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IRS Announces Additional Revisions to "Anti-Inversion" Regulations Under Code Section 7874

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On September 17, 2009, the Internal Revenue Service ("IRS") issued Notice 2009-78 ("Notice") announcing its intention to issue additional regulations under the "anti-inversion" rules of Section 7874 of the Internal Revenue Code of 1986, as amended ("Code"). The most recent previous guidance by the IRS under Code Section 7874 was final and temporary regulations issued in June, 2009.[1] The additional new regulations will incorporate the rules described in the Notice that will identify certain stock of a foreign corporation that is disregarded for determining ownership of the foreign corporation in applying the anti-inversion rules.

Related Practices:

- Federal Tax
- Tax

Background

Generally, Code Section 7874 targets certain inversion transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership) to an offshore jurisdiction. Under current law, a foreign corporation is generally treated as a "surrogate foreign corporation" for this purpose if, pursuant to a plan (or a series of related transactions), the following three conditions are satisfied:

(1) the foreign corporation directly or indirectly acquires substantially all of the properties of a domestic corporation;

(2) after the acquisition, at least 60% of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation; and

(3) after the acquisition, the expanded affiliated group ("EAG") (as defined in Code Section 7874(c)(1)) that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the laws of which, the foreign corporation is created or organized, when compared to the total business activities of the EAG.

Similar provisions apply to transactions involving the acquisition by a foreign corporation of substantially all of the properties constituting a trade or business of a domestic partnership.

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The U.S. tax consequences of surrogate foreign corporation status depend upon the degree of ownership of the surrogate foreign corporation by former shareholders of the domestic corporation. If the former shareholders own at least 60% but less than 80%, the inversion transaction is respected, but certain additional U.S. tax burdens are imposed on the acquired domestic corporation and its affiliates with respect to the inversion transaction itself, certain related restructuring steps and transactions during the 10 year period following the inversion. For example, the acquired corporation's gain on the inversion transaction cannot be offset by net operating losses or other otherwise available tax attributes. If the other elements for treatment as a surrogate foreign corporation are present, but former shareholders own at least 80%, then the foreign corporation is no longer treated as a surrogate foreign corporation. Rather, the inversion transaction is effectively disregarded by treating the foreign corporation as a domestic corporation for all purposes of the Code, resulting in U.S. taxation of its worldwide income.

In determining the stock ownership thresholds of 60% and 80%, stock held by members of the EAG that includes the foreign corporation or stock of such foreign corporation that is "sold in a public offering" related to the inversion transaction is not taken into account.

Notice

Identified Transactions

In the Notice, the IRS has identified certain transactions that are intended to avoid the application of Code Section 7874. The Notice describes, as an example, a transaction in which the shareholders of a domestic corporation transfer all their stock to a newly-formed foreign corporation in exchange for 79% of its stock. In a related transaction, an investor transfers cash to the newly-formed foreign corporation in exchange for the remaining 21% of its stock. The parties to the transaction take the position that the stock issued to the investor is not sold in a public offering and that the transaction was not part of a plan a principal purpose of which is to avoid the application of Code Section 7874. As a result, the parties take the position that the former shareholders of the domestic corporation own 79% of the newly-formed foreign corporation in determining the above described ownership thresholds, thereby avoiding treatment of the foreign corporation as a domestic corporation.

On the other hand, the Notice also identifies certain transactions that may appropriately be excluded from the application of Code Section 7874. In that regard, the Notice describes a transaction in which the shareholders of a publicly-traded domestic corporation and the shareholders of a publicly-traded foreign corporation transfer their stock to a newly-formed publicly-traded foreign corporation. If the stock issued to the shareholders of the foreign corporation is considered to be sold in a public offering, the former shareholders of the domestic corporation would be considered to own 100% of the newly-formed foreign corporation, thereby subjecting such foreign corporation to Code Section 7874. The IRS indicates that subjecting such a transaction to Code Section 7874 may be inappropriate in certain cases.

New Regulations

To address the above described transactions, and similar transactions, the new regulations will provide that stock of the foreign corporation issued in exchange for "nonqualified property" in a transaction related to the inversion transaction is not taken into account in determining the stock ownership thresholds of 60% and 80% (thus increasing the ownership by former shareholders of the domestic corporation for purposes of applying Code Section 7874). Subject to certain exceptions, "nonqualified property" generally means: (i) cash or cash equivalents, (ii) marketable securities as defined in Code Section 453(f)(2), and (iii) any other property acquired in a transaction with a principal purpose of avoiding the purposes of Code Section 7874. To address transactions not appropriately subject to Code Section 7874, the new regulations will provide that marketable securities for these purposes generally do not include stock issued by a member of the EAG that after the acquisition includes the foreign corporation, unless a principal purpose of the issuance of the stock of the foreign corporation was the avoidance of Code Section 7874. In addition, the new regulations will also clarify that certain stock "sold in a public offering" will be taken into account in determining the stock ownership thresholds.

Effective Date

The new regulations will apply to acquisitions completed on or after September 17, 2009.

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Footnotes

[1] Please see our previous legal update at http://www.mofo.com/news/updates/files/15679.html.

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