg. § 1.989(a)-1(c) is a useful point of reference for this purpose. Although such determination is heavily dependent on a facts and circumstances analysis, Treas. Reg. § 1.989(a)-1(c) provides additional criteria. For instance, the regulations state that a group of activities constituting a trade or business must ordinarily include every operation that forms a part of, or a step in, a process by which an enterprise may earn income or a profit. A similar definition of the term “trade or business” is also adopted in Treas. Reg. § 1.367(a)-2T(b)(2).

(3) What constitutes “direct or indirect”? – Section 7874(a)(2)(B)(i) consolidates all direct and indirect acquisitions of assets in determining whether the Acquisition Requirement is satisfied. The “direct and indirect” language is necessary in order to accord equal treatment to stock and asset inversions. Regulations should clarify that a “direct or indirect” standard does not require that *one* entity acquire “substantially all” the transferred assets. Accordingly, the Acquisition Requirement could not be avoided simply by dispersing the assets of the domestic corporation among the foreign acquiring group. Also, special rules may be required for measuring the Shareholder Continuity Requirement in the context of a dispersed transfer of assets among various members of a foreign acquiring group since, under section

7874(a)(2)(B)(ii), the stock ownership of former shareholders of the transferring domestic corporation is only measured with respect to a *single* foreign acquiring corporation.

Another area for guidance will be how to determine the *quantum* of assets associated with specific stock for purposes of calculating the amount of assets “indirectly” transferred or acquired. For example, this issue may arise in the context where a foreign acquiring entity does not acquire all of the stock of the domestic parent corporation and such domestic parent corporation has various classes of stock outstanding with differing preferences in liquidation, dividends etc. (including shares that track the earnings and/or assets of less than all the assets of the corporation).

The issue of how to define “indirect” will similarly arise where not all the interests in a partnership are acquired. In analogous situations, a “look-through” approach is used to determine the partner’s share of the partnership assets.³⁹ Possible look-through methodologies might include the allocation of partnership assets to a partner in proportion to such partner’s interest in the partnership, or in proportion to such partner’s share of the partnership capital.⁴⁰ However, the determination of what constitutes a partner’s share of the partnership assets as well as what constitutes a partner’s interest in the partnership is not well defined.⁴¹ For example, what if the limited partner has a preference on the partnership income that in the past has been allocated based on widely varying percentages of the partnership earnings? In the case of a complex partnership arrangement where the partners have capital and income interests that can

³⁹ This is generally determined under sections 701 through 761 and the regulations thereunder.

⁴⁰ See Treas. Reg. §1.367(a)-1T(c)(3)(ii). Compare Treas. Reg. §1.751-1(a)(2) (allocating hot asset gain or loss on the basis of the partner’s share of hot asset income as if all assets of the partnership were sold in a taxable transaction) with Treas. Reg. §1.856-3(g) (interest of a partner in the assets of a partnership determined in accordance with the partner’s capital interest in the partnership).

⁴¹ The partnership rules do not contain any bright line tests in this regard other than to acknowledge that the determination of a partner’s interest in the partnership is computed by reference to various factors such as the relative contributions, interests in the economic profits and losses, cash flow and liquidation rights. Treas. Reg. §1.704-1(b)(3)(i) and (ii).

vary from year-to-year, a partner's interest in the partnership property may be difficult to determine without specific rules. These issues, of course, arise under current law in various contexts but the magnitude of the consequences is rarely as significant as would be the case under section 7874.

d. Clarification of the Shareholder Continuity Requirement.

