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NEWS ANALYSIS

Guidance on Inversions Is a Priority

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The American Bar Association Section of Taxation has assigned high priority to issuance of regs or other published guidance on applying inversion rules to creditors of bankrupt and insolvent companies under reg. section 1.7874-2(i)(2). Application of this rule may lead to inversion treatment in situations that do not raise the concerns that the inversion rules are designed to address. Relatively straightforward changes could be made to fix those inappropriate results while still preventing the problem the rule was designed to protect against.

A tax inversion is a restructuring that replaces a U.S. parent company with a foreign parent so that the original parent becomes a subsidiary and the tax residence of the target business changes to a foreign country. The inversion rules in section 7874 and regs are intended to discourage inversions by limiting the ability of U.S. corporations to move their operations overseas without unfavorable U.S. tax consequences.

Section 7874

Sections 7874(a)-(g) provide rules related to expatriated entities and their foreign parents. It was added to the code by the American Jobs Creation Act of 2004 (P.L. 108-357). The guidance has:

- a general rule imposing a tax on inversion gains;
- a rule treating inverted corporations as U.S. corporations;
- an assortment of definitions and special rules (paragraphs (c)-(e));
- a rule that prohibits an exemption from section 7874 under a U.S. treaty obligation; and
- a grant of authority to issue regs, including antiavoidance regs.

The general rule in section 7874(a)(1)-(3) imposes a tax on inversion gain when entities expatriate. Paragraph (a)(1) provides that the taxable income of an expatriated entity for any tax year that includes any portion of an applicable period may never be less than the entity's inversion gain for the year.

Paragraph (a)(2)(A) defines expatriated entity as:

- a U.S. corporation or partnership described in paragraph (a)(2)(B)(i) that transfers property to a surrogate foreign corporation; or
- any U.S. person who is related (within the meaning of section 267(b) or 707(b)(1)) to a U.S. corporation or partnership that transfers property to a surrogate foreign corporation.

Paragraphs (a)(2)(B)(i)-(iii) define surrogate foreign corporation as any foreign corporation that meets an acquisition test, an ownership test, and a substantial business activities test. A foreign corporation is a surrogate foreign corporation if, as part of a plan (or series of related transactions):

- the entity completes (after March 4, 2003) the direct or indirect acquisition of substantially all of a U.S. corporation's properties or the properties constituting a U.S. partnership's trade or business;
- after the acquisition, at least 60 percent of the stock (by vote or fair market value) of the acquiring entity is held by former shareholders of the target U.S. corporation because they held stock in the U.S. corporation, or by former partners of the U.S. partnership because they held a capital or profits interest in the U.S. partnership; and
- after the acquisition, the expanded affiliated group (EAG) that includes the acquiring entity does not have substantial business activities in the foreign country in which the acquiring entity is created or organized compared with the total business activities of the EAG.

An entity described in paragraph (a)(2)(B)(i) is nevertheless not treated as described if (on or before March 4, 2003) it acquired more than half the properties held directly or indirectly by the U.S. corporation or more than half the properties constituting the partnership's trade or business.

Paragraph (a)(3) coordinates paragraphs (a) and (b) by providing that a corporation treated as a U.S. corporation under paragraph (b) is not

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treated as a surrogate foreign corporation under paragraph (a)(2).

Paragraph (b) provides that inverted corporations are treated as U.S. corporations notwithstanding the section 7701(a)(4) definition of a U.S. corporation or partnership as an entity created or organized in the United States. A foreign corporation is treated as a U.S. corporation when the corporation would be a surrogate foreign corporation if section 7874(a)(2) were applied using an 80 percent ownership threshold (instead of the 60 percent threshold in section 7874(a)(2)).

Paragraphs (c)(1)-(6) provide definitions and special rules. Paragraph (c)(1) describes EAG as an affiliated group as defined in section 1504(a) (providing an 80 percent vote and value ownership threshold) without regard to section 1504(b)(3) (excluding foreign corporations from affiliated groups), except that section 1504(a) is applied by using an ownership threshold of more than 50 percent (instead of at least 80 percent).

Paragraph (c)(2) provides that, in determining whether the 60 percent ownership threshold in subsection (a)(2)(B)(ii) for surrogate foreign corporation status is met, taxpayers should disregard:

- stock held by members of the EAG that includes the acquiring foreign corporation; or
- stock of a foreign corporation sold in a public offering related to the acquisition described in paragraph (a)(2)(B)(i).

Paragraph (c)(3) assumes a plan is present if a foreign corporation acquires directly or indirectly substantially all the properties of a U.S. corporation or partnership during the four-year period beginning on the date that is two years before the 60-percent-ownership requirements of paragraph (a)(2)(B)(ii) are met. The acquisitions during that period are treated as part of a plan.

Paragraph (c)(4) disregards the transfer of properties or liabilities (including by contribution or distribution) if the transfers are part of a plan to avoid section 7874.

