LB&I International Practice Service
Concept Unit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Business Outbound	–	–
Volume	1	Income Shifting Outbound	**Level 1 UIL**	9411
Part	1.10	Corporate Inversions (IRC 7874)	**Level 2 UIL**	9411.10
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Unit Name	Corporate Inversions – Overview of Major Issues

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Corporate Inversions - Overview of Major Issues

A U.S. parent of a multinational group of companies may enter into a series of transactions that replaces the U.S. parent with a new foreign parent corporation in order to minimize its exposure to U.S. taxation. These transactions are commonly referred to as "corporate inversions." Historically, a new foreign parent corporation was formed in a foreign country that imposes little or no tax on income (e.g., Bermuda, Cayman Islands, etc.). However, there has been an increasing trend to use certain European jurisdictions (e.g. U.K., Ireland, Switzerland, etc.) as the country of incorporation for the new foreign parent and the foreign company that will function as the merger inversion partner. The prior shareholders of the U.S. parent become shareholders of the new foreign parent.

There are many motivations for a U.S. parent to consider a corporate inversion. After an inversion transaction has been completed, numerous transactions may occur in order to significantly reduce exposure to U.S. taxation. The new foreign parent may pursue its future growth in foreign jurisdictions without risk of U.S. tax exposure. Additionally, U.S. affiliates of the foreign parent may become burdened with significant intercompany debt owed to the foreign parent or one of its foreign affiliates which may serve to strip U.S. earnings from the U.S. Alternatively, the foreign parent may access offshore untaxed earnings of Controlled Foreign Corporations (CFCs) owned by the U.S. Parent by having these CFCs loan funds to the new foreign parent or other non-CFC foreign subsidiaries. These loan proceeds will avoid dividend treatment for U.S. tax purposes and escape the application of IRC 956, investment in U.S. property. CFCs may be moved "out from under" U.S. control as part of the inversion or in post- inversion transactions so that they are no longer treated as CFCs going forward, thus avoiding subpart F and other U.S. anti-deferral rules. Post-inversion changes in transfer pricing relationships (e.g., de-risking of U.S. operations) may also occur to minimize U.S. taxable income. It should be noted that Notice 2014-52 and Notice 2015-79 have restricted the ability to utilize some of the above described post-inversion transactions that occur on or after September 22, 2014 and November 19, 2015 respectively. Rules implementing these Notices are incorporated in temporary regulations.

Before the addition of IRC 7874, the only tax cost was to shareholders (S/H) of an inverting U.S. Parent Corporation who were subject to a potential "toll charge", under IRC 367(a). However, it was not uncommon for the corporate inversion to be undertaken when the shareholders' built-in gain in the stock of the U.S. parent was minimal (or in the case of foreign or tax exempt shareholders potentially no U.S. tax at all) thus weakening the toll charge as an effective deterrent to the inversion. Therefore, despite the fact that the U.S. parent may have been subject to taxable income under IRC 367(b) (e.g., on the de-controlling its CFCs), these tax costs at the U.S. parent and shareholder levels in many cases were outweighed by the potential U.S. tax savings going forward and did not deter the inversion.

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General Overview (cont'd)

Corporate Inversions - Overview of Major Issues
Corporate inversions may be accomplished in a variety of ways. For example, an inversion may occur in a simple exchange of domestic target stock for new foreign parent acquiring stock, a merger of a domestic corporation into a foreign parent, or a transaction involving both domestic and foreign target stock being acquired by a new foreign parent. In 2004, IRC 7874 was enacted to address corporate inversions. IRC 7874 contains provisions aimed at reducing the incentives for entering into such inversions of U.S. multinational companies out of U.S. taxing jurisdiction. IRC 7874 applies to certain inversions of a domestic corporation (DC) or a domestic partnership (P/S) in which a new foreign parent corporation of the domestic target is treated as a "surrogate foreign corporation" (SFC). In order for the foreign corporation (FC) to be treated as a SFC, all of the following three tests must be met: 1) acquisition test, 2) ownership test; and 3) substantial business activities (SBA) test. The tax consequences under IRC 7874 are dependent on satisfaction of the ownership test, which is the necessary percentage ownership of FC held by the former S/Hs/partners of the domestic target "by reason of" having held ownership in domestic target. The inversions for which the tax consequences are governed by IRC 7874 are sometimes referred to as "80% inversions" and "60% inversions". As a result, the determination of this ownership threshold is a critical element in determining whether the transaction is governed by IRC 7874. Under an 80% inversion, the new foreign parent is treated as a domestic corporation (DC) for all purposes of the IRC. IRC 367(a) does not apply to the domestic target's shareholders in this case since for U.S. tax purposes there has been no outbound transfer of property and therefore no outbound "toll charge" is imposed on domestic target's shareholders. Under a 60% inversion, the new foreign parent will be respected as a foreign corporation for U.S. tax purposes. However, the taxable income of an expatriated entity shall not be less than its "inversion gain" recognized during the 10-year applicable period. IRC 7874 effectively limits the expatriated entities' ability to use net operating losses (NOLs) or other tax attributes to reduce U.S. tax on their inversion gain. Most inversions that are subject to IRC 7874 are currently falling into the 60% inversion category.

General Overview (cont'd)

Corporate Inversions - Overview of Major Issues
Many inversions may not be captured by IRC 7874 due to effective tax planning which ensures that the transaction does not meet all three requirements of IRC 7874. For example, taxpayers may structure an inversion in a manner which limits the ownership of new foreign parent by former shareholders of domestic target. To achieve this result, taxpayers may "shop" for and select a prospective foreign company target that is of a sufficiently large size to specifically avoid application of IRC 7874's stock ownership requirement in a merger inversion transaction. In 2014, Treasury and the IRS issued Notice 2014-52 which describes regulations that Treasury and the IRS intend to issue that will address pre-inversion transactions structured to avoid section 7874 and post-inversion transactions structured to prevent the application of IRC 956 or the imposition of U.S. tax on pre-inversion E&P of CFCs. The Notice intends that the regulations to be issued would generally apply to specific inversions completed on or after September 22, 2014. These regulations were issued on April 4, 2016.

General Overview (cont'd)

Corporate Inversions - Overview of Major Issues

! **CAUTION:** On November 19, 2015, Treasury and the IRS issued Notice 2015-79 which describes additional regulations that Treasury and the IRS intend to issue to address inversions and describes revisions and clarifications that Treasury and IRS intend to make with respect to certain rules announced in Notice 2014-52.

- Specifically, Notice 2015-79 describes regulations that Treasury and the IRS intend to issue that will address transactions that are structured to avoid the purposes of section 7874 by (i) requiring the foreign acquiring corporation to be subject to tax as a resident of the relevant foreign country in order to have substantial business activities in the relevant foreign country; (ii) disregarding certain stock of the foreign acquiring corporation in "third-country" transactions; and (iii) clarifying the definition of nonqualified property for purposes of disregarding certain stock of the foreign acquiring corporation.

- Notice 2015-79 also describes regulations that the Treasury and the IRS intend to issue that will address certain post-inversion tax avoidance transactions by (i) defining inversion gain for purposes of section 7874 to include certain income or gain recognized by an expatriated entity from an indirect transfer or license of property and providing for aggregate treatment of certain transfers or licenses of property by foreign partnerships for purposes of determining inversion gain; and (ii) requiring an exchanging shareholder to recognize all of the gain realized upon an exchange of stock of a controlled foreign corporation (as defined in section 957) (CFC), without regard to the amount of the CFC's undistributed earnings and profits, if the transaction terminates the status of the foreign subsidiary as a CFC or substantially dilutes the interest of a United States shareholder (as defined in section 951(b)) (U.S. shareholder) in the CFC.

- Notice 2015-79 also describes revisions and clarifications that Treasury and the IRS intend to make with respect to certain rules announced in Notice 2014-52.

Notice 2015-79 is beyond the scope of this Unit and is not otherwise mentioned in this unit. Regulations were issued on April 4, 2016.