As noted earlier, section 7874(a)(2)(B)(ii), is clearly not limited to transfers solely by U.S. persons. Rather, section 7874 can apply even to a transfer of stock in a domestic corporation solely within a *foreign controlled group*.⁴² However, regulatory solutions for many of the interpretive issues raised below also have the potential to significantly impact the scope of section 7874. The regulations should be drafted in a manner that reflects the same balanced approach adopted in the 2005 Regulations when addressing the treatment of EAG stock.⁴³

(1) *Identifying Stock Issued “by reason of”* – Section 7874(a)(2)(B)(ii) requires that the Shareholder Continuity fraction be determined “after the acquisition” and further, solely with respect to the acquiring foreign corporation shares received by the former shareholders (or former partners) “by reason of holding stock in the domestic corporation.” The “by reason of” limitation insures that shareholder continuity is only measured with respect to those shares issued in the inversion transaction. Accordingly, guidance should include an example illustrating that a pre-existing stock ownership interest in the acquiring foreign

⁴² In this respect, we note that the scope of the inversion transactions covered by the House and Senate Bills were different. *Compare* H.R. 4520, section 601 (House bill) with S. 1637, section 441(a) (Senate bill), 108th Cong. (2d Sess. 2004). For example, the Senate bill contained language excluding transactions involving a U.S. corporation no class of the stock of which was traded on an established securities market at any time within the four-year period preceding the acquisition. However, such language was not adopted in the final legislation.

⁴³ *See* the Tax Relief Act of 2005, S. 2020, section 541(a)(5), 109th Cong. (1st Sess. 2005), proposing to add the following language to section 7874(a)(2) -

Except as provided in regulations, an acquisition of properties of a domestic corporation shall not be treated as described in subparagraph (B) if none of the corporation's stock was readily tradable on an established securities market at any time during the 4-year period ending on the date of the acquisition.

corporation (issued in a transaction unrelated to the inversion transaction) will be disregarded in computing whether the former shareholders satisfy the Shareholder Continuity Requirement.

The regulations should also clarify when, in the case of contemporaneous transfers of stock in different domestic corporations (not part of the same EAG) involving the same former shareholders, the transfers might be considered “related transactions.” Presumably, the acquiring foreign corporation’s shares received by former shareholders with respect to the transfer of *different* domestic corporations would not be aggregated, given that the statute measures the acquiring foreign corporation stock received solely “by reason of holding stock of the domestic corporation.”⁴⁴ For example, assume that USCo1 and USCo2 are unrelated corporations and that the acquiring foreign corporation acquires the assets of USCo1 on January 1, 2006 in exchange for 35 percent (by vote and value) of the acquiring foreign corporation stock outstanding at that time. On February 1, 2006, the acquiring foreign corporation completes the acquisition of the assets of USCo2 in exchange for 35 percent (by vote and value) of the then outstanding stock of the acquiring foreign corporation. However, if both transactions are combined, the “combined” former shareholder groups of both USCo1 and USCo2 hold 62 percent of the acquiring foreign corporation. Under these circumstances, the regulations should clarify that the two transactions should be tested separately inasmuch as the statute requires that Shareholder Continuity Requirement be determined “by reason of holding stock in the domestic corporation.”⁴⁵

(2) *Disregarding Stock Sold in a Related Public Offering* - In measuring the post-transaction ownership of the acquiring foreign corporation stock under section

⁴⁴ Compare the specific anti-abuse rule effectively requiring the consolidation of transfers by commonly controlled partnerships under I.R.C. 7874(c)(5).

⁴⁵ The analysis should be the same if the example involved the acquisition of unrelated partnerships since the Shareholder Continuity Requirement is determined with reference to the acquiring foreign corporation stock acquired by the former partners “by reason of holding a capital and profits interest in the domestic partnership.” I.R.C. § 7874(a)(2)(B)(ii)(II). There is, however, an anti-abuse rule for commonly controlled partnerships.

7874(c)(2)(B)(ii), stock sold in a public offering “related” to the acquisition is disregarded. Guidance is needed in order to identify how this “relationship” is to be tested. The purpose of the rule disregarding stock issued in related public offerings clearly is to prevent avoidance of the Shareholder Continuity Requirement where an inversion is related to a public offering of stock in the acquiring corporation. Accordingly, the concept of “related” should be flexible enough to capture attempts at such avoidance.