Paragraph (c)(5) has a special rule for applying paragraph (a)(2)(B)(ii) to the acquisition of a trade or business of a U.S. partnership. Except as provided in regs, all partnerships that are under common control (within the meaning of section 482) are treated as one partnership.

Paragraph (c)(6) grants the Treasury secretary authority to prescribe regs that help taxpayers determine whether a corporation is a surrogate foreign corporation, including regs that treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and to treat stock as not stock.

Paragraphs (d)(1)-(3) provide additional definitions. Paragraphs (d)(1)(A)-(B) define applicable period as:

- beginning on the first date properties are acquired as part of the acquisition described in paragraph (a)(2)(B)(i); and
- ending on the date that is 10 years after the last date properties are acquired as part of the acquisition.

Paragraphs (d)(2)(A)-(B) define inversion gain as the income or gain recognized because of a transfer during the applicable period of stock or other properties by an expatriated entity, and income received or accrued during the applicable period because of a license of property by an expatriated entity:

- as part of the acquisition described in paragraph (a)(2)(B)(i); or
- after the acquisition, if the recipient of the transfer or license is a foreign related person.

Paragraph (d)(2)(B) does not apply to property described in section 1221(a)(1) as inventory or property held for sale to customers in the hands of the expatriated entity.

Paragraphs (d)(3)(A)-(B) define foreign related person as a foreign person that:

- is related (within the meaning of section 267(b) or 707(b)(1)) to an expatriated entity; or
- is under the same common control (within the meaning of section 482) as an expatriated entity.

Paragraphs (e)(1)-(4) provide special rules that address tax credits, expatriated partnerships, coordination with net operating loss provisions, and the statute of limitations.

Paragraphs (e)(1)(A)-(B) limit the use of tax credits to offset the tax on inversion gain. Credits (other than the foreign tax credit allowed by

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section 901) are allowed against the tax imposed on an expatriated entity for any tax year described in paragraph (a), but only to the extent the tax exceeds the product of:

- the amount of inversion gain for the year; and
- the highest rate of tax specified in section 11(b) or 21 percent.

To determine the FTC allowed by section 901, inversion gain is treated as U.S.-source income.

Paragraphs (e)(2)(A)-(C) apply when the expatriated entity is a partnership and provide that:

- paragraph (a)(1) applies at the partner (rather than the partnership) level;
- a partner's inversion gain for the year is equal to the sum of:
  - the partner's distributive share of the partnership's inversion gain for the year; plus
  - gain recognized by the partner because of the transfer during the applicable period of any partnership interest to a surrogate foreign corporation; and
- the highest tax rate specified in the rate schedule applicable to the partner is used instead of the tax rate referred to in paragraph (e)(1), the rate in section 11(b).

Paragraph (e)(3) coordinates the tax on inversion gain with the alternative minimum tax rules in section 55 and the NOL rules in section 172. It provides that rules like those in section 860E(a)(3) and (4) apply to implement the tax in paragraph (a). Those rules generally provide that NOLs and alternative tax NOLs may not offset excess inclusions related to residual interests in real estate mortgage investment conduits.

Paragraphs (e)(4)(A)-(B) modify the statute of limitations for deficiencies attributable to inversion gains. The statutory period for the assessment of deficiency attributable to the inversion gain of a taxpayer for a pre-inversion year does not expire before three years from the date the Treasury secretary is notified by the taxpayer of the acquisition described in paragraph (a)(2)(B)(i) to which the gain relates. Any deficiency may be assessed before the expiration of the three-year period, notwithstanding any other law that would otherwise prevent an assessment.

A pre-inversion year is any tax year if:

- any portion of the applicable period is included in the year; and
- the year ends before the year in which the acquisition described in paragraph (a)(2)(B)(i) is completed.

Paragraph (f) provides that nothing in section 894 (addressing income affected by a treaty), 7852(d) (addressing the relationship between treaty provisions and U.S. law), or any other law permits an exemption from section 7874 under a U.S. treaty obligation (whether the treaty was entered into before or after enactment of section 7874).

Paragraphs (g)(1)-(2) give authority to the Treasury secretary to provide regs necessary to carry out section 7874, including regs providing for adjustments to prevent avoidance of the section through:

- the use of related persons, passthrough or other noncorporate entities, or other intermediaries; or
- transactions designed to have persons cease to be (or not become) members of EAGs or related persons.

Section 7874 imposes tax on the inversion gains of expatriated entities, which are U.S. entities that transfer substantially all their properties to surrogate foreign corporations. Surrogate foreign corporations are foreign corporations that satisfy the acquisition, ownership, and substantial business activities tests in paragraphs (a)(2)(B)(i)-(iii).

Inversion gain is the income recognized by an expatriated entity from the transfer during the applicable period of stock or other properties, and any income received during the applicable period under a license of property as part of the acquisition or after the acquisition if the property transfer or license is to a foreign related person.