The regulations issued on April 4, 2016 implementing Notice 2015-79 are also beyond the scope of this Unit and are not substantively discussed. However, these regulations may be listed in the Resources section where appropriate.

General Overview (cont'd)

Corporate Inversions - Overview of Major Issues

This International Practice Service (IPS) Concept Unit provides a brief overview of:

- Whether the inversion would be governed by IRC 7874,
- The three qualifying tests required by IRC 7874 - (acquisition, ownership and substantial business activities (SBA))
- The distinction between the tax consequences of an 80% inversion and a 60% inversion if IRC 7874 applies to the inversion, and
- The identification of potential tax issues that may artificially reduce U.S. tax (regardless of whether IRC 7874 applies to the inversion).

As part of the process of illustrating the distinction between an 80% or 60% inversion, this unit provides a decision tree flowchart that depicts the "basic" mechanics involved in determining whether a corporate inversion is governed by IRC 7874.

The determination of whether an inversion falls under the jurisdiction of IRC 7874 is critical not only for addressing issues in the taxable year the inversion occurs, but also for addressing post-transaction activity such as "inversion gain" recognition or events addressed by Notice 2014-52 in subsequent years.

NOTE: IRC 7874 may apply to the inversion of a domestic partnership. However, this Concept Unit focuses solely on corporate inversions. The inversion of a domestic partnership is beyond the scope of this unit. However, the tests discussed in this Practice Unit for corporate inversions may be similarly applied to partnership inversions, with some modifications. See a future Practice Unit for further information on partnership inversions.

Relevant Key Factors

Corporate Inversions - Overview of Major Issues
Key Factors
<u>TYPE OF TRANSACTION – KEY FACTOR</u>: The purpose of IRC 7874 is to reduce the incentives for entering into inversions. The tax consequences that result from the application of IRC 7874 depend on the percentage ownership held by the owners of the domestic target in the foreign acquiring corporation immediately after the transaction. The acquiring FC is a Surrogate Foreign Corporation (SFC), as defined in IRC 7874(a)(2)(B), if: ▪ FC directly or indirectly acquires substantially all of the properties held by a DC; ▪ at least 60% of the stock (vote or value) of FC is held by former S/Hs of DC “by reason of” holding stock in DC; and ▪ the “Expanded Affiliated Group” (EAG) that includes the acquiring FC does not have substantial business activities (SBA) in the foreign country in which the acquiring FC was created or organized when compared to the EAG’s worldwide (WW) activities. In order to determine whether IRC 7874 applies to the transaction, you need to understand exactly how the transaction was carried out. It is not uncommon for the domestic target corporation to be publicly held. As a result, significant information on the transaction can be found in public documents, such as: ▪ News releases ▪ Securities and Exchange Commission (SEC) filings – 10K, 8K, etc. ▪ Prospectus to S/H ▪ Internet searches (e.g. practitioner articles or industry publications) ▪ Taxpayer websites

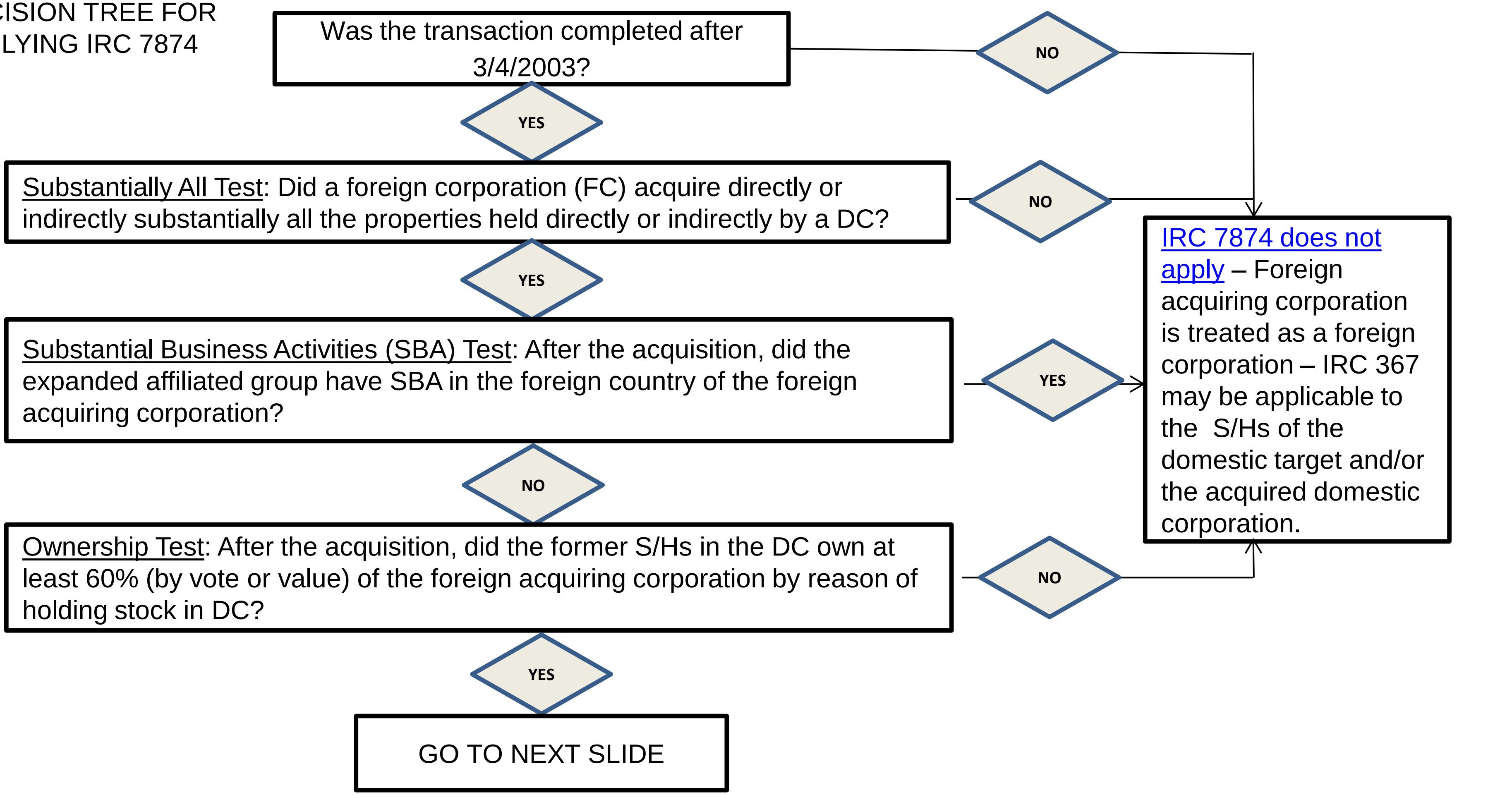
Relevant Key Factors (cont'd)

Corporate Inversions - Overview of Major Issues
Key Factors
TYPE OF TRANSACTION – KEY FACTOR (cont'd) Once you have determined that there has been a direct or indirect acquisition of assets of a DC by a FC and the prior S/Hs have exchanged their ownership in the target DC for some percentage of stock ownership in the acquiring FC, you must proceed with the detailed analysis to determine whether IRC 7874 may be applicable to the transaction. This determination requires further analysis of the following three tests (briefly described in the Detailed Analysis section of this Unit): ▪ Ownership Test ▪ "Substantially All" Test ▪ Substantial Business Activities (SBA) Test ! **CAUTION:** All three of the above tests must be met in order for IRC 7874 to apply to the transaction. This concept unit will provide a high level overview of each of the three tests under IRC 7874. See future related Practice Units for more detailed analysis of the tests.