The IRS presumably could treat proximity in time as a factor in finding that a public offering and inversion transaction are related. We note that under U.S. securities laws, a public offering would require disclosure of any material transactions that are contemplated. Disclosure requirements under the securities laws of other countries with substantial shareholder populations may well be similar. Another factor to take into account in determining the relationship of an inversion transaction to a public offering, in addition to proximity in time, could be whether disclosure of the inversion transaction is made or required to be made in the disclosure documents for the public offering.

Guidance also is needed in respect of the definition of a public offering. There are various references to “public offerings” in the Code,⁴⁶ but many such references do not take into account foreign public offerings. In the context of describing “publicly traded debt,” Treas. Reg. §§1.1273-2(f)(1) and (2) provide analogous guidance for discerning “exchange listed” property.⁴⁷ Moreover, such regulations include a temporal notion of how close in time the public trading should occur relative to the issuance of the shares. Thus, property will be considered as

⁴⁶ See e.g., I.R.C. § 67(c)(2)(B)(i).

⁴⁷ Treas. Reg. §1.1273-2(f)(2) describes “exchange listed” property to include, *inter alia*, property listed on an international stock exchange. Alternatively, we would not favor an approach that does a hypothetical analysis. Thus, we would not recommend a standard such as that found in Treas. Reg. §1.1275-1(b) because it relies on a hypothetical analysis as to whether a non-registered instrument would be the type of instrument required to be registered under U.S. domestic law if such instrument were sold in the U.S. market.

publicly traded if listed (within the meaning of the regulations) at any time during the 60-day period ending 30 days after the issue date of the stock.⁴⁸ Such a temporal rule may be useful for defining a “public offering” in the context of section 7874(c)(2)(B) in order to prevent avoidance.

(3) *Computing the Post-Transaction Continuity of Former Partners* – Section 7874(c)(5) requires that the partner continuity test be determined by treating partnerships under common control as a single partnership. This anti-abuse provision prevents a domestic partnership from dividing itself into several domestic partnerships (under common control) in preparation for an acquisition by a foreign corporation. Accordingly, solely for testing post-transaction partner continuity, the stock in the acquiring foreign corporation acquired directly or indirectly by the former partners of all commonly controlled transferring partnerships will be considered in determining whether such partners have received at least a 60-percent or 80-percent interest in the acquiring foreign corporation “by reason of” its partnership interests.

Literally read, the partnership aggregation rules do not distinguish between commonly controlled U.S. and foreign partnerships. Given that only the transfer of *domestic* partnership assets can constitute an inversion, clarification is needed to ensure that the anti-abuse rule of section 7874(c)(5) does not apply in a way to trigger a partnership inversion on the basis of the acquiring foreign corporation transactions with *foreign* partnerships.

(4) *Meaning of Former Partners under Section 7874(a)(2)(b)(ii) (II)* - Clarification is needed in order to apply the statute in the circumstances where the *transferring partnership* retains ownership of the acquiring foreign corporation stock issued in the transaction. For example, assume that a domestic partnership contributes assets constituting a

⁴⁸ Treas. Reg. §1.1273-2(f)(1).

trade or business to a foreign corporation and receives more than 80% of the stock of the foreign corporation, which is retained by the domestic partnership. The domestic partnership remains in existence after the transaction, perhaps conducting a separate trade or business. In these circumstances, the partners of the transferring partnership are not “former” partners. Presumably, however, the foreign corporation is a “SFC” and “former partners” should be construed to include all persons who were partners of the domestic partnership prior to the transaction regardless of whether they continue to be partners.

