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Client Alert
Commentary

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Treasury Issues Stringent Inversion Regulations, Proposes Far-Reaching Related-Party Debt Rules

New regulations expand prior guidance reducing tax benefits of inversions. Proposed debt-equity rules will impact even routine intercompany transactions.

On April 4, 2016, the US Department of the Treasury (Treasury) and the Internal Revenue Service (the IRS) issued new regulations (the Temporary Regulations) aimed at curbing the cross-border corporate expatriation transactions commonly referred to as inversions and the associated tax advantages. Concurrently, Treasury and the IRS issued strikingly broad new proposed regulations limiting the use of related-party debt, which, according to Treasury, taxpayers have used to engage in "earnings stripping" and certain other tax planning techniques the government deems inappropriate. The new rules, particularly with respect to related-party debt, go further than any previous guidance and indeed target a number of relatively common structures multinational business enterprises have utilized over the last decades.

Overall, the new guidance encompasses a wide range of actions falling generally into three categories:

- Rules identifying what transactions qualify as inversions under Section 7874,[1] discussed in Part I, below

- Restrictions on various post-inversion planning techniques designed to maximize tax efficiencies under the inverted corporate group structure, discussed in Part II, below

- Proposed rules that would recharacterize related-party debt in certain circumstances as stock, in whole or in part. If adopted in their proposed form, these rules would have broad application, reaching well beyond corporations seeking to invert. Please see the concurrently published Latham & Watkins *Client Alert* "Treasury Targets Related-Party Debt with Proposed Regulations to Treat Debt as Equity" for more detail on the proposed rules.[2]

The Temporary Regulations are the latest in several rounds of official pronouncements on inversions and largely expand on guidance issued over the last two years. Notice 2014-52[3] (the 2014 Notice), issued in September 2014, announced Treasury's and the IRS' intent to promulgate regulations that make inversions more difficult and the results following a successful inversion less economically attractive. In November 2015, Treasury and the IRS issued Notice 2015-79[4] (the 2015 Notice and, together with the 2014 Notice, the Notices), describing further intended tightening of the anti-inversion rules. The Temporary Regulations represent the rules outlined in the Notices, with certain additional limitations not previously announced.

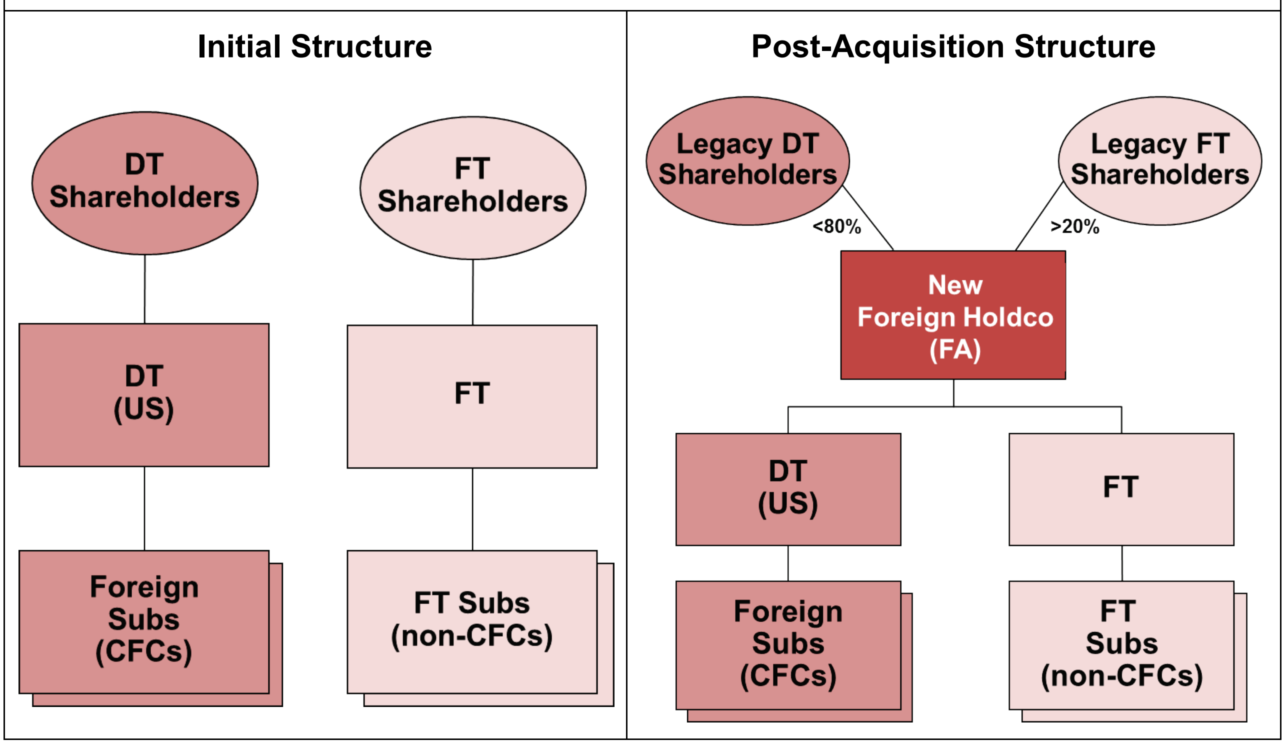
The effective dates within the Temporary Regulations reflect whether an individual rule was contained in the 2014 Notice or the 2015 Notice, or is a new or revised rule. Thus, provisions of the Temporary Regulations implementing rules contained in the 2014 Notice generally apply to transactions completed on or after September 22, 2014, and provisions of the Temporary Regulations implementing rules contained in the 2015 Notice generally apply to transactions completed on or after November 19, 2015. For new rules not contained in either of the Notices, the effective date generally is for transactions completed on or after April 4, 2016.

The inversion rules can apply to stock and asset transfers involving US corporations, as well as transfers of trades or businesses held by US partnerships. In either case, certain provisions in the Temporary Regulations set forth special rules relating to the treatment of partnerships, which are beyond the scope of this *Client Alert*.

I. Inversion Regulations

For purposes of the following discussion, unless otherwise indicated, assume that a US corporation (DT) and a foreign corporation (FT) seek to combine under a new foreign holding corporation (FA). The first chart in Figure 1 below depicts the structure immediately before the transaction, and the second depicts the structure after the transaction.

Figure 1: Basic Transaction



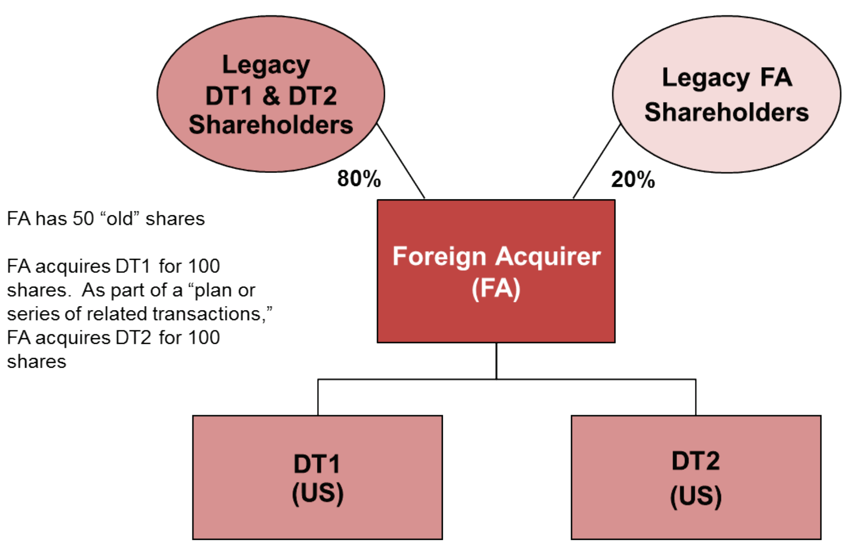
Under statutory anti-inversion provisions, a foreign corporation acquiring a US corporation is treated as a US corporation for US tax purposes if, among other requirements, (i) the amount of stock (by vote or value) of the foreign acquiring corporation owned by former shareholders of the acquired US corporation following the acquisition by reason of ownership of the acquired US corporation (the inversion fraction) is at least 80%, and (ii) the expanded affiliated group (EAG) of the acquirer does not have substantial business activities in the foreign country in which the acquirer is organized (the relevant foreign country). If the former shareholders of the acquired US corporation own less than 80% but at least 60% of the shares and the EAG does not have substantial business activities in the relevant foreign country, then certain limitations apply to the entire corporate group on the use of tax attributes, and an excise tax may apply to certain executive compensation.