If the 60-percent-ownership test is met, the new foreign parent will still be treated as a foreign corporation, but the expatriated entity's taxable income cannot be less than the inversion gain recognized during the 10-year applicable period, and the ability to offset the gain with FTCs or NOLs is limited.

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If an 80-percent-ownership test in section 7874(b) is met, the new foreign parent is treated as a U.S. corporation (not a surrogate foreign corporation) and the inversion is not respected under U.S. tax law. Moreover, section 367(a) does not apply to the expatriated entity's shareholders because no outbound property transfer has occurred.

Reg. Sections 1.7874-1 to -12

Regs accompanying section 7874 are provided in reg. sections 1.7874-1 to -12. The guidance provides:

- rules addressing the disregard of affiliate-owned stock in determining ownership;
- clarification on the definition of surrogate foreign corporation;
- a description of substantial business activities;
- rules addressing the disregard of stock related to a U.S. entity acquisition;
- a description of the effect of stock transfers related to a U.S. entity acquisition;
- rules addressing stock transferred by EAG members;
- rules addressing the disregard of stock attributable to passive assets;
- rules addressing the disregard of stock attributable to multiple U.S. entity acquisitions;
- rules addressing the disregard of stock attributable to third-country transactions;
- rules addressing the disregard of stock distributions;
- a description of inversion gain; and
- definitions.

Reg. section 1.7874-2 was added by T.D. 9591 on June 12, 2012; amended by T.D. 9761 on April 8, 2016; and amended by T.D. 9834 on July 12, 2018.

Reg. Section 1.7874-2

Reg. section 1.7874-2(a)-(l) clarifies the definition of surrogate foreign corporation and is the subject of the ABA tax section's suggestion for priority guidance. The guidance provides:

- an overview and description of the scope of reg. section 1.7874-2 as providing rules for determining whether a foreign corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B);
- definitions and special rules;
- rules to determine whether a foreign corporation has acquired properties held by a U.S. corporation (or a partnership);
- rules that apply when two or more foreign corporations complete (in the aggregate) a U.S. entity acquisition;
- rules that apply when (as part of a plan) a single foreign corporation completes more than one U.S. entity acquisition;
- rules to identify the stock of a foreign corporation held by reason of holding stock in a U.S. corporation (or an interest in a U.S. partnership);
- rules that treat foreign publicly traded partnerships as foreign corporations under section 7874;
- rules addressing the treatment of options (or similar interests) under section 7874;
- rules that treat various non-stock interests (including debt, stock, or a partnership interest) and creditors' claims as stock of a foreign corporation;
- rules addressing the conversion of a foreign corporation to a U.S. corporation under section 7874(b);
- examples that illustrate the rules of reg. section 1.7874-2; and
- applicability dates.

Definitions and Special Rules

Paragraphs (b)(1)-(13) contain an assortment of definitions and special rules in addition to the definitions in reg. section 1.7874-12(a)(1)-(20).

Paragraph (b)(1) reminds taxpayers that the rules in reg. section 1.7874-2 are subject to section 7874(c)(4), which provides that transfers of properties or liabilities are disregarded if they are part of a plan to avoid section 7874.

Under paragraph (b)(2), references to properties held by a U.S. corporation include properties held directly or indirectly by the corporation.

Paragraph (b)(3) provides that the rules and principles of sections 701-777 (of subchapter K) apply to determine a proportionate amount or share of properties held by a partnership,

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including stock. Sections 771-777 were repealed in 2015.

Paragraph (b)(4) provides that any reference to the acquisition of properties held by a U.S. corporation (or a partnership) includes a direct or indirect acquisition of properties.

Under paragraph (b)(5), in the case of an acquisition of stock of a U.S. corporation or an interest in a partnership, the proportionate amount of properties held by the U.S. corporation or partnership treated as indirectly acquired is determined at the time of the acquisition based on the relative FMV of:

- the stock acquired compared with all outstanding stock of the U.S. corporation; or
- the interest acquired compared with all interests in the partnership.

Under paragraph (b)(6), the determination of whether a foreign corporation is a surrogate foreign corporation is made after the U.S. entity acquisition. A foreign corporation that is treated as a surrogate foreign corporation (including a foreign corporation treated as a U.S. corporation described in section 7874(b)) will continue to be treated as a surrogate foreign corporation (or a U.S. corporation), even if the conditions of section 7874(a)(2)(B)(ii) and (iii) are not later satisfied.

Under paragraph (b)(7), a former shareholder of an initial acquiring corporation is any person that held stock in the initial acquiring corporation before the subsequent acquisition, including any person that holds stock in the initial acquiring corporation both before and after a subsequent acquisition.

Under paragraph (b)(8), an initial acquisition is a U.S. entity acquisition before a subsequent acquisition as part of a plan that includes the subsequent acquisition (or a series of related transactions).

Paragraph (b)(9) defines initial acquiring corporation as the foreign acquiring corporation in an initial acquisition.

