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**WEBINAR**: **NEW TREASURY/IRS TAX INVERSION AND SECTION 385 INTEREST STRIPPING REGULATIONS**

**A BASIC GUIDE TO THE TREASURY’S APRIL 2016 REGULATIONS ON INVERSIONS AND INTER-COMPANY DEBT**

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# INTRODUCTION TO THE 2016 TREASURY REGULATIONS: (1) IMPLEMENTING THE 2014 AND 2015 TREASURY NOTICES, AND (2) PROMULGATING REGULATIONS UNDER SECTION 385

## THE REGULATIONS

On April 4, 2016, the Treasury issued two sets of regulations addressing inversions. The regulations implement and expand upon two Notices on inversions issued by the Treasury and IRS in 2014 and 2015. In September 2014, the Treasury and IRS issued Notice 2014-52 (the 2014 Inversion Notice), and in November 2015, the Treasury and IRS issued Notice 2015-79 (the 2015 Inversion Notice), which supplemented and modified the 2014 Inversion Notice. The 2014 Notice and 2015 Notice are summarized in the following documents which are available on request.

* Samuel C. Thompson, Jr., *A Guide to the Treasury 2014 Notice on Inversions* (Oct 8, 2014), and
* Samuel C. Thompson, Jr., *A Guide to the IRS/Treasury Notice 2015-79 on Inversions* (Dec. 10, 2015).[[2]](#footnote-2)

One set of the April 4, 2016 regulations implements the concepts discussed in the 2014 and 2015 Notices, and the basic principles in this set of regulations are discussed in this Section II. This set of temporary regulations is titled “*Inversions and Related Transactions*” (the 2016 General Inversion Regs.),[[3]](#footnote-3) and is generally effective as of the date the provision was first announced either in the 2014 or 2015 Notices or on April 4, 2016.

The second set of regulations, which are in proposed form, is issued under Section 385, which authorizes the Treasury to issue regulations dealing with debt-equity issues. Among other things, this set of regulations, which is titled “*Treatment of Certain Interest in Corporations as Stock or Indebtedness*” (the 2016 Section 385 Regs)[[4]](#footnote-4) treats as stock certain debt instruments issued to related parties in transactions, including inversions, which can be used for interest stripping. These 2016 Section 385 Regs are discussed in Section III.

It must be emphasized that this is merely a basic summary of these very detailed regulations. The 2016 General Inversion Regs were issued in a 204 page “Final and Temporary Regulations,” and the 2016 Section 385 Regs were issued in a 136 page “Notice of Proposed Rulemaking.” Consequently, this discussion merely touches on the basic principles with the purpose of alerting the reader to the issues.

## SLIDES ILLUSTRATING A PROTOTYPICAL INVERSION

Slides 1 to 4 illustrate a prototypical inversion transaction, as follows:

1. Slide # 1, Pre-Inversion Structure,
2. Slide # 2, Summary of the Pre-Inversion Structure,
3. Slide # 3, The Inversion Transaction, and
4. Slide # 4, The Post-Inversion Structure.

## SECTION 7874: RULES RELATING TO EXPATRIATED ENTITIES AND THEIR FOREIGN PARENTS

Section 7874 is set out in full here:

(a) Tax on inversion gain of expatriated entities

(1) In general

The taxable income of an expatriated entity for any taxable year which includes any portion of the applicable period shall in no event be less than the inversion gain of the entity for the taxable year.

(2) Expatriated entity For purposes of this subsection—

(A) In general The term “expatriated entity” means—

(i) the domestic corporation or partnership referred to in subparagraph (B)(i) with respect to which a foreign corporation is a surrogate foreign corporation, and

(ii) any United States person who is related (within the meaning of section 267(b) or 707(b)(1)) to a domestic corporation or partnership described in clause (i).

(B) Surrogate foreign corporation A **foreign corporation** shall be treated as a **surrogate foreign corporation** if, pursuant to a plan (or a series of related transactions)—

(i) the entity **[the foreign corporation]** completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a **domestic corporation** or substantially all of the properties constituting a trade or business of a domestic partnership,

(ii) **[the Ownership Percentage]** after the acquisition **at least 60 percent of the stock (by vote or value) of the entity [the foreign corporation]** **[note that this stock of the foreign corporation is the denominator in the Ownership Fraction]** **is held—**

(I) in the case of an acquisition with respect to a domestic corporation, by former shareholders of the domestic corporation **by reason of** holding stock in the domestic corporation **[note that this “by reason of” stock of the foreign corporation is the numerator in the Ownership Fraction]**, or

(II) in the case of an acquisition with respect to a domestic partnership, by former partners of the domestic partnership by reason of holding a capital or profits interest in the domestic partnership, and

(iii) after the acquisition the expanded affiliated group which includes the entity does not have substantial business activities in the foreign country in which, or under the law of which, the entity is created or organized, when compared to the total business activities of such expanded affiliated group.

