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New IRS Notice Continues Attack on Inversions

There is no love lost between the U.S. Treasury and U.S. companies seeking offshore tax homes. Absent congressional action to stem the inversion tide, the Treasury and IRS are left to flex their regulatory and administrative authority. In November, the Treasury and IRS issued Notice 2015-79, the second notice in as many years pronouncing new anti-inversion measures. The recent notice describes guidance alluded to in last year's Notice 2014-52—namely, rules that further attack Section 7874 avoidance transactions and reduce the benefits of certain post-inversion transactions.

Background

Added to the Code in 2004 to combat tax-motivated inversions, Section 7874 applies if (1) a foreign corporation 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 foreign corporation after the acquisition by reason of holding stock of or partnership interests in the U.S. entity; and (3) the foreign acquiring corporation's (FAC) 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 any "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 U.S. tax purposes.

Even since Section 7874's enactment, a number of U.S. companies, including some high-profile names, have inverted. The IRS and Treasury, meanwhile, have worked to promulgate regulations and guidance to enhance the statute's reach. Regulations finalized and made effective as of June 3, 2015, adopted, for example, a (highly criticized) bright-line 25 percent test for determining whether an EAG has substantial business activities. In Notice 2014-52, the Treasury and IRS announced rules making it more likely that inversions would be subject to Section 7874 and restricting the ability of FACs to access the earnings of controlled foreign corporations (CFCs) of the inverted U.S. corporation. Notice 2014-52 also promised future guidance to thwart Section 7874-avoidance transactions and limit post-inversion transaction benefits.

Rules on Section 7874 Avoidance

The recent notice delivers some of the guidance promised in last year's notice. To deal with Section 7874-avoidance transactions, Notice 2015-79 announces rules that (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 rules described in the 2014 notice). These rules are generally effective for acquisitions on or after November 18, 2015.

The first rule reflects the Treasury and IRS's belief that the policy underlying the substantial business activities exception in the relevant foreign country is premised on the FAC's being subject to tax as a resident in the relevant foreign country. Allowing the substantial business activities exception to apply when the FAC is not a tax resident of the relevant jurisdiction means that an EAG can relocate its tax residence anywhere, without regard to the location of the group's substantial business activities—a result the notice calls contrary to the policy behind the exception. Thus, the FAC's tax residence will be a condition of having substantial business activities in the relevant foreign country.

The second rule is based on the Treasury and IRS's skepticism of the existence of non-tax motive for transactions in which a U.S. entity combines with an existing foreign corporation (FT) under an FAC that is tax resident in a "third country" (i.e., not FT's tax residence country). The FT shareholders receive more than 20 percent of the stock of the FAC, thus avoiding the 80 percent threshold of Section 7874 to treat the FAC as a domestic corporation for U.S. tax purposes. Under the notice, FAC stock issued to FT shareholders in such transactions would be disregarded—excluded from the numerator and denominator of the ownership fraction—for purposes of the ownership test if four conditions are met.

First, there is a "foreign target acquisition," a transaction related to the acquisition of the U.S. entity in which the FAC acquires directly or indirectly substantially all the property of another foreign corporation (i.e., FT). Second, the gross value of all property acquired by the FAC in the foreign target acquisition exceeds 60 percent of the gross value of all foreign group property (defined in Notice 2014-52), excluding foreign group nonqualified property (also defined in Notice 2014-52, but with a correction in the recent notice). Third, the tax residence of the FAC is not the same as FT, as determined before the foreign target acquisition or any related transaction. For purposes of the third condition, a change in the location of FT's management and control is treated as a transaction. Fourth, the ownership percentage, without applying the notice's rule to disregard FAC stock issued to FT shareholders, is at least 60 percent but less than 80 percent.

The third anti-avoidance rule clarifies the definition of "nonqualified property" for purposes of the rules that disregard certain FAC stock transferred in exchange for such property (the "anti-stuffing" rules). Under existing temporary regulations, "nonqualified property" means (1) cash or cash equivalents; (2) marketable securities; (3) certain obligations (e.g., obligations owed by EAG members); or (4) any property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of Section 7874. The notice expresses concern that taxpayers are narrowly interpreting the fourth category of nonqualified property (so-called "avoidance property"). New regulations will "clarify" that avoidance property means any property acquired with a principal purpose to avoid the purposes of Section 7874, whether or not the transaction involves an indirect transfer of specified nonqualified property.

Rules on Post-Inversion Avoidance

Notice 2015-79 also provides rules to limit post-inversion tax benefits by (1) expanding the definition of inversion gain to include income recognized by the inverted U.S. entity from an indirect transfer or license of property and providing for aggregate treatment of certain transfers or licenses by foreign partnerships in determining inversion gain; and (2) requiring an exchanging shareholder to recognize all gain realized on an exchange of CFC stock, regardless of the CFC's undistributed earnings and profits, if the transaction terminates a foreign subsidiary's CFC status or dilutes a U.S. shareholder's interest in the CFC. These rules are effective for post-inversion transactions on or after November 18, 2015, but only if the inversion transaction is completed after September 21, 2014 (relating back to the effective date of Notice 2014-52).

