

January 22, 2014

## Corporate Inversion Transactions

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### IRS and Treasury Issue Temporary Regulations to Determine When Stock Is Disregarded for Purposes of the Internal Revenue Code's Anti-Inversion Rules

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#### SUMMARY

On January 16, 2014, the IRS and the Treasury Department issued temporary and proposed regulations (the "Regulations")<sup>1</sup> that disregard certain stock of a foreign corporation when calculating ownership of the foreign corporation in determining whether the foreign corporation is a "surrogate foreign corporation" for purposes of the anti-inversion rules contained in Section 7874. The Regulations largely adopt the rules described in Notice 2009-78 (the "Notice"), issued on September 17, 2009, but contain several important modifications and additions, including:

- a rule that disregards stock transferred for "obligations" (the "Obligation Rule"), and
- a rule that is intended to provide a safe harbor where former shareholders of the domestic entity own less than 5% of the resulting entity (the "5% Rule").

The preamble to the Regulations (the "Preamble") also:

- clarifies that the distinction between asset deals and stock deals is intentional,
- indicates that the application of the "Internal Group Restructuring" exception of Treasury Regulations Section 1.7874-1(c)(2) to divisive transactions could depend on whether the company that only temporarily holds the foreign acquiror stock is domestic or foreign, and
- signals that the IRS and the Treasury Department are studying "sponsored" deals where the buyer in a going-private transaction could exit via a public offering, achieving, according to the IRS and the Treasury Department, the equivalent of inverting a publicly traded U.S. company.

In general, the rules that were both described in the Notice and set forth in the Regulations apply to acquisitions completed on or after September 17, 2009. Additional rules adopted in the Regulations (such as the Obligation Rule) apply to acquisitions completed on or after January 16, 2014.

## BACKGROUND

Section 7874 generally targets “inversion” or “expatriation” transactions 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) unless such foreign entity has “substantial business activities” in the jurisdiction of its organization. If 80% by vote or value of the foreign acquiror is held by the former shareholders or partners of the expatriated U.S. entity “by reason of holding” stock or a capital or profits interest<sup>2</sup> in the expatriated entity (the “Domestic Stockholders”) and the “substantial business activities” test is not satisfied,<sup>3</sup> the foreign acquiror is treated as a domestic entity for U.S. tax purposes. If 60% or more by vote or value, but less than 80%, is held by the Domestic Stockholders and the “substantial business activities” test is not satisfied, the foreign acquiror 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.<sup>4</sup> Whether Section 7874 applies to a transaction therefore depends on the percentage of the foreign entity that is held by the Domestic Stockholders (the “Ownership Fraction”). We refer to these ownership requirements as the “Ownership Condition”.

Under Section 7874(c)(2), stock of the foreign acquiror is not taken into account in determining whether the Ownership Condition is satisfied in two circumstances: when stock of the foreign acquiror is held by members of the “expanded affiliated group”<sup>5</sup> that includes the foreign acquiror, and when stock of the foreign acquiror is sold in a public offering related to the transaction (the “Public Offering Rule”). In response to perceived abuses of the Public Offering Rule, the Notice announced that the IRS and the Treasury Department intended to issue regulations expanding the Public Offering Rule to disregard stock of the foreign acquiror issued for cash in certain common “going private transactions”, thereby increasing the likelihood that the Ownership Condition would be met and Section 7874 would apply.<sup>6</sup>

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## THE REGULATIONS

The Regulations provide that, subject to the 5% Rule described below, “disqualified stock” “transferred” in a manner described in the Regulations is excluded from the denominator of the Ownership Fraction (the “Exclusion Rule”). “Disqualified stock” is defined as:

- (1) stock of the foreign acquiror that is transferred to a person other than the domestic entity in exchange for certain nonqualified property including cash, certain marketable securities and “obligations” (the “Nonqualified Property Rule”), and
- (2) stock transferred to a person (including the domestic entity) in exchange for property to the extent that, pursuant to the same plan (or series of related transactions), the transferee subsequently transfers the stock in exchange for the satisfaction or the assumption of an “obligation” associated with the property exchanged (the “Associated Liability Rule”).<sup>7</sup>

