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APRIL 15, 2016

New Temporary Regulations Continue the Fight Against Inversions

On April 4, the Treasury released temporary regulations to attack (and prevent) inversions. Aimed at transactions designed to avoid the purposes of Sections 7874 and 367 and certain post-inversion avoidance transactions, the regulations take particular aim at "serial inverters." The regulations incorporate the provisions in Notices 2014-52 and 2015-79, with certain modifications (see our coverage of prior anti-inversion guidance here). In addition, the temporary regulations introduced rules to (1) identify the foreign acquiring corporation (FAC) in multistep acquisitions; (2) disregard FAC stock attributable to prior domestic entity acquisitions; (3) require a controlled foreign corporation (CFC) to recognize gain on certain transfers that shift assets to non-CFC foreign related persons; and (4) clarify the definition of "group income" for the substantial business activities test.

The temporary and proposed regulations are the latest in a string of anti-inversion activity by the Treasury and IRS. Commentators have already credited the new regulations with the undoing of a number of anticipated, high-profile transactions. The new rules could also limit the benefits of previously completed inversion deals. While the new regulations package has teeth, many people, including President Obama and Treasury Secretary Lew, continue to call for legislative action to address the inversion problem more comprehensively.

Background

Added to the Code in 2004 to combat tax-motivated inversions, Section 7874 applies if (1) a FAC 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 FAC after the acquisition by reason of holding stock of or partnership interests in the U.S. entity (the "ownership test"); and (3) the FAC's expanded affiliated group (EAG) does not have substantial business activities in the foreign country where the foreign acquiring corporation is incorporated. Section 7874 fully taxes "inversion gain" to the inverted entity (disallowing the use of offsetting tax attributes) or, in cases where the former owners of the U.S. entity hold at least 80 percent of the FAC, treat the FAC as a domestic corporation for tax purposes.

In 2014, the Treasury and IRS released Notice 2014-52, announcing rules that generally made it more likely that an inversion would be subject to Section 7874 (by disregarding certain stock of the FAC) and restricting the FAC's ability to access earnings of CFCs of the inverted U.S. corporation. The Treasury and IRS followed up the 2014 notice with Notice 2015-79, which introduced provisions to (1) require the FAC to be a tax resident of the relevant foreign country to be considered having substantial business activities there; (2) disregard FAC stock in certain "third country" transactions for purposes of the ownership test; and (3) clarify the definition of "nonqualified property" for purposes of disregarding FAC stock (under the "anti-stuffing rules" of Notice 2014-52).

Among other things, Notice 2015-79 also sought to limit post-inversion tax benefits by expanding the definition of "inversion gain" to include income recognized by the inverted U.S. entity from certain indirect transfers or licenses of property. In addition, the 2015 notice required an exchanging U.S. shareholder to recognize, under Section 367, all gain realized on an exchange of CFC stock, regardless of the CFC's undistributed earnings and profits, if the exchange terminated a foreign subsidiary's CFC status or diluted a U.S. shareholder's interest in the CFC.

New Provisions in the 2016 Temporary Regulations

One concern of the Treasury and IRS is that taxpayers are taking the position that certain transactions are not domestic entity acquisitions subject to Section 7874 even though the transactions involve the policy concerns underlying the statute. For example, a foreign corporation (ForCo1) may acquire substantially all the assets of a U.S. entity (the "initial acquisition") that does not implicate Section 7874, e.g., because the ownership test is not met or the EAG has substantial business activities in the relevant foreign country. Then, pursuant to a plan or series of transactions that includes the initial acquisition, another foreign corporation (ForCo2) acquires substantially all of the assets of ForCo1 (the "subsequent acquisition"). Under Section 1.7874-2(c)(2), ForCo2 is not considered to have indirectly acquired the assets of the domestic entity.

To address the government's concern, a new "multiple-step acquisition rule" treats the subsequent acquisition as a domestic entity acquisition, ForCo2 as a FAC, and stock of ForCo2 received in exchange for ForCo1 stock, pursuant to the subsequent acquisition, as stock held by reason of holding stock in the domestic entity. Moreover, if pursuant to the same plan or series of related transactions, a foreign corporation (ForCo3, etc.) acquires substantially all the properties held by a subsequent acquiring corporation (i.e., ForCo2), the principles of the multiple-step acquisition rule extend to such subsequent acquisitions. Section 7874 may apply to the initial and subsequent acquisitions.

The temporary regulations also provide that, for purposes of calculating the ownership percentage for a domestic entity acquisition (the "relevant domestic entity acquisition"), the denominator of the ownership fraction will exclude FAC stock attributable to certain prior domestic entity acquisitions. This "multiple domestic entity acquisition rule" applies if the FAC (or a predecessor) completed one or more domestic entity acquisitions within the 36-month period ending on the signing date for the relevant domestic entity acquisition. The regulations describe a three-step process to determine the amount of FAC stock excluded, which is based on the current value of the FAC shares issued in the prior acquisition, adjusted for intervening redemptions and other capital structure changes.

The multiple domestic entity acquisition rule applies after taking into account Section 1.7874-2(e), which may treat multiple acquisitions as a single acquisition. If two acquisitions are aggregated under Section 1.7874-2(e), they are not treated separately for purposes of the new multiple domestic entity acquisition rule. In general, prior domestic entity acquisitions will not implicate the multiple domestic entity acquisition rule if the ownership percentage for the acquisition was less than 5 percent and the value of the by-reason-of stock received by the former owners of the domestic entity did not exceed $50 million.

