June 13, 2012

Corporate Expatriation Transactions

IRS and Treasury Issue Regulations on the "Substantial Business Activities" Exception and Finalize Regulations on Surrogate Foreign Corporations Under Section 7874

SUMMARY

On June 7, 2012, the IRS and the Treasury Department issued temporary and proposed regulations (the "Regulations") that provide for an exclusive bright-line rule to determine when a foreign corporation or publicly traded foreign partnership will be covered by the "substantial business activities" exception to the definition of a "surrogate foreign corporation." If not so covered, the foreign corporation will be subject to U.S. tax on the "inversion gain" recognized in the next ten years, notwithstanding any contrary tax treaty provision. The Regulations are an apparent response to a number of recent transactions in which U.S. corporations, in connection with acquisitions of foreign corporations, expatriated to Ireland or Switzerland.[1] The Regulations generally apply to acquisitions completed on or after June 7, 2012, but grandfather transactions completed after that date which are described in SEC filings or subject to a binding agreement before that date.

In contrast to prior IRS guidance, the Regulations eliminate the possibility of satisfying the exception on the basis of the facts-and-circumstances approach and significantly narrow the circumstances in which the substantial business activity requirement may be met. Under the Regulations, an "expanded affiliated group" will have substantial business activities in a foreign country only if at least 25% of the group's employees (both by head count and compensation), gross tangible assets and gross income are located or derived in the foreign country (compared with a 10% safe harbor, since repealed, contained in the temporary regulations promulgated in 2006).

The Regulations also provide that a partnership's employees, assets and gross income may be taken into account in the substantial business activities test only if one or more members of the group holds, in the aggregate, more than 50% (by value) of the interests in the partnership. If the 50% ownership threshold

is met, then all (and not only a proportionate share) of the items of the partnership may be taken into account for purposes of the test.

On the same date, the IRS finalized regulations on other aspects relating to when a foreign corporation would be treated as a "surrogate foreign corporation" under Section 7874.

BACKGROUND

Section 7874 generally disregards any "inversion" or "expatriation" transactions – and therefore, the expatriated entity is treated as continuing to be domestic – in which a foreign corporation or publicly traded foreign partnership acquires substantially all of the assets of a U.S. corporation or partnership (including by way of acquiring the ownership interests in such corporation or partnership) and 80% by vote or value of the foreign entity is held by the former shareholders or partners of the expatriated entity.[2] If 60% or more by vote or value, but less than 80%, is held by the former shareholders or partners, the transaction is respected, and the expatriated entity is treated as foreign but is subject to U.S. tax on the "inversion gain" recognized in the next ten years, notwithstanding any contrary tax treaty provision.[3] Specifically, in such a case, Section 7874 will apply if, pursuant to a plan or series of related transactions, all of the following conditions are met:

- a foreign corporation or publicly traded foreign partnership completes a direct or indirect acquisition of substantially all of the assets that were directly or indirectly owned by a U.S. corporation or substantially all of the assets constituting a trade or business of a U.S. partnership (the "Substantially All Requirement");
- after the acquisition, 60% or more of the stock or partnership interests, measured by either vote or value, of the acquiring foreign entity is owned by former shareholders (or, in the case of a partnership, partners) of the U.S. entity "by reason of holding" stock or a capital or profits interest in the U.S. entity (the "Ownership Condition"); and
- after the acquisition, the "expanded affiliated group"[4] including the foreign entity "does not have substantial business activities" in the foreign jurisdiction in which (or under the law of which) the foreign entity is created or organized "when compared with the total business activities of the expanded affiliated group."[5]

The requirement in the third bullet means that an exception to Section 7874 applies if an expanded affiliated group has "substantial business activities" in the foreign jurisdiction in which the foreign entity is created or organized. Temporary regulations adopted in 2006[6] (the "2006 Temporary Regulations") required the evaluation of all the facts and circumstances in making that determination, but included a safe harbor that was met if at least 10% of the group's employees (both by headcount and compensation), assets and sales were located or derived in the foreign country.

Temporary regulations reissued in 2009[7] (the "2009 Temporary Regulations") retained the facts-and-circumstances test but removed the safe harbor. In removing the safe harbor, the IRS and the Treasury Department noted that the safe harbor may have applied to "certain transactions that are inconsistent with the purposes of [S]ection 7874."[8]

THE REGULATIONS

The Regulations[9] eliminate the facts-and-circumstances test that was in both the 2006 Temporary Regulations and the 2009 Temporary Regulations. Therefore, the Regulations limit the relevant "business activities" solely to employees, assets and gross income and no other factors will be considered (*e.g.*, location of senior management). Moreover, as compared to the safe harbors in the 2006 Temporary Regulations, the numerical threshold for satisfying the test has been raised from 10% to 25%, with some additional variations on the definitions and mechanics (some of which may be more limiting, and others more liberalizing for the taxpayer).

The preamble to the Regulations notes that adopting a bright-line rule "will provide more certainty in applying section 7874 to particular transactions . . . and will improve the administrability of this provision."

A. THE THRESHOLD OF BUSINESS ACTIVITIES

In determining whether an expanded affiliated group meets the 25% threshold, the Regulations provide mechanical rules relating to the group's employees, assets and gross income in the foreign jurisdiction.