(5) ***What is “Stock” for Purposes of the Ownership Tests?*** - Pursuant to section 7874(c)(6), the Secretary is granted broad regulatory authority to define the term “stock” for purposes of determining whether a foreign entity is an SFC. This authority includes the right, *inter alia*, to treat certain contract rights in equity (*e.g.*, options to acquire stock) as stock and to treat stock as non-stock.⁴⁹ As a general matter, this provision should be applied as an anti-abuse provision giving due recognition to the fact that stock rights will not generally rise to the level of stock ownership.⁵⁰ Potentially abusive stock rights can be targeted, for example, such as certain deep-in-the-money options typically treated as exercised and the underlying stock as issued and outstanding.⁵¹ A targeted anti-abuse approach would also have the secondary benefit of eliminating uncertainty for both the government and taxpayers since fairness would dictate that any more generalized rules reclassifying stock rights as stock for purposes of section 7874 would have to be applied across the board (*e.g.*, deep-in-the-money options in the acquiring foreign corporation would also be treated as outstanding stock). Finally, another administrative reason

⁴⁹ This regulatory authority to define the term stock is identical to that incorporated in section 382(k)(6)(B) (limitation with respect to the carryover of net operating losses).

⁵⁰ See *e.g.*, treatment of stock rights under section 351. Treas. Reg. §1.351-1(a)(1), last sentence.

⁵¹ See *e.g.*, Rev. Rul. 82-150, 1982-2 C.B. 110 (ownership of deep-in-the-money call option treated as ownership of the underlying stock for section 551 purposes).

for limiting the reclassification of stock rights to equity would be the potential complexity in coordinating how such rights are treated under the computational guidance provided in the 2005 Regulations (*e.g.*, stock rights of an EAG member that are reclassified as an equity interest would be disregarded similar to the rule that would disregard any issued and outstanding stock actually owned by such EAG member).

Furthermore, the regulations should presumably apply a single standard to discern whether equity interests held by the acquiring foreign corporation shareholders really represent disguised non-stock interests (*e.g.*, the “fee-only” interest typically held by an accommodation party). Again, this standard should also presumably apply to determining whether equity interests held by former shareholders of the domestic target corporation really represent non-stock interests in the acquiring foreign corporation (in which case they would not count in the computation of such former shareholder’s post-transaction interest). Stock most typically regarded as non-stock is classic non-participating, non-convertible, preferred stock⁵² since the limited economic rights of classic preferred are often recognized as comparable to the rights of holders of debt. Since the definition of the EAG incorporates by reference section 1504(a), there is a basis for excluding section 1504(a)(4) stock for all purposes of applying the Shareholder Continuity Requirement.

The appropriateness of whether section 1504(a)(4) stock should be disregarded for determining any ownership thresholds under section 7874 should turn on whether this type of stock interest could inappropriately facilitate the avoidance of section 7874. Section 1504(a)(4) preferred stock arguably presents such an opportunity to dilute a “strategic shareholder’s” post-transaction ownership interest in the acquiring foreign corporation without sacrificing

⁵² See *e.g.*, I.R.C. § 382(k)(6); I.R.C. § 351(g)(2); and I.R.C. § 1504(a)(4).

management control (*i.e.*, classic preferred shareholders would typically constitute “financial” investors rather than strategic investors).⁵³ The exclusion of section 1504(a)(4) preferred stock could also have the added benefit of eliminating a significant potential source of uncertainty associated with the reclassification of acquiring foreign corporation “debt” as equity since reclassified debt generally contains rights consistent with section 1504(a)(4) preferred stock.

(6) *Application of Rules to Canadian Income Deposit Securities* - A number of U.S. companies have recently offered securities in the Canadian public markets through a type of investment unit commonly referred to as an “income deposit security” (“IDS”). In such an offering, 90 percent of the stock of a U.S. corporation is typically acquired by a new Canadian corporation, which issues stock in the Canadian capital markets in an initial public offering (“IPO”). The original shareholders of the U.S. corporation retain a 10 percent equity interest. The U.S. corporation also issues debt to the public shareholders of the Canadian company. This debt is “packaged” together with the stock of the Canadian corporation, and traded as a single investment unit (the IDS) in the Canadian capital markets. The 10-percent equity retained by the original shareholders of the U.S. corporation may, or may not, have rights to have their equity converted into IDSs, or, more likely, rights to have their equity exchanged for an amount determined by reference to the value of an IDS.

