

Part III - Administrative, Procedural, and Miscellaneous

Section 7874: Treatment of Certain Stock of the Foreign Acquiring Corporation

Notice 2009-78

SECTION 1. OVERVIEW

The Internal Revenue Service (IRS) and the Treasury Department (Treasury) intend to issue regulations under section 7874 of the Internal Revenue Code (Code) incorporating the rules described in this notice that will identify certain stock of a foreign corporation that is disregarded for determining ownership of the foreign corporation for purposes of section 7874(a)(2)(B)(ii). In general, and as described below, the regulations to be issued pursuant to this notice shall apply to acquisitions completed on or after September 17, 2009.

SECTION 2. BACKGROUND

Section 7874 provides rules for expatriated entities and their surrogate foreign corporations. An expatriated entity is a domestic corporation (or domestic partnership) with respect to which a foreign corporation (which includes certain publicly traded foreign partnerships) is a surrogate foreign corporation, and any United States person

related to such domestic corporation (or domestic partnership) (within the meaning of sections 267(b) or 707(b)(1)). Section 7874(a)(2)(A).

A foreign corporation constitutes a surrogate foreign corporation if three conditions are satisfied. First, the foreign corporation completes, after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation. Section 7874(a)(2)(B)(i). Second, after the acquisition at least 60 percent of the stock of the foreign corporation (by vote or value) is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation (the Ownership Condition). Section 7874(a)(2)(B)(ii). Third, after the acquisition the expanded affiliated group (defined in section 7874(c)(1)) that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group. Section 7874(a)(2)(B)(iii). Similar provisions apply if a foreign corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership.

Under section 7874(c)(2), certain stock of the foreign corporation is not taken into account in determining whether the Ownership Condition is satisfied: (1) stock of the foreign corporation held by members of the expanded affiliated group that includes the foreign corporation, and (2) stock of the foreign corporation sold in a public offering related to the acquisition described in section 7874(a)(2)(B)(i).

Regulations addressing the Ownership Condition were published in the Federal

Register on May 20, 2008, and June 12, 2009 (TD 9399, 73 FR 29054; TD 9453, 74 FR 27920).

Under section 7874(c)(4) a transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874.

Section 7874(g) grants the Secretary broad authority to provide regulations necessary to carry out section 7874, including regulations adjusting the application of section 7874 as necessary to prevent the avoidance of the purposes of section 7874. More specifically, section 7874(c)(6) grants the Secretary authority to prescribe regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat stock as not stock.

In TD 9453, the IRS and Treasury modified §1.7874-2T(e)(5), Example 3, to eliminate an unintended implication as to the scope or application of the public offering rule of section 7874(c)(2)(B). The TD 9453 preamble states that the IRS and Treasury are considering issuing guidance concerning the scope and application of the public offering rule and request comments in this regard.

SECTION 3. TRANSACTIONS AT ISSUE

The IRS and Treasury have become aware of transactions intended to avoid the application of section 7874 that involve a transfer of cash (or certain other assets) to the foreign corporation in a transaction related to the acquisition described in section 7874(a)(2)(B)(i), thereby minimizing the former shareholders' ownership in the foreign corporation for purposes of the Ownership Condition. In one such transaction, for

example, the shareholders of a domestic corporation (DC) transfer all their DC stock to a newly-formed foreign corporation (New FCo) in exchange for 79 percent of the stock of New FCo and, in a related transaction, an investor transfers cash to New FCo in exchange for the remaining 21 percent of the New FCo stock. The parties to the transaction take the position that the New FCo stock issued to the investor is not “sold in a public offering” and thus not subject to section 7874(c)(2)(B). The parties also assert that the transfer of cash from the investor to New FCo was not part of a plan a principal purpose of which is to avoid the purposes of section 7874 such that section 7874(c)(4) does not apply to disregard the investor’s transfer of cash to New FCo in exchange for New FCo stock.

Under these positions, the parties assert that the investor’s New FCo stock would be taken into account for purposes of the Ownership Condition. Thus, the former shareholders of DC would hold only 79 percent of the stock of New FCo by reason of holding stock of DC, in which case section 7874(a)(1) would apply to DC (and any other expatriated entity) but section 7874(b) would not apply to treat New FCo as a domestic corporation for purposes of the Code. The IRS and Treasury understand that similar transactions may be structured with respect to the acquisition of a domestic corporation in a title 11 or similar case (as defined in section 368(a)(3)) or a domestic partnership. These transactions are inconsistent with the purposes of section 7874.

The IRS and Treasury also understand that taxpayers are concerned the public offering rule of section 7874(c)(2)(B) applies to all public issuances of stock by a foreign corporation, regardless of the property exchanged for the stock. For example, assume

that, pursuant to a business combination, the shareholders of a publicly-traded foreign corporation (FT) and a publicly-traded domestic corporation (DT) intend to transfer their FT and DT stock, respectively, to a newly-formed foreign corporation (FA) that will be publicly-traded. To effectuate the transaction, as part of a plan FA acquires all of the FT and the DT stock, respectively, from the FT and DT shareholders in exchange solely for newly-issued FA stock. If the FA stock issued to the FT shareholders is considered “sold in a public offering” and thus subject to section 7874(c)(2)(B), the former shareholders of DT would be treated as owning 100 percent of the stock of FA for purposes of the Ownership Condition, and FA would therefore be treated as a domestic corporation for purposes of the Code under section 7874(b). A similar result would occur if instead FT merged with and into FA and the FT shareholders exchanged their FT stock for FA stock pursuant to the merger. The IRS and Treasury believe that such a result could be inappropriate in certain cases.

