Penn State Law

Center for the Study of M&A

Webinar: The Treasury and IRS Notice on Tax Inversion

A Guide to the Notice
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I INTRODUCTION

This paper summarizes the major principles set out in Notice 2014-52. This paper focuses on the basic transactions and not on all of the combinations and permutations of the transactions that could be affected by the Notice. This paper refers to a companion set of slides entitled: *Slides Illustrating (1) a Prototypical Inversion Transaction, and (2) the Impact of Treasury and IRS Notice 2014-52*.

For purposes of simplification, the following terms are used here and in the slides: (1) "Domestic Inverter" is a domestic corporation that engages in an inversion transaction; (2) "DI's CFC # 1" and "DI's CFC # 2" are controlled foreign corporation that are wholly owned by Domestic Inverter; (3) DI's CFC ## 1 and 2 have substantial deferred foreign earnings; (4) Foreign Inversion Target is the foreign corporation that participates in the inversion; (5) Foreign Holding Company is the newly formed holding company that after the inversion holds the stock of Domestic Inverter and Foreign Inversion Target, (6) U.S. Merger Sub and Foreign Amalgamation Sub are the two subs of Foreign Holding Company that are used to effectuate Foreign Holding Company's acquisition, respectively, of the stock of Domestic Inverter and Foreign Inversion Target.

This paper contains many direct quotes from the Notice.

II THE PROTOTYPICAL INVERSION

Slides 1 to 4 illustrate a prototypical inversion transaction.

III SECTION 2 OF THE NOTICE: REGULATIONS TO ADDRESS INVERSION TRANSACTIONS DIRECTLY

A. INTRODUCTION TO THE ANTI-CASH BOX AND ANTI-SLIMMING DOWN RULES

Pursuant to Section 7874, if the shareholders of the Domestic Inverter end up with 80% or more of the stock of Foreign Holding Company, that company is treated as a domestic corporation thereby defeating the purposes of the inversion. Consequently, to make the transaction work, the shareholders of Domestic Inverter must receive less than 80% of the stock of Foreign Holding Company, and the shareholders of Foreign Inversion Target must receive more than 20% of the stock of Foreign Holding Company. This is referred to hereafter as the "U.S.-79%, Foreign-21% Ownership Split." Thus, Domestic Inverter and Foreign Inversion Target must be the "right size" relative to each other.

The parties could engage in pre-inversion "right sizing" transactions to ensure the U.S.-79%, Foreign-21% Ownership Split is satisfied. In many cases this will entail either (1) finding a Foreign Inversion Target bulked up with passive assets, or (2) slimming down a Domestic Inverter. The Notice addresses these two potential tailoring strategies in the Anti-Cash Box rule and Anti-Slimming Down rule, which are discussed next.

B. ANTI-"CASH BOX" REGS:

1. Section 2.01, Disregarding Certain Stock Of A Foreign Acquiring Corp Attributable To Passive Assets—Regs Under Section 7874

a. Transaction of Concern

"The Treasury Department and the IRS are aware that taxpayers may be engaging in transactions with a foreign corporation that has substantial cash and other liquid assets in order to facilitate an inversion to avoid the application of section 7874. Although §1.7874-4T addresses cases in which nonqualified property held directly or indirectly by the foreign acquiring corporation is received in exchange for stock of the foreign acquiring corporation in a transaction related to the acquisition, that regulation will not apply to nonqualified property held directly or indirectly by the foreign acquiring corporation that was not acquired by the foreign acquiring corporation in a transaction related to the acquisition. As a result of this limitation in the application of §1.7874-4T, stock of the foreign acquiring corporation may be included in the denominator of the ownership fraction, thereby decreasing the ownership fraction, even though a substantial portion of the value of such stock is attributable to nonqualified property."

b. General Rule Set Out In The Notice

"The Treasury Department and the IRS intend to issue regulations under section 7874 (c) (6) providing that, if more than 50 percent of the gross value of all "foreign group property" constitutes "foreign group nonqualified property," a portion of the stock of the foreign acquiring corporation will be excluded from the denominator of the ownership fraction. * * * This 50 percent test is applied after the acquisition and all transactions related to the acquisition, if any, are completed. * * *

"If the 50 percent threshold is satisfied, the portion of the stock of the foreign acquiring corporation that will be excluded from the denominator of the ownership fraction is the product of (i) the value of the stock of the foreign acquiring corporation other than (a) stock described in section 7874 (a) (2) (B) (ii) (that is, stock held by reason of), and (b) stock excluded from the denominator of the ownership fraction under either §1.7874-1 (b) (because it is held by a member of the EAG **[Expanded Affiliated Group]**)[2] or §1.7874-4T (b) (because it is disqualified stock); and (ii) a fraction (foreign group nonqualified property fraction), the numerator of which is the gross value of all foreign group nonqualified property, and the denominator of which is the gross value of all foreign group property. Solely for purposes of the preceding sentence, property received by the foreign acquiring corporation that gives rise to disqualified stock (within the meaning of §1.7874-4T (c)) that is excluded from the denominator of the ownership fraction pursuant to §1.7874-4T (b) is excluded from both the numerator and the denominator of the foreign group nonqualified property fraction."

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[2] The expanded affiliated group is defined in Section 7874(c)(1) as an "affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3) [*i.e.*, the exclusion for foreign corporations]], except that section 1504(a) shall be applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears."

c. Effective Date

"[T]he regulations described in (i) section 2.01 (b) of this notice (which disregards certain stock of the foreign acquiring corporation attributable to passive assets) will apply to acquisitions completed on or after September 22, 2014[.]"

2. Illustration See Slide 5

3. Impact

This regulation should have an impact in limited transactions. It merely limits, and probably not in a significant way, the universe of potential Foreign Inversion Targets.