Corporate Inversions - Overview of Major Issues

Facts of Concept

DECISION TREE FOR APPLYING IRC 7874



Facts of Concept (cont'd)

Corporate Inversions - Overview of Major Issues

Facts of Concept

DECISION TREE FOR APPLYING IRC 7874 (cont'd)

From Prior Slide - After the acquisition, did the former S/Hs in the DC own at least 60% of the foreign acquiring corporation by reason of holding stock in DC? (see applicable regs for rules)

NO

IRC 7874 does not apply – Foreign acquiring corporation is treated as a foreign corporation – IRC Section 367 may be applicable to the prior S/Hs and/or the acquired domestic corporation.

YES

After the acquisition, did the former S/Hs in the DC own at least 80% of the foreign acquiring corporation by reason of holding stock in DC?

NO

60% Inversion - IRC 7874 applies – Foreign acquiring corporation is treated as a foreign corporation – IRC Section 367 is applicable to the S/Hs of domestic target corporation and/or the acquired DC.

YES

80% Inversion - IRC 7874 applies – Foreign acquiring corporation is treated as a domestic corporation for all purposes of the code.

IRC 367(a) does not apply to the prior S/Hs.

IRC 7874 applies – The taxable income of the expatriated entity shall not be less than the inversion gain for any taxable year in the applicable period. The inversion gain means any income or gain recognized by reason of the transfer (e.g. 367 (a) or 367(d) income inclusion) of stock or other properties by an expatriated entity and any income received or accrued by reason of a license of property by an expatriated entity as part of the acquisition or after such acquisition if the transfer or license is to a foreign related party.

See Next Page for more details if transaction occurred on or after September 22, 2014.

Facts of Concept (cont'd)

Corporate Inversions - Overview of Major Issues

Facts of Concept

DECISION TREE FOR APPLYING IRC 7874 - Application of Notice 2014-52 (cont'd)

From Prior Slide - If IRC 7874 applies to a 60% Inversion or the ownership of the foreign acquiring corporation held by former owners of the inverted domestic (expatriated) entity is less than 60%, did the transaction occur on or after September 22, 2014?

NO

Notice 2014-52 and the regulations issued pursuant to the Notice do not apply to the transaction except for Treas. Reg. 1.304-7T as described on slide 13.

YES

Notice 2014-52 described regulations that Treasury and the IRS intended to issue that could impact the "ownership" of the foreign acquiring corporation for purposes of the ownership test (and thus the determination of the "ownership fraction") for acquisitions completed on or after September 22, 2014. For example, application of the rules described in the Notice may cause an inversion to be considered an 80% inversion when absent the rules it would be a 60% inversion. The following regulations were issued that could impact the determination of the ownership fraction:

- Treas. Reg. 1.7874-7T – Disregarding certain stock of the foreign acquiring corporation that holds a substantial amount of passive assets.
- Treas. Reg. 1.7874-10T – Disregarding "non-ordinary course distributions" paid by the inverted domestic (expatriated) entity prior to the inversion
- Treas. Reg. 1.7874-6T – Subsequent transfers of stock of the foreign acquiring corporation under IRC 7874 (e.g., a spin-off) that occur after an acquisition

Regulations implementing Notice 2014-52 were issued on April 4, 2016.

See Next Page for additional details if transaction occurred on or after September 22, 2014.

Facts of Concept (cont'd)

Corporate Inversions - Overview of Major Issues

Facts of Concept

DECISION TREE FOR APPLYING IRC 7874
- Application of Notice 2014-52

(cont'd)

Did a 60% inversion occur on or after September 22, 2014?

YES

NO

Treas. Reg. 1.304-7T was issued that may impact the U.S. federal tax treatment of certain IRC 304 transactions (regardless of whether related to an inversion transaction). This section focuses on the preventing the removal of untaxed E&P in certain 304 transactions.

Notice 2014-52 also described regulations that Treasury and the IRS intended to issue that may impact the U.S. federal tax treatment of a transaction undertaken after the occurrence of a 60% inversion on or after September 22, 2014. The following regulations that were issued that could have such an impact:

- Treas. Reg. 1.956-2T – Acquisition of Obligations and Stock that Avoid IRC 956 – Investment in U.S. Property. This section addresses certain loans or pledges made by a CFC of the inverted domestic (expatriated) entity with a foreign related person.
- Treas. Reg. 1.7701(l)-4T – Post-inversion transactions to de-control or significantly dilute the ownership of CFCs that were held by the inverted domestic (expatriated) entity before the inversion.
- Treas. Reg. 1.304-7T – Certain IRC 304 transactions (regardless of whether related to an inversion). This section focuses on preventing the removal of untaxed E&P in certain IRC 304 transactions.

! **CAUTION:** Notice 2014-52 and the regulations issued pursuant to the Notice are beyond the scope of this Corporate Inversion concept unit and are only mentioned to provide an awareness of potential additional issues raised by the rules described in Notice 2014-52.

Detailed Explanation of the Concept

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply?

Analysis	Resources
One of the key factors to consider in determining whether an "inversion" has taken place is an analysis of the ownership composition of the acquiring foreign corporation immediately after the transaction. In most inversions, the U.S. parent of the affiliated group is publicly held immediately prior to the transaction (but privately held companies may also invert). Immediately after the transaction, such U.S. parent becomes a foreign controlled U.S. subsidiary of a new foreign parent (the foreign acquiring corporation). The new foreign parent may be a newly publicly traded entity or may be an existing publicly traded entity. In such cases, the prior shareholders of the U.S. parent become shareholders of the new foreign parent. If the prior shareholders of the U.S. parent own at least 60% of the new foreign parent, then IRC 7874 may apply to the corporate inversion. However, if the prior shareholders do not own at least 60% of the new foreign parent then IRC 7874 will not apply, but the transaction may still have other tax issues associated with the inversion (e.g. IRC 367) and also post inversion tax issues (discussed later in this unit). Note, however, that for determining the ownership fraction, the rules of IRC 7874 and Treas. Reg. 1.7874-4T apply.	▪ IRC 7874 ▪ IRC 367

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
Corporate inversions may avoid the application of IRC 7874 by effective tax planning. For example, a corporate inversion may be structured so U.S. target shareholders do not receive 60% stock ownership in the new foreign parent. This may be accomplished by utilizing a corporate inversion structure in which two target corporations (one U.S., and the other foreign) invert under one newly established acquiring foreign parent. In this transaction, the shareholders of the foreign target receive sufficient stock of the new foreign parent in order for the inverted U.S. target to avoid IRC 7874 (i.e. less than 60% stock ownership of new foreign parent is possessed by former shareholders of U.S. target by reason of their former ownership in U.S. target). The above structuring technique reflects a recent trend in inversions where a second foreign corporation (and its former shareholders) is utilized; the result of which is to specifically fail the IRC 7874 ownership test discussed in this Practice Unit.	▪ IRC 7874

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
An acquisition of a domestic corporation's stock by a foreign corporation whereby the former shareholders are "bought out" (i.e., they retain no continuing stock ownership, direct or indirect, in the domestic corporation) does not constitute an inversion subject to IRC 7874. An internal restructuring of a U.S. subsidiary under a CFC owned by the U.S. parent generally is not an inversion, pursuant to Treas. Reg. 1.7874-1. However, it there are distributions of the stock of the CFC, this rule may not apply. For inversions occurring on or after September 22, 2014, regulations issued pursuant to Notice 2014-52 may impact the calculation of the ownership fraction and thus whether the ownership test is met.	▪ IRC 7874 ▪ Treas. Reg. 1.7874-7T – *Disregard of certain stock attributable to passive assets* ▪ Treas. Reg. 1.7874-10T – *Disregard of certain distributions*

Detailed Explanation of the Concept (cont’d)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont’d)

Analysis	Resources
In a 60% stock inversion that is governed by IRC 7874, a shareholder of the domestic target corporation is required to recognize gain under IRC 367(a) when the shareholder exchanges its domestic target stock for stock in the new foreign parent. In a 60% asset inversion, the domestic corporation is required to report gain on the outbound transfer of certain assets to the new foreign parent under IRC 367(a).	▪ IRC 7874 ▪ IRC 367(a) ▪ Treas. Reg. 1.367(a)-3(c) – Outbound transfer of domestic stock

