ALSTON & BIRD LLP

WWW.ALSTON.COM

International Tax ADVISORY ▪

FEBRUARY 15, 2014

New Regulations Address Stock Ownership Determination under Anti-Inversion Provisions

On January 16, 2014, Treasury and the IRS issued new temporary and proposed regulations under the anti-inversion provisions of Section 7874. These regulations, following up on Notice 2009-78, provide guidance for determining stock ownership—specifically, when stock of a foreign acquiring corporation will be disregarded and excluded from the ownership fraction.

Background on Section 7874 and Notice 2009-78

Section 7874 was enacted in 2004 to fight the perceived abuse of inversions of U.S. entities into foreign corporations. If applicable, the anti-inversion provisions may tax fully any inversion gain or, in some cases, treat the foreign acquiring corporation as a domestic corporation for tax purposes. Section 7874 applies if (1) a foreign corporation acquires substantially all the assets of a U.S. corporation (or partnership), (2) the former owners of the U.S. entity hold at least 60 percent by vote or value of the stock of the foreign corporation after the acquisition by reason of holding stock of (or partnership interests in) the U.S. entity and (3) the foreign acquiring corporation's expanded affiliated group does not have substantial business activities in the foreign country where the foreign acquiring corporation is incorporated. Regarding the stock ownership condition, Section 7874(c)(2)(B) (the "statutory public offering rule") provides that stock of a foreign acquiring corporation sold in an acquisition-related public offering is not counted in determining the ownership fraction (i.e., it is not included in the denominator). The rule thus increases the ratio of stock held by former owners of the U.S. entity by reason of holding interests in the domestic entity relative to the foreign corporation's other outstanding stock.

In late 2009, Treasury and IRS released Notice 2009-78 (the "notice"), which announced the forthcoming issuance of regulations that would clarify the scope of the statutory public offering rule. The notice stated that the regulations would exclude from the ownership fraction stock of a foreign acquiring corporation that is

This advisory is published by Alston & Bird LLP to provide a summary of significant developments to our clients and friends. It is intended to be informational and does not constitute legal advice regarding any specific situation. This material may also be considered attorney advertising under court rules of certain jurisdictions.

issued in exchange for "nonqualified property" in acquisition-related transactions, whether or not the stock is publicly traded. Under the notice, nonqualified property meant cash and cash equivalents, marketable securities as defined in Section 453(f)(2) and any other property acquired with a principal purpose to avoid Section 7874. The notice illustrates this rule with an example:

> The shareholders of a domestic corporation (DC) transfer all their DC stock to a newly formed foreign corporation (New FCo) in exchange for 79 percent of the New Fco stock and, in a related transaction, an investor transfers cash to New FCo in exchange for the other 21 percent of the New FCo stock. Because the stock issued to the investor is not "sold in a public offering," the taxpayers would argue that the statutory rule does not apply to exclude the investor's New FCo stock from the ownership fraction: 79 held by former owners divided by 100, or 79 + 21, is 79 percent, so New FCo is not treated as a domestic corporation under Section 7874 (assuming the transactions were not part of a plan, a principal purpose of which is to avoid the purposes of the section). The notice rejects this reasoning and result. Instead, the stock issued to the investor for cash (nonqualified property) is disregarded: the ownership fraction is thus 100 percent, 79 percent divided by 79 percent, meaning that New FCo will be treated as a domestic corporation (as the ownership fraction exceeds 80 percent).

The notice also says that, under the regulations, certain stock otherwise excluded under the statutory public offering rule would still be taken into account. For example, foreign acquiring corporation stock issued in exchange for stock of members of the foreign corporation's expanded affiliated group, post-acquisition, will not be excluded from the ownership fraction—unless a principal purpose of the issuance is to avoid Section 7874.

New Regulations

The new regulations incorporate much of the notice, although with some changes. (New rules not described in the notice are only effective for acquisitions on or after January 16, 2014.) The regulations set forth a new "exclusion rule," which modifies the statutory public offering rule in an attempt to moderate the statutory rule's over- and under-inclusiveness. "Consistent with the notice," the regulations observe that stock of a foreign acquiring corporation may be transferred other than by public offering, but still in a way that "inappropriately" decreases the ownership fraction (e.g., private placements). At the same time, the new rules note that the statutory rule could apply improperly to stock issued in transactions that "meaningfully alter the way the expanded affiliated group that includes the foreign acquiring corporation does business" and thus should be taken into account.

The new exclusion rule, subject to a de minimis exception, states that "disqualified stock" is excluded from the denominator of the ownership fraction. Stock of a foreign acquiring corporation may be disqualified regardless of whether it is publicly traded; transferred by issuance, sale, distribution, exchange or other disposition; or transferred by the foreign acquiring corporation or another person. Of course, stock of the foreign acquiring corporation held by former shareholders (or partners) of the acquired domestic entity by reason of their holding interests in the domestic entity will not be disqualified stock.