C. ANTI-"SLIMMING DOWN" REGS:

1. Section 2.02, Disregarding Certain Distributions By The Domestic Target- Regs Under Sections 7874 And 367

a. Transactions of Concern

"The Treasury Department and the IRS are aware that a domestic entity may distribute property to its former shareholders (within the meaning of §1.7874-2 (b) (2)) * * * in order to reduce the ownership fraction by reducing the numerator. Similarly, to avoid the application of section 367 (a) (1), a U.S. target company may distribute property to its shareholders in contemplation of an acquisition to satisfy the substantiality test. To address these transactions, the Treasury Department and the IRS intend to issue regulations under sections 7874 and 367, as described below."

b. General Rule for Section 7874 Set Out In The Notice

"For purposes of applying section 7874 (c) (4) (which disregards transfers of properties or liabilities if the transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874), non-ordinary course distributions (defined below) made by the domestic entity (including a predecessor) during the 36-month period ending on the acquisition date (within the meaning of §1.7874-3T (d) (1)) will be treated as part of a plan a principal purpose of which is to avoid the purposes of section 7874. Accordingly, such distributions will be disregarded for purposes of section 7874.

"For purposes of this notice, non-ordinary course distributions mean the excess of all distributions made during a taxable year by the domestic entity with respect to its stock or partnership interests, as applicable, over 110 percent of the average of such distributions during the thirty-six month period immediately preceding such taxable year. A distribution means any distribution, regardless of whether it is treated as a dividend or whether, for example, it qualifies under section 355. Thus, a distribution includes any distribution made by the domestic entity in redemption of its stock, such as a distribution to which section 302 (a) applies. A distribution also includes a transfer of money or other property to the owners of the domestic entity that is made in connection with the acquisition described in section 7874 (a) (2) (B) (i) to the extent the money or other property is directly or indirectly provided by the domestic entity. For example, if the acquisition of the domestic entity by the foreign acquiring corporation qualifies as a

reorganization under section 368 (a) and the shareholders of the domestic entity receive other property or "boot" (within the meaning of section 356) in connection with the reorganization, then, to the extent the boot is directly or indirectly provided by the domestic entity for purposes of section 356, the domestic entity is treated as having made a distribution in the amount of that boot for purposes of this section 2.02 (b))."

c. General Rule for Section 367 Set Out In The Notice

"Section 1.367 (a)-3 (c) will be modified to include a rule [relating to the "substantiality test"] that incorporates the principles described above for purposes of the substantiality test."

d. Effective Dates

"[T]he regulations described in * * * section 2.02 (b) of this notice (which disregards certain distributions by a domestic entity) will apply to acquisitions, or to transfers of domestic stock described in §1.367 (a)-3 (c), completed on or after September 22, 2014[.]"

2. Illustration See Slide 6

3. Observation Of The Significance Of The Anti-Slimming Down Rule

a. Impact On Section 7874

As with the case of the Anti-Cash Box rule, this rule should have an impact in limited transactions. It merely ensures that the Domestic Inverter can't shed itself of assets in order to ensure that the U.S.-79%, Foreign-21% Ownership Split is satisfied.

b. Impact On Section 367

As a result of this rule, Slimming down distributions will be taken into account in determining if the "substantiality test" in Reg 1.367 (a)-3 (c) is satisfied. Under the substantiality test, in order for an acquisition by a foreign acquiror of a U.S. target in a reorganization to qualify for tax free treatment for the shareholders of the U.S. target, at the time of the transaction, the fair market value of the foreign acquiror must be at least equal to the fair market value of the U.S. target. It is important to note that this becomes relevant only where the U.S. shareholders receive no more than 50% of the stock of the foreign acquiror. In most if not all of the new inversions, the shareholders of the U.S. target receive more than 50% but less than 80% of the stock of the foreign acquiror. Consequently, without respect to the substantiality test, the transaction is taxable under Section 367(a) in the absence of an override of Section 367(a) by the Killer B regs under Section 367(b).

D. ANTI-SPINVERSION REGS

1. Section 2.03. Regulations Under Section 7874 Regarding Subsequent Transfers Of Stock Of The Foreign Acquiring Corporation

a. Basic Transaction of Concern

"Section 7874 (c) (2) (A) provides that stock of a foreign acquiring corporation that is held by members of the EAG is not included in the numerator or the denominator of the ownership fraction (**statutory EAG rule**). To illustrate the application of the statutory EAG rule, assume a

domestic corporation (DC) is wholly owned by a U.S. parent corporation (USP), and that USP transfers all the DC stock to a newly formed foreign corporation (FA) in exchange for all of the stock of FA. Absent the statutory EAG rule, the ownership fraction would be 100 percent and the foreign acquiring corporation would be treated as a domestic corporation (assuming the EAG does not have substantial business activities in the relevant foreign country).

"However, under the statutory EAG rule, the stock of FA held by USP is excluded from the numerator and the denominator of the ownership fraction, so that the numerator and the denominator of the ownership fraction are zero and FA is respected as a foreign corporation."

b. General Rule Set Out In The Notice

"Except as provided in section 2.03 (b) (ii) or (iii) of this notice **[relating to certain internal restructurings]**, if stock of the foreign acquiring corporation described in section 7874 (a) (2) (B) (ii) (that is, stock of the foreign acquiring corporation **held by reason of**) is received by a former corporate shareholder **[*e.g.*, a distributing corporation in a divisive D]** * * * of the domestic entity (transferring corporation), and, in a transaction (or series of transactions) related to the acquisition, that stock (transferred stock) is subsequently transferred, the transferred stock is not treated as held by a member of the EAG for purposes of applying the EAG rules. Accordingly, the transferred stock is included in the numerator and the denominator of the ownership fraction."

c. The Spin-Version Example In The Notice

"Example 1. (i) Facts. D, a domestic corporation, owns all of the stock of DT, also a domestic corporation, and stock of other subsidiaries. The DT stock does not represent substantially all of the property of D for purposes of section 7874. Pursuant to a reorganization described in section 368 (a) (1) (D), D transfers all the stock of DT to FA, a newly formed foreign corporation, in exchange solely for 100 shares of FA stock (DT acquisition) and distributes all of the FA stock to its shareholders pursuant to section 361 (c) (1) (subsequent distribution). D is the common parent of a U.S.-parented group before and after the DT acquisition.