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
OWNERSHIP TEST – KEY FACTOR: In order for IRC 7874 to apply, the transaction must meet the "Ownership Test" in addition to the "Acquisition" and "SBA" Tests. (See IRC 7874,Treas. Reg. 1.7874-2). As a consequence, when structuring a corporate inversion taxpayers may attempt to implement certain tax planning strategies that establish ownership percentages of the target's former shareholders in the new foreign parent to be less than the specific "ownership test" thresholds. For example, if the taxpayer is successful in diluting the former shareholders' ownership percentages in the new foreign parent to < 80% but ≥ 60%, then a 60% inversion will result. If < 60%, then IRC 7874 will not apply at all. These are the results despite the fact that in either case any resulting "EAG" may have no substantial business activities in the foreign country of the foreign parent. Regulations 1.7874-6T, 1.7874-7T and 1.7874-10T, which were issued pursuant to Notice 2014-52 - Sec. 2, may impact the calculation of the ownership fraction for transactions occurring on or after September 22, 2014.	▪ Treas. Reg. 1.7874-1 – *Disregard of affiliate-owned stock* ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas. Reg. 1.7874-2(f) – *Stock held by reason of holding stock in a domestic corporation* ▪ Treas. Reg. 1.7874-4T – *Disregard of certain stock related to the acquisition* ▪ Treas. Reg. 1.7874-6T – *Stock transferred by members of the EAG* ▪ Treas. Reg. 1.7874-5T – *Effect of certain transfers of stock related to the acquisition* ▪ Treas. Reg. 1.7874-7T – *Disregard of certain stock attributable to passive assets* ▪ Treas. Reg. 1.7874-10T – *Disregard of certain distributions*

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Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
<u>The Ownership Test- General Rule:</u> This test is satisfied, if AFTER the acquisition (see Acquisition test) by the foreign corporation**:** ▪ at least 60% of the stock (by vote or value) of the FC is held by former S/Hs of the DC "by reason of" holding stock in the DC. Former S/H: Any person that held stock in the DC before the acquisition, including any person that holds stock in the DC both before and after the acquisition.	▪ Treas. Reg. 1.7874-1 – *Disregard of affiliate-owned stock* ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas. Reg. 1.7874-2(f) – *Stock held by reason of holding stock in a domestic corporation* ▪ Treas. Reg. 1.7874-4T – *Disregard of certain stock related to the acquisition* ▪ Treas. Reg. 1.7874-5T – *Effect of certain transfers of stock related to the acquisition* ▪ Treas. Reg. 1.7874-6T – *Stock transferred by members of the EAG* ▪ Treas. Reg. 1.7874-7T – *Disregard of certain stock attributable to passive assets* ▪ Treas. Reg. 1.7874-10T – *Disregard of certain distributions*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
Notice 2014-52 describes regulations that Treasury and the IRS intend to issue that may impact the calculation of the ownership fraction for transactions occurring on or after September 22, 2014. Section 2 of the Notice specifically addresses the consequences when: ▪ More than 50% of the gross value of all "foreign group property" constitutes passive assets or ▪ Certain "Non-ordinary course distributions" are made by the domestic target entity prior to the inversion or ▪ Subsequent transfers of stock in the foreign acquiring corporation are made after acquisition of domestic target. Notice 2014-52- Sec. 2 – Describes regulations that Treasury and the IRS intend to issue that may impact the calculation of the ownership fraction for transactions occurring on or after September 22, 2014.. Treas. Reg. 1.7874-6T, Treas. Reg. 1.7874-7T and -10T were issued pursuant to Notice 2014-52.	▪ Treas. Reg. 1.7874-1 – *Disregard of affiliate-owned stock* ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas. Reg. 1.7874-2(f) – *Stock held by reason of holding stock in a domestic corporation* ▪ Treas. Reg. 1.7874-4T – *Disregard of certain stock related to the acquisition* ▪ Treas. Reg. 1.7874-5T – *Effect of certain transfers of stock related to the acquisition* ▪ Treas. Reg. 1.7874-6T- *Stock transferred by members of the EAG* ▪ Treas. Reg. 1.7874-7T – *Disregard of certain stock attributable to passive assets* ▪ Treas. Reg. 1.7874-10T – *Disregard of certain distributions*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
There are several special rules and exceptions depicted in the 7874 regulations that must be considered in computing the ownership percentage. These rules are beyond the scope of this Concept Unit. See future related Practice Units for more detailed analysis of the ownership tests, as well as the acquisition and SBA tests briefly described in this Practice Unit.	▪ Treas. Reg. 1.7874-1 – *Disregard of affiliate-owned stock* ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas. Reg. 1.7874-2(f) – *Stock held by reason of holding stock in a domestic corporation* ▪ Treas. Reg. 1.7874-4T – *Disregard of certain stock related to the acquisition* ▪ Treas. Reg. 1.7874-5T – *Effect of certain transfers of stock related to the acquisition* ▪ Treas. Reg. 1.7874-6T- *Stock transferred by members of the EAG* ▪ Treas. Reg. 1.7874-7T – *Disregard of certain stock attributable to passive assets* ▪ Treas. Reg. 1.7874-10T – *Disregard of certain distributions*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
<u>SUBSTANTIALLY ALL TEST – KEY FACTOR:</u> The "Substantially All" Test is the second of the three tests which must be analyzed in order to determine whether IRC 7874 applies to the transaction in question. <u>Substantially All Test - General Rule:</u> In order for IRC 7874 to apply, the transaction must meet the substantially all test: (See IRC 7874, Treas. Reg. 1.7874-2): ▪ Pursuant to a plan, a FC completes the direct or indirect acquisition in a transaction completed after March 4, 2003 of substantially all of the properties held directly or indirectly by a DC. ▪ If a FC acquires directly or indirectly substantially all of the properties of a DC during the 4 - year period beginning on the date which is 2 years before the "ownership test" is met, then such actions are treated as occurring "pursuant to a plan." See IRC 7874(c)(3).	▪ IRC 7874 ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas. Reg. 1.7874-2(c), (d), and (e) – Acquisition of property ▪ IRC 7874(c)(3)

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
Indirect Acquisitions: (See Treas. Reg. 1.7874-2): ▪ An acquisition by a FC of stock of a DC is treated as an acquisition of a proportionate amount of the properties held by the DC. ▪ An acquisition by a foreign or domestic corporation (acquiring corporation) of properties held by a DC in exchange for stock of a FC (foreign issuing corporation) that is part of the Expanded Affiliated Group ("EAG"), as defined in IRC 7874(c)(1), that includes the acquiring corporation after the acquisition is treated as an acquisition by the foreign issuing corporation. ▪ Generally, an acquisition by a FC of stock in another FC that owns directly or indirectly a DC is NOT treated as an indirect acquisition under IRC 7874.	▪ IRC 7874 ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas. Reg. 1.7874-2(c), (d), and (e) – Acquisition of property

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	**Resources**
<u>SUBSTANTIAL BUSINESS ACTIVITIES (SBA) TEST – KEY FACTOR:</u> In order for IRC 7874 to apply, the transaction must also meet the third test - "Substantial Business Activities" (SBA) test. (See IRC 7874, Treas. Reg. 1.7874-3, Treas. Reg. 1.7874-3T). <u>SBA Test - General Rule:</u> ▪ The SBA test is met if AFTER the acquisition the expanded affiliate group (EAG) does NOT have SBA in the foreign country in which, or under the law of which ("relevant foreign country"), the acquiring FC is created or organized in comparison with the total worldwide (WW) business activities of the EAG. ▪ The EAG is comprised of the affiliated group (including the foreign acquiring corporation) as defined under IRC 1504(a), but substituting "more than 50" for "at least 80%" and may include foreign corporations. (See IRC 7874(c)(2)).	▪ IRC 7874 ▪ Treas. Reg. 1.7874-3 – *Substantial business activities* - Effective for acquisitions completed on or after June 3, 2015 ▪ Treas. Reg. 1.7874-3T – *Substantial business activities* - Effective for transactions completed on or after June 7, 2012 and before June 3, 2015