Presumably, stock that is part of an investment unit, such as an IDS, is considered stock under section 7874(c)(6)(A). Therefore, the Canadian company in the above example may satisfy the Acquisition and Shareholder Continuity Requirements based on *exchange rights*, if any, held by the historic U.S. shareholders because, under section 7874(c)(2)(B), the stock of the

⁵³ Conversely, it is arguable that the statutory requirement to determine post-transaction ownership on a “vote or value” basis would necessarily require the consideration of preferred stock as outstanding for these purposes. However, it is uncertain how much weight should be accorded this fact given the explicit directive to Treasury to promulgate regulations determining which stock will be treated as stock under section 7874.

Canadian corporation held by its public shareholders would be disregarded.⁵⁴ Under such circumstances, the Canadian company could constitute an SFC if it did not have substantial business activities within its EAG in Canada. Accordingly, the IDS situation should be considered in drafting regulations addressing which non-stock interests are to be treated as stock for purposes of section 7874.

e. No Substantial Business Activities.

Under section 7874(a)(2)(B)(iii), a foreign corporation will be considered an SFC (provided the Acquisition and Shareholder Continuity Requirements are met) only if the EAG that includes such foreign corporation has “no substantial business activities” in its jurisdiction of incorporation. Thus, despite a transaction otherwise satisfying the inversion transaction requirements, such transaction will not be deemed an abusive inversion by reason of the presence of substantial business activities in the acquiring foreign corporation’s jurisdiction of incorporation (which presumably is considered to demonstrate a non-tax purpose).

The No Substantial Business Activities requirement is likely to be relied upon, in practice, to avoid classification of the acquiring corporation as an SFC. Accordingly, guidance is needed to define the threshold level of activities required. The adoption of a bright-line test (in addition to a more general facts and circumstances test or as a safe harbor) for the presence of substantial business activities will be particularly helpful in order to avoid subjecting an inadvertent inversion to section 7874.⁵⁵ Any opportunity for abuse provided by a clear numerical test can be tempered by the Secretary’s broad anti-abuse power provided in section

⁵⁴ For this purpose, such publicly issued stock of the acquiring foreign corporation would be excluded from both the numerator and the denominator of the Shareholder Continuity fraction unless the special rule described in Treas. Reg. §1.7874-1T(c) were to apply.

⁵⁵ Although there could be fairness issues raised with applying an inflexible mathematical test for determining the presence of business activities, a bright-line test is more appropriate on balance since the timing and location of the business activities is ultimately within the control of the acquiring foreign corporation and each member of its EAG.

7874(c)(4) to disregard any transfer of properties and liabilities with a principal purpose of avoiding the application of section 7874.

In developing a simple numerical proxy for locating the business activities, no single factor such as the presence of assets, the relative size of revenue, etc. would suffice. Accordingly, one approach would be to adopt a multi-factor approach. We note an analogous substantiality test employed in certain U.S. bilateral income tax conventions that could be used as a template for this purpose. Under this test, the EAG would be considered to conduct substantial business activities in the foreign jurisdiction if, for a specified period (see discussion of temporal aspect below), the asset value, gross income, and payroll expense of the group in that jurisdiction are at least equal to 7.5 percent of the EAG total, and the average of these three ratios for the group in that jurisdiction is at least 10 percent of the EAG total.⁵⁶

The time frame for measuring the location of substantial business activities is provided in the statute as “after the acquisition.” However, the regulations should reflect the inclusion of other transactions consummated at different times that must be considered as part of the inversion plan, such as acquisitions and dispositions involving the acquiring foreign corporation and any member of the EAG as part of the same plan.

f. Consequences of Treating the SFC as a Domestic Corporation.