Each of the Temporary Regulations, discussed below, puts pressure on the ability of shareholders of acquired US corporations to stay below the 60% and 80% ownership thresholds. In short, the rules have the overall effect of increasing the numerator and decreasing the denominator of the inversion fraction.

Serial Acquisitions: New Domestic Entity Acquisition Rule

In this example, assume FA is a legacy foreign corporation. Regulations issued in 2009 provide that if FA acquires two unrelated domestic target entities or DTs (DT1 and DT2) as part of a "plan or series of related transactions," DT1 and DT2 are treated as a single domestic entity acquired by FA for purposes of the inversion rules, thus aggregating the shares of FA issued to DT1 and DT2 shareholders in the numerator of the inversion fraction under Treasury Regulations Section 1.7874-2(e) (the Serial Acquisition Rule). See Figure 2. This may result in the acquisition of DT2 triggering the application of the inversion rules, even if each acquisition, measured separately, would not have triggered the rules. Under those 2009 regulations, if the acquisitions of DT1 and DT2 were not part of a plan or series of related transactions, FA would generally be able to include FA shares issued to former DT1 shareholders in the denominator of the DT2 acquisition inversion fraction. The 2009 regulations were meant to provide that FA's acquisition of DT1 and DT2 must bear a factual linkage under a step transaction doctrine in order for this rule to apply.

Figure 2: <u>The Serial Acquisition Rule</u>



Under Treas. Reg. § 1.7874-2(e), FA shares issued to DT1 and DT2 legacy shareholders in the numerator are aggregated because DT2 was acquired as part of a "plan or series of related transactions." Therefore, the former shareholders of a single US company would be treated as owning 200/250 shares, or 80%. This results in FA being treated as a domestic corporation.

If there is no "plan or series of related transactions," under Treas. Reg. § 1.7874-2(e), the shareholders of DT2 would be treated as owning 100/250 shares, or 40%. FA would not be treated as a domestic corporation as a result of DT2 acquisition.

Treasury and the IRS concluded that, in addition to a facts and circumstances analysis in the Serial Acquisition Rule, there should be a new, separate test under a per se rule to link acquisitions of US companies undertaken over a 36-month period. So the new regulations have included in Temporary Regulations Section 1.7874-8T the "multiple domestic entity acquisition rule."

The multiple domestic entity acquisition rule excludes FA stock attributable to certain prior domestic entity acquisitions from the denominator of the inversion fraction. Specifically, the Temporary Regulations exclude FA stock from the denominator of the DT2 acquisition inversion fraction to the extent the stock relates to the earlier acquisition of DT1. See Figure 3.

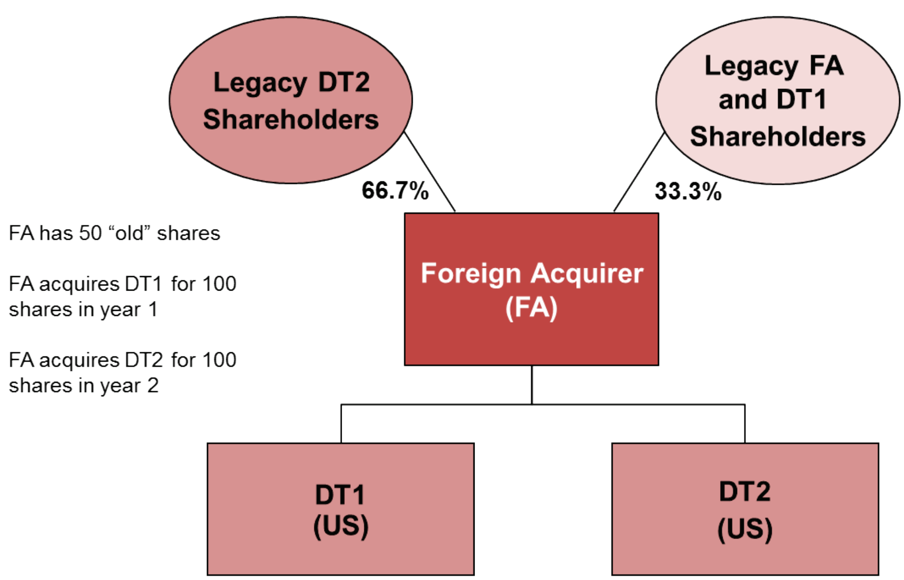
The multiple domestic entity acquisition rule looks back at acquisitions of domestic entities during the 36-month period ending on the signing date of the domestic entity acquisition at issue. The prior acquisition of DT1 will be excluded from this rule if the ownership percentage for the acquisition of DT1 was less than 5% <u>and</u> if the fair market value of the stock received by legacy DT1 shareholders did not exceed US$50 million.

Certain adjustments are taken into account in the case of FA redemptions or share splits occurring in between the acquisitions of DT1 and DT2.

The multiple domestic entity acquisition rule applies after taking into account the Serial Acquisition Rule described above.

Important note: While the multiple domestic entity acquisition rule was a completely new addition in the Temporary Regulations issued on April 4, 2016, and therefore only applies prospectively, the rule does take into account acquisitions made prior to April 4, 2016, for purposes of the 36-month look-back period.