Paragraph (b)(10) defines subsequent acquisition as a transaction occurring (as part of a plan or a series of related transactions that includes the initial acquisition) after an initial acquisition in which a foreign corporation directly or indirectly acquires (within the meaning of paragraph (c)(4)(ii)) substantially all the properties held directly or indirectly by the initial acquiring corporation.

Paragraph (b)(11) defines a subsequent acquiring corporation as the foreign corporation that directly or indirectly acquires substantially all the properties held directly or indirectly by the initial acquiring corporation.

Paragraph (b)(12) provides that the determination of the 60 percent ownership described in section 7874(a)(2)(B)(ii) is made without regard to the subsequent acquisition and related transactions after the subsequent acquisition.

Under paragraph (b)(13), if a subsequent acquisition (or a similar acquisition under paragraph (c)(4)(i)) is an inversion transaction, the applicable period begins on the first date that properties are acquired as part of the initial acquisition.

Reg. section 1.7874-12(a)(15) defines an inversion transaction as a U.S. entity acquisition in which the foreign acquiring corporation is treated as a surrogate foreign corporation under section 7874(a)(2)(B), taking into account section 7874(a)(3) (providing that a foreign acquiring corporation meeting the 80 percent threshold in section 7874(b) is not treated as a surrogate foreign corporation).

Indirect Acquisitions

Paragraphs (c)(1)-(4) addresses indirect acquisitions, including acquisitions of stock in foreign corporations, downstream transactions, and multiple-step acquisitions.

Paragraph (c)(1) provides that an indirect acquisition of properties held by a U.S. corporation (or a partnership) includes the acquisitions described in paragraphs (c)(1)(i)-(iv). An acquisition of less than all the stock of a U.S. corporation (or interests in a partnership) constitutes an indirect acquisition of a proportionate amount of the properties held by the U.S. corporation or the partnership.

The indirect acquisitions described in paragraphs (c)(1)(i)-(iv) are:

- an acquisition of stock of a U.S. corporation (see Example 1);
- an acquisition of an interest in a partnership (see Example 2);

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- an acquisition by a corporation (the acquiring corporation) of properties held by a U.S. corporation or partnership in exchange for stock in a foreign corporation (the foreign issuing corporation) that is part of the EAG including the acquiring corporation after the acquisition (treated as an acquisition by the foreign issuing corporation) (see Example 3); and
- an acquisition by a partnership (the acquiring partnership) of properties held by a U.S. corporation or partnership in exchange for stock of a foreign corporation that is part of the EAG that would include the acquiring partnership after the acquisition if the partnership were a corporation (again, treated as an acquisition by the foreign issuing corporation).

Under paragraph (c)(2), except as provided in paragraph (c)(4), an acquisition of stock of a foreign corporation that owns directly or indirectly stock of a U.S. corporation (or an interest in a partnership) does not constitute an indirect acquisition of any properties held by the U.S. corporation (or the partnership) (see Example 4).

Under paragraph (c)(3), an acquisition by a corporation of its own stock from another corporation or a partnership (for example, because of a downstream merger) is treated as an acquisition of the other corporation's or partnership's properties under section 7874(a)(2)(B)(i).

Paragraphs (c)(4)(i)-(iii) address multiple-step acquisitions. Paragraph (c)(4)(i) provides that a subsequent acquisition is treated as a U.S. entity acquisition, and the subsequent acquiring corporation is treated as a foreign acquiring corporation (see Example 21 and paragraph (f)(1)(iv), treating stock of the subsequent acquiring corporation as stock of a foreign corporation held by reason of holding stock or a partnership interest in the U.S. entity).

Under paragraph (c)(4)(ii), in determining whether a foreign corporation directly or indirectly acquires substantially all the properties held directly or indirectly by an initial acquiring corporation, the principles of section 7874(a)(2)(B)(i) apply (including reg. section 1.7874-2(c)), other than paragraph (c)(2). The principles of paragraphs (c)(1) and (b)(5) apply by using the term "foreign" instead of "U.S."

Under paragraph (c)(4)(iii), if, as part of the same plan (or series of related transactions), a foreign corporation directly or indirectly acquires (under the principles of paragraph (c)(4)(ii)) substantially all the properties directly or indirectly held by a subsequent acquiring corporation in a transaction after the subsequent acquisition, then the principles of paragraph (c)(4)(i) apply to the transaction (and any subsequent transactions that are part of the plan or series of related transactions).

Multiple Acquirers or Acquisitions

Paragraph (d) addresses acquisitions by multiple foreign corporations and applies when two or more foreign corporations complete a U.S. entity acquisition as part of a plan or series of transactions. Paragraph (e) addresses acquisitions of multiple U.S. entities and applies if a foreign corporation completes two or more U.S. entity acquisitions involving U.S. corporations or U.S. partnerships as part of a plan or series of related transactions. These provisions will be covered in a future article.