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
<u>SBA Test - General Rule (cont'd):</u> ▪ For transactions completed on or after June 7, 2012, the EAG will have SBA only if the following three sub-tests set forth in the regulations are all satisfied in the "relevant foreign country" of the new foreign parent in comparison with the total WW activities group of the EAG: – 25% or more Group Employees ▪ Headcount as of the "applicable date" (the acquisition date or the last day of the month immediately preceding the month in which the acquisition is completed) ▪ Employee compensation for "testing period" (1 year period ending on the applicable date) – 25% or more Group Assets (tangible assets) as of the applicable date – 25% or more Group Income resulting from transactions occurring in the ordinary course of business with unrelated customers located in the relevant foreign country during the testing period. ▪ In addition, for transactions completed on or after November 19, 2015, in order for the EAG to have SBA the foreign acquiring corporation must be subject to tax as a resident of the "relevant foreign country".	▪ IRC 7874 ▪ Treas. Reg. 1.7874-3 – *Substantial business activities* - Effective for acquisitions completed on or after June 3, 2015 ▪ Treas. Reg. 1.7874-3T – *Substantial business activities* - Effective for transactions completed on or after June 7, 2012 and before June 3, 2015 ▪ Treas. Reg. 1.7874-3T(b)(4) – Substantial business activities – Effective for transactions completed on or after November 19, 2015.

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
When does IRC 7874 apply? (cont'd)

Analysis	Resources
SBA Test - General Rule (cont'd): ▪ For transactions completed before June 7, 2012, a "facts and circumstances" test for determining SBA was set forth in the immediate prior version of regulations (2009 temporary regulations – TD 9453); the facts and circumstances test was replaced by the "bright line" rules discussed above. The 2009 temporary regulations were in effect for transactions completed on or after June 9, 2009 and before June 7, 2012. The 2009 temporary regulations removed a prior 10% safe harbor rule of the 2006 temporary regulations (TD 9265).	▪ IRC 7874 ▪ Treas. Reg. 1.7874-2T (revised as of April 1, 2012) – Effective for transactions completed on or after June 9, 2009 and before June 7, 2012

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of an 80% Inversion?

Analysis	Resources
Under IRC 7874, an "80% inversion" occurs when: ▪ FC directly or indirectly acquires substantially all of the properties held directly or indirectly by DC and DC either ceases to exist or becomes a U.S. subsidiary of the FC, ▪ Former S/Hs of DC own at least 80 percent (vote or value) of the stock of the acquiring FC after the transaction by reason of holding stock in DC, and ▪ the EAG (expanded affiliated group (including the FC)) does NOT have substantial business activities in the FC's country of incorporation in comparison to the WW business activities of the EAG. Once there is an 80% inversion, one must determine compliance under IRC 7874. IRC 7874(b) treats the FC (new foreign parent) as a domestic corporation since FC (based on the above facts establishing an 80% inversion) would be a "surrogate foreign corporation" (SFC) under the definition in IRC 7874(a)(2) by substituting "80 percent" for "60 percent."	▪ IRC 7874(b) – Treated as a domestic corporation ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas Reg. 1.7874-2(j) – Application of IRC 7874(b)

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of an 80% Inversion? (cont'd)

Analysis	Resources
"80% Inversion" KEY TAX IMPLICATIONS: In a transaction described under IRC 367(a) which would constitute an 80% inversion, the foreign acquiring corporation is treated as a DC for all U.S. tax purposes; therefore, the transaction (reorganization or IRC 351 exchange) will not be taxable to either the U.S. S/Hs of DC or the DC under IRC 367(a). Accordingly, the acquiring corporation will be taxable by the U.S. on its WW income, and any CFCs owned by DC immediately before the inversion will remain CFCs immediately after the inversion. In addition, any pre-existing non-U.S. subsidiaries of the new foreign parent could become CFCs post inversion due to the new foreign parent being treated as a domestic corporation. Keep in mind that inversions may be structured in a way that avoid being 80% inversions under IRC 7874 since this provision basically negates all the tax advantages of entering into such transaction. The treatment of the new foreign parent as a domestic corporation for all U.S. tax purposes results in no U.S. tax savings being realized by the EAG and could potentially increase the U.S. tax burden. Such increase may result from the application of subpart F to any pre-existing foreign subsidiaries of the new foreign parent or potential transfer pricing issues relating to any transactions with these entities.	▪ IRC 7874(b) – Treated as a domestic corporation ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas Reg. 1.7874-2(j)(1) – *Conversion to a domestic corporation* – Application of IRC 7874(b) ▪ Treas. Reg. 1.7874-2(j)(2) – *Entity classification* ▪ Treas. Reg. 1.7874-2(j)(3) – *Application of section 367*

Corporate Inversions - Overview of Major Issues
What are the tax consequences of an 80% Inversion? (cont'd)

Analysis	Resources
<u>"80% Inversion" KEY TAX IMPLICATIONS (cont'd)</u> Some of the tax consequences are: ▪ When the acquiring FC is treated as a DC under IRC 7874(b) the "conversion" is treated as an inbound (I/B) IRC 368(a)(1)(F) reorganization (in effect a deemed change in place of incorporation to the U.S. for U.S. federal tax purposes) occurring at the later of the end of the day immediately preceding the first date properties are acquired as part of the acquisition or immediately after the formation of the FC. (See Treas. Reg. 1.7874-2(j)(1)). ▪ FC, which is treated as a domestic corporation under IRC 7874(b), is not an eligible entity for entity classification purposes (e.g. check-the-box (CTB) election), and as such may not elect non-corporate status under the CTB rules. Its classification is defined by statute as a DC. (See Treas. Reg.1.7874-2(j)(2) and 301.7701-3).	▪ IRC 7874(b) – Treated as a domestic corporation ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas Reg. 1.7874-2(j)(1) – *Conversion to a domestic corporation* – Application of IRC 7874(b) ▪ Treas. Reg. 1.7874-2(j)(2) – *Entity classification* ▪ Treas. Reg. 1.7874-2(j)(3) – *Application of section 367*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of an 80% Inversion? (cont'd)

Analysis	Resources
<u>"80% Inversion" KEY TAX IMPLICATIONS (cont'd)</u> Some of the tax consequences are (cont'd): ▪ IRC 367(a) requires U.S. persons to recognize gain on certain outbound (O/B) transfers of property to foreign corporations. However, IRC 367(a) does not apply to transfers of property by U.S. persons to a FC that is treated as a DC for U.S. tax purposes under IRC 7874(b) since no outbound transfer of property has occurred for U.S. tax purposes. In an 80% inversion, IRC 367(a) does not apply to the prior S/Hs of DC on exchange of their DC stock for FC stock because FC is deemed to be a DC. Thus, no IRC 367(a) O/B transfer of stock has occurred since the S/Hs of DC are deemed to be exchanging domestic stock for domestic stock which will typically receive non-recognition treatment. In addition, there is no requirement for the filing of a gain recognition agreement under IRC 367(a) at the S/H level in order to secure nontaxable treatment. See Treas. Reg. 1.7874-2(j)(3).	▪ IRC 7874(b) – Treated as a domestic corporation ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas Reg. 1.7874-2(j)(1) – *Conversion to a domestic corporation* – Application of IRC 7874(b) ▪ Treas. Reg. 1.7874-2(j)(2) – *Entity classification* ▪ Treas. Reg. 1.7874-2(j)(3) – *Application of section 367* ▪ IRC 367(a)

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of an 80% Inversion? (cont'd)

Analysis	Resources
<u>"80% Inversion" KEY TAX IMPLICATIONS (cont'd)</u> Some of the tax consequences are (cont'd): ▪ The acquiring FC, treated as a domestic corporation, is taxable by the U.S. on its WW income and is required to file a Form 1120. All foreign corporations in which the acquiring SFC has direct or indirect interests exceeding 50%, by vote or by value, are CFCs and thus acquiring FC must file Forms 5471 for these corporations. ▪ IRC 367(b) may apply to the deemed conversion of FC (newly created or existing FC) into a "new" DC as a result of the inbound IRC 368(a)(1)(F) reorganization. (See Treas. Reg. 1.367(b)-2, (b)-3 and 1.7874-2(k) Example 20). However in the context of an inversion and depending on how the inversion was structured, a tax domestication of FC into DC may have little or no immediate IRC 367(b) consequences if FC is a newly established entity with no significant assets or tax attributes (e.g., E&P). If the FC was in existence prior to the inversion, IRC 367(b) may require taxation to certain exchanging shareholders of the FC.	▪ IRC 7874(b) – Treated as a domestic corporation ▪ Treas. Reg. 1.7874-2 – *Surrogate foreign corporation* ▪ Treas. Reg. 1.7874-2(j)(3) – *Application of section 367* ▪ IRC 367(b)

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of a 60% Inversion?

