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Corporate Inversion Transactions

IRS and Treasury Issue Final and Temporary Regulations Modifying Disqualified Stock Rules Under Section 7874

SUMMARY

On January 13, 2017, the Internal Revenue Service (the "IRS") and the Treasury Department (the "Treasury") published new final and temporary regulations (the "New Regulations") and issued a notice of proposed rulemaking by cross-reference to the temporary regulations that address inversion transactions. The New Regulations generally finalize the previous temporary and proposed regulations while making a few technical changes. Most notably, the New Regulations:

- expand the application of the "associated obligations" rule and exclude intercompany obligations from "nonqualified property" that gives rise to disqualified stock,
- retain the distinction between stock and asset reorganizations,
- leave undisturbed pre-IPO buyout transactions and
- modify certain *de minimis* exceptions.

BACKGROUND

Section 7874[1] generally targets "inversion" or "expatriation" transactions in which a foreign corporation or publicly traded foreign partnership (in each case, a "foreign acquiror") acquires substantially all of the assets of a U.S. corporation or partnership (in each case, a "domestic target")—including by way of acquiring the ownership interests in such corporation or partnership—unless the foreign acquiror has "substantial business activities" in the jurisdiction of its organization.[2] Whether Section 7874 applies to a transaction therefore depends on the percentage of the combined entity that is held by the target's stockholders (the "Ownership Fraction").

If at least 80 percent (by vote or value) of the foreign acquiror is held by the former shareholders or partners of the expatriated entity "by reason of holding" stock or a capital or profits interest[3] in the domestic target (the "Target Stockholders") and the "substantial business activities" test is not satisfied, the foreign acquiror is treated as a domestic corporation for U.S. tax purposes.[4]

If at least 60 percent (by vote or value), but less than 80 percent, is held by the Target Stockholders and the "substantial business activities" test is not satisfied, the foreign acquiror generally is respected as foreign, but is subject to various tax disadvantages, including U.S. tax on any "inversion gain" recognized in the ten years following the transaction.[5]

In January 2014, the IRS and Treasury issued temporary and proposed regulations under Section 7874 (the "2014 Regulations"), subsequently modified by temporary and proposed regulations issued in April 2016 (the "2016 Regulations" and together with the 2014 Regulations, the "Prior Regulations").

THE NEW REGULATIONS

The New Regulations generally adopt the Prior Regulations, but incorporate a number of modifications in response to public comments received in response to the 2014 Regulations.

A. MODIFICATIONS TO ASSOCIATED OBLIGATIONS RULE AND EXCHANGES THAT GIVE RISE TO "DISQUALIFIED STOCK"

Among other special rules, the Prior Regulations generally disregard certain "disqualified stock" of the foreign acquiror when calculating the Ownership Fraction. Such stock is excluded from the denominator of the Ownership Fraction, thereby increasing the amount of stock deemed held by the Target Stockholders by reason of holding their interests in the domestic target.[6] The Prior Regulations generally define "disqualified stock" as stock issued for cash, certain marketable securities, obligations of the foreign acquiror, property transferred with a principal purpose of avoiding Section 7874, as well as stock transferred in exchange for property where, in a related transaction, the transferred stock is used to satisfy an obligation associated with the transferred property (the "Associated Obligations Rule"). For this purpose, stock is disqualified stock only to the extent that the "transfer" of the stock increases the fair market value of the assets of the foreign acquiror or decreases the amount of its liabilities.

The New Regulations expand the Associated Obligations Rule to include *indirect* use of stock of the foreign acquiror to satisfy the transferee's associated obligations, as part of the same plan or series of transactions that includes the original transfer of the foreign acquiror's stock.[7] Thus, for example, if an entity receives stock of a foreign acquiror in exchange for the entity's assets, and the entity subsequently (and as part of the same plan or series of transactions) sells the stock for cash to repay an obligation associated with the exchanged assets, the portion of the stock sold to fund the repayment of the obligation is treated as disqualified stock.