SECTION 4. REGULATIONS TO BE ISSUED

To address certain transactions, including those described in Section 3 of this notice, the IRS and Treasury intend to issue regulations identifying stock of the foreign corporation that is not taken into account for purposes of the Ownership Condition. The regulations will identify stock of the foreign corporation that shall not be taken into account for purposes of the Ownership Condition, even if such stock may not otherwise be described in section 7874(c)(2)(B). The regulations will also clarify that certain stock, which may be described in section 7874(c)(2)(B), shall nonetheless be taken into account for purposes of the Ownership Condition.

The regulations issued pursuant to this notice shall provide that stock of the foreign corporation issued in exchange for “nonqualified property” in a transaction related to the acquisition described in section 7874(a)(2)(B)(i) is not taken into account for purposes of the Ownership Condition, without regard to whether such stock is publicly traded on the date of issuance or otherwise. Subject to certain exceptions, the term “nonqualified property” shall generally mean: (1) cash or cash equivalents; (2) marketable securities as defined in section 453(f)(2); and (3) any other property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874.

For this purpose, however, marketable securities generally shall not include stock (or a partnership interest) issued by a member of the expanded affiliated group (as defined in section 7874(c)(1)) that after the acquisition includes the foreign corporation, unless a principal purpose of the issuance of the stock of the foreign corporation in exchange for such property was the avoidance of the purposes of section 7874. For this purpose, a partnership shall be treated as a member of an expanded affiliated group if the partnership would be a member of the expanded affiliated group if it were a corporation.

The regulations shall provide similar rules to address acquisitions of property by one or more members of the expanded affiliated group (that includes the foreign corporation after the acquisition) in exchange for stock of the foreign corporation, including, for example, pursuant to a triangular reorganization. For this purpose, a partnership shall be treated as a member of an expanded affiliated group if the

partnership would be a member of the expanded affiliated group if it were a corporation.

The rules described in this notice are not intended to affect the application of section 7874(c)(2)(A), §1.7874-1, or section 7874(c)(4).

The following examples illustrate the rules concerning the Ownership Condition that are intended to be included in the regulations described in this notice. For purposes of the examples, unless otherwise indicated, FA, FMS and FT are foreign corporations, DMS and DT are domestic corporations, PRS is a partnership, all entities are unrelated, and section 7874(c)(4) may apply to disregard certain transfers.

Example 1. Stock issued in exchange for marketable securities. (i) Facts. Individual A wholly owns DT. FA, a newly formed corporation, acquires all the DT stock from individual A in exchange solely for FA stock. In a transaction related to FA's acquisition of the DT stock, PRS transfers marketable securities (within the meaning of section 453(f)(2)) to FA solely in exchange for FA stock.

(ii) Analysis. The FA stock issued to PRS in exchange for the marketable securities is not taken into account for purposes of the Ownership Condition.

Example 2. Stock issued with a principal purpose of avoiding section 7874. (i) Facts. FA acquires all the DT stock in exchange solely for FA stock. In a transaction related to FA's acquisition of the DT stock, PRS transfers marketable securities (within the meaning of section 453(f)(2)) to FT, a newly formed corporation, solely in exchange for FT stock and then transfers the FT stock to FA in exchange solely for FA stock. The shares of FT stock do not constitute marketable securities within the meaning of section 453(f)(2).

(ii) Analysis. The FA stock issued to PRS in exchange for the FT stock is not taken into account for purposes of the Ownership Condition because a principal purpose of such issuance is the avoidance of the purposes of section 7874.

Example 3. Stock issued or exchanged for stock of a foreign corporation. (i) Facts. The stock of DT and FT is publicly traded. The following transactions are completed pursuant to a plan: FT forms FA, and FA forms DMS and FMS. FMS merges with and into FT, with FT surviving the merger. Pursuant to the FMS-FT merger, the FT shareholders exchange their FT stock solely for FA stock. Following the FMS-FT merger, DMS merges with and into DT, with DT surviving the merger.

Pursuant to the DMS-DT merger, the DT shareholders exchange their DT stock solely for FA stock. After completion of the plan, FA wholly owns FT and DT.

(ii) Analysis. After the FMS-FT merger, FT is a member of the expanded affiliated group that includes FA. Therefore, the shares of FT stock are not treated as marketable securities and therefore do not constitute nonqualified property. Thus, the FA stock issued or exchanged for the FT stock is taken into account for purposes of the Ownership Condition.

(iii) Alternative facts. Assume the same facts as in paragraph (i) of this example except that, instead, FT merges with and into FA with FA surviving the merger. At the time of the merger, FT does not hold nonqualified property. Pursuant to the FT-FA merger, the FT shareholders exchange their FT stock solely for FA stock. Because the properties transferred by FT to FA pursuant to the FT-FA merger do not constitute nonqualified property, the FA stock issued in exchange for such properties pursuant to the merger will be taken into account for purposes of the Ownership Condition.

SECTION 5. EFFECTIVE DATE

The regulations described in this notice shall apply to acquisitions completed on or after September 17, 2009. Taxpayers may apply the rules described in this notice in their entirety to acquisitions completed on or after September 17, 2009, and before publication of the regulations described in this notice if the rules are applied consistently to all such acquisitions.

No inference is intended as to the treatment of transactions described in this notice under current law and the IRS may, where appropriate, challenge such transactions under applicable provisions, including under section 7874(c)(4) or judicial doctrines (such as the substance-over-form doctrine).

SECTION 6. DRAFTING INFORMATION

The principal author of this notice is S. James Hawes of the Office of Associate Chief Counsel (International). However, other personnel from the IRS and the Treasury

Department participated in its development. For further information regarding this notice, contact Mr. Hawes or Milton M. Cahn at (202) 622-3860 (not a toll-free call).