Under section 7874(b), when former shareholders of the domestic target corporation own at least 80 percent of the stock of the SFC, the SFC is treated as a U.S. corporation “for purposes of this title.” Despite the broad cross-reference to the entire Code, the specific treatment of the SFC in the year of the acquisition remains unclear. For example, it is unclear whether the SFC, upon the consummation of an inversion transaction, will be considered as

⁵⁶ See The 1996 U.S. Model Treaty, Article 22(3)(c) (treaty benefits not otherwise permitted to a resident of a contracting state are permitted if such resident has an active trade or business in its resident state which is substantial in relation to the activity in the other contracting state generating the income for which treaty benefits are sought).

actually engaging in a domestication transaction. For example, should the SFC be considered to have actually domesticated in a reorganization under section 368(a)(1)(F).⁵⁷ In addition, it is also unclear whether the newly domesticated foreign corporation is eligible to join in the filing of a consolidated return with the other U.S. members. Accordingly, it would be helpful if examples demonstrate the effect of the acquiring foreign corporation's changed status and its implication under such provisions as section 367 and section 1503(d) (*e.g.*, assuming that the acquiring foreign corporation remains subject to residence-based taxation in its jurisdiction of incorporation). In addition, examples should highlight the application of treaties to an entity treated as a domestic entity for U.S. tax purposes, including but not limited to withholding tax implications on payments to, and from, such an entity.⁵⁸

g. Treatment of Certain Royalties as U.S. Source Income.

Section 7874(e)(1) treats as U.S. source income any royalties earned by an expatriated entity under section 7874(a)(2)(A)(ii) from related foreign persons. If a domestic corporation transfers assets in a transaction that constitutes a 60-percent inversion, such transferring corporation and all related *non-transferring* domestic corporations will each constitute an expatriated entity despite the fact that the assets of the related *non-transferring* domestic corporation are not transferred and remain in such entity and subject to U.S. taxation. Thus, the related *non-transferring* domestic entities will be unable for ten years to credit foreign withholding taxes on royalties paid by the acquiring foreign corporation. We recommend that the Treasury and the IRS use their interpretive authority to limit the scope of section

⁵⁷ See *e.g.*, Treas. Reg. §§1.367(b)-2(g), (h), and (i) (regarding the treatment of a foreign corporation electing section 1504(d) status or section 953(d) status or meeting the definition of an entity with stapled stock under section 269B).

⁵⁸ In this regard, we note that the obligation to collect withholding tax under the current regime will shift from a U.S. entity (with presence and nexus in the United States) to an entity whose assets are legally beyond the U.S. borders. It would be preferable if U.S. withholding with respect to an 80-percent expatriated entity would be imposed on transactions with such entity.

7874(d)(2)(B) to avoid this result.

h. Statute of Limitations for Assessment of Tax Linked to Reporting.

Section 7874(e)(4)(A) provides a special statute of limitations for assessment of any deficiency attributable to inversion gain. The limitations period begins when the taxpayer reports the inversion transaction under rules to be prescribed. We recommend that the Treasury and the IRS provide guidance describing the type of information required to start this special statute of limitations.

i. Is the Section 4985 Excise Tax Subject to Withholding?

It is not clear whether the section 4985(f)(2) tax on certain stock-based compensation is subject to withholding tax under section 3402 if the person holding the stock-based compensation is an employee. It should be noted that section 4999(c)(1) (relating to the 20-percent excise tax on excess parachute payments) specifically requires the employer to withhold if the parachute payment constitutes wages.

j. When is the “Expatriation Date” under Section 4985?

The section 4985 excise tax on stock-based compensation associated with an inversion transaction applies to certain compensation held at any time within a 12-month period, the midpoint of which is the “expatriation date.” To clarify the application of this section, we recommend that the Treasury and the IRS define the term “expatriation date” to refer to the date which is immediately after the acquisition of substantially all the properties as defined for purposes of the Acquisition Requirement under section 7874.