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A “transfer” of stock for these purposes is defined expansively and is not limited to issuances by the foreign acquiror; rather a “transfer” under the Regulations includes an issuance, sale, distribution, exchange, or any other type of disposition and regardless of whether the stock is transferred by the foreign acquiror or another person. For this purpose, however, 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. Thus secondary transfers (*e.g.*, among shareholders, even if prearranged) that do not increase the net assets of the foreign acquiror are not counted as a “transfer” for disqualified property and therefore are not excluded from the denominator of the Ownership Fraction. (Since the expanded definition of transfer was not contained in the Notice, the expanded definition applies only to transactions occurring on or after January 16, 2014.)<sup>8</sup>

The Preamble further states that stock described in the numerator of the Ownership Fraction (*i.e.*, foreign acquiror stock held by Domestic Stockholders) “will never be subject to the [Nonqualified Property Rule] or the [Associated Liability Rule]” and as such “the [Exclusion Rule] will never apply to such stock.”

As noted above, the Nonqualified Property Rule and the Associated Liability Rule generally disregard stock that is transferred in exchange for, or in satisfaction or assumption of, “obligations.” This Obligation Rule is an expansion beyond the terms of the Notice and is targeted at transactions in which the foreign entity, for example, transfers its stock to the expatriated domestic entity’s creditors. However, an “obligation” is broadly defined (*i.e.*, by reference to Treasury Regulation Section 1.752-1(a)(4)(ii))<sup>9</sup> and thus includes “any fixed or contingent obligation to make payment.” The only identified limit on the Obligation Rule is that stock will not be considered disqualified stock if the transfer of such stock does not increase the net assets of the foreign acquiror.<sup>10</sup>

Finally, a separate rule clarifies that stock of the foreign acquiror received by a Domestic Stockholder “shall not cease to [be described in the numerator of the Ownership Fraction] as a result of any subsequent transfer of the stock...even if the subsequent transfer is related to the acquisition.”<sup>11</sup> In other words, while there is authority in other areas of the U.S. tax law stating that a shareholder is not treated as owning stock that it has committed to transfer to a third party, those authorities expressly do not apply to reduce the Ownership Fraction.

### A. THE 5% RULE

Under the approach announced in the Notice, all stock issued in exchange for cash would be disregarded for purposes of determining whether the Ownership Condition is satisfied, with the surprising (and, to many, inappropriate) result that management rollovers in typical “going private” transactions would be caught by Section 7874 even where the predominant character of the transaction is a sale. The Regulations provide an exception so that such rollovers will often be excluded. The mechanism for doing this is the 5% Rule: Under the Regulations, the Exclusion Rule does not apply (and therefore stock is not excluded from the denominator of the Ownership Fraction) in situations where (1) the Ownership

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Fraction, determined without regard to the Exclusion Rule, is less than five percent by both vote and value and, (2) after the acquisition and all related transactions, the Domestic Stockholders in the aggregate own (applying the attribution rules of Section 318(a)) less than five percent by both vote and value of the stock of any member of the expanded affiliated group that includes the foreign acquiror.<sup>12</sup>

Application of the 5% Rule may be of limited application if the terms of a transaction would otherwise contemplate a larger management rollover. Moreover, application of the 5% Rule is subject to an anti-avoidance provision: the 5% Rule will not apply to “disqualified stock that is transferred in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874.”<sup>13</sup> It is unclear in what circumstances this anti-avoidance exception would apply, since the 5% Rule is itself a sanctioned exception to the Exclusion Rule involving disqualified stock. In addition, the Preamble generates additional uncertainty in typical “sponsored buyouts.” The Preamble describes an example where a private buyer creates a newly formed foreign entity to purchase all of the stock of a publicly traded U.S. corporation for cash and a small amount of the foreign entity’s stock, which is issued to the management of the U.S. corporation, and, after period of time, the buyer sells its foreign entity stock pursuant to a public offering, which may have been one of the intended exit strategies of the buyer all along. The Preamble states that such a situation could be inconsistent with the policies underlying Section 7874 and invites comment. It would appear that the 5% Rule, especially if it were to have any practical effect, should not depend on whether the disqualified stock is issued in a private or a public offering.