Additionally, the Associated Obligations Rule was broadened to include satisfaction of an *unrelated* obligation of the transferee to the extent of any associated obligation that was not assumed by the foreign acquiror. However, the New Regulations limit the amount of stock of the foreign acquiror disqualified under the Associated Obligations Rule to the "proportionate share" of associated obligations that are not assumed by the foreign acquiror.[8] Thus, to the extent that a transferee has obligations, some of which are associated with the exchanged property and some of which are not, the Associated Obligations Rule cannot be avoided by electing to use the foreign acquiror stock to satisfy the non-associated obligations. In a similar, but distinguishable structure, the preamble to the New Regulations ("Preamble") notes that the use by a transferee of transferred stock to satisfy unrelated obligations (when there are no associated obligations) raises concerns, but declines to address such transactions by regulations at this time in favor of continued monitoring.[9]

Under the Prior Regulations, nonqualified property included an obligation owed by a member of the "expanded affiliated group" (or "EAG")[10] that includes the foreign acquiror and certain related persons.[11] The New Regulations adopt a comment that the definition of "nonqualified property" should generally exclude intercompany obligations from its scope (*i.e.*, an obligation owed by a member of the EAG if the holder of the obligation before the domestic target acquisition (and any related transactions), or the holder's successor, remains a member of the EAG after such transactions).[12] This change could significantly simplify complexities in, for example, transactions involving cross-border European mergers (whose corporate-law mechanics often result in their being treated as an "asset reorganization" from a U.S. tax perspective).

The Prior Regulations also treated an obligation owed by an equity holder of the domestic target as "nonqualified property". The New Regulations provide that such treatment only applies to persons directly or indirectly holding at least 5% (by vote or value) of the equity interests (a "5% Holder") of the domestic target.[13] The Preamble notes, however, that statutory anti-abuse rules may continue to apply to obligations owed by sub-5% holders.

B. CONTINUED DISTINCTION BETWEEN STOCK AND ASSET ACQUISITIONS

As noted in the preamble to the 2014 Regulations, stock and asset acquisitions could result in different tax treatment depending on, for example, the type of assets that the foreign acquiror receives in exchange for its stock. For example, if the foreign acquiror receives stock of another foreign corporation in exchange for its stock rather than assets of the other foreign corporation—which likely would include some cash and other nonqualified property—there would be less disqualified stock than if the transaction was structured as an asset sale. A number of comments requested more consistent treatment between stock and asset acquisitions. For example, one comment suggested that when the foreign acquiror acquires "substantially all" of the properties of a foreign target, the foreign acquiror and foreign target be treated as a single combined unit for purposes of the disqualified stock rule—so as to be treated similarly to stock acquisitions. While again acknowledging the discrepancy, the IRS and Treasury declined to adopt such a rule, taking a view that such a rule would present opportunities to "inappropriately dilute" the Ownership Fraction. Rather, the Preamble asserts that the "preferable approach" would instead be to treat stock acquisitions more like asset acquisitions by looking through stock to underlying assets (which may include nonqualified property). Ultimately, however, the New Regulations did not adopt such an approach "out of concerns of undue complexity and administrative burden."

C. CONTINUED STUDY OF PRE-IPO BUYOUT TRANSACTIONS

The New Regulations do not make changes with respect to "pre-IPO buyouts" as described in the preamble to the 2014 Regulations. That preamble described an example where a private buyer creates a newly formed foreign entity to purchase all of the stock of a publicly traded domestic target for cash and a small amount of the foreign acquiror's stock (issued to management of the domestic target), and after a period of time, the buyer sells its foreign acquiror stock pursuant to a public offering, which may have been the buyer's originally intended exit strategy. The Preamble states that the IRS and Treasury declined at this time to provide special rules to address such transactions, but notes that existing anti-abuse rules in Section 7874 and existing judicial doctrines may apply to address the concerns raised by these transactions.[14]

D. MODIFICATIONS TO *DE MINIMIS* EXCEPTIONS

Under the Prior Regulations, the exclusion of disqualified stock from the denominator of the Ownership Fraction did not apply when (1) the Ownership Fraction is less than 5% by both vote and value before taking into account the exclusion of disqualified stock (*i.e.*, less than 5% of foreign acquiring stock is stock issued in the domestic target acquisition to Target Stockholders) and (2) after the domestic target acquisition and all related transactions, the Target Stockholders *in the aggregate* own less than 5% by both vote and value of the equity of each member of the EAG that includes the foreign acquiror, including any stock held by related persons attributed to the Target Stockholders and any stock held by Target Stockholders independently of the transactions.[15] The Preamble states that comments suggested changes to this requirement in light of the difficulty of determining stock held by attribution on an aggregate basis, notwithstanding that the domestic target acquisition may otherwise resemble a purchase. Accordingly, the New Regulations allow the second prong to be satisfied as long as *each* Target Stockholder (applying the attribution rules of Section 318(a)) holds less than 5% by vote or value of each EAG member.[16] However, the first prong, which applies with respect to foreign acquiror stock issued to Target Stockholders on an aggregate basis, remains unchanged.