"(ii) Analysis. Under §1.7874-2 (f) (1), the 100 shares of FA stock received by D in the DT acquisition is stock of a foreign corporation (FA) that is held by reason of holding stock in a domestic corporation (DT). Accordingly, such stock is described in section 7874 (a) (2) (B) (ii). Under §1.7874-5T (a), all 100 shares of FA stock retain their status as being described in section 7874 (a) (2) (B) (ii) even though D subsequently transfers all of the FA stock to its shareholders in the subsequent distribution. Under section 2.03 (b) (i) of this notice, the FA stock received by D is not treated as held by a member of the EAG for purposes of applying the EAG rules. The exception provided in section 2.03 (b) (ii) of this notice does not apply because, after the DT acquisition, the shareholders of D and FA are not members of the U.S.-parented group. Accordingly, the ownership fraction is 100/100."

d. Effective Date

"[T]he regulations described in * * * section 2.03 (b) of this notice (regarding the application of the EAG rules upon a subsequent transfer of stock of the foreign acquiring corporation) will apply to acquisitions completed on or after September 22, 2014[.]"

2. Observation

This spinversion rule appears to have a limited application. For example, it does not reach a situation in which a U.S. corporation in a divisive spin-off transfers stock of its CFC to a newly formed foreign corporation and then transfers the stock of the foreign corporation to its shareholders. However, for other reasons, not discussed here, such a spin-off may have adverse tax consequences.

IV SECTION 3 OF THE NOTICE: REGULATIONS TO ADDRESS POST INVERSION TAX AVOIDANCE TRANSACTIONS

A. ANTI-"HOPSCOTCH" LOANS

1. Section 3.01, Regulations To Address Acquisitions Of Obligations And Stock That Avoid Section 956

a. Purpose Of Section 956 As Stated In The Treasury Notice

"Section 956 is intended to prevent a U.S. shareholder of a CFC from inappropriately deferring U.S. taxation of CFC earnings and profits by 'prevent[ing] the repatriation of income to the United States in a manner which does not subject it to U.S. taxation.' H.R. Rep. No. 1447, 87th Cong., 2d Sess., at 58 (1962). In the absence of section 956, a U.S. shareholder of a CFC could access the CFC's funds (untaxed earnings and profits) in a variety of ways other than by the payment of an actual taxable dividend, such that there would be no reason for the U.S. shareholder to incur the dividend tax. Section 956 eliminates this disincentive to pay a dividend by ensuring parity of treatment for different ways that CFC earnings can be made available for use in the United States or for use by the U.S. shareholder. Accordingly, under section 956, the investment by a CFC of its earnings and profits in United States property is 'taxed to the [CFC's] shareholders on the grounds that this is substantially the equivalent of a dividend.' S. Rep. No. 1881, 87th Cong., 2d Sess., at 88 (1962). Section 956 (e) provides the Secretary with authority to 'prescribe such regulations as may be necessary . . . to prevent the avoidance of the provisions of [section 956] through reorganizations or otherwise.'"

b. The Section 956 Avoidance Problem As Described In The Notice

"An inversion transaction may permit the top corporate parent in the newly inverted group, a group still principally comprised of U.S. shareholders and their CFCs, to avoid section 956 by accessing the untaxed earnings and profits of the CFCs without a current tax to the U.S. shareholders. This is a result that the U.S. shareholders could not achieve before the inversion. The ability of the new foreign parent to access deferred CFC earnings and profits would in many cases eliminate the need for the CFCs to pay dividends to the U.S. shareholders, thereby circumventing the purposes of section 956. Section 956 (e) directs the Secretary to prescribe regulations to prevent the avoidance of the provisions of section 956 through reorganizations or otherwise; an inversion is an example of such a transaction."

c. The Regulations To Be Issued, Section 3.01(b)

"In order to prevent this avoidance of section 956, the Treasury Department and the IRS intend to issue regulations under section 956 (e) providing that, solely for purposes of section 956, any obligation or stock of a foreign related person (within the meaning of section 7874 (d) (3) other

than an **"expatriated foreign subsidiary"**) (such person, a "non-CFC foreign related person") will be treated as United States property within the meaning of section 956 (c) (1) to the extent such obligation or stock is acquired by an expatriated foreign subsidiary during the applicable period (within the meaning of section 7874 (d) (1)) **[That is, for the 10 year period after the inversion.]**. For purposes of this notice, except as provided in the succeeding sentence, an **expatriated foreign subsidiary** is a CFC with respect to which an **expatriated entity** (as defined in section 2.01 (a) of this notice) **[that is, the inverted U.S. corporation and certain related U.S. persons]** is a U.S. shareholder. An expatriated foreign subsidiary does not include a CFC that is a member of the EAG immediately after the acquisition and all transactions related to the acquisition are completed (completion date) if the domestic entity is not a U.S. shareholder with respect to the CFC on or before the completion date. In addition, for purposes of this section, an expatriated foreign subsidiary that is a pledgor or guarantor of an obligation of a non-CFC foreign related person under the principles of section 956 (d) and §1.956-2 (c) will be considered as holding such obligation."

d. What The Notice Does Not Reach

The Notice does not prevent a CFC from investing in or making a loan to a sister CFC or otherwise investing in foreign assets that are unrelated to the foreign holding company. As long as the investments or loans stay "under" the U.S. parent, the rule does not apply. It applies only to those investments or loans that come "out from under" the U.S. parent.

e. Request For Comments

"The Treasury Department and the IRS are considering, and request comments on, whether any exceptions under section 956 (c) (2) or §1.956-2 should apply to an obligation or stock of a foreign related person that is determined to be United States property within the meaning of section 956 (c) (1) pursuant to the regulations described in this section 3.01 (b). However, the exception to the definition of obligation provided by Notice 88-108, 1988-2 C.B. 446, will not apply to such obligations."

f. Effective Date

"[T]he regulations described in * * * section 3.01 (b) of this notice will apply to acquisitions of obligations or stock of a non-CFC foreign related person by an expatriated foreign subsidiary completed on or after September 22, 2014, but only if the inversion transaction is completed on or after September 22, 2014[.]"