Successor Ownership

Paragraphs (f)(1)-(3) describe stock held by reason of holding stock in a U.S. corporation or an interest in a U.S. partnership. Under paragraph (f)(1), to apply section 7874(a)(2)(B)(ii), stock of a foreign corporation that is held by reason of holding stock in a U.S. corporation (or an interest in a U.S. partnership) includes the stock described in paragraphs (f)(1)(i)-(iv) as:

- stock of a foreign corporation received in exchange for, or as a distribution related to, stock of a U.S. corporation (see Example 9);
- stock of a foreign corporation received in exchange for, or as a distribution related to, an interest in a U.S. partnership;
- (to the extent that paragraph (f)(1)(ii) does not apply) stock of a foreign corporation received by a U.S. partnership in exchange for all or part of the partnership's properties (each partner in the U.S. partnership is treated as holding its proportionate share of the foreign corporation stock by reason of

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holding an interest in the U.S. partnership); and
- stock of a subsequent acquiring corporation received by a former initial acquiring corporation shareholder in a subsequent acquisition in exchange for, or as a distribution related to, stock of an initial acquiring corporation that is held by reason of holding stock or a partnership interest in a U.S. entity.

Paragraphs (f)(2)(i)-(ii) address transactions involving property transferred in addition to stock or partnership interests. If, as part of the same transaction, stock of a foreign corporation and other property is received in exchange for, or as a distribution related to, stock of a U.S. corporation, the stock of the foreign corporation is determined based on the relative FMV of the stock compared with the aggregate FMV of the stock and other property.

If, as part of the same transaction, stock of a foreign corporation and other property is received in exchange for, or as a distribution related to, an interest in a U.S. partnership, the stock of the foreign corporation is determined based on the relative FMV of the interest in the U.S. partnership compared with the aggregate FMV of the partnership interest and other property (see examples 8 and 10).

Foreign PTPs

Paragraphs (g)(1)-(6) address treatment of foreign PTPs. These are generally treated as a foreign corporation organized in the foreign country in which the partnership was created or organized. The partnership interests are treated as stock of the deemed foreign corporation. These provisions will be covered in a future article.

Options

Paragraphs (h)(1)-(6) address treatment of options. To determine the membership of an EAG under section 7874(c)(1), an option to acquire stock or a partnership interest is treated as stock in the corporation or an interest in the partnership. These provisions will be covered in a future article.

Deemed Stock Treatment

Paragraphs (i)(1)-(2) address treatment of non-stock ownership interests and creditors' claims as stock of a foreign corporation. Under paragraph (i)(1), if the conditions of paragraphs (i)(1)(i)-(ii) are satisfied, then any interest (including stock or a partnership interest) that is not otherwise treated as stock of a foreign corporation (including options under paragraph (h)) is treated as stock of the foreign corporation (see examples 17 and 18 for illustration of paragraph (i)(1)).

The two conditions in paragraphs (i)(1)(i)-(ii) are:
- the interest holder has distribution rights that are substantially similar in all material aspects to the distribution rights accompanying stock in the foreign corporation; and
- treating the interest as stock of the foreign corporation has the effect of treating the foreign corporation as a surrogate foreign corporation under section 7874(a)(2)(B).

Distribution rights described in paragraph (i)(1)(i) include rights to dividends (or partnership distributions), distributions in whole or partial redemption of the interest, distributions in liquidation, and other similar distributions that represent a return on (or of) the holder's investment in the interest.

Paragraphs (i)(2)(i)-(iii) address treatment of creditor claims against U.S. corporations or U.S. or foreign partnerships as stock or partnership interests, and treatment of the creditors as shareholders or partners.

Each creditor of a U.S. corporation is treated as a shareholder of the corporation, and any claim of the creditor against the U.S. corporation is treated as stock of the U.S. corporation if, immediately before the first date properties are acquired as part of a U.S. entity acquisition, the U.S. corporation is:
- in a title 11 reorganization bankruptcy or similar case (as defined in section 368(a)(3) to include a receivership, foreclosure, or similar proceeding in a federal or state court); or
- the liabilities of the U.S. corporation exceed the FMV of its assets.

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If immediately before the first date properties are acquired as part of a U.S. entity acquisition, a partnership (foreign or U.S.) is in a title 11 or similar case, or the partnership's liabilities exceed the FMV of its assets, then each creditor of the partnership is treated as a partner in the partnership, and any claim of the creditor against the partnership is treated as an interest in the partnership.

A creditor that is treated as a shareholder or partner under paragraphs (i)(2)(i) or (ii) is treated as a shareholder or partner to apply all provisions of section 7874 (see reg. sections 1.7874-1(c) and -2(f); and see Example 19 for an illustration of paragraph (i)(2)).

Deemed U.S. Corporation

Paragraphs (j)(1)-(3) address the application of section 7874(b), which treats inverted foreign corporations as U.S. corporations when an 80-percent-ownership threshold is met. These provisions will be covered in a future article.