The new regulations describe all situations in which stock of a foreign acquiring corporation will be excluded from the ownership fraction under Section 7874(c)(2)(B). Only acquisition-related transactions that increase the net assets of the foreign acquiring corporation can give rise to disqualified stock. Disqualified stock includes stock of the foreign acquiring corporation transferred to a person other than the acquired domestic entity in exchange for "nonqualified property" (the "nonqualified property rule"). Nonqualified property has the same definition as under the 2009 notice with one addition: "disqualified obligations." A disqualified obligation is an obligation (as defined in Section 1.752-1(a)(4)(ii) of the regulations) of (i) a member of the expanded affiliated group that includes the foreign acquiring corporation; (ii) a former shareholder or partner of the acquired domestic entity, within the meaning of Section 1.7874-2(b) of the regulations; or (iii) a person that, before or after the acquisition, either owns stock of (or a partnership interest in) a person described in (i) or (ii) or is related to any such person (within the meaning of Section 267 or 707(b) of the Code).

Disqualified stock also includes stock of a foreign acquiring corporation transferred to a person (including the domestic entity) in exchange for property, when—pursuant to the same plan or series of related transactions—the stock is subsequently transferred for the satisfaction or assumption of an obligation associated with the exchanged property (the "associated obligation rule"). The regulations coordinate the application of the associated obligation rule with the nonqualified property rule when property exchanged by a person other than the domestic entity includes nonqualified property.

The de minimis exception provides that the exclusion rule will not apply to certain transactions with unrelated parties if the ownership fraction, without regard to the rule, is less than five percent by vote and value. The exclusion rule also does not apply for purposes of applying the expanded affiliated group rules.

Conclusion

The new regulations offer a couple of welcome changes in the Section 7874 arena, such as the de minimis exception and addressing the statutory public offering rule's over-inclusiveness. Still, the inclusion of "disqualified obligations" as nonqualified property, the associated obligation rule and other "clarifications" make the new exclusion rule's application exceedingly likely, thereby making the 60-percent stock ownership threshold a pretty lower hurdle. The new rules, particularly in combination with the bright-line test for "substantial business activities" in 2012 regulations, make falling outside of Section 7874 quite difficult. Nevertheless, Treasury and IRS have promised that they will continue to study the potential for abuse in this area and further means to prevent it.

For more information, contact **Edward Tanenbaum** at (212) 210-9425 or **Heather Ripley** at (212) 210-9549.

If you would like to receive future *International Tax Advisories* electronically, please forward your contact information to **tax.advisory@alston.com.** Be sure to put "**subscribe**" in the subject line.

If you have any questions or would like additional information, please contact your Alston & Bird attorney or any of the following:

Sam K. Kaywood, Jr.
Co-Chair
404.881.7481
sam.kaywood@alston.com

Edward Tanenbaum
Co-Chair
212.210.9425
edward.tanenbaum@alston.com

John F. Baron
704.444.1434
john.baron@alston.com

Henry J. Birnkrant
202.239.3319
henry.birnkrant@alston.com

James E. Croker, Jr.
202.239.3309
jim.croker@alston.com

Jasper L. Cummings, Jr.
919.862.2302
jack.cummings@alston.com

Brian D. Harvel
404.881.4491
brian.harvel@alston.com

L. Andrew Immerman
404.881.7532
andy.immerman@alston.com

Brian E. Lebowitz
202.239.3394
brian.lebowitz@alston.com

Clay A. Littlefield
704.444.1440
clay.littlefield@alston.com

Ashley B. Menser
919.862.2209
ashley.menser@alston.com

Matthew P. Moseley
202.239.3828
matthew.moseley@alston.com

Heather Ripley
212.210.9549
heather.ripley@alston.com

Jennifer H. Weiss
404.881.7453
jennifer.weiss@alston.com

ALSTON & BIRD LLP

WWW.ALSTON.COM

© ALSTON & BIRD LLP 2013

ATLANTA: One Atlantic Center ■ 1201 West Peachtree Street ■ Atlanta, Georgia, USA, 30309-3424 ■ 404.881.7000 ■ Fax: 404.881.7777
BRUSSELS: Level 20 Bastion Tower ■ Place du Champ de Mars ■ B-1050 Brussels, BE ■ +32 2 550 3700 ■ Fax: +32 2 550 3719
CHARLOTTE: Bank of America Plaza ■ 101 South Tryon Street ■ Suite 4000 ■ Charlotte, North Carolina, USA, 28280-4000 ■ 704.444.1000 ■ Fax: 704.444.1111
DALLAS: 2828 North Harwood Street ■ 18th Floor ■ Dallas, Texas, USA, 75201 ■ 214.922.3400 ■ Fax: 214.922.3899
LOS ANGELES: 333 South Hope Street ■ 16th Floor ■ Los Angeles, California, USA, 90071-3004 ■ 213.576.1000 ■ Fax: 213-576-1100
NEW YORK: 90 Park Avenue ■ 12th Floor ■ New York, New York, USA, 10016-1387 ■ 212.210.9400 ■ Fax: 212.210.9444
RESEARCH TRIANGLE: 4721 Emperor Blvd. ■ Suite 400 ■ Durham, North Carolina, USA, 27703-85802 ■ 919.862.2200 ■ Fax: 919.862.2260
SILICON VALLEY: 275 Middlefield Road ■ Suite 150 ■ Menlo Park, California, USA, 94025-4004 ■ 650-838-2000 ■ Fax: 650.838.2001
WASHINGTON, DC: The Atlantic Building ■ 950 F Street, NW ■ Washington, DC, USA, 20004-1404 ■ 202.756.3300 ■ Fax: 202.756.3333