Figure 3: <u>The Multiple Domestic Entity Acquisition Rule</u>

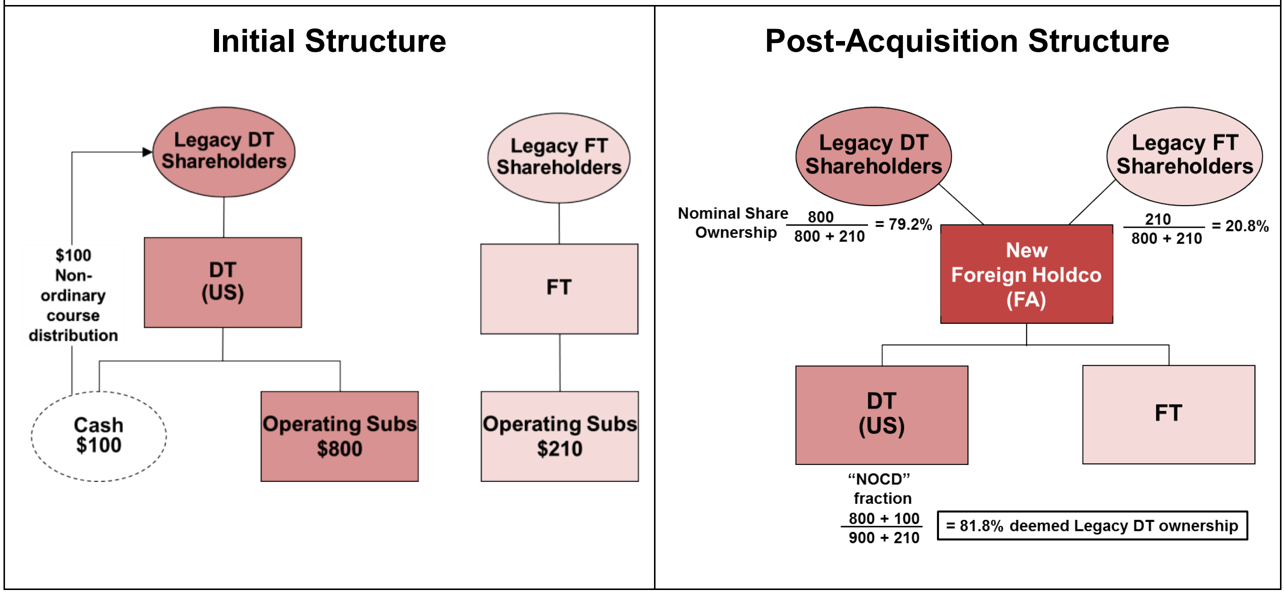


Under new Temp. Treas. Reg. § 1.7874-8T, even if DT1 and DT2 are not acquired as part of a "plan or series of related transactions," if DT2 is acquired within 36 months of DT1, the shares of FA held by Legacy DT1 shareholders are excluded from the denominator. Therefore, DT2 shareholders would be treated as owning 100/150 shares, or 66.7%.

Non-Ordinary Course Distributions

In the 2014 Notice, Treasury and the IRS announced their intention to limit taxpayers' ability to reduce the size of DT in advance of an inversion transaction (and thereby favorably reduce its inversion fraction) by paying extraordinary dividends, often referred to as "diet" or "skinny-down" dividends.

Figure 4: The Non-Ordinary Course Distribution Rule



Temporary Regulations Section 1.7874-10T clarifies some of the computational rules described in the 2014 Notice, and will disregard any non-ordinary course distributions by DT during the 36-month period before the inversion transaction. Non-ordinary course distributions are measured in 12-month increments (look-back years), and generally equal the excess of (i) all distributions made during a look-back year by DT over (ii) 110% of the average of all distributions during the 36-month period immediately preceding such look-back year. Special rules apply if DT does not have the full 36 months of look-back years or distribution history. Under the Temporary Regulations, DT will also inherit the distribution history with respect to certain predecessor corporations.

- The Temporary Regulations provide for a *de minimis* exception if, generally, the legacy DT shareholders receive less than 5% of the stock of FA (disregarding the non-ordinary course distribution rule and the passive assets rule of Temporary Regulations Section 1.7874-7T, discussed below), and do not, actually or constructively, own more than 5% of any member of the EAG.

- As in the 2014 Notice, distributions under the Temporary Regulations include not only dividends and distributions made in redemption of stock, but also the transfer of money or other property to shareholders in connection with the inversion transaction (to the extent that DT directly or indirectly provides such money or other property).

- As under the 2014 Notice, non-ordinary course distributions will be disregarded regardless of their purpose. Thus, for example, a spin-off in the three years preceding the inversion transaction might be disregarded under this provision. A special rule applies to spin-offs if the distributed corporation is larger in value than the distributing corporation.

Note that diet dividends have also been used to shrink DT's value for purposes of enabling FA's acquisition of DT to qualify as a tax-free transaction for the DT shareholders under the "Helen of Troy" regulations under Section 367. (The "substantiality" test portion of those regulations requires that the fair market value of DT be no greater than the fair market value of FT.) As under the 2014 Notice, Temporary Regulations Section 1.367-3T(c)(3)(iii)(C) states that non-ordinary course distributions are disregarded for this purpose as well.

Disqualification of FA Shares Issued in Exchange for Cash and Other Property

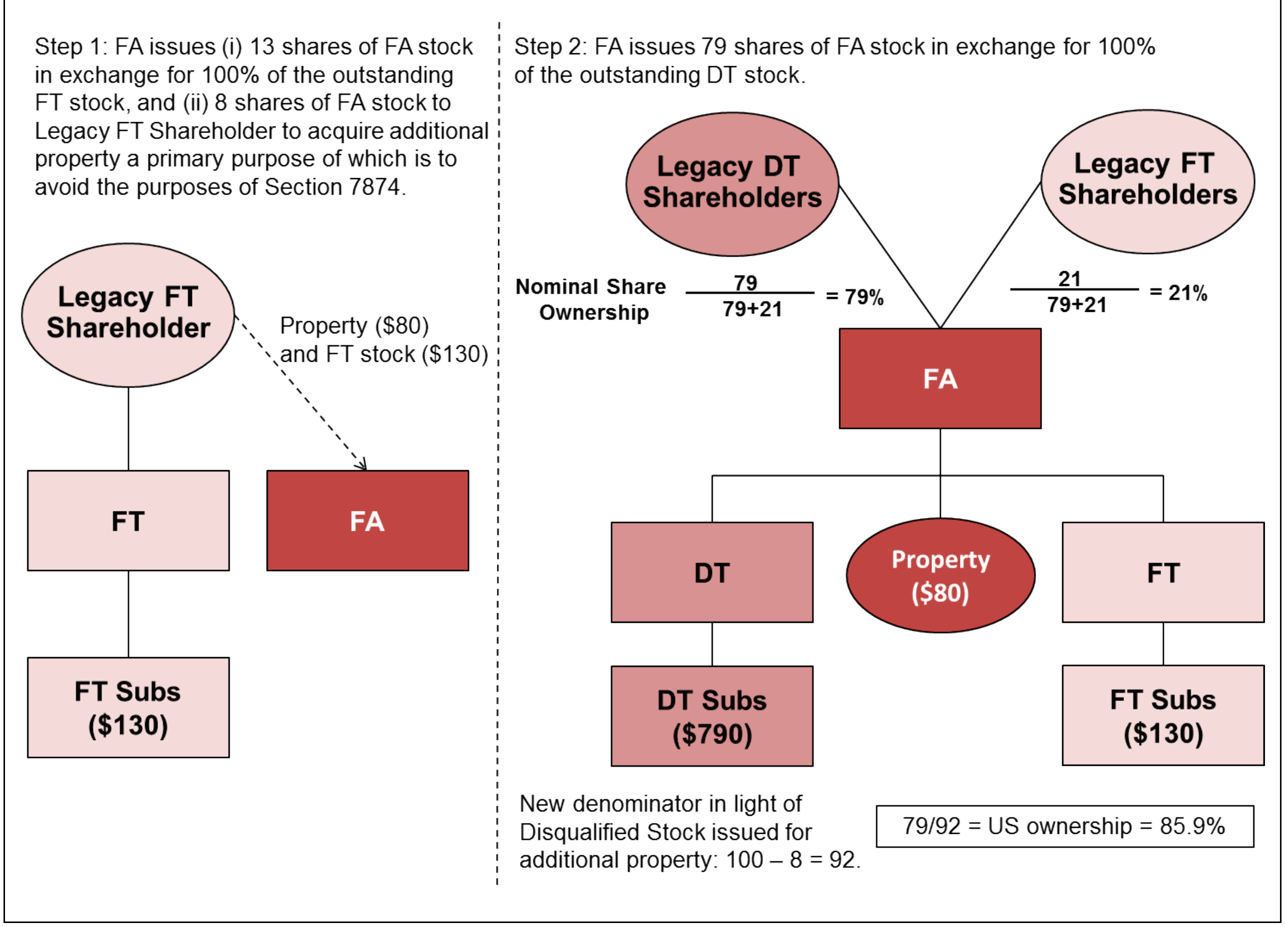
Under prior guidance,[5] stock of FA transferred to a party other than DT would generally be excluded from the denominator for purposes of calculating the inversion fraction (disqualified stock), if exchanged for certain "nonqualified property." This provision traces its roots back to Notice 2009-78.[6]

As initially drafted in 2014, Temporary Treasury Regulations Section 1.7874-4T(i)(7) defined nonqualified property generally to include certain specified types of property, as well as any property acquired in a transaction (or series of transactions) related to the inversion transaction and with a principal purpose of avoiding the purposes of Section 7874 (avoidance property). However, in the 2015 Notice, the IRS expressed concern over taxpayers potentially interpreting the definition of avoidance property too narrowly by arguing that the definition is limited to property used to indirectly transfer other types of nonqualified property to FA, and expressed an intent to further clarify Treasury Regulations Section 1.7874-4T to address such concern.