Analysis	Resources
If a 60% inversion occurs then: ▪ FC is treated as a "surrogate foreign corporation" (SFC); ▪ FC is respected and treated as a FC for U.S. federal tax purposes; and ▪ During the "applicable period" any "inversion gain" required to be recognized by an "expatriated entity" (e.g., DC or one of its domestic subsidiaries) may not be offset by certain tax attributes (e.g., net operating losses), and any tax specifically attributable to inversion gain may not be offset by certain tax credits. <u>"60% Inversion" KEY DEFINITIONS</u>: "Applicable period" is the period beginning on the first date properties held directly or indirectly by DC are acquired directly or indirectly by FC as part of the inversion transaction, and ending on the date which is 10 years after the last date properties held directly or indirectly by DC are acquired directly or indirectly by FC as part of the inversion transaction.	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities –* General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(1) – *Applicable Period* ▪ IRC 7874(d)(2) – *Inversion Gain*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of a 60% Inversion? (cont'd)

Analysis	Resources
<u>"60% Inversion" KEY DEFINITIONS (cont'd)</u>: Under IRC 7874, a "60% inversion" occurs when: (i) a DC becomes a subsidiary of a FC or otherwise transfers substantially all of its properties to such FC in a transaction completed after March 4, 2003; (ii) former S/H's of DC hold (by reason of holding stock in DC) at least 60%, but less than 80% (by vote or value) of the stock of FC after the transaction; and (iii) the EAG (expanded affiliated group, including FC) does not have SBA in FC's country of incorporation, compared to the total WW business activities of the EAG. Once there is a 60% inversion, one must determine compliance under IRC 7874 and how it impacts the SFC, the inverted DC and/or the prior S/Hs of DC. One should also consider potential application of Notice 2014-52 and the regulations that were issued pursuant to the Notice for transactions on or after 09/21/2014 (see discussion beginning on slide 38).	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities* – General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(2) – *Inversion Gain*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of a 60% Inversion? (cont'd)

Analysis	Resources
“60% Inversion” KEY DEFINITIONS (cont'd): “Inversion gain” is income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period by reason of a direct or indirect transfer of stock or other properties or license of any property, by an expatriated entity: (i) as part of the acquisition described in IRC 7874(a)(2)(B)(i) which results in the expatriated entity; or (ii) after the acquisition if the transfer or license is to a “related foreign person” (which is determined by applying rules of IRC 267(b) or 707(b), or the common control standards of IRC 482.) Inversion gain does not apply to property described in IRC 1221(a)(1) in the hands of the expatriated entity. “Expatriated entity” is the DC with respect to which FC is a SFC and any U.S. person related to that DC within the meaning of IRC 267(b) or 707(b)(1).	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities –* General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(2) – *Inversion Gain* ▪ IRC 7874(d)(3) – *Foreign Related Person* ▪ Treas. Reg. 1.7874-11T – *Rules regarding inversion gain*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of a 60% Inversion? (cont'd)

Analysis	Resources
<u>"60% Inversion" KEY DEFINITIONS (cont'd)</u>: ▪ In other words, inversion gain of the inverted DC may include, but is not limited to: – IRC 367(a) gain on the O/B transfer of certain assets by DC to New FC and/or IRC 367(d) income on O/B transfer of intangible property as part of an asset inversion; – related royalties or services income determined under IRC 482 on transactions with related foreign affiliates during the 10 year applicable period and/or – gain on sale of property other than property described in IRC 1221(a)(1) (generally inventory property) to a related foreign affiliate during the 10 year applicable period. ▪ In addition to DC's potential inversion gain under IRC 7874, gain may also exist at the S/H level on the O/B transfer of DC stock for FC stock under IRC 367(a).	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities* – General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(1) – *Applicable Period* ▪ IRC 7874(d)(2) – *Inversion Gain* ▪ IRC 367(a)(1) – Outbound transfer of domestic stock at S/H level ▪ Treas. Reg. 1.367(a)-3(c) – Outbound transfer of domestic stock to a foreign corporation ▪ Treas. Reg. 1.7874-11T – *Rules regarding inversion gain*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of a 60% Inversion? (cont'd)

Analysis	Resources
“60% Inversion” KEY TAX IMPLICATIONS: In the event of a 60% inversion, the following attribute restrictions will generally apply at the expatriated entity level: 1. The taxable income of the expatriated entity (e.g. DC or related U.S. person) for any tax year which includes any portion of the applicable period, must be at least equal to the amount of the entity's inversion gain for the taxable year. 2. If the expatriated entity may otherwise offset its income tax with credits (other than with credits allowed by IRC 901), the expatriated entity's inversion gain must remain effectively subject to federal income tax at the maximum corporate rate without reduction by those tax credits (other than credits allowed by IRC 901). 3. For purposes of determining the credit allowed by Section IRC 901, inversion gain will be treated as U.S. source income.	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities* – General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(1) – *Applicable Period* ▪ IRC 7874(d)(2) – *Inversion Gain*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
What are the tax consequences of a 60% Inversion? (cont'd)

Analysis	Resources
“60% Inversion” KEY TAX IMPLICATIONS (cont'd): ▪ The above provisions potentially restrict the expatriated entity's utilization of various tax attributes (e.g., NOLs) to offset any inversion gain and any tax attributable to inversion gain. Tax attribute limitation is the primary tax cost at the expatriated entity level when utilizing a 60% stock inversion structure. However, there may also be tax costs at the expatriated entity S/H level when utilizing a 60% stock inversion structure (e.g., IRC 367(a) shareholder level gain).	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities* – General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(1) – *Applicable Period* ▪ IRC 7874(d)(2) – *Inversion Gain*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
Post Inversion Tax Issues

Analysis	Resources
An inversion, in which the new parent is treated as a foreign corporation, by itself does not yield any U.S. tax savings. However, the inversion allows for the implementation of a variety of tax planning strategies that may reduce the U.S. tax expense and lower the group's overall ETR. Some of these tax planning strategies may artificially reduce U.S. tax and hence should be reviewed in the post-inversion years for compliance issues. These strategies include (but are not limited to) changes in transfer pricing (e.g., de-risking of U.S. operations), increase in intercompany debt owed to the foreign parent or one of its foreign affiliates which may serve to strip U.S. earnings from the U.S. and "out from under" planning to move CFCs and avoid application of subpart F going forward. Notice 2014-52 and the regulations that were issued pursuant to the Notice address some of these post-inversion issues for transactions on or after September 22, 2014 for certain inversions that fall under IRC 7874. Some post-inversion issues, including those covered by Notice 2014-52, will be discussed in the following pages of this Practice Unit.	▪ IRC 7874 ▪ Notice 2014-52 Sec. 3.03

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
Post-Inversion Tax Issues (cont'd)

