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JUNE 15, 2015

Final Anti-Inversion Regulations Keep Strict 25 Percent Tests for Substantial Business Activities

Earlier this month, the IRS and U.S. Treasury released final regulations under the anti-inversion provisions of Section 7874 (T.D. 9720). The final rules, effective for acquisitions completed on or after June 3, 2015, include few changes from the regulations proposed in 2012, including certain provisions for determining the members of an expanded affiliated group (EAG). Most notably, the final rules retain the 25 percent bright-line tests for whether an EAG has "substantial business activities" in a foreign country for the purpose of determining whether the foreign parent of an inverted corporation will be treated as a "surrogate foreign corporation."

The controversial bright-line tests first appeared in the 2012 proposed regulations, and many stakeholders found the tests—especially the 25 percent threshold—unnecessarily tough to achieve Section 7874's policy objectives. Multinationals with operations in many countries, for example, could have trouble meeting the 25 percent thresholds in any single foreign country where an acquiring foreign corporation is organized. The 2015 regulations include some helpful, simplifying rules in applying the substantial business activities tests, but the retention of the strict bright-line threshold reflects the government's and the general public's unsympathetic view of inverting companies and ongoing efforts to rein in the trend.

Background

Section 7874 was added by the American Jobs Creation Act of 2004 to combat the perceived abuse of U.S. entities inverting into foreign corporations to move their tax residency from the U.S. to a foreign jurisdiction. The statute's provisions operate to prevent these transactions by fully taxing gain on the inversion transaction or, in some cases, by treating the foreign acquiring corporation as a domestic corporation for U.S. tax purposes. The anti-inversion provisions apply and a foreign corporation is a surrogate foreign corporation if, pursuant to a plan or a series of related transactions, (1) a foreign corporation acquires substantially all the assets of a U.S. entity, (2) after the acquisition, the former owners of the U.S. entity hold at least 60 percent (by vote or value) of the stock of the foreign corporation by reason of holding interests in the U.S. entity, and (3) the EAG (connected by more than 50 percent ownership) that includes the acquiring foreign corporation does not have substantial business activities in the foreign country in which the foreign corporation is incorporated.

In 2006, the IRS and Treasury issued temporary and proposed regulations under Section 7874. Those rules provided that whether an EAG had substantial business activities in the relevant foreign jurisdiction would be based on all the facts and circumstances. Additionally, the 2006 proposed regulations offered a safe harbor if at least 10 percent of an EAG's employees, assets and sales were in the relevant foreign country. In 2009, the 2006 regulations were withdrawn and new temporary and proposed rules were issued. The 2009 regulations kept the facts and circumstances test, with some changes, but eliminated the 10 percent safe harbor.

The IRS and Treasury dropped the facts and circumstances test in temporary and proposed regulations issued in 2012. Those rules employed a bright-line test, with a relatively high threshold for whether an EAG had substantial business activities in the relevant foreign country. Under the 2012 regulations, an EAG "will have substantial business activities in the relevant foreign country only if at least 25 percent" of the group's total number of employees, employee compensation, assets and income are based in or derived in the relevant foreign country. Group assets, employees or income that were either related to an avoidance plan or subsequently transferred out of the relevant foreign country pursuant to a plan existing at the time of the inversion were excluded from the numerator of the threshold fractions. The 2012 regulations provided that more than 50 percent owned partnerships could be treated as members of an EAG (the "deemed corporation rule").

2015 Regulations

The recently finalized regulations maintain, unfortunately, the strict 25 percent tests of the 2012 regulations to determine whether a group satisfies the substantial business activities condition of Section 7874. Moreover, the regulations include several "operational" rules for applying the bright-line tests. Items disregarded under Section 7874(c)(4) (relating to avoidance transfers) are excluded from both the numerator and denominator of the relevant fractions. The timing and amount of employee compensation for purposes of the 25 percent test must be determined under U.S. income tax principles, while the issue of whether an individual is an employee of an EAG member can be resolved under U.S. income tax law or applicable foreign law—provided the same standard applies to all EAG members. The 2015 rules simplify the group income test, which now requires only that group income be determined consistently for all EAG members using U.S. income tax principles, U.S. generally accepted accounting principles (GAAP) or International Financial Reporting Standards (IFRS).

The new regulations also "clarify" certain rules for determining the members of an EAG. An entity that is not a member of an EAG on the acquisition date will not be a member of the EAG even though it was a member earlier in the testing period (i.e., the one-year period ending on the date the acquisition is completed or the last day of month preceding the acquisition month). Further, the members of an EAG are determined by taking into account all transactions related to an acquisition, even those that occur after the acquisition. The 2015 regulations coordinate application of the 2012 regulations' deemed corporation rule with a partnership "look-through rule." The look-through rule treats each partner in a partnership as holding its proportionate share of stock held through the partnership. The preamble to the regulations states that the look-through rule will apply first to identify the actual corporations included in an EAG. Next, the deemed corporation rule applies to treat partnerships in which those corporations own more than 50 percent interests as corporations and, therefore, members of the EAG. These EAG rules could potentially help or hurt a taxpayer's ability to satisfy the substantial business activities test.

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