Consistent with that intent, the Temporary Regulations expand the concept of nonqualified property to generally include any property acquired with a principal purpose of avoiding the purposes of Section 7874, regardless of whether such property is acquired in a transaction that is related to the inversion transaction and regardless of whether the transaction otherwise involved an indirect transfer of other specified nonqualified property. Accordingly, the Temporary Regulations broaden the potential application of the general Section 7874 anti-abuse provision in the context of determining what portion of FA stock may be excluded as disqualified stock from the denominator for purposes of calculating the inversion fraction.

Below is an example of the potential effect of excluding disqualified stock from the denominator for purposes of calculating the inversion fraction:

Figure 5: The Disqualified Stock Rule



EAG/Spin Issues

In general, for purposes of calculating the 60% and 80% ownership thresholds, stock of FA held by members of the EAG is excluded from both the numerator and the denominator of the inversion fraction, subject to exceptions for certain internal group restructurings or for transactions where there is a loss of control by former DT shareholders (the EAG rules). If either exception applies, then FA shares held by an EAG member are included in the denominator, but not the numerator, of the inversion fraction (thereby decreasing the ownership percentage and the likelihood that Section 7874 will apply).

The 2014 Notice and Temporary Regulations Section 1.7874-6T provide additional rules that limit the application of the EAG rules if there is a subsequent transfer of FA stock in a transaction related to the acquisition of DT. If FA stock received by legacy DT shareholders in the acquisition is subsequently transferred in a related transaction, absent an exception, such stock is generally not treated as held by a member of the EAG for purposes of the EAG rules and is therefore included in both the numerator and the denominator of the inversion fraction (thereby increasing the ownership percentage and the likelihood that Section 7874 will apply). Temporary Regulations Section 1.7874-6T describes two exceptions to this general rule for US-parented groups and foreign-parented groups. If either of the following exceptions applies, the subsequently transferred FA stock is treated as held by a member of the EAG and is excluded from the numerator of the inversion fraction (and may be excluded from the denominator):

- The US-parented group exception applies if (1) before the DT acquisition, the transferring corporation is a member of the US-parented group **and** (2) after the DT acquisition, the transferring corporation (or its successor), any person that holds the subsequently transferred stock, and FA all are members of the US-parented group, the common parent of which either (a) was a member of the US-parented group before the DT acquisition **or** (b) was formed in a transaction related to the DT acquisition and was a member of the US-parented group immediately after its formation.

- The foreign-parented group exception applies if (1) before the DT acquisition, the transferring corporation and DT are members of the same foreign-parented group **and** (2) after the DT acquisition, the transferring corporation either is a member of the EAG **or** would be a member of the EAG absent the transfer of FA stock by a member of the foreign-parented group in a transaction related to the DT acquisition.

The new rules effectively prevent the application of the EAG rules and limit the applicability of the internal group restructuring exception in certain "spinversion" transactions, in which a US publicly traded parent corporation transfers stock of DT (its US subsidiary) to FA (a newly formed foreign subsidiary) and then subsequently distributes FA stock to the parent company's shareholders. Without the application of the EAG rules, the FA stock received by the publicly traded parent would be included in the numerator of the inversion fraction (generally resulting in 100% US ownership). By contrast, if the EAG rules apply, the FA stock would be excluded from the numerator of the inversion fraction (resulting in 0% US ownership).

However, when the FA stock is subsequently distributed to the publicly traded parent's shareholders in a related transaction (resulting in the FA stock being held outside the EAG), under the general rule in Temporary Regulations Section 1.7874-6T, the FA stock is not treated as held by a member of the EAG and is thus counted in both the numerator and the denominator of the inversion fraction. Neither the US-parented group exception nor the foreign-parented group exception would be available in this case.

The Temporary Regulations include a special rule for the subsequent transfer of "fungible stock." If a transferring shareholder receives stock of FA in the DT acquisition transaction and holds other FA stock with the same terms (*i.e.*, "fungible stock") and if the transferring shareholder makes a subsequent transfer of less than all of such fungible stock, the Temporary Regulations require that a pro rata portion of such stock is treated as stock of FA received in the DT acquisition.

Multi-Step Acquisitions

Temporary Regulations Section 1.7874-2T introduces a new "multi-step acquisition rule" aimed at transactions which acquire a DT through a series of steps and thereby potentially undermine the purposes of Section 7874, as follows.

Existing regulations under Section 7874 have provided that if a foreign corporation (F1) owned DT and a second foreign corporation (F2) subsequently acquired F1, this second acquisition would not be treated as an indirect acquisition of DT's properties for purposes of Section 7874. The rationale for that regulation was that if DT was already owned by a foreign parent (F1) prior to the acquisition by F2, then F2's acquisition of F1 would typically not give rise to the policy concerns reflected in Section 7874. However, suppose that F2 wanted to acquire DT, but instead of doing so directly, F1 first acquired DT in a transaction that did not result in F1 being treated as a US corporation (for example, because the ownership percentage was less than 80%) and then, pursuant to a plan or series of related transactions, F2 acquired F1. This would potentially implicate the policy concerns of Section 7874, including the third-country rule described below (if F2 and F1 are tax residents of different foreign countries) or the substantial business activities exception (if the EAG has substantial business activities in F1's country but not in F2's country). Nonetheless, if the form was respected, F2's acquisition of F1 would not be tested as an acquisition of DT by F2 under Section 7874.