Examples

Paragraphs (k)(1)-(2) provide 21 examples that illustrate the rules of reg. section 1.7874-2. Some of the examples mention an ownership fraction, which is defined in reg. section 1.7874-12(a)(17) as the ownership percentage described in section 7874(a)(2)(B)(ii) expressed as a fraction. The 21 examples are in paragraph (k)(2). Paragraphs (k)(1)(i)-(x) provide facts that are assumed for all examples in paragraph (k)(2) unless stated otherwise:

- DC1 and DC2 are U.S. corporations;
- FA, FP, F1, F2, F3, and F4 are foreign corporations organized in Country A;
- DPS is a U.S. partnership that conducts a trade or business;
- FPS is a foreign partnership that is not publicly traded;
- under the terms of the DPS and FPS partnership agreements, each partner's share in the partnership's items of income, gain, deduction, and loss is determined in accordance with the partner's partnership interest percentage as stated in the examples;
- A, B, and C are unrelated individuals;
- each entity has a single class of equity outstanding and is unrelated to all other entities;
- all transactions are completed as part of a plan;
- all acquisitions of properties are completed after March 4, 2003; and
- the antiavoidance rule in section 7874(c)(4) does not apply, and no option is issued or acquired with a principal purpose of avoiding treatment of a foreign corporation as a surrogate foreign corporation.

Example 1 illustrates the acquisition of stock of a U.S. corporation. Foreign corporation FA acquires 25 percent of the outstanding stock of U.S. corporation DC1. Under paragraph (c)(1)(i) and section 7874(a)(2)(B)(i), FA is treated as acquiring 25 percent of the properties held by DC1 on the date of the stock acquisition.

Example 2 illustrates the acquisition of a U.S. partnership interest. U.S. partnership DPS wholly owns U.S. corporation DC1. Foreign corporation FA acquires a 40 percent interest in DPS. Under paragraph (c)(1)(ii) and section 7874(a)(2)(B)(i), FA is treated as acquiring 40 percent of the DC1 stock held by DPS on the date of the acquisition of the partnership interest. Moreover, under paragraph (c)(1)(i) and section 7874(a)(2)(B)(i), FA is treated as acquiring 40 percent of the properties held by DC1 on the date of the acquisition of the partnership interest.

Example 3 illustrates the acquisition of stock by a subsidiary. Foreign parent corporation FP wholly owns foreign subsidiary FA. FA acquires all the outstanding stock of U.S. corporation DC1 in exchange solely for FP stock. FP and FA are members of the same EAG after the acquisition.

Under paragraph (c)(1)(i) and section 7874(a)(2)(B)(i), FA is treated as acquiring 100 percent of the properties held by DC1 on the date of the stock acquisition. Further, under paragraph (c)(1)(iii) and section 7874(a)(2)(B)(i), FP is also treated as acquiring 100 percent of the properties held by DC1 on the date of the stock acquisition. The result would be the same if instead FA had directly acquired all the properties held by DC1 in exchange for FP stock.

Example 4 illustrates the acquisition of stock of a foreign corporation. Foreign parent FP wholly owns U.S. corporation DC1. Foreign corporation

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FA acquires all the outstanding stock of FP. Under paragraph (c)(2) and section 7874(a)(2)(B)(i), FA is not treated as acquiring any properties held by DC1 on the date of the acquisition of the FP stock.

Examples 5-7 illustrate acquisitions by multiple foreign corporations and acquisitions of multiple U.S. corporations. They will be covered in a future article.

Example 8 illustrates an exchange of stock and other property. Individual A wholly owns DC1 and F1. DC1 has a $40 FMV and F1 has a $60 FMV. Individual A transfers all the DC1 stock and F1 stock to newly formed FA in exchange solely for FA stock.

Under paragraphs (f)(1)(i) and (f)(2)(i) and section 7874(a)(2)(B)(ii), A is considered to hold 40 percent of the FA stock by reason of holding stock in DC1 ($100 FA stock * $40/$100, the DC1 stock FMV as a fraction of all property transferred by A to FA).

Example 9 illustrates stock received as a distribution. As part of a divisive reorganization described in section 368(a)(1)(D), DC1 contributes substantially all its properties to newly formed corporation FA in exchange for FA stock and then distributes the FA stock to its shareholders in a transaction qualifying as a tax-free spin-off under section 355.

Under paragraph (f)(1)(i) and section 7874(a)(2)(B)(ii), the FA stock received by the DC1 shareholders as a distribution related to the DC1 stock is considered held by reason of holding stock in DC1. The result would be the same if the transaction did not qualify as a reorganization (for example, if the distribution were subject to sections 301 and 311(b)).

Example 10 illustrates incorporation of a partnership trade or business. Individuals A and B equally own 50 percent interests in U.S. partnership DPS. DPS transfers substantially all its properties constituting a trade or business to newly formed foreign corporation FA solely in exchange for FA stock. DPS retains the FA stock after the transaction. Under paragraph (f)(1)(iii) and section 7874(a)(2)(B)(ii), A and B are treated as holding a proportionate amount (50 percent each) of the FA stock held by DPS by reason of holding an interest in DPS.