1. Group Employees

The Regulations provide for two tests, both of which must be met with respect to an expanded affiliated group's employees. First, the head count of the group employees based in the foreign jurisdiction must be at least 25% of the total number of all group employees determined on the applicable date. The applicable date is either (i) the date of the acquisition or (ii) the last day of the month immediately preceding the month in which the acquisition is completed. Second, the compensation of group employees based in the foreign jurisdiction must be at least 25% of the compensation of all group employees for the one-year testing period.[10] For purposes of both tests, a group employee is considered to be based in a foreign jurisdiction if the employee spends more time providing services there than in any other single country in a testing period. Unlike the safe harbor in the 2006 Temporary Regulations, the Regulations do not require employees to be employed on a full-time basis in order to be counted for these tests.

2. Group Assets

The group assets test is met if the value of the group assets located in the foreign jurisdiction is at least 25% of the total value of all group assets determined on the applicable date. For this purpose, "group assets" means the gross value (not reduced by liabilities) of tangible personal property or real property held or used by a member of the expanded affiliated group in the active conduct of a trade or business. As with the safe harbor in the 2006 Temporary Regulations, an expanded affiliated group's intangible property is not counted in the group assets test. A group asset is considered to be located in a foreign jurisdiction if the asset was physically located in the foreign jurisdiction at the close of the acquisition date and for more time than in any other single country during the testing period. Tangible personal property or real property that is rented from another person other than a member of the expanded affiliated group and used in the active conduct of a trade or business may also be included in the test by multiplying the net annual rent by a factor of 8. The 2006 Temporary Regulations did not allow for rental property to be counted in the previous safe harbor.

3. Group Income

The group income test is met if the gross income derived in the foreign jurisdiction is at least 25% of the total gross income for the one-year testing period. For purposes of this test, gross income must be income of the members of the expanded affiliated group derived from transactions occurring in the ordinary course of business with customers that are not related persons. Income is sourced to a particular foreign jurisdiction by the location of the customer. Notably, the safe harbor in the 2006 Temporary Regulations used the gross receipts of an expanded affiliated group rather than its gross income. Although not specified in the Regulations, gross income generally takes into account cost of goods sold as a subtraction from gross receipts.

B. ATTRIBUTION FROM A PARTNERSHIP

As compared to the 2009 Temporary Regulations, the current Regulations impose a higher standard as to when a partnership's employees, assets and gross income may be taken into account and attributed to an expanded affiliated group in the substantial business activities test. Under the Regulations, attribution is permitted only if one or more members of the group hold, in the aggregate, more than 50% (by value) of the interests in the partnership. If the 50% ownership threshold is met, then all (and not only a proportionate share) of the items of the partnership may be taken into account for purposes of the test. Under the 2009 Temporary Regulations, a member of an expanded affiliated group need only hold at least a 10% capital and profits interest in a partnership in order to take into account its proportionate share of the partnership's items (such as its employees, assets and sales) in the facts-and-circumstances test.

Finally, the Regulations request public comment as to what extent partners of a partnership should be treated as employees for purposes of the group employee tests.

FINALIZATION OF REGULATIONS REGARDING SURROGATE FOREIGN CORPORATIONS

The IRS also finalized regulations relating to when a foreign corporation would be treated as a "surrogate foreign corporation" under Section 7874.[11] The final regulations adopt the 2009 Temporary Regulations with certain changes. In determining the Ownership Condition, the final regulations made technical changes to the treatment of options in a corporation or partnership. Furthermore, the final regulations clarified that for purposes of the Substantially All Requirement, if a domestic corporation holds stock of a foreign corporation and merges with the foreign corporation, then the foreign corporation is treated as having acquired all of the domestic corporation's property.

The final regulations apply to acquisitions completed on or after June 7, 2012. In contrast to the Regulations on the substantial business activities exception, there is no grandfathering of transactions described in SEC filings or subject to a binding agreement before that date.

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ENDNOTES

[1] For recent examples of expatriations, *see* Martin A. Sullivan, "Eaton Migrates to Ireland: Will the U.S. Now Go Territorial?", 135 Tax Notes 1302 (June 11, 2012).

[2] *See* Section 7874(b). For additional background on Section 7874, please see the Sullivan & Cromwell LLP publication entitled "Corporate Expatriation Transactions: IRS Announces Intent to Issue Further Guidance Under Section 7874" (September 25, 2009), which may be obtained by following the instructions at the end of this publication.

[3] "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 to the non-U.S. corporation) and certain gain and licensing income recognized by an expatriated entity during the ten-year period. *See* Section 7874(d)(2), (f). The U.S. tax on the inversion gain may not be offset by credits, net operating losses or other tax attributes. *See* H.R. Conf. Rep't No. 108-755.

[4] 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).

[5] Section 7874(a)(2)(B).

[6] Former Treas. Reg. § 1.7874-2T(d). *See* T.D. 9265, 71 Fed. Reg. 32437 (June 6, 2006).

[7] Former Treas. Reg. § 1.7874-2T(g). *See* T.D. 9453, 74 Fed. Reg. 27920 (June 12, 2009).

[8] T.D. 9453, 74 Fed. Reg. 27920 (June 12, 2009). An IRS official explained that "the IRS was troubled that under the original safe harbor both a widely dispersed company with operations in numerous countries and a company with 90 percent of its operations in the United States would fall under the safe harbor." David D. Stewart, "IRS Open to New Safe Harbor in Inversion Guidance, Official Says," 55 Tax Notes Int'l 1012 (Sept. 21, 2009).

[9] T.D. 9592 (June 12, 2012).

[10] The testing period is the one-year period ending on the applicable date and is used throughout the tests discussed herein.

[11] *See* T.D. 9591 (June 12, 2012).

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