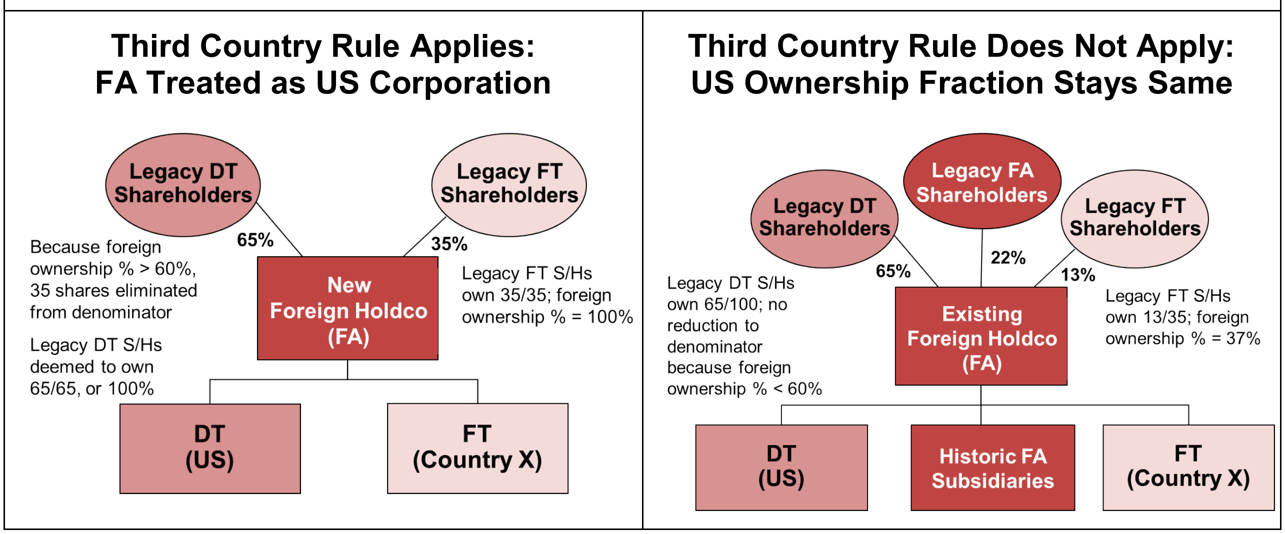
The multi-step acquisition rule treats F2's subsequent acquisition of F1 as if F2 actually acquired DT, provided both acquisitions are part of a plan or series of related transactions. Thus, F2's acquisition of F1 is tested under Section 7874 notwithstanding the form of the acquisition. Note that this rule does not affect the application of Section 7874 to the initial acquisition of DT by F1, and hence Section 7874 may apply to both F1's acquisition of DT as well as F2's acquisition of F1.

Note that, unlike the multiple domestic entity acquisition rule described above, the multi-step acquisition rule does not include a specified deemed plan look-back period. Thus, taxpayers are left to determine whether multiple acquisitions are treated as a plan or series of related transactions.

Third Countries

Temporary Regulations Section 1.7874-9T adopts the "third country rule" announced in the 2015 Notice with a few modifications. This rule aims at certain transactions in which DT combines with FT under FA, which is a tax resident of a third country (*i.e.*, a country other than the country of FT's tax residency). Treasury and the IRS believe these transactions are generally motivated to avoid US taxation, rather than to achieve non-tax business purposes.

Figure 6: <u>The Third Country Rule</u>



The third country rule applies if all of the following conditions are met:

- FA acquires FT in a transaction related to the acquisition of DT.
- At least 60% of the stock (by vote or value) of FA is held by legacy FT shareholders by reason of ownership of FT (ignoring for this purpose FA stock held by legacy DT shareholders).
- FA's country of tax residence (determined after the acquisition of FT and all related transactions) is not the same as that of FT (determined before the acquisition of FT and all related transactions, including any change in FT's location of management or control).

- Ignoring the third country rule, the ownership percentage of legacy DT shareholders in FA after the transaction is at least 60%, but less than 80%.

If these four requirements are satisfied, FA stock issued to legacy FT shareholders by reason of ownership of FT is excluded from the denominator of the inversion fraction.

This exclusion increases the likelihood that the inversion fraction will reach 80% or more (resulting in FA as being treated as a US corporation), particularly if FA is newly formed with little or no historic assets or operations.

Substantial Business Activities

Under current law, the EAG will generally be considered to have substantial business activities in the relevant foreign country only if (i) at least 25% of the total number of its employees are based in the relevant foreign country and at least 25% of total compensation is incurred by such employees, (ii) at least 25% of the value of all EAG assets are located in the relevant foreign country (the asset test), **and** (iii) at least 25% of the EAG's total income during the relevant testing period is derived in the relevant foreign country (the income test). In addition, consistent with the intent set forth in the 2015 Notice and without significant change to the approach outlined therein, the Temporary Regulations provide that the EAG will only be treated as having substantial business activities in the relevant foreign country where FA is subject to tax as a resident of such country.

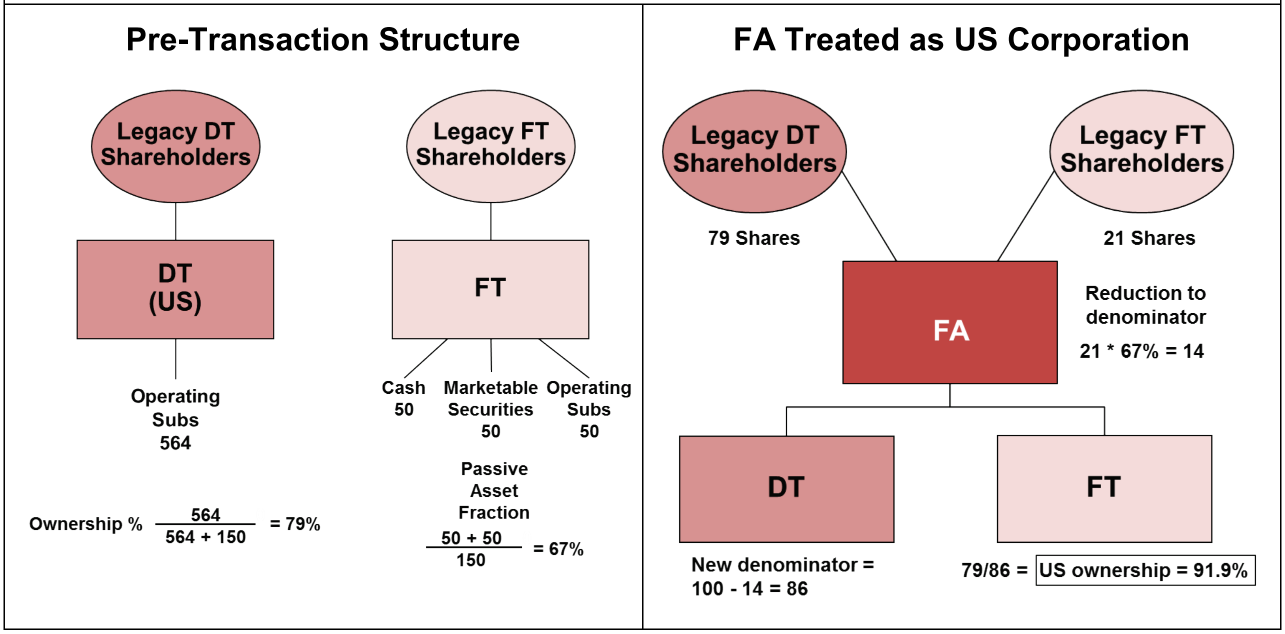
- Only tangible real or personal property that is owned or held by an EAG member as lessee and used (or held for use) in an active trade or business will be considered for purposes of the asset test. Accordingly, the value of intangible assets (*e.g.*, intellectual property, licenses) will not be taken into account.

- Only income earned in the ordinary course of business and with customers that are unrelated to the EAG members will be considered for purposes of the income test. While the determination of the EAG's gross income may generally be made according to its financial statements, the Temporary Regulations clarify that such statements cannot be used to identify which entities will be treated as EAG members. Instead, the Temporary Regulations provide that all entities treated as EAG members for purposes of Section 7874 must be taken into account.

Cash Box Rule and Passive Assets

Temporary Regulations Section 1.7874-7T makes some modifications to the "passive assets" rule described in both the 2014 and 2015 Notices. This rule targets transactions in which more than 50% of all "foreign group property" (*i.e.*, the property held by FA's "modified EAG" (as described below) immediately after the acquisition of DT and all related transactions, but excluding assets previously held directly or indirectly by DT) consists of "foreign group nonqualified property" (generally, passive assets, such as cash or marketable securities, with exceptions for certain assets of companies engaged in financing, banking and insurance activities). If these conditions are met, then a portion of the FA stock corresponding to such nonqualified property will be excluded from the denominator of the inversion fraction. See Figure 7. Thus, this rule increases the likelihood that the 60% or 80% threshold of the inversion fraction will be met.