Analysis	Resources
NOTICE 2014-52 – Post Inversion Transactions and Issues Notice 2014-52 describes regulations that Treasury and IRS intend to issue that may impact the U.S. federal tax treatment of transactions undertaken subsequent to certain 60% inversions that occur on or after September 22, 2014. On April 6, 2016, regulations implementing the Notice were issued and apply only if an IRC 7874 inversion occurs on or after September 22, 2014, with the exception of the regulations addressing IRC 304 which are intended to apply regardless of whether an IRC 7874 inversion has occurred.	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities –* General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(1) – *Applicable Period* ▪ IRC 7874(d)(2) – *Inversion Gain* ▪ Treas. Reg. 1.304-7T– *Certain acquisition by foreign acquiring corporations*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
Post-Inversion Tax Issues (cont'd)

Analysis	Resources
NOTICE 2014-52 – Post Inversion Transactions and Issues (cont'd) IRC 956 Application to Certain Transactions – Post-IRC 7874 Inversions Utilization of Offshore Cash of CFCs: Once the U.S. corporation is controlled by a new foreign parent, taxpayer may attempt to effectively distribute untaxed CFC earnings and profits to new foreign parent and/or its non-CFC foreign affiliates for foreign expansion or other foreign activity needs. For example, the CFCs may attempt to loan cash funds to the non-CFC foreign affiliates (e.g., the foreign parent or foreign entities owned directly by the foreign parent) without triggering investment in U.S. property under IRC 956. By creating a loan directly between the CFCs and new foreign parent or non-CFC foreign affiliates, the lent funds hopscotch the direct U.S. parent and thus are not available for future cash dividends or investment in U.S. property inclusions to the direct U.S. parent.	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities* – General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(1) – *Applicable Period* ▪ IRC 7874(d)(2) – *Inversion Gain* ▪ Notice 2014-52 – Sec 3 ▪ IRC 956 – Investment in U.S. Property

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
Post-Inversion Tax Issues (cont'd)

Analysis	Resources
NOTICE 2014-52 – Post Inversion Transactions and Issues (cont'd) IRC 956 Application to Certain Transactions – Post-IRC 7874 Inversions Utilization of Offshore Cash of CFCs (cont'd): Generally, Treas. Reg. 1.956-2T issued pursuant to Notice 2014-52 provides that an obligation or stock of a non CFC foreign related person, to the extent acquired by an expatriated foreign subsidiary during the 10 year period after the inversion, will be treated as U.S. property for purposes of IRC 956. Look for future Practice Units to address IRC 956 and post-inversion loan issues.	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities –* General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(1) – *Applicable Period* ▪ IRC 7874(d)(2) – *Inversion Gain* ▪ IRC 956 – Investment in U.S. Property ▪ Treas. Reg. 1.956-2T – *Definition of United States Property*

Corporate Inversions - Overview of Major Issues
Post-Inversion Tax Issues (cont'd)

Analysis	Resources
NOTICE 2014-52 – Post Inversion Transactions and Issues (cont'd) De-Control Transactions Under IRC 7701(l): Notice 2014-52 at section 3.02 describes regulations that Treasury and the IRS intend to issue which will address when stock in an "expatriated foreign subsidiary" (a CFC owned by the expatriated U.S. entity before the inversion) is transferred to a "specified related person" (e.g. a non-CFC foreign related person) during the 10-year applicable period, i.e. generally, the 10 year period following an inversion, in an attempt to de-control the CFC. Treas. Reg. 1.7701(l)-4T which was issued pursuant to the Notice will recharacterize the de-controlling transaction so that the expatriated foreign corporation remains a CFC of the expatriated U.S. entity, effectively disregarding for U.S. tax purposes the dilution of U.S. ownership and control.	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities* – General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(1) – *Applicable Period* ▪ IRC 7874(d)(2) – *Inversion Gain* ▪ Notice 2014-52 – Sec. 3.02 ▪ IRC 7701(l) – Conduit Arrangements ▪ IRC 367(b) ▪ Treas. Reg. 1.367(b)-4(b)(1)(i)(A) – Exchanging shareholder definition ▪ Treas. Reg. 1.367(b)-4(b)(1)(i)(B) – Loss of IRC 1248 shareholder or CFC status ▪ Treas. Reg. 1.7701(l)-4T – *Rules regarding inversion transactions*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
Post-Inversion Tax Issues (cont'd)

Analysis	Resources
NOTICE 2014-52 – Post Inversion Transactions and Issues (cont'd) Dilution of Expatriated Foreign Subsidiary Ownership by Certain Exchanging Shareholders: As part of a related provision, the same section of the Notice has announced that IRC 367(b) regulations will be issued that will require certain "exchanging shareholders" to include in income as a deemed dividend the IRC 1248 amount attributable to stock of an expatriated foreign subsidiary upon certain exchanges of the shares of the expatriated foreign subsidiary for shares of another foreign corporation in either a IRC 351 exchange or in a reorganization. An exchanging shareholder to which this rule applies includes a U.S. person that is an IRC 1248 shareholder of a foreign corporation. This rule applies to a "specified exchange" without regard to whether there is a loss of IRC 1248 shareholder or CFC status. See also Notice 2015-79, and Treas. Reg. 1.367(b)-4T(e), for an expansion of the consequences of the rule's application.	▪ IRC 7874(a)(1) – *Tax on Inversion Gain of Expatriated Entities* – General Rule ▪ IRC 7874(a)(2) – *Expatriated Entity* ▪ IRC 7874(a)(2)(B) – *Surrogate Foreign Corporation* ▪ IRC 7874(d)(1) – *Applicable Period* ▪ IRC 7874(d)(2) – *Inversion Gain* ▪ Notice 2014-52 – Sec. 3.02 ▪ IRC 7701(l) – Conduit Arrangements ▪ IRC 367(b) ▪ Treas. Reg. 1.367(b)-4(b)(1)(i)(A) – Exchanging shareholder definition ▪ Treas. Reg. 1.367(b)-4(b)(1)(i)(B) – Loss of IRC 1248 shareholder or CFC status ▪ Treas. Reg. 1.367(b)-4T(e) – *Income inclusion and gain recognition in certain exchanges following an inversion transaction*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
Post Inversion Tax Issues (cont'd)

Analysis	Resources
IRC 304 Transactions: Notice 2014-52 Section 3.03 provides that Treasury and the IRS intend to issue regulations addressing IRC 304 transactions that occur on or after September 22, 2014 without regard to whether an inversion subject to IRC 7874 has occurred. Notice 2014-52 includes rules that focus on transactions that reduce the untaxed E&P of a CFC to facilitate repatriation of cash or other property of the CFC through certain IRC 304 transactions. Treas. Reg. 1.304-7T, issued pursuant to Notice 2014-52, provides that for purposes of applying IRC 304(b)(5)(B) the determination of whether >50% of the dividend that arises under IRC 304(b)(2) is subject to U.S. tax or includible in the E&P of a CFC will be made by taking into account only the E&P of the foreign "acquiring" corporation (therefore excluding the E&P of the issuing corporation).	▪ IRC 7874 ▪ Notice 2014-52 Sec. 3.03 ▪ IRC 301 ▪ IRC 304 – Certain stock purchases ▪ IRC 304(b)(5)(B) – Special rule – Foreign "Acquiring" Corporation – Determination of E&P treated as dividend ▪ Treas. Reg. 1.304-7T – *Certain acquisition by foreign acquiring corporations*

Corporate Inversions - Overview of Major Issues
Post Inversion Tax Issues (cont'd)