Section 7874(a)(1) requires the taxable income of an "expatriated entity" (defined in Section 7874(a)(2)(A)) for any taxable year that includes any portion of the "applicable period" (defined in Section 7874(d)(1)) to be no less than the "inversion gain" for the year. If the expatriated entity is a partnership, Section 7874(a)(1) applies at the partner level. Inversion gain means income or gain recognized by reason of the transfer or license during the applicable period of stock or other property by an expatriated entity as part of the acquisition of the U.S. entity or after the acquisition if the transfer or license is to a foreign related person. Section 7874(e)(1) generally prevents the use of certain tax attributes to offset tax on inversion gain.

The Treasury and IRS are worried that certain indirect transfers of stock or other property can have the effect of removing foreign operations from U.S. taxing jurisdiction while avoiding the Section 7874 toll charge. For example, a CFC of an expatriated entity could transfer or license property (including stock of a lower-tier CFC) to a specified related person (defined in Notice 2014-52), throwing off Subpart F income that requires a Section 951(a) inclusion by the expatriated entity. Under current law, that inclusion is not inversion gain and, therefore, could be offset with tax attributes. Deeming such results inconsistent with the purposes of Section 7874, the Treasury and IRS will issue regulations defining inversion gain to include income or gain recognized by an expatriated entity from the indirect transfer or license of property (e.g., Section 951(a) inclusions) during the applicable period. Regulations would also treat the partners of a partnership that is a foreign related person as transferring or licensing its proportionate share of the transferred or licensed property, for purposes of determining inversion gain.

The notice's second rule to limit post-inversion tax benefits implicates regulatory authority under Section 367(b). Section 367(b) provides that, in the case of certain nonrecognition transactions that do not involve an outbound transfer by a U.S. person, a foreign corporation will be treated as a corporation except as provided in regulations. Current regulations (without regard to Notice 2014-52) generally require a shareholder that exchanges stock of a foreign corporation in a Section 367(b) exchange to include as a deemed dividend the "Section 1248 amount" (defined in regulations Section 1.367(b)-2(c)(1)) if the exchange results in the loss of CFC status or the loss of Section 1248 shareholder status.

Notice 2014-52 announced amendments to the Section 367(b) regulations that would require an income inclusion for certain nonrecognition transactions that occur after an inversion and that dilute the interest of a "U.S. shareholder" in a CFC (as defined in Section 951(b)). Subject to a de minimis rule, the 2014 notice provides that an exchanging shareholder must include the Section 1248 amount with respect to stock of an expatriated foreign subsidiary exchanged in a specified exchange during the applicable period, regardless of whether any condition of regulations Section 1.367(b)-4(b)(1)(i)(B) is met. ("Expatriated foreign subsidiary" and "specified exchange" are defined in Notice 2014-52.)

Notice 2015-79 says that the Treasury and IRS are bothered that certain nonrecognition transactions that dilute a U.S. shareholder's ownership of an expatriated foreign subsidiary could allow the shareholder to avoid U.S. tax on unrealized appreciation in property held by the subsidiary at the time of the exchange. This result could occur when the realized gain from the exchange of the stock of the expatriated foreign subsidiary in a specified exchange exceeds the earnings and profits attributable to the stock for Section 1248 purposes. The Treasury and IRS have determined that net unrealized built-in gain in property of an expatriated foreign subsidiary at the time of exchange poses the same policy concern as earnings and profits of the subsidiary that exist at that time. The Section 367(b) regulations would be amended to provide that an exchanging shareholder that Notice 2014-52 would require to include the Section 1248 amount as a deemed dividend must also recognize all gain realized with respect to the stock exchanged, after taking into account the basis increase from the deemed dividend (as provided in the regulations).

Other Guidance

In addition to the new guidance addressing avoidance transactions and post-inversion benefits, Notice 2015-79 describes various corrections and clarifications to rules in Notice 2014-52 and existing regulations. Among the corrections, Notice 2015-79 provides that assets used in an active insurance business are not treated as passive for purposes of the "cash box" rule that disregards FAC stock attributable to existing passive assets. The notice also announces a de minimis exception to the "anti-slimming" rule in Notice 2014-52, which ignores certain pre-inversion extraordinary dividends by the U.S. entity. The new exception would apply if (1) the ownership percentage is less than 5 percent (by vote and value), without regard to the application of regulations Section 1.7874-4T(b) and the rules in Sections 2.01(b) and 2.02(b) of the 2014 notice; and (2) after the acquisition and all related transactions, former shareholders or partners of the U.S. entity, in the aggregate, own less than 5 percent of any EAG member that includes the FAC.

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