Figure 7: The Passive Assets Rule



- The Temporary Regulations clarify that if FA is not the common parent of the EAG, foreign group property includes only assets of the modified EAG (redetermined as if FA were the common parent and ignoring any assets held upstream of FA).

- The Temporary Regulations add a new *de minimis* exception, if, generally, the legacy DT shareholders receive less than 5% of the stock of FA (disregarding the disqualified stock, non-ordinary course distribution and passive assets rules), and do not, actually or constructively, own more than 5% of any member of the EAG.

- The Temporary Regulations confirm that passive assets that result in disqualified stock under Temporary Regulations Section 1.7874-4T will count towards the 50% passive assets threshold, even though such stock is already disregarded from the denominator of the inversion fraction. Non-passive assets acquired for passive assets (such as cash) in a transaction related to the DT acquisition are viewed as substitute property and count toward the 50% threshold.

II. Post-Inversion Issues

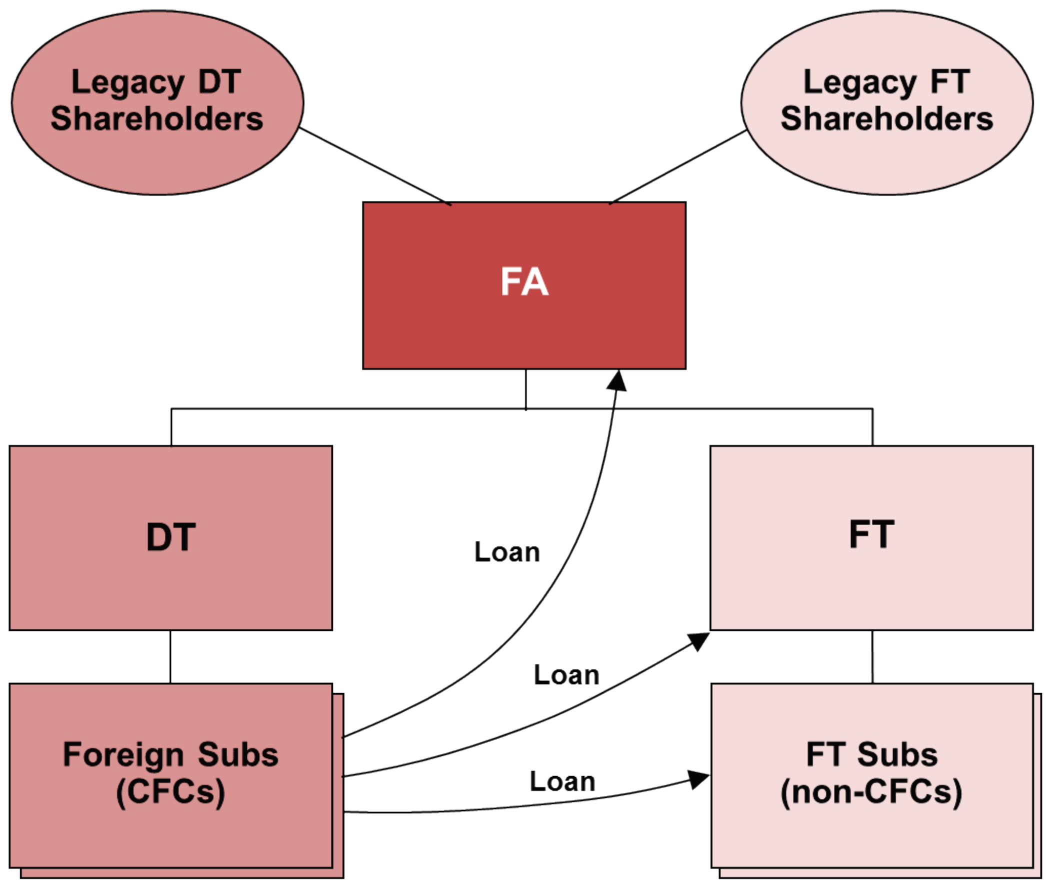
Limitation on Foreign Acquirer Access to Legacy CFC Earnings

The Temporary Regulations generally implement the rules set forth in the 2014 Notice which targeted the extraction of earnings and profits of pre-inversion controlled foreign corporations (CFCs) through so called “hopscotch loans” and other financing techniques. To help prevent CFCs from repatriating their foreign earnings without the imposition of US tax, Section 951 of the Code creates an income inclusion for certain US shareholders of a CFC, based on the CFC’s investments in “United States property” as that term is defined in Section 956, which generally includes stock or debt of US persons that are related to the CFC. Under these rules, investments by a CFC in the stock or debt of its US-organized corporate parent (or the parent’s domestic affiliates) typically trigger the potential income inclusion.

Treasury and the IRS raised the concern that following an inversion transaction, the earnings of CFCs of DT — for example, via loans from such CFCs to FA, FT or FT's foreign subsidiaries — could potentially be used to fund dividends, share buybacks and other transactions without the imposition of US tax. As discussed above, if those earnings were loaned from the CFCs to DT, the debt of DT held by the CFCs would generally constitute an investment in United States property and trigger the potential income inclusion under Section 951.

Under the Temporary Regulations, which implement the rules described in the 2014 Notice with minor modifications, investments by legacy CFCs of DT (referred to as "Expatriated Foreign Subsidiaries") in stock or debt of foreign, non-CFC related parties (referred to as "Non-CFC Foreign Related Persons") generally are treated as investments in United States property for purposes of Section 956 (and thus may trigger an income inclusion under Section 951). See Figure 8. Similar rules apply with respect to credit support (such as guarantees and pledges of shares) that is provided by an Expatriated Foreign Subsidiary with respect to an obligation of a Non-CFC Foreign Related Person.

Figure 8: Application of New Regulations Under Section 956



- Foreign Subs – "Expatriated Foreign Subsidiaries"
- FA, FT and FT Subs – "Non-CFC Foreign Related Persons"

Under new Temp. Treas. Reg. § 1.956-2T(a)(4), loans made by the CFCs to FA, FT and FT Subs are treated as investments in United States Property for purposes of Section 956.

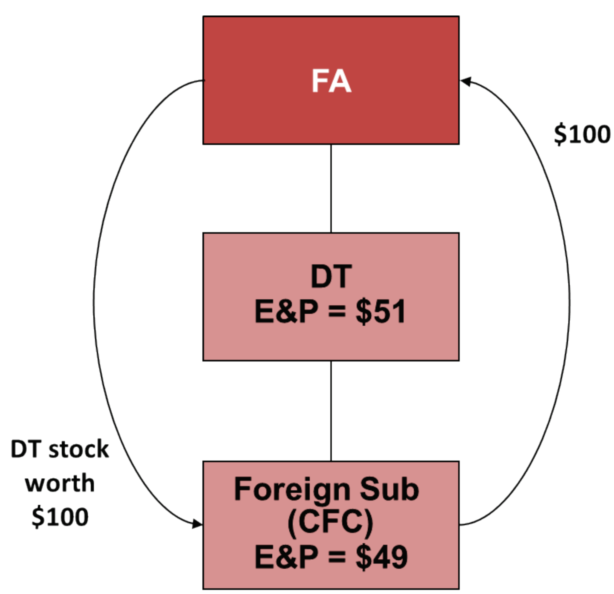
Limitation on Intercompany Stock Sales

The Temporary Regulations implement the proposed rule in the 2014 Notice targeting intra-group stock sales that can result, through the application of the deemed stock redemption provisions of Section 304, in a reduction in a CFC's earnings and profits (thereby facilitating a future tax-free repatriation of cash or assets from such CFC) without corresponding US federal income tax liability. Note that these regulations apply whether or not an inversion has occurred, and therefore are applicable to existing, "old and cold" foreign-parented groups.