2. Illustration See Slide 7

3. Query: Re Treatment of Pre-September 22, 2014 Hopscotch Loans?

Has the IRS considered whether pre-September 22 Hopscotch loans are reachable under general tax principles under Section 956? For example, is a Hopscotch loan an actual constructive dividend or Section 956 constructive dividend to the U.S. parent? This clearly should be the case where the funds are invested by the foreign holding company into the U.S.

B. ANTI-DE-CONTROLLING OF CFCs

1. Section 3.02, Regulations To Address Transactions To De-Control Or Significantly Dilute CFCs

a. The Decontrol Avoidance Problem As Described In The Notice

"After an inversion transaction, the inverted group may cause an expatriated foreign subsidiary to cease to be a CFC using transactions that avoid the imposition of U.S. income tax, so as to avoid U.S. tax on the CFC's pre-inversion earnings and profits. For example, after an inversion transaction, a foreign acquiring corporation could issue a note or transfer property to an expatriated foreign subsidiary in exchange for stock representing at least 50 percent of the voting power and value of the expatriated foreign subsidiary. The expatriated foreign subsidiary would cease to be a CFC, and the U.S. shareholders would no longer be subject to subpart F of the Code with respect to the expatriated foreign subsidiary. As a result, the expatriated foreign subsidiary could make its pre-inversion earnings and profits available to the U.S. shareholders without causing an income inclusion under section 956.

"Even if the foreign acquiring corporation acquired less stock of an expatriated foreign subsidiary, such that the expatriated foreign subsidiary remains a CFC, it could nevertheless substantially dilute a U.S. shareholder's ownership of the CFC. As a result, the U.S. shareholder could avoid tax on the CFC's pre-inversion earnings and profits if, for example, the CFC later redeemed, on a non pro rata basis, its stock held by the foreign acquiring corporation. As another example, the U.S. shareholder could avoid tax on a CFC's pre-inversion earnings and profits if the CFC paid a pro rata extraordinary distribution, although in this case the U.S. shareholder could be required to pay some tax.

"The Treasury Department and the IRS have determined that it is appropriate, in order to prevent the avoidance of U.S. tax, to issue regulations under section 7701 (l) that will recharacterize certain transactions that facilitate the avoidance of U.S. tax on the expatriated foreign subsidiary's pre-inversion earnings and profits. The Treasury Department and the IRS also intend to issue regulations that will modify the application of section 367 (b), so as to require an income inclusion in certain nonrecognition transactions that dilute a U.S. shareholder's ownership of a CFC."

b. The Regulations To Be Issued Under Section 7701(l) (Relating To Conduit Arrangements), Section 3.02(e)(i)

i. *Definition Of "Specified Transaction" And "Specified Related Person"*

"The Treasury Department and the IRS intend to issue regulations under section 7701 (l) providing that a **"specified transaction" [defined below]** completed during the applicable period (as defined in section 7874 (d) (1) **[*i.e.*, the 10 year period after the inversion]**) will be **[subject to certain exceptions not discussed here]** recharacterized in the manner described in section 3.02 (e) (i) (A) of this notice **[see below.] * * *** For this purpose, a **specified transaction** is a transaction in which stock in an expatriated foreign subsidiary **[*e.g.*, DI's CFC # 2]** (as defined in section 3.01 (b) of this notice) (specified stock) **[*e.g.,* stock in DI's CFC # 2]** is

transferred (including by issuance) to a "specified related person" **[defined next]**. For this purpose, a specified related person means a non-CFC foreign related person (as defined in section 3.01 (b) of this notice) **[*e.g*., Foreign Holding Company and Foreign Inversion Target]."** * * *

ii. *Summary Of The Definition Of A "Specified Transaction" And "Specified Related Person"*

To summarize, a **specified transaction** is a transaction in which stock in an expatriated foreign subsidiary **[*e.g*., DI's CFC # 2]** is transferred to a "specified related person", that is, a non-CFC foreign related person such as **Foreign Holding Company and Foreign Inversion Target.**

iii. *Recharacterization Of A "Specified Transaction:" The Basic Recharacterization Rule*

"A specified transaction **[defined above, *e.g*., a transfer by DI's CFC # 2of its stock to Foreign Holding Company]** is recharacterized for all purposes of the Code, as of the date on which the specified transaction occurs, as an arrangement directly between the specified related person **[*e.g*., Foreign Holding Company]** and one or more section 958 (a) U.S. shareholders **[*e.g*., Domestic Inverter]** of the expatriated foreign subsidiary **[*e.g*., DI's CFC # 2]**. * * *

"If an expatriated foreign subsidiary **[*e.g*., DI's CFC # 2]** issues the specified stock **[*e.g*., stock of DI's CFC # 2]** to a specified related person **[*e.g*., Foreign Holding Company]**, the specified transaction will be recharacterized as follows:

> (i) the property transferred by the specified related person **[*e.g*. the Foreign Holding Company]** to acquire the specified stock **[*e.g*., stock of DI's CFC # 2]** (transferred property) will be treated as having been transferred by the specified related person **[*e.g*. Foreign Holding Company]** to the section 958 (a) U.S. shareholder(s) **[*e.g.*, Domestic Inverter]** of the expatriated foreign subsidiary **[*e.g*., DI's CFC # 2]** in exchange for instruments deemed issued by the section 958 (a) U.S. shareholder(s) **[*e.g*, Domestic Inverter]** (deemed instrument(s)); and
>
> (ii) the transferred property or proportionate share thereof will be treated as having been contributed by the section 958 (a) U.S. shareholder(s) **[*e.g.*, Domestic Inverter]** (through intervening entities, if any, in exchange for equity in such entities) to the expatriated foreign subsidiary **[*e.g*., DI's CFC # 2]** in exchange for stock in the expatriated foreign subsidiary. See section 3.02 (e) (iii), Example 1, of this notice **[discussed next].**"

c. Example Of The Basic Recharacterization Rule

i. *Parties To The Example*

The introduction to the examples of the recharacterization rule explains that FA is a foreign corporation [***e.g.,* Foreign Holding Company]** that wholly owns DT, a domestic corporation [***e.g.,* Domestic Inverter]**, which, in turn, wholly owns FT, a foreign corporation that is a CFC, [***e.g.,* DI's CFC # 2]**. FA **[*e.g*., Foreign Holding Company]** also wholly owns FS a foreign corporation that is not a CFC **[*e.g.,* Foreign Inversion Target].** The introduction goes on to explain:

FA [*e.g.*, **Foreign Holding Company]** acquired DT **[*e.g.*, Domestic Inverter]** in an inversion transaction that was completed on January 1, 2015. Accordingly, DT **[Domestic Inverter]** is a domestic entity, FT **[*e.g.*, DI's CFC # 2]** is an expatriated foreign subsidiary, and FS **[*e.g.*, Foreign Inversion Target]** is a specified related person with respect to FT **[*e.g.*, DI's CFC # 2]**.

ii. *Recharacterization Example 1, Illustration of the Basic Recharacterization Rule*

Example 1. (i) Facts. On February 1, 2015, FA **[*e.g.*, Foreign Holding Company]** acquires $10x of FT stock **[*e.g.*, stock of a CFC such as DI's CFC # 2]** from FT **[*e.g.*, DI's CFC # 2]**, representing 60 percent of total voting power and value of the stock of FT **[*e.g.*, DI's CFC # 2]**, in exchange for $10x of cash. **[Note: In the absence of the recharacterization rule, this transaction would de-control DI's CFC# 2]**

(ii) Analysis. (A) FA's **[*e.g.*, Foreign Holding Company's]** acquisition of the FT **[*e.g.*, DI's CFC # 2]** stock from FT is a specified transaction, because stock of an expatriated foreign subsidiary **[*e.g.*, DI's CFC # 2]** was transferred (by issuance) to a specified related person (FA) **[*e.g.*, Foreign Holding Company]**.

(B) FA's **[*e.g.*, Foreign Holding Company's]** acquisition of the FT **[*e.g.*, DI's CFC # 2]** stock is recharacterized as follows, with the result that FT **[*e.g.*, DI's CFC # 2]** continues to be a CFC:

(1) DT **[*e.g.*, Domestic Inverter]** is treated as having issued a deemed instrument to FA **[*e.g.*, Foreign Holding Company]** in exchange for $10x of cash.

(2) DT **[*e.g.*, Domestic Inverter]** is treated as having contributed the $10x of cash to FT **[*e.g.*, DI's CFC # 2]** in exchange for FT **[*e.g.*, DI's CFC # 2]** stock.

(C) Any distribution with respect to the FT **[*e.g.*, DI's CFC # 2]** stock actually acquired by FA **[*e.g.*, Foreign Holding Company]** will be treated as a distribution to DT **[*e.g.*, Domestic Inverter]**, which, in turn, will be treated as making a matching distribution with respect to the deemed instrument that DT **[*e.g.*, Domestic Inverter]** is treated as having issued to FA **[*e.g.*, Foreign Holding Company]**. FT **[*e.g.*, DI's CFC # 2]** is treated as the paying agent of DT **[*e.g.*, Domestic Inverter]** with respect to the deemed instrument issued by DT **[*e.g.*, Domestic Inverter]** to FA **[*e.g.*, Foreign Holding Company]**.

2. Effective Date

"[T]he regulations described in * * * section 3.02 (e) of this notice will apply to specified transactions and specified exchanges completed on or after September 22, 2014, but only if the inversion transaction is completed on or after September 22, 2014."

3. Illustration See Slide 8

4. Questions and Observations Re Recharacterization

a. Impact of the Recaharcterization Rule

If this rule applies, Domestic Inverter is deemed to own all of the stock of DI's CFC # 2even though as a corporate matter Foreign Holding Company continues to own such stock.

b. Authority

It appears to me that the authority for issuing the regulations under Section 7701(l) may be a much more aggressive use of administrative authority than an issuance of regulations dealing with interest stripping under Section 385.

c. Correct Policy Answer to a De-Control Generally

It appears to me that the correct policy answer in any de-controlling of a CFC is that all U.S. shareholders should be deemed to have disposed of their stock at the time of the de-control. Is there authority to treat an de-control event as a disposition event for all U.S. shareholders?

C. ANTI-AVOIDANCE OF SECTION 1248 BY DILUTING AN INTEREST IN A CFC IN A SECTION 367(b) TRANSACTION

1. Background On Section 367(b) And The Transactions At Issue, Section 3.02(e)(ii)

"Section 367 (b) (1) provides that, in the case of an exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367 (a) (1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. Section 367 (b) (2) provides that the regulations prescribed pursuant to section 367 (b) (1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing the circumstances under which gain is recognized or deferred, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to the basis of stock or securities.

"Regulations under section 367 (b) generally provide that if the potential application of section 1248 cannot be preserved following the acquisition of the stock or assets of a foreign corporation (foreign acquired corporation) by another foreign corporation in an exchange subject to section 367 (b), then certain exchanging shareholders of the foreign acquired corporation must include in income as a dividend the section 1248 amount (as defined in §1.367 (b)-2 (c) (1)) attributable to the stock of the foreign acquired corporation exchanged. See §1.367 (b)-4 (b). Specifically, subject to certain exceptions, §1.367 (b)-4 (b) (1) (i) requires a deemed dividend inclusion if the exchange satisfies two conditions. First, immediately before the exchange, the exchanging shareholder is either (i) a U.S. person that is a section 1248 shareholder with respect to the foreign acquired corporation, or (ii) a foreign corporation in which a U.S. person is a section 1248 shareholder with respect to such foreign corporation and the foreign acquired corporation. See §1.367 (b)-4 (b) (1) (i) (A). Second, immediately after the exchange, either (i) the stock

received by the exchanging shareholder is not stock in a CFC as to which the U.S. person described in the preceding sentence is a section 1248 shareholder, or (ii) the foreign acquiring corporation (for this purpose, as defined in §1.367 (b)-4 (a)) or the foreign acquired corporation (in the case of an acquisition of the stock of the foreign acquired corporation) is not a CFC as to which the U.S. person is a section 1248 shareholder. See §1.367 (b)-4 (b) (1) (i) (B).