Examples 11-13 illustrate the inversion rules as applied to foreign PTPs and will be covered in a future article.

Examples 14-16 illustrate the inversion rules as applied to warrants and options and will be covered in a future article.

Example 17 illustrates treatment of stock in a subsidiary as stock of a foreign parent corporation. Individuals A and B equally own DC1. Newly formed corporation FA issues stock in a public offering for cash. FA contributes part of the cash from the public offering to newly formed corporation DC2 in exchange for all the stock of DC2.

DC2 merges into DC1 with DC1 surviving. Under the merger agreement, A and B exchange their DC1 stock for cash and shares of class B stock of DC1. Following the merger FA owns all the class A stock of DC1. FA does not hold significant assets other than the class A stock of DC1. A and B own all the class B stock of DC1. DC1 has no other class of stock outstanding.

The class B stock entitles A and B to dividend distributions approximately equal to any dividend distributions made by FA to shareholders of its publicly traded stock. The class B stock also permits A and B to require DC1 to redeem the stock at FMV. The class B stock does not give A and B voting rights over FA.

The class B stock dividend rights are substantially similar in all material respects to the dividend rights provided by the FA stock. Because FA does not hold significant assets other than the class A stock, the FMV of the class B stock held by A and B is approximately equal to the FMV of a corresponding amount of publicly traded FA stock.

The class B stock distribution rights on liquidation (or redemption) are therefore substantially similar in all material respects to the FA stock distribution rights on liquidation (or redemption). As a result, the class B stock distribution rights are substantially similar in all material respects to the publicly traded FA stock distribution rights.

Thus, if treating the class B stock as FA stock would have the effect of treating FA as a surrogate foreign corporation, the class B stock will be treated as FA stock under paragraph (i)(1).

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Example 18 illustrates a partnership interest treated as stock of a foreign acquiring corporation. Individuals A and B own equal 50 percent interests in DC1. Newly formed corporation FA issues stock in a public offering for cash. A, B, and FA organize foreign partnership FPS. FA transfers part of the cash from the public offering to FPS in exchange for a class A partnership interest. FA does not hold any significant assets other than the class A partnership interest. A and B transfer their DC1 stock to FPS in exchange for class B partnership interests.

The class B partnership interests entitle A and B to cash distributions from FPS approximately equal to any dividend distributions made by FA to shareholders of its publicly traded stock. The class B partnership interests also permit A and B to require FPS to redeem the interests in exchange for cash equal to the FMV of an amount of FA stock as determined on the redemption date. The class B partnership interests do not give A or B voting rights over FA.

The non-liquidating distribution rights provided by the class B partnership interests are substantially similar in all material respects to the dividend rights provided by the FA stock. Because FA does not hold any significant assets other than the class A partnership interest, the FMV of the class B partnership interests held by A and B is approximately equal to a corresponding amount of FA stock.

The distribution rights on liquidation (or redemption) provided by the class B partnership interests are therefore substantially similar in all material respects to distribution rights on liquidation (or redemption) provided by the FA stock.

The distribution rights provided by the class B partnership interests are substantially similar in all material respects to the distribution rights provided by the publicly traded FA stock. As a result, if treating the class B partnership interests as FA stock would have the effect of treating FA as a surrogate foreign corporation, the class B partnership interests will be treated as FA stock under paragraph (i)(1).

Example 19 illustrates treatment of a creditor as a shareholder and is the subject of the ABA tax section's suggestion for priority guidance. Individuals A and B each own 50 percent interests in DC1. The liabilities of DC1 exceed the FMV of its assets. As part of a plan:

- newly formed corporation FA acquires substantially all the properties held by DC1 in exchange solely for FA stock;
- the DC1 stock held by A and B is cancelled; and
- the creditors of DC1 receive all the FA stock in exchange for their claims against DC1.

Because the liabilities of DC1 exceed the FMV of its assets immediately before the first date on which properties are acquired as part of the U.S. entity acquisition, under paragraph (i)(2)(i), the creditors of DC1 are treated as shareholders of DC1 and the creditors' claims against DC1 are treated as DC1 stock.

Therefore, under section 7874(a)(2)(B)(ii), the FA stock received by the creditors of DC1 by reason of their claims against DC1 is considered held by former U.S. entity shareholders of DC1 by reason of holding DC1 stock.

Example 20 illustrates the conversion of a foreign corporation to a U.S. corporation under section 7874(b) and the resulting application of section 367. It will be covered in a future article.

