SUTHERLAND

LEGAL ALERT

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The House Always Wins: Treasury and the IRS Offer a Loaded Deck of Regulations Addressing Global Reshufflings

On June 7, 2012, Treasury and the Internal Revenue Service (the IRS) issued much-anticipated final, temporary, and proposed regulations under section 7874, which provides rules governing so-called “inversion transactions.” In an effort to provide certainty with respect to the determination of “substantial business activities” in a foreign country for purposes of the statutory exception of section 7874(a)(2)(B)(iii), the temporary and proposed regulations have effectively nullified that exception to the application of the inversion rules. In this regard, the new regulations adopt a bright-line rule for purposes of the substantial business activities determination that few multinational companies could be expected to satisfy. Moreover, the final regulations have made several changes with respect to the rules concerning the treatment of options and “downstream transactions” for purposes of the ownership and acquisition tests of the statute.

Background

Section 7874 provides rules for two types of inversion transactions. First, if a foreign corporation acquires substantially all of the properties held by a domestic corporation, and the shareholders of the domestic corporation receive at least 80% of the vote or value of the stock of the acquiring foreign corporation, the acquiring foreign corporation generally will be treated as a domestic corporation for federal tax purposes. Second, if the shareholders of the domestic corporation receive at least 60%, but less than 80%, of the vote or value of the acquiring foreign corporation’s stock, then, among other consequences, the use of the acquired domestic corporation’s tax attributes (if any) generally will be limited for a 10-year period.

Section 7874(a)(2)(B)(iii) provides an important exception to the foregoing rules. Specifically, an inversion will not be deemed to have occurred where the “expanded affiliated group” that includes the acquiring foreign corporation has substantial business activities in the foreign country in which, or under the laws of which, the acquiring foreign corporation is created or organized, when compared to the total business activities of such expanded affiliated group. For purposes of this rule, an expanded affiliated group (an EAG) can include both foreign corporations and domestic corporations so long as ownership of more than 50% of the vote and value in respect of the stock of the relevant corporation (except the common parent of the EAG) is owned by one or more members of the EAG.

The final regulations, along with the temporary and proposed regulations (the 2012 Temporary Regulations), were issued just before the scheduled sunset of temporary regulations issued in 2009 (the 2009 Temporary Regulations). The 2009 Temporary Regulations generally applied to acquisitions completed on or after June 9, 2009, and replaced earlier temporary regulations issued in 2006 (the 2006 Temporary Regulations).

Under the 2006 and 2009 Temporary Regulations, the determination of whether an EAG had substantial business activities in a foreign country was based on all the facts and circumstances. The 2006 Temporary Regulations also provided a safe harbor, however, under which the EAG generally was deemed to have substantial business activities in a foreign country if at least 10% of its employees, assets, and sales were in the foreign country (the Former Safe Harbor). The 2009 Temporary Regulations removed the Former Safe Harbor and all of the examples illustrating the application of the

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facts and circumstances test. Commentators to the 2009 Temporary Regulations had called for a return of safe harbor provisions or a test that permitted more certainty in the determination.

Overview of the 2012 Temporary Regulations

In response to criticism of the 2009 Temporary Regulations, the 2012 Temporary Regulations replace the facts and circumstances test of the 2009 Temporary Regulations in its entirety with a bright-line rule. Specifically, an EAG will be considered to have substantial business activities in a foreign country only if at least 25% of its employees, assets, and gross income are based in that country. In order for these tests to be satisfied, the following facts must be established:

1. The number of employees of members of the EAG (group employees) based in the foreign country must be at least 25% of the total number of group employees as of the applicable date, and the employee compensation incurred with respect to the group employees based in the relevant foreign country must be at least 25% of the total employee compensation incurred with respect to all group employees during the testing period;

2. At least 25% of the EAG's tangible personal property and real property used or held for use in the active conduct of a trade or business by members of the EAG must be located in the foreign country on the applicable date; and

3. At least 25% of the gross income of the members of the EAG for the testing period must be derived from transactions occurring in the ordinary course of business with customers located in the foreign country that are not related persons.

The 2012 Temporary Regulations also provide that certain items will be excluded from the numerator, but will be included in the denominator, of these tests. For example, any items located or derived in the relevant foreign country that are part of a plan with a principal purpose of avoiding the purposes of section 7874 will be excluded from the numerator of these tests.

Commentators had criticized the absence of a bright-line rule or safe harbor in the 2009 Temporary Regulations. However, the bright-line rule included in the 2012 Temporary Regulations hardly addresses these concerns and is substantially more onerous than the Former Safe Harbor. In this regard, the 25% threshold makes it highly unlikely that any multinational company will be able to satisfy the substantial business activities test under the 2012 Temporary Regulations. Stated differently, these regulations effectively eliminate the substantial business activities exception in the interest of providing greater "certainty" and "administrability."

The 2012 Temporary Regulations generally apply to acquisitions occurring on or after June 7, 2012. The 2012 Temporary Regulations also have a limited transition rule for transactions subject to Securities and Exchange Commission filings or binding written agreements as of June 7, 2012.

Overview of the Final Regulations

The final regulations largely follow the 2009 Temporary Regulations with respect to the rules for applying the ownership and acquisition tests of the statute. However, the final regulations have made several changes to the rules concerning the treatment of options and "downstream transactions" for purposes of those tests.

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As noted above, the ownership thresholds of the statute can be satisfied through the acquisition of the requisite amount of stock in terms of either vote or value. The final regulations have clarified that, for purposes of testing ownership by value, options generally count as stock to the extent that they are in the money. However, for purposes of testing ownership by vote, the final regulations treat an option as exercised only if a principal purpose for issuing or acquiring the option is to avoid the foreign corporation's being treated as a surrogate foreign corporation. For purposes of the foregoing rules, an option includes an interest similar to an option.

With respect to downstream transactions, *i.e.*, the acquisition by a corporation of its own stock from a corporation or a partnership (for example, in a downstream reorganization), the final regulations purport to clarify that such an acquisition counts as an acquisition of property for purposes of the statute, regardless of the fact that the acquired stock no longer exists for federal tax purposes after the acquisition. Thus, for example, if a domestic corporation that holds stock in a foreign corporation merges with and into the foreign corporation, with the foreign corporation surviving, the foreign corporation generally will be treated as acquiring properties of the domestic corporation in the form of the foreign corporation's stock for purposes of the statute.

The final regulations apply to acquisitions completed on or after June 7, 2012.

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