"Section 1.367 (b)-4 (c) (1) provides that a section 1248 amount included as a deemed dividend under §1.367 (b)-4 (b) is not included as foreign personal holding company [*42] income under section 954 (c)."

2. Transactions at Issue [Under Section 367(b)]

"The Treasury Department and the IRS also intend to issue regulations that will modify the application of section 367 (b), so as to require an income inclusion in certain nonrecognition transactions that dilute a U.S. shareholder's ownership of a CFC."

3. Regulations under Section 367 (b), Section 3.03(e)(2)

"The Treasury Department and the IRS intend to amend the regulations under section 367 (b) to provide that an exchanging shareholder described in §1.367 (b)-4 (b) (1) (i) (A) will be required to include in income as a deemed dividend the section 1248 amount attributable to the stock of an expatriated foreign subsidiary exchanged in a "specified exchange," without regard to whether the conditions set forth in §1.367 (b)-4 (b) (1) (i) (B) are satisfied. The regulations will apply to specified exchanges completed during the applicable period (as defined in section 7874 (d) (1)). For this purpose, a specified exchange is an exchange in which a shareholder of an expatriated foreign subsidiary exchanges stock in the expatriated foreign subsidiary for stock in another foreign corporation pursuant to a transaction described in §1.367 (b)-4 (a). See section 3.02 (e) (iii), Example 3, of this notice.

"In addition, the regulations will provide an exception that incorporates the principles of the second exception described in section 3.02 (e) (i) (C) of this notice (regarding specified transactions that do not decrease, in aggregate, the section 958 (a) U.S. shareholders' ownership of stock in an expatriated foreign subsidiary (or lower-tier expatriated foreign subsidiary) by more than 10 percent).

"Finally, the regulations will provide that §1.367 (b)-4 (c) (1) (regarding the exclusion of a deemed dividend from foreign personal holding company income) will not apply to a deemed dividend that results from a specified exchange pursuant to the regulations described in this section 3.02 (e) (ii) and that such deemed dividend will not qualify for the exceptions from foreign personal holding company income provided by section 954 (c) (3) (A) (i) [*51] or section 954 (c) (6) (to the extent in effect)."

4. Example of the Section 367 Rule

"Example 3. (i) Facts. On February 1, 2015, DT **[*e.g.*, Domestic Inverter]** exchanges all of the stock of FT **[*e.g.*, DI's CFC # 2]** solely in exchange for 60% of the stock of FS **[*e.g.*, Foreign Inversion Target]** pursuant to a reorganization described in section 368 (a) (1) (B). Immediately before the exchange, FT **[*e.g.*, DI's CFC # 2]** is a CFC in which DT **[*e.g.*, Domestic Inverter]** is a section 1248 shareholder. Immediately after the exchange, FS **[*e.g.*, Foreign Inversion**

Target] and FT **[*e.g.*, DI's CFC # 2]** are CFCs in which DT **[*e.g.*, Domestic Inverter]** is a section 1248 shareholder.

(ii) Analysis. (A) DT's **[*e.g.*, Domestic Inverter's]** exchange of the FT **[*e.g.*, DI's CFC # 2]** stock is a specified exchange described in section 3.02 (e) (ii) of this notice, because DT **[*e.g.*, Domestic Inverter]** exchanged stock of an expatriated foreign subsidiary (FT) **[*e.g.*, DI's CFC # 2]** for stock in a foreign corporation (FS) **[*e.g.*, Foreign Inversion Target]** pursuant to a transaction described in §1.367 (b)-4 (a) (which includes a reorganization described in section 368 (a) (1) (B)). Although the specified exchange is also a specified transaction because there is a transfer of FT **[*e.g.*, DI's CFC # 2]** stock to a specified related person (FS) **[*e.g.*, Foreign Inversion Target]**, the exchange is not recharacterized under section 3.02 (e) (i) (A) of this notice pursuant to the first exception in section 3.02 (e) (i) (C) of this notice.

(B) Under §1.367 (b)-4 (b) (1) (i), as modified by the regulations described in section 3.02 (e) (ii) of this notice, DT **[*e.g.*, Domestic Inverter]** must include in income the section 1248 amount with respect to the FT **[*e.g.*, DI's CFC # 2]** stock exchanged, without regard to the fact that immediately after the exchange, (i) the FS **[*e.g.*, Foreign Inversion Target]** stock received by DT **[*e.g.*, Domestic Inverter]** in the exchange is stock in a corporation that is a CFC as to which DT **[*e.g.*, Domestic Inverter]** is a section 1248 shareholder, and (ii) FT **[*e.g.*, DI's CFC # 2]** is a CFC as to which DT **[*e.g.*, Domestic Inverter]** is a section 1248 shareholder."

5. Effective Date

"[T]he regulations described in * * * section 3.02 (e) of this notice will apply to specified transactions and specified exchanges completed on or after September 22, 2014, but only if the inversion transaction is completed on or after September 22, 2014."

6. Illustration See Slide 9

7. Illustration of Impact of the Example

In the absence of this rule, DI's CFC # 2 could make tax-free distributions of its E&P to Foreign Inversion Target without any income inclusion for Domestic Inverter even though Foreign Inversion Target had become a CFC of Domestic Inverter. Obviously, there could be other consequences of having Foreign Inversion Target become a CFC.