Example 21 illustrates application of the multiple-step acquisition rule in paragraphs (c)(4)(i)-(iii). Individual A owns all 70 shares of stock of DC1, a U.S. corporation. Individual B owns all 30 shares of stock of F1, a foreign corporation that is a tax resident of Country X (as described in reg. section 1.7874-3(d)(11)). As part of a reorganization described in section 368(a)(1)(D), DC1 transfers all its properties to F1 solely in exchange for 70 newly issued voting shares of F1 stock (the DC1 acquisition) and distributes the F1 stock to A in liquidation under section 361(c)(1).

As part of a plan that includes the DC1 acquisition, newly formed corporation F2 (also a tax resident of Country X) acquires 100 percent of the stock of F1 solely in exchange for 100 newly issued shares of F2 stock (the F1 acquisition). After the F1 acquisition:

- A owns 70 shares of F2 stock;
- B owns 30 shares of F2 stock;
- F2 owns all 100 shares of F1 stock; and
- F1 owns all the properties held by DC1 immediately before the DC1 acquisition.

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The form of the transaction is respected under U.S. tax law.

The DC1 acquisition is a U.S. entity acquisition, and F1 is a foreign acquiring corporation because F1 directly acquires 100 percent of the properties of DC1. Also, the 70 shares of F1 stock received by A in exchange for the A DC1 stock are stock of a foreign corporation that is held by reason of holding stock in DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying section 7874 to the DC1 acquisition.

The DC1 acquisition is also an initial acquisition because it is a U.S. entity acquisition that, under a plan that includes the F1 acquisition, occurs before the F1 acquisition (which is a subsequent acquisition). Thus, F1 is the initial acquiring corporation.

The F1 acquisition is a subsequent acquisition because it occurs, under a plan that includes the DC1 acquisition, after the DC1 acquisition, and as part of the F1 acquisition, F2 acquires 100 percent of the stock of F1 and is therefore treated under paragraph (c)(4)(ii) (which applies the principles of section 7874(a)(2)(B)(i) with modifications) as indirectly acquiring substantially all the properties held directly or indirectly by F1. Thus, F2 is the subsequent acquiring corporation.

Under paragraph (c)(4)(i), the F1 acquisition is treated as a U.S. entity acquisition, and F2 is treated as a foreign acquiring corporation. Also, under paragraph (f)(1)(iv), the 70 shares of F2 stock received by A (a former initial acquiring corporation shareholder) as part of the F1 acquisition in exchange for the A F1 stock are stock of a foreign corporation held by reason of holding stock in DC1. As a result, those 70 shares are included in both the numerator and the denominator of the ownership fraction when applying section 7874 to the F1 acquisition.

Applicability Dates

Paragraphs (l)(1)-(2) provide applicability dates. Reg. section 1.7874-2 generally applies to U.S. entity acquisitions completed on or after June 7, 2012. For U.S. entity acquisitions completed before June 7, 2012, see reg. section 1.7874-2T(o), as revised April 1, 2012.

However, paragraphs (a), (b)(7)-(13), (c)(2) and (4), and (f)(1)(iv); the introductory text of paragraph (f)(1); and Example 21 apply to U.S. entity acquisitions completed on or after April 4, 2016.

Suggested Guidance

Anthony Sexton of Kirkland & Ellis LLP generally describes section 7874 and regs as an antiabuse regime. The legislative history to section 7874 and the preambles to the regs confirm that the rules were intended to prevent companies included in the U.S. tax base from relocating operations to foreign countries outside of the U.S. tax net in a non-economic way.

In Anthony's view, treating creditors' claims as stock of a new foreign parent in title 11 or insolvency cases is necessary for the inversion rules to be effective, but the rules may cause inappropriate outcomes when implemented.

To prevent the inappropriate application of section 7874 in insolvent and bankrupt workout situations, he suggests clarifying reg. section 1.7874-1(i)(2)(i) to explicitly require a domestic entity acquisition before treating creditors' claims as stock in a foreign corporation. This would prevent treatment of a foreign acquiring corporation as a surrogate foreign corporation (or a U.S. corporation) in cases in which the foreign corporation does not directly or indirectly acquire substantially all of the properties of a U.S. entity but instead simply converts some or all of the outstanding debt to equity.

That remedy (which clarifies a position already widely taken by the bar) is helpful, but not sufficient, to addressing all concerns surrounding the creditor inversion rules. Anthony suggests a safe harbor rule that prevents the application of section 7874 to U.S. entities that have foreign parent corporations before and after their restructurings. This safe harbor rule would ensure that the creditor inversion rules do not inappropriately preclude corporate structuring necessary to implement title 11 plans under non-U.S. corporate law.

Finally, to ensure the inversion rules do not inappropriately penalize bankrupt and insolvent companies, the disqualified stock rules in reg. section 1.2874-4 should be modified to treat creditors of foreign entities identically to creditors

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of domestic entities in calculating the ownership fraction.

Further elaboration on these proposals is provided in an August 31 letter from the ABA tax section to the IRS commissioner that was principally authored by Devon Bodoh and Graham Magill of Weil, Gotshal & Manges LLP. ■

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