Analysis	Resources
<u>Movement of CFCs – "Out from Under" Issues:</u> Once the U.S. corporation is controlled by a foreign parent, the U.S. may attempt to remove its previously owned CFCs "out from under" the U.S. ownership structure to avoid future subpart F and IRC 956 investment in U.S. property income inclusions. The U.S. corporation may sell, reorganize, or distribute the CFCs to another foreign affiliate (e.g. the foreign parent or a foreign entity owned directly by the foreign parent). Such transactions could invoke IRC 367, IRC 1248, and/or IRC 355 issues. Any gain on a sale or transfer of CFC stock should normally be reported on the U.S. return and may be treated as ordinary income pursuant to IRC 1248. See the following Practice Units relating to outbound transfer of CFC stock: ▪ Practice Unit, "Outbound Transfer of Property to a Foreign Corporation – IRC 367 Overview," DCN: ISO/9411.08_01(2013) ▪ Practice Unit, "Outbound Transfer of Foreign Stock," DCN: ISO/9411.08_04(2014) Look for future Practice Units to address other "out from under" transactions/issues.	▪ IRC 367(a) ▪ IRC 1248 ▪ IRC 355 ▪ Treas. Reg. 1.367(a)-3(b) – Outbound Transfer of Foreign Stock

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
Post Inversion Tax Issues (cont'd)

Analysis	Resources
<u>Transfer Pricing Post Inversion Issues</u>: The taxpayer may make changes to its overall transfer pricing regime in establishing transfer pricing relationships between the acquired U.S. corporation and its affiliates, and the acquiring new foreign parent and its affiliates. This could include a restructuring of product flow between the U.S. and its foreign affiliates, pricing of goods and services, and possible movement of intangibles through transfers, licensing or cost sharing arrangements. See related Practice Unit, "Purchase of Tangible Goods from a Foreign Parent – CUP Method," DCN: ISI/9422.07_05(2013) for further information on tangible good transactions by a controlled U.S. corporation with its foreign parent.	▪ IRC 7874 ▪ IRC 482 ▪ Treas. Reg. 1.482-1 ▪ Treas. Reg. 1.482-3 – *Methods to determine taxable income in connection with a transfer of tangible property* ▪ Treas. Reg. 1.482-5 – *Comparable profits method*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
Post Inversion Tax Issues (cont'd)

Analysis	Resources
Transfer Pricing Post Inversion Issues (cont'd): In addition, the taxpayer may also take steps to de-risk certain U.S. operations such as converting a full risk U.S. distributor or manufacturer to a limited risk distributor or contract or consignment manufacturer. See the following related Practice Units that have been completed as of 01/2016: ▪ Practice Unit, "CPM Simple Distributor Inbound," DCN: ISI/9422.07_07(2013) ▪ Practice Unit, "Inbound Resale Price Method: Routine Distributor," DCN: ISI/9422.07_08(2013) ▪ Practice Unit, "Best Method Determination for an Inbound Distributor," DCN: ISI/9422.09_04(2013) ▪ Practice Unit, "Risk Shifting to Controlled Foreign Corporations," DCN: ISO/9411.04_01(2013)	▪ IRC 7874 ▪ IRC 482 ▪ Treas. Reg. 1.482-1 ▪ Treas. Reg. 1.482-3 – *Methods to determine taxable income in connection with a transfer of tangible property* ▪ Treas. Reg. 1.482-5 – *Comparable profits method*

Detailed Explanation of the Concept (cont'd)

Corporate Inversions - Overview of Major Issues
Post Inversion Tax Issues (cont'd)

Analysis	Resources
Earning Stripping: One of the most common post-inversion issues involves the earnings stripping of the inverted U.S. corporation and/or its other U.S. group affiliates, now controlled by a new foreign parent, through various intercompany debt transactions. In some instances, the U.S. group may be saddled with third-party debt relating to the inversion itself. Also, the U.S. group may enter into intercompany debt relationships with its new foreign parent (or foreign entities owned by the foreign parent) in an attempt to reduce U.S. taxable income and to repatriate earnings via interest and principal payments. In both instances of intercompany and third party debt, the U.S. incurs substantial interest expense thus reducing U.S. taxable income and its effective tax rate. The E&P of CFCs may be similarly stripped. There are numerous issues to consider in such intercompany debt transactions including, but not limited to, earning stripping under IRC 163(j), and debt vs. equity characterizations under IRC 385 and general case law standards. See Practice Unit, "Interest Expense Limitation Computation under IRC 163(j)," DCN: IBF/9423.05_04(2013). Look for future Practice Units to address these issues. New regulations under IRC 385, Prop. Treas. Reg. 1.385-1, -2, -3, and ,-4, were proposed on April 4, 2016 which, in relevant part, under certain circumstances would recharacterize a debt instrument, or part of the debt instrument, as equity.	▪ IRC 163(j) ▪ IRC 267(a)(3)

Corporate Inversions - Overview of Major Issues

Type of Resource	Description(s) and/or Instructions for Accessing	References
CENTRA sessions	▪ 2014 (TPO) CPE CENTRA – Corporate Inversions and IRC 7874 Overview ▪ 2015 (TPO) & (IBC) CENTRA – Inversion Notice 2014-52	
Reference Materials – Treaties	▪ *BNA Tax Management Int'l Portfolio* 919-3rd Sec. VII – *IRC 7874 – Corporate inversions.* ▪ Dolan - *U.S. Tax Int'l Mergers, Acquis. & Jt. Ventures* – Chapter 24 – *Expatriations of U.S. Corporations* ▪ *Bittker & Lokken – Fed. Tax'n Inc., Est and Gift* Para. 66.2 – *Inversions and Expatriated Entities*	

Glossary of Terms and Acronyms

Term/Acronym	Definition
CFC	Controlled Foreign Corporation
CPM	Comparable Profit Method
CTB	Check the Box
CUP	Comparable Uncontrolled Price
DC	Domestic Corporation
DCN	Document Control Number
EAG	Expanded Affiliated Group
E&P	Earnings and Profits
FC	Foreign Corporation
FMV	Fair Market Value
FP	Foreign Parent
IBF	Inbound Financing
IPS	International Practice Service
IRC	Internal Revenue Code

Glossary of Terms and Acronyms (cont'd)

Term/Acronym	Definition
NOL	Net Operating Loss
O/B	Outbound
P/S	Partnership
RPA	Repatriation
SBA	Substantial Business Activities
SEC	U.S. Securities & Exchange Commission
SFC	Surrogate Foreign Corporation
S/H	Shareholder
T/B	Trade or Business
TD	Treasury Decision
WW	Worldwide

Index of Related Issues

Issue	Associated UIL(s)	References
Risk Shifting to Controlled Foreign Corps	9411.04	Practice Unit, “Risk Shifting to Controlled Foreign Corporations,” DCN: ISO/9411.04_01(2013)
Outbound Transfer of Property to FC – IRC 367 Overview	9411.08	Practice Unit, “Outbound Transfer of Property to Foreign Corporations – IRC 367 Overview,” DCN: ISO/9411.08_01(2013)
Outbound Transfer of Foreign Stock to FC – IRC 367 Overview	9411.08	Practice Unit, “Outbound Transfer of Foreign Stock,” DCN: ISO/9411.08_04(2014)
CPM Simple Distributor Inbound	9422.07	Practice Unit, “CPM Simple Distributor Inbound,” DCN: ISI/9422.07_07(2013)
Purchase of Tangible Goods from a Foreign Parent – CUP Method –	9422.07	Practice Unit, “Purchase of Tangible Goods from a Foreign Parent – CUP Method,” DCN: ISI/9422.07_05(2013)
Inbound Resale Price Method: Routine Distributor	9422.07	Practice Unit, “Inbound Resale Price Method: Routine Distributor,” DCN: ISI/9422.07_08(2013)
Best Method Determination for an Inbound Distributor	9422.09	Practice Unit, “Best Method Determination for an Inbound Distributor,” DCN: ISI/9422.09_04(2013)
Earning Stripping	9423.05	Practice Unit, “Interest Expense Limitation Computation under IRC Section 163(j),” DCN: IBF/9423.05_04(2013)

Index of Related Issues (cont'd)

Issue	Associated UIL(s)	References
Bona Fide Debt	9423.01-01	Practice Unit, "Bona Fide Debt Determination," DCN: IBF/9423.01_02(2016) Practice Unit, "Ability to Service and Repay the Debt", DCN: IBF/CU/SC_07.1.1.2_01(2016)