An entity otherwise described in clause (i) with respect to any domestic corporation or partnership trade or business shall be treated as not so described if, on or before March 4, 2003, such entity acquired directly or indirectly more than half of the properties held directly or indirectly by such corporation or more than half of the properties constituting such partnership trade or business, as the case may be.

(3) Coordination with subsection (b)

A corporation which is treated as a domestic corporation under subsection (b) shall not be treated as a surrogate foreign corporation for purposes of paragraph (2)(A).

(b) Inverted corporations treated as domestic corporations

Notwithstanding section 7701(a)(4), a foreign corporation shall be treated for purposes of this title as a domestic corporation if such corporation would be a surrogate foreign corporation if subsection (a)(2) were applied by substituting “80 percent” for “60 percent”.

(c) Definitions and special rules

(1) Expanded affiliated group

The term “expanded affiliated group” means an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) shall be applied by substituting “more than 50 percent” for “at least 80 percent” each place it appears.

(2) Certain stock disregarded There shall not be taken into account in determining ownership under subsection (a)(2)(B)(ii)—

(A) stock held by members of the expanded affiliated group which includes the foreign corporation, or

(B) **stock of such foreign corporation which is sold in a public offering related to the acquisition described in subsection (a)(2)(B)(i)** **[the Statutory Public Offering Rule]**.

(3) Plan deemed in certain cases

If a foreign corporation acquires directly or indirectly substantially all of the properties of a domestic corporation or partnership during the 4-year period beginning on the date which is 2 years before the ownership requirements of subsection (a)(2)(B)(ii) are met, such actions shall be treated as pursuant to a plan.

(4) Certain transfers disregarded

The transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of this section.

(5) Special rule for related partnerships

For purposes of applying subsection (a)(2)(B)(ii) to the acquisition of a trade or business of a domestic partnership, except as provided in regulations, all partnerships which are under common control (within the meaning of section 482) shall be treated as 1 partnership.

(6) **Regulations The Secretary shall prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations—**

**(A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and**

**(B) to treat stock as not stock.**

(d) Other definitions For purposes of this section—

(1) Applicable period The term “applicable period” means the period—

(A) beginning on the first date properties are acquired as part of the acquisition described in subsection (a)(2)(B)(i), and

(B) ending on the date which is 10 years after the last date properties are acquired as part of such acquisition.

(2) Inversion gain The term “inversion gain” means the income or gain recognized by reason of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period by reason of a license of any property by an expatriated entity—

(A) as part of the acquisition described in subsection (a)(2)(B)(i), or

(B) after such acquisition if the transfer or license is to a foreign related person.

Subparagraph (B) shall not apply to property described in section 1221(a)(1) in the hands of the expatriated entity.

(3) Foreign related personThe term “foreign related person” means, with respect to any expatriated entity, a foreign person which—

(A) is related (within the meaning of section 267(b) or 707(b)(1)) to such entity, or

(B) is under the same common control (within the meaning of section 482) as such entity.

(e) Special rules

(1) Credits not allowed against tax on inversion gainCredits (other than the credit allowed by section 901) shall be allowed against the tax imposed by this chapter on an expatriated entity for any taxable year described in subsection (a) only to the extent such tax exceeds the product of—

(A) the amount of the inversion gain for the taxable year, and

(B) the highest rate of tax specified in section 11(b)(1).

For purposes of determining the credit allowed by section 901, inversion gain shall be treated as from sources within the United States.

(2) Special rules for partnershipsIn the case of an expatriated entity which is a partnership—

(A) subsection (a)(1) shall apply at the partner rather than the partnership level,

(B) the inversion gain of any partner for any taxable year shall be equal to the sum of—

(i) the partner’s distributive share of inversion gain of the partnership for such taxable year, plus

(ii) gain recognized for the taxable year by the partner by reason of the transfer during the applicable period of any partnership interest of the partner in such partnership to the surrogate foreign corporation, and

(C) the highest rate of tax specified in the rate schedule applicable to the partner under this chapter shall be substituted for the rate of tax referred to in paragraph (1).

(3) Coordination with section 172 and minimum tax

Rules similar to the rules of paragraphs (3) and (4) of section 860E(a) shall apply for purposes of subsection (a).

(4) Statute of limitations

(A) In general

The statutory period for the assessment of any deficiency attributable to the inversion gain of any taxpayer for any pre-inversion year shall not expire before the expiration of 3 years from the date the Secretary is notified by the taxpayer (in such manner as the Secretary may prescribe) of the acquisition described in subsection (a)(2)(B)(i) to which such gain relates and such deficiency may be assessed before the expiration of such 3-year period notwithstanding the