Section 304 generally provides that certain acquisitions of stock between related corporations will be recharacterized as stock redemptions, with the amount of any dividend resulting from such deemed redemption determined first with respect to the acquiring corporation's earnings and profits, and second with respect to the issuing corporation's earnings and profits. If the acquiring corporation is foreign, however, Section 304(b)(5)(B) provides that no earnings and profits of the acquiring corporation shall be taken into account if more than 50% of the dividends arising from such deemed acquisition would not be subject to US tax (in that taxable year) or included in the income of a CFC. A foreign shareholder could, therefore, sell its stock in a domestic corporation to a CFC of the domestic corporation in exchange for cash. If more than 50% of the amount of the resulting deemed distribution (determined without regard to Section 304(b)(5)(B)) was sourced from the domestic corporation, Treasury and the IRS were concerned that the taxpayer could take the position that Section 304(b)(5)(B) did not apply (even if an applicable treaty resulted in a reduced rate of withholding or no withholding on the US-source dividend). In such case, the transaction would result in a tax-free distribution of the CFC's earnings and profits, with the result that such earnings and profits would never be subject to US tax.

Consistent with the rule set forth in the 2014 Notice, the Temporary Regulations address this concern by providing that for purposes of Section 304(b)(5)(B), the determination of whether more than 50% of the dividends arising from such acquisition is subject to US tax or included in the income of a CFC is made by taking into account only the earnings and profits of the acquiring corporation (*i.e.*, the CFC). See Figure 9. Treasury declined to respond to a comment seeking clarification that an amount is considered "subject to tax" if it is reportable in the income of a US person, even if it does not result in a current tax liability due to other tax attributes of such US person.

Figure 9: Application of Temporary Regulations Section 1.304-7T



Pre-Regulation Result:

- Since > 50% of the deemed dividend is sourced at DT, Section 304(b)(5)(B) does not apply.
- No amount of the CFC's E&P is subject to US tax.

Results Under New Regulation:

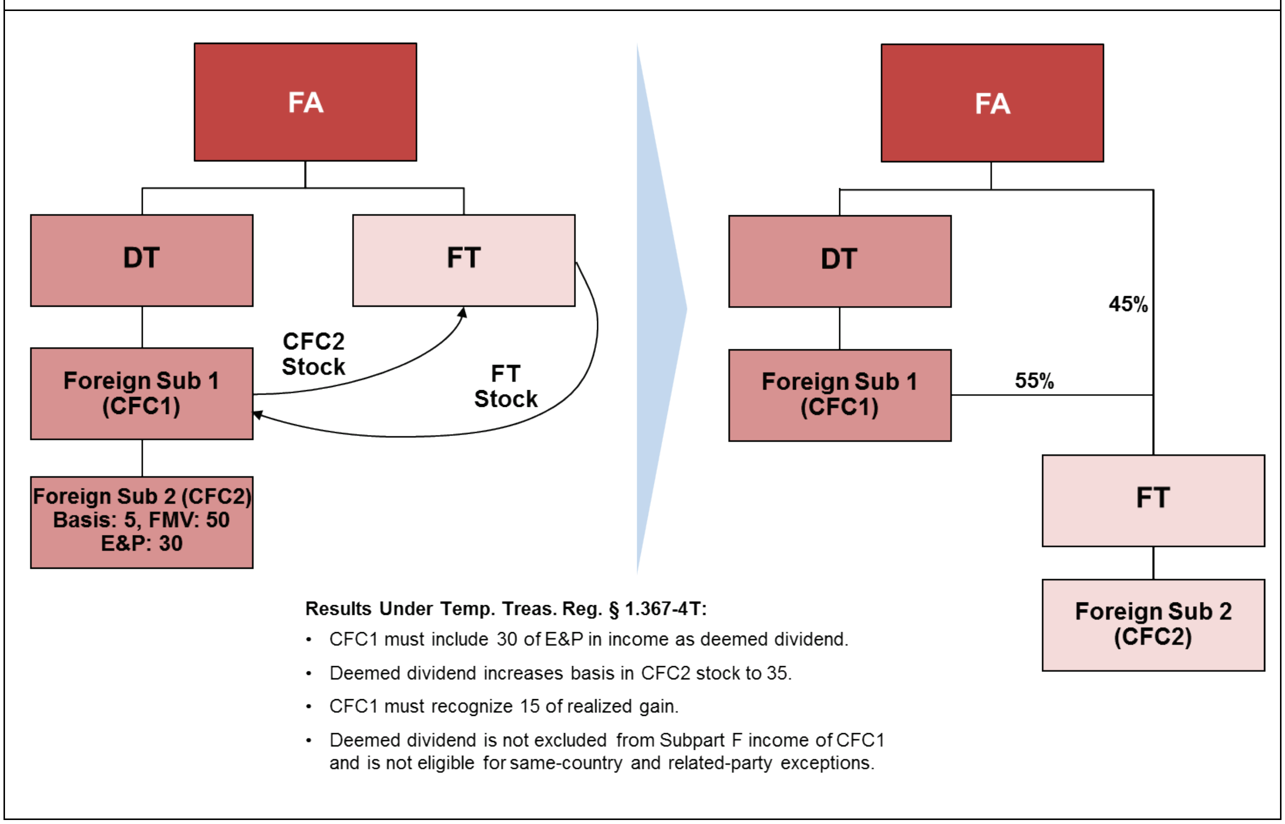
- Taking into account only E&P of the CFC, > 50% of the deemed dividend would not be subject to tax or included in the E&P of a CFC.
- Section 304(b)(5)(B) applies and the distribution is treated as a dividend to the extent of E&P of DT.

Limitation on Stock and Asset Dilution

The Temporary Regulations generally implement the Notices' rules targeting the dilution of Expatriated Foreign Subsidiary stock through certain non-recognition transactions in an attempt to avoid US federal income tax on such subsidiary's earnings and profits or asset appreciation. In addition to implementing rules with respect to stock dilution, the Temporary Regulations implement rules with respect to asset dilution under the same general principles.

As a result, an expatriated domestic entity or Expatriated Foreign Subsidiary that transfers stock of an Expatriated Foreign Subsidiary to a foreign corporation in exchange for stock of the foreign corporation in a transaction described in Section 351, or transfers stock or assets of an Expatriated Foreign Subsidiary to a foreign corporation in exchange for stock of the foreign corporation in a reorganization described in Section 368(a)(1), must, subject to certain exceptions, include in income as a deemed dividend the corresponding "section 1248 amount" (generally, that portion of the transferred corporation's earnings and profits that is attributable to the transferor's ownership of such entity) and recognize all realized gain with respect to the transferred stock, after taking into account any increase in stock basis resulting from the deemed dividend. See Figure 10. Any deemed dividend included in income is not excluded from foreign personal holding company income and is not eligible for the same-country and related-party exceptions under Section 954(c)(3)(A)(i) and Section 954(c)(6), respectively. In addition, if an Expatriated Foreign Subsidiary transfers appreciated assets (other than stock of a lower-tier Expatriated Foreign Subsidiary) to a foreign corporation in an exchange described in Section 351, the Expatriated Foreign Subsidiary must recognize all gain with respect to the transferred property. There is no exception in the regulations for a transaction undertaken for bona fide business integration purposes even if the inverted group does not exploit its form to avoid US taxation on an Expatriated Foreign Subsidiary's pre-inversion earnings.