### B. OTHER OBSERVATIONS

#### 1. Stock and Asset Acquisitions

The IRS and the Treasury Department affirmed in the Preamble that stock and asset acquisitions could result in differing tax treatment depending, for example, on the type of assets that the foreign acquiror receives in exchange for its stock (e.g., 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). The IRS and the Treasury Department acknowledged that stock and asset acquisitions could often have disparate effects under tax law and chose to rely instead on the general anti-avoidance rule if the principal purpose of the acquisition of the stock is for the avoidance of Section 7874.<sup>14</sup>

#### 2. Divisive Transactions

The Preamble notes that the IRS and the Treasury Department are studying certain divisive transactions described in Sections 355 and 368 that involve subsequent distributions by a corporation of the stock of the foreign acquiror. For example, a parent corporation contributes a U.S. subsidiary to a foreign corporation prior to spinning the foreign corporation to its shareholders. The preamble to the 2009 Treasury Regulations issued under Section 7874<sup>15</sup> suggested broadly that in a divisive transaction the

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“Internal Group Restructuring” exception of Treasury Regulations Section 1.7874-1(c)(2) might not apply, and that the IRS and the Treasury Department would issue regulations to that effect. The Preamble notes that the IRS and the Treasury Department are considering whether a distinction should be made if the parent corporation that only temporarily holds the foreign acquiror stock is foreign or domestic. Presumably, if the corporation is foreign, it appears less likely that the policy underlying Section 7874 is offended.

### 3. Interaction with Expanded Affiliated Group Rules

The Regulations provide that the Exclusion Rule and the expanded affiliated group rules of Treasury Regulations Section 1.7874-1(c) may operate separately. In general, under the rules in effect both before and after the Regulations became effective, stock held by one or more members of the “expanded affiliated group” of the foreign acquiror is not included in either the numerator or the denominator of the Ownership Fraction. Two exceptions to this rule apply: stock held by one or more members of the foreign acquiror’s expanded affiliated group is included in the denominator, but not in the numerator, of the Ownership Fraction, if the acquisition qualifies as an “Internal Group Restructuring” or results in a “Loss of Control” by the former shareholders of the domestic entity, in each case as defined in the applicable regulations. The Regulations provide that, for purposes of determining whether an “expanded affiliated group” exists and whether the “Internal Group Restructuring” or “Loss of Control” exceptions of Treasury Regulations Section 1.7874-1(c) apply, the rules operate independently.<sup>16</sup> Thus, for purposes of determining whether the Ownership Condition is satisfied, disqualified stock will be ignored even if it would otherwise have been included in the denominator of the Ownership Condition as a result of the acquisition meeting the Internal Group Restructuring or Loss of Control exception, but disqualified stock is included for purposes of determining whether an “expanded affiliated group” exists.

### C. DATE OF APPLICABILITY

In general, the rules that were both described in the Notice and set forth in the Regulations apply to acquisitions completed on or after September 17, 2009. Additional rules adopted in the Regulations (such as the Obligation Rule and the expanded definition of “transfer”) apply to acquisitions completed on or after January 16, 2014.<sup>17</sup>

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ENDNOTES

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- 1 January 16, 2014 (TD 9654; NPRM REG-121534-12).
- 2 For ease of reference, we will refer to all such interests as “stock.”
- 3 See Section 7874(b). For additional background on Section 7874, please see the Sullivan & Cromwell LLP publication entitled [“Corporate Expatriation Transactions: IRS and Treasury Issue Regulations on the ‘Substantial Business Activities’ Exception and Finalize Regulations on Surrogate Foreign Corporations Under Section 7874”](#) (June 13, 2012), which may be obtained by following the instructions at the end of this publication.
- 4 “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.
- 5 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).
- 6 For additional background on the Notice, 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.
- 7 Treasury Regulations Section 1.7874-4T(c)(1).
- 8 Treasury Regulations Sections 1.7874-4T(i)(10) and (k)(2) .
- 9 Treasury Regulations Section 1.7874-4T(i)(8).
- 10 Treasury Regulations Section 1.7874-4T(c)(2).
- 11 Treasury Regulations Section 1.7874-5T(a).
- 12 Treasury Regulations Section 1.7874-4T(d)(1).
- 13 Treasury Regulations Section 1.7874-4T(d)(2).
- 14 See Example 2 of Treasury Regulations Section 1.7874-4T(j).
- 15 June 12, 2009 (TD 9453, 2009-28 IRB 114).
- 16 Treasury Regulations Section 1.7874-4T(h).
- 17 Treasury Regulations Section 1.7874-4T(k).

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