D. ANTI-AVOIDANCE OF SECTION 304(b)

1. Background On Section 304(b) And The Transactions At Issue, Section 3.03

"Section 304 (a) (1) generally provides that, for purposes of sections 302 and 303, if one or more persons are in control of each of two corporations and in return for property one of the corporations (acquiring corporation) acquires stock in the other corporation (issuing corporation) from the person (or persons) so in control, then (unless section 304 (a) (2) applies) the property shall be treated as a distribution in redemption of the stock of the acquiring corporation. **[Thus, Section 304(a)(1) deals with acquisitions by a sister corporation of stock of a brother corporation from a common parent.]**

“Section 304 (a) (2) provides that, for purposes of sections 302 and 303, if in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and the issuing corporation controls the acquiring corporation, then the property shall be treated as a distribution in redemption of the stock of the issuing corporation. **[Thus, Section 304(a)(2) deals with acquisitions by a subsidiary corporation of stock of its parent corporation from the ultimate controlling shareholder.]**

[Specifically, Section 304(a)(2) provides:

304(a)(2) Acquisition by subsidiary.—
For purposes of sections 302 and 303, if—
304(a)(2)(A)
in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and
304(a)(2)(B)
the issuing corporation controls the acquiring corporation,
then such property shall be treated as a distribution in redemption of the stock of the issuing corporation.]

“Section 304 (b) (2) provides that, in the case of any acquisition to which section 304 (a) applies, the determination of the amount that is a dividend (and the source thereof) shall be made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation **[*i.e.,* the corporation whose stock is acquired]** to the extent of its earnings and profits.

[Specifically, Section 302(b)(2) provides:

304(b)(2) Amount constituting dividend.—
In the case of any acquisition of stock to which subsection (a) applies, the determination of the amount which is a dividend (and the source thereof) shall be made as if the property were distributed—
304(b)(2)(A)
by the acquiring corporation to the extent of its earnings and profits, and
304(b)(2)(B)
then by the issuing corporation to the extent of its earnings and profits.]

“Section 304 (b) (5) (B) limits the earnings and profits taken into account under section 304 (b) (2) where the acquiring corporation is foreign.

[Specifically, Section 304(b)(5)provides:

304(b)(5) Acquisitions by foreign corporations.—

304(b)(5)(A) In general.—
In the case of any acquisition to which subsection (a) applies in which the acquiring corporation is a foreign corporation, the only earnings and profits taken into account under paragraph (2)(A) shall be those earnings and profits—
304(b)(5)(A)(i)

which are attributable (under regulations prescribed by the Secretary) to stock of the acquiring corporation owned (within the meaning of section 958(a)) by a corporation or individual which is—
304(b)(5)(A)(i)(I)
a United States shareholder (within the meaning of section 951(b)) of the acquiring corporation, and
304(b)(5)(A)(i)(II)
the transferor or a person who bears a relationship to the transferor described in section 267(b) or 707(b), and
304(b)(5)(A)(ii)
which were accumulated during the period or periods such stock was owned by such person while the acquiring corporation was a controlled foreign corporation.
304(b)(5)(B) Special rule in case of foreign acquiring corporation.—
In the case of any acquisition to which subsection (a) applies in which the acquiring corporation is a foreign corporation, no earnings and profits shall be taken into account under paragraph (2)(A) (and subparagraph (A) shall not apply) if more than 50 percent of the dividends arising from such acquisition (determined without regard to this subparagraph) would neither—
304(b)(5)(B)(i)
be subject to tax under this chapter for the taxable year in which the dividends arise, nor
304(b)(5)(B)(ii)
be includible in the earnings and profits of a controlled foreign corporation (as defined in section 957 and without regard to section 953(c)).
304(b)(5)(C) Regulations.—
The Secretary shall prescribe such regulations as are appropriate to carry out the purposes of this paragraph.]

"Specifically, section 304 (b) (5) (B) provides that no earnings and profits are taken into account for purposes of section 304 (b) (2) (A) (and section 304 (b) (2) (A) shall not apply) if more than 50 percent of the dividends arising from such acquisition (determined without regard to section 304 (b) (5) (B)) would neither be subject to tax for the taxable year in which the dividends arise, nor be included in the earnings and profits of a CFC. The Staff of the Joint Committee on Taxation's technical explanation of section 304 (b) (5) (B) provides:

> "The provision prevents the foreign acquiring corporation's E&P from permanently escaping U.S. taxation by being deemed to be distributed directly to a foreign person (i.e., the transferor) without an intermediate distribution to a domestic corporation in the chain of ownership between the acquiring corporation and the transferor corporation.

"Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010, at 28 (August 10, 2010).

"Section 304 (b) (5) (C) provides that the Secretary shall prescribe such regulations as are necessary to carry out the purposes of section 304 (b) (5).

"Dividends paid by a domestic corporation to a foreign person generally are subject to a 30-percent gross basis tax under section 871 (a) or 881 (a), and to withholding under section 1441 or 1442, unless reduced or eliminated pursuant to an applicable income tax treaty."

2. Transaction At Issue

"Taxpayers may be engaging in certain transactions following an inversion transaction that reduce the earnings and profits of a CFC to facilitate repatriation of cash and other property of the CFC. For example, after an inversion transaction, the foreign acquiring corporation **[*e.g.*, Foreign Holding Company]** may sell a portion of the stock of the domestic corporation **[*e.g.*, Domestic Inverter]** acquired in the inversion transaction to a wholly owned CFC of the domestic corporation **[*e.g.*, DI's CFC # 2]** in exchange for property of the CFC. This sale would be subject to section 304 (a) (2). The exchange of property (for stock of the domestic corporation) by the CFC in many cases will not result in income or gain that gives rise to an income inclusion under section 951, even though the CFC generally will recognize income or gain on the exchange of the property (other than cash) for U.S. tax purposes pursuant to section 1001. For example, the property exchanged may be property used by the CFC in a trade or business, including property held by the CFC through an entity that is disregarded as an entity separate from its owner, as described in §301.7701-2 (c) (2) (i). See §1.954-2 (e) (1) (ii). The Treasury Department and the IRS understand that taxpayers may interpret section 304 (b) (5) (B) to not apply where more than 50 percent of the dividend arising upon application of section 304 is sourced from the domestic corporation, even though, for example, pursuant to an income tax treaty there may be no (or a reduced rate of) U.S. withholding tax imposed on a dividend sourced from the domestic corporation. Under this position, the dividend sourced from earnings and profits of the CFC would never be subject to U.S. tax. To address these transactions, the Treasury Department and the IRS intend to issue regulations under section 304 (b) (5) (C) as described below.