The preamble indicates that the Treasury and IRS worry that certain Section 351 transfers by an expatriated foreign subsidiary (i.e., CFCs of the inverted domestic entity) could dilute a U.S. shareholder's indirect interest in the property without gain recognition by the CFC or by the U.S. shareholder. The temporary regulations will require the expatriated foreign subsidiary to recognize all gain in the transferred property that is not otherwise recognized. This "Section 367(b) asset dilution rule" applies when an expatriated foreign subsidiary transfers property (other than stock of a lower-tier expatriated foreign subsidiary) in a Section 351 exchange to a foreign transferee corporation during the applicable period. An exception applies to transfers in which there is only a de minimis shift of ownership of the transferred property to non-CFC foreign related persons.

Under Notice 2015-79 (and now the new regulations), an EAG cannot have substantial business activities in a foreign country unless the FAC is subject to tax as a resident in that country. Under regulations finalized in mid-2015, substantial business activities means 25 percent or more of each of an EAG's employees, assets and income being in the relevant country. The temporary regulations clarify that financial reporting principles are relevant only in determining the amount of items of income taken into account, as the EAG must take into account all items recognized by all group members (based on the regulatory definition of EAG) during the testing period.

Treasury Makes Big Moves in Proposed Earnings Stripping Regulations

Dovetailing with the new anti-inversion regulations and released on the same day, proposed regulations under Section 385 tackle earnings stripping structures that increase related-party debt that does not finance U.S. investment. Section 385(a) authorizes the Treasury to prescribe regulations to determine whether an interest in a corporation is debt or equity (or part debt and part equity) for tax purposes. A substantial body of case law developed around debt-equity characterization in the absence of regulations (the last set were withdrawn in 1983). In a sharp departure from the facts-and-circumstances approach of the courts and Section 385(b), certain provisions in the new regulations would categorically treat related-party debt as stock if issued in certain transactions. The proposed rules also set forth documentation requirements for certain taxpayers to treat related-party interests as debt and allow the IRS on audit to treat related-party interests as part debt and part equity (rather than as all of one or the other).

The proposed regulations apply to purported debt issued by a corporation or controlled partnership to related parties, specifically members of an "expanded group" (EG). Interests not designated as debt and interests among members of the same U.S. consolidated group (treated as a single corporation under the rules) are generally not covered. Though defined by reference to the term "affiliated group" in Section 1504(a), EG is a broader concept. A corporation is part of an EG if group members own 80 percent of the corporation by vote *or* value (not both, as required under Section 1504). An EG may include foreign and tax-exempt corporations and corporations held indirectly through partnerships, and the attribution rules of Section 304(c)(3) apply. Notably, the regulations apply whether related parties are foreign or domestic.

Section 1.385-3 of the proposed regulations offers three rules for treating an EG interest (EGI) as stock: the general rule, the funding rule and the anti-abuse rule. These rules reflect the Treasury's concern that debt issued in (or to fund) particular transactions has limited nontax significance and, therefore, produces improper results. The general rule treats an EGI as stock to the extent issued by a corporation to a member of the corporation's EG in a distribution, in exchange for expanded group stock, other than a defined exempt exchange, or in exchange for property in an asset reorganization, to the extent a shareholder that was an EG member receives debt in exchange for stock of the transferor corporation. The funding rule treats as stock an EGI issued with the principal purpose of funding a transaction described in the general rule. Under the anti-abuse rule, a debt instrument is treated as stock if issued with the principal purpose of avoiding the purposes of the regulations. Significantly, these rules (and provisions related to consolidated groups) are generally effective for debt instruments issued or deemed issued on or after April 4, 2016. Under transition rules, however, certain distributions and acquisitions occurring before April 8, 2016, may not be taken into account, and certain debt instruments may continue to be treated as debt until after the regulations become final.

Under Section 1.385-2 of the proposed regulations, certain taxpayers must prepare and maintain timely documentation to treat an EGI as debt. Specifically, the documentation must evince a legally binding obligation to pay, the creditor's right to enforce the obligation, a reasonable expectation of repayment at the time the interest is created and an ongoing debtor-creditor relationship consistent with arm's-length relationships between unrelated parties. While these characteristics are derived from case law and Section 385(b), the regulations impose a "degree of discipline in the creation of necessary documentation, and in the conduct of reasonable financial diligence … that exceeds what is required under current law." The Treasury cites the fact-intensive nature of debt-equity characterization and the increased complexity of related-party transactions as justification for the documentation rules, which apply only if an EG member's stock is traded on an established financial market or if certain financial thresholds are met ($100 million in assets or $50 million in revenues). Of course, satisfying these requirements will not be dispositive of an EGI's treatment for tax purposes.

Rather, the documentation is meant to inform a larger facts-and-circumstances analysis. The documentation rules are not effective until the proposed regulations become final.

The Treasury believes that the all-or-nothing approach to debt-equity characterization often fails to reflect economic substance. Consequently, Section 1.385-1(d) of the proposed rules permits (but does not require) the IRS to bifurcate related-party interests and treat them as part debt and part stock. For purposes of this rule, a lower 50 percent threshold for relatedness applies. The Treasury makes clear that the proposed regulations do not affect the IRS's authority to disregard an interest as stock or debt, treat a purported debt interest as debt or equity of another entity, or otherwise treat an instrument according to its substance. These provisions would not be effective until the regulations become final.

While Notices 2014-52 and 2015-79 hinted at earnings stripping regulations to combat post-inversion avoidance schemes, the proposed rules go well beyond that aim. The regulations ensnare common related-party financing structures outside the inversion context. There is also some question whether the rules exceed the Treasury's authority under Section 385—particularly Section 1.385-3, which categorically treats certain related-party interests as stock, eschewing the factor-based analysis recommended by the statute. The Treasury has invited comments by July 7, 2016, on the proposed regulations, including whether the proposed rules merit additional guidance under Section 909 regarding hybrid splitter arrangements.

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