Figure 10: Anti-Stock Dilution Rules in Temporary Regulations Section 1.367(b)-4T



Limitations on De-Controlling Transactions

The Temporary Regulations implement, with some modification, the Notices' rules which recharacterized specified transactions that would have otherwise allowed access to a CFC's earnings without subjecting such earnings to US taxation. The regulations target "de-controlling" transactions where an inverted group may cause an Expatriated Foreign Subsidiary to cease to be a CFC or substantially dilute a Section 958(a) US Shareholder's (*i.e.*, a US shareholder that owns directly and indirectly stock of the Expatriated Foreign Subsidiary and that is an expatriated entity) ownership of a CFC. Subject to limited exceptions, specified transactions are generally transactions in which stock in an Expatriated Foreign Subsidiary is transferred (including by a new issuance of stock) to a Specified Related Person (*i.e.*, a Non-CFC Foreign Related Person, a US partnership with any partner that is a Non-CFC Foreign Related Person or a US trust with any beneficiary that is a Non-CFC Foreign Related Person) during the 10-year period following an inversion.

As with the anti-stock dilution rules described above, there is no exception in the regulations for a de-controlling transaction undertaken for bona fide business integration purposes. However, these rules will not apply to a transaction where pursuant to Temporary Regulations Section 1.367(b)-4T, the transferor recognized in full its section 1248 amount and any remaining gain on the transfer.

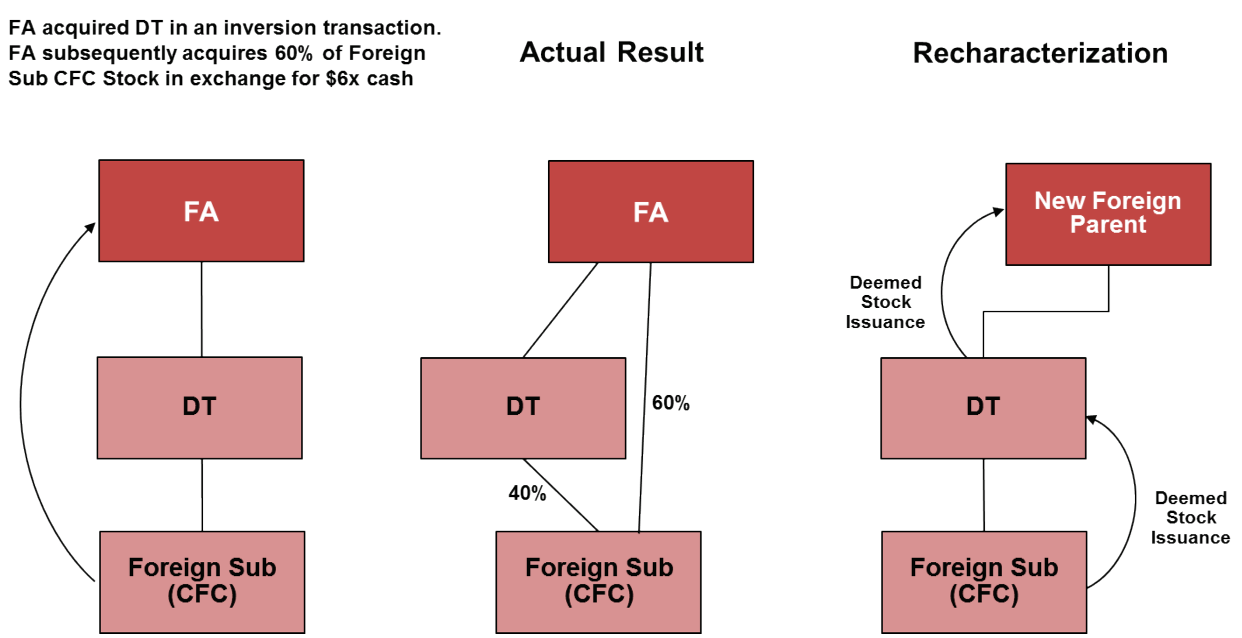
If a post-inversion transaction is a specified transaction, then the transaction will be recharacterized, for all purposes of the Code, as:

- in the case of an issuance by the Expatriated Foreign Subsidiary to a Specified Related Person for property, (1) the transfer of the property by the Specified Related Person to the 958(a) US Shareholder(s) in exchange for a deemed issuance of stock **and** (2) the contribution of the property by the 958(a) US Shareholder(s) to the Expatriated Foreign Subsidiary (through intermediate entities, if appropriate) in exchange for a deemed issuance of stock (see Figure 11), **and**

- in the case of a transfer of stock by shareholders of the Expatriated Foreign Subsidiary to a Specified Related Person, (1) a deemed issuance of stock by the 958(a) US Shareholder(s) in exchange for property transferred by the Specified Related Person **and** (2) if the 958(a) US Shareholder(s) are not the transferring shareholders, a contribution of the property by such 958(a) US Shareholder(s) to the transferring shareholders.

Unlike the rules proposed in the Notices, in certain circumstances (such as when an Expatriated Foreign Subsidiary ceases to be a Foreign Related Person), the recharacterization will be unwound.

Figure 11: Section 7701(l) Regulations



If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Michael J. Brody
michael.brody@lw.com
+1.213.891.8724
Los Angeles

Nicholas J. DeNovio
nicholas.denovio@lw.com
+1.202.637.1034
Washington, D.C.

Diana S. Doyle
diana.doyle@lw.com
+1.312.876.7679
Chicago

Jiyeon Lee-Lim
jiyeon.lee-lim@lw.com
+1.212.906.1298
New York

Jocelyn F. Noll
jocelyn.noll@lw.com
+1.212.906.1616
New York

Laurence J. Stein
larry.stein@lw.com
+1.213.891.8322
Los Angeles

Kirt Switzer
kirt.switzer@lw.com
+1.415.395.8885
San Francisco

Lisa G. Watts
lisa.watts@lw.com
+1.212.906.1200
New York

Katherine M. Baldwin*
katherine.baldwin@lw.com
+1.212.906.1206
New York

E. Rene de Vera
rene.devera@lw.com
+1.312.876.7610
Chicago

Sean M. FitzGerald
sean.fitzgerald@lw.com
+1.202.637.2226
Washington, D.C.

Jared W. Grimley
jared.grimley@lw.com
+1.713.546.7403
Houston

Shruti Hazra
shruti.hazra@lw.com
+1.212.906.4641
New York

Alan R. Kimball†
alan.kimball@lw.com
+1.212.906.1683
New York

Nicolle Nonken Gibbs
nicolle.gibbs@lw.com
+1.202.637.1031
Washington, D.C.

Thomas H. Halpern
Knowledge Management Lawyer
thomas.halpern@lw.com
+1.213.891.8684
Los Angeles

*Admitted to practice in California only
†Admitted to practice in Massachusetts only

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Endnotes

[1] All references to "Section" refer to sections of the Internal Revenue Code of 1986, as amended (the Code), unless otherwise indicated. All references to "§" refer to sections of the Treasury Regulations or Temporary Treasury Regulations promulgated under the Code, as the case may be.

[2] For further discussion, please refer to: Latham & Watkins *Client Alert* No. 1955 (Apr. 21, 2016), Treasury Targets Related-Party Debt with Proposed Regulations to Treat Debt as Equity ***available at*** http://www.lw.com/thoughtleadership/treasury-proposed-regulations-debt-equity.

[3] 2014-2 C.B. 712.

[4] 2015-49 I.R.B. 775.

[5] Notice 2014-52, 2014-2 C.B. 712; Temp. Treas. Reg. § 1.7874-4T (2014).

[6] 2009-2 C.B. 452.