The New Regulations make similar changes to other *de minimis* exceptions under the Section 7874 regulations, namely (1) the *de minimis* exception to the exclusion from the Ownership Fraction of stock attributable to nonqualified property of so-called "cash box" foreign groups (*i.e.*, groups with more than 50% of gross assets constituting nonqualified property)[17] and (2) the *de minimis* exception to the add-back for non-ordinary course distributions made by the domestic target (so-called "skinny-down" distributions).[18]

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ENDNOTES

1 All "Section" references herein are to Sections of the Internal Revenue Code of 1986, as amended, unless otherwise indicated.

2 Section 7874(a)(2)(B).

3 *See* Section 7874(a)(2)(B)(ii), (b).

4 Section 7874(b).

5 "Inversion gain" is any income or gain recognized by reason of the inversion transaction (which includes gain recognized on the transfer or sale of assets after the inversion to a related non-U.S. person) and certain gain and licensing income recognized by an expatriated entity during the ten-year period following the inversion. *See* Section 7874(d)(2), (f).

6 For additional background on Section 7874, please see the Sullivan & Cromwell LLP publications entitled "Corporate Inversion Transactions: IRS and Treasury Issue Temporary Regulations Intended to Limit Ability of Corporations to Invert and Reduce the Tax Benefits of Inversion Transactions" (April 14, 2016) and "Corporate Inversion Transactions: IRS and Treasury Issue Temporary Regulations to Determine When Stock Is Disregarded for Purposes of the Internal Revenue Code's Anti-Inversion Rules" (January 22, 2014).

7 Treasury Regulations Section 1.7874-4(c).

8 Treasury Regulations Section 1.7874-4(c)(1)(B). Where the transferee is the domestic entity, the "proportionate share" is the portion of the associated obligation that corresponds to the fair market value of the exchanged property relative to the fair market value of all properties with which the obligations are associated. Where the transferee is not the domestic entity, the amount described above is further multiplied by a fraction, the numerator of which is the amount of qualified exchanged property and the denominator of which is the total amount of exchanged property. For example, assume that the domestic target has property with a fair market value of 70 that has associated obligations of 20. The foreign acquiror transfers stock to the domestic target in exchange for 42 of the target property and 0 of the associated obligation. In a related transaction, the domestic target transfers the foreign acquiror stock to creditors in satisfaction of the associated obligation. The "proportionate share" is 12, calculated as 20 (the total associated obligations) multiplied by 42/70 (the fair market value of the exchanged property relative to the fair market value of all property with which the obligations are associated). *See* Treasury Regulations Section 1.7874-4(j) *Example 10*.

9 The Preamble notes that a transfer of the foreign acquiror's stock in satisfaction of the non-associated obligation could be disregarded under existing statutory anti-avoidance rules if the transfer is part of a plan a principal purpose of which is to avoid the purposes of Section 7874. *See* Section 7874(c).

10 An "expanded affiliated group" is defined under Section 7874(c)(1) as an affiliated group, as defined by Section 1504(a), but by substituting a 50% ownership requirement for the 80% ownership requirement in Section 1504(a) and disregarding the Section 1504(b)(3) prohibition on including non-U.S. corporations in an affiliated group. In general, an "expanded affiliated group" will be a group of corporations that is connected by a chain of at least 50% ownership (as measured by vote and value).

11 Former Treasury Regulations Section 1.7874-4T(i)(7)(iii).

12 Treasury Regulations Section 1.7874-4(i)(2).

13 Treasury Regulations Section 1.7874-4(i)(2). The Prior Regulations also treated an obligation as "nonqualified property" if owed by a person holding equity in, or related (within the meaning of Section 267 or 707(b)) to, an equity holder of the domestic target. The New Regulations apply such treatment only if the obligation is owed by a person who is at least a 5% Holder of, or related to, a 5% Holder of the domestic target. *Id*.

ENDNOTES (CONTINUED)

[14] "[S]ection 7874(c)(4), §1.7874-4(d)(2) (providing that the *de minimis* exception does not apply to disqualified stock that is transferred with a principal purpose of avoiding the purposes of section 7874), and judicial doctrines each may apply to address the concerns raised by these transactions." T.D. 9812 (82 Fed. Reg. 5388).

[15] Former Treasury Regulations Section 1.7874-4T(d)(1)(ii).

[16] Treasury Regulations Section 1.7874-4(d)(1)(ii).

[17] Treasury Regulations Section 1.7874-7(c)(2).

[18] Treasury Regulations Section 1.7874-10(d)(2).

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