3. Regulations To Be Issued

"The Treasury Department and the IRS intend to issue regulations providing that, for purposes of applying section 304 (b) (5) (B), the determination of whether more than 50 percent of the dividends that arise under section 304 (b) (2) is subject to tax or includible in the earnings and profits of a CFC will be made by taking into account only the earnings and profits of the acquiring corporation (and therefore excluding the earnings and profits of the issuing corporation). * * *

"The rules of this section 3.03 (b) will apply as a general matter, without regard to whether an inversion transaction has occurred."

4. Effective Date

"[T]he regulations described in * * * section 3.03 (b) of this notice will apply to acquisitions of stock described in section 304 completed on or after September 22, 2014."

5. Example

The introduction to the examples of the recharacterization rule explains that FA is a foreign corporation like **Foreign Holding Company**, that wholly owns DT, a domestic corporation like **Domestic Inverter**, which, in turn, wholly owns FT, a foreign corporation that is a CFC, like **DI's CFC # 2**. FA **[*e.g*., Foreign Holding Company]** also wholly owns FS a foreign corporation that is not a CFC like **Foreign Inversion Target**. The introduction goes on to explain:

"Example 1. (i) Facts. FA **[*e.g*., Foreign Holding Company]**, a foreign corporation that is not a CFC, wholly owns DT **[*e.g*., Domestic Inverter]**, a domestic corporation. DT **[*e.g*., Domestic Inverter]** wholly owns FS1 [***e.g.,* DI's CFC # 2**], a CFC. DT **[*e.g*., Domestic Inverter]** has earnings and profits of $51x, and FS1 [***e.g.,* DI's CFC # 2**] has earnings and profits of $49x. FA **[*e.g*., Foreign Holding Company]** transfers DT **[*e.g*., Domestic Inverter]** stock with a value of $100x to FS1 [***e.g.,* DI's CFC # 2**] in exchange for $100x of cash.

"(ii) Analysis. Under section 304 (a) (2), the $100x of cash is treated as a distribution in redemption of the stock of DT **[*e.g*., Domestic Inverter]**. The redemption of the DT stock is treated as a distribution to which section 301 applies pursuant to section 302 (d), which ordinarily would be sourced first from FS1 [***e.g.,* DI's CFC # 2**] under section 304 (b) (2) (A). Without regard to the application of section 304 (b) (5) (B), more than 50 percent of the dividend arising from the acquisition, taking into account only the earnings and profits of FS1 [***e.g.,* DI's CFC # 2**] pursuant to this section 3.03 (b), would not be subject to tax under Chapter 1 of the Code. In particular, no portion of a dividend from FS1 [***e.g.,* DI's CFC # 2**] would be subject to U.S. tax or includible in the earnings and profits of a CFC. Accordingly, section 304 (b) (5) (B) applies to the transaction, and no portion of the distribution of $100x is treated under section 301 (c) (1) as a dividend (as defined in section 316) out of the earnings and profits of FS1 [***e.g.,* DI's CFC # 2**]. Furthermore, the $100x of cash is treated as a dividend to the extent of the earnings and profits of DT **[*e.g*., Domestic Inverter]** ($51x)."

6. Illustration See Slide 10

V SECTION 5 REQUEST FOR COMMENTS INCLUDING COMMENTS ON INTEREST STRIPPING

A. In General And With Regard To Interest Stripping

"The Treasury Department and the IRS expect to issue additional guidance to further limit inversion transactions that are contrary to the purposes of section 7874 and the benefits of post-inversion tax avoidance transactions. In particular, the Treasury Department and the IRS are considering guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or "stripping" U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt. Comments are requested regarding the approaches such guidance should take. Future guidance will apply prospectively; however, the Treasury Department and the IRS expect that, to the extent any tax avoidance guidance applies only to inverted groups, such guidance will apply to groups that completed inversion transactions on or after September 22, 2014.

"The Treasury Department is also reviewing its tax treaty policy regarding inverted groups and the extent to which taxpayers inappropriately obtain tax treaty benefits that reduce U.S. withholding taxes on U.S. source income."

B. Illustration Of Interest Stripping, See Slide 11

C. Should The Section 385 Regulations Apply To Interest Stripping Transactions?

For arguments that they should *see e.g*., Stephen E. Shay, *Mr. Secretary, Take The Tax Juice Out Of Corporate Expatriations*, Tax Notes, Vol. 144 , No. 473, July 28, 2014, available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2473192, and Samuel C. Thompson, Jr. *Professor Says Debt/Equity Regs Can Apply to Inversions*, 144 Tax Notes 883 (Aug. 18, 2014).

D. Other Possible Issues To Be Addressed In Comments

1. The Advisability Of Eliminating The Section 367(b) Priority Rule In The Killer B Regulations

Under the Killer B regulations, if certain gain to Domestic Inverter realized upon the issuance of its note for stock of the Foreign Holding Company exceeds the Section 367(a)(1) gain that would be realized by the shareholders of the Domestic Inverter, then the Section 367(b) rules take priority and the shareholders of Domestic Inverter are not subject to the Section 367(a)(1) gain recognition rule. Is this priority rule working effectively and if not, should it be eliminated possibly by applying both Section 367(a)(1) and Section 367(b) to the transaction? *See e.g*., Samuel C. Thompson, Jr., *New Inversions, the 'Joe Frazier Left Hook,' the IRS Notice, and Pfizer*, Tax Notes 1413 (June 23, 2014).

2. Does The Partnership Used In The Burger King Inversion In Essence Nullify The Section 367(a) Gain Recognition Rule?

See Samuel C. Thompson, Jr. *The Cat-and-Mouse Inversion Game with Burger King*, 144 Tax Notes 1317 (Sept. 15, 2014) and Samuel C. Thompson, Jr. *Professor Responds to Criticism of Recent Article*, Letter to the Editor, 144 Tax Notes 1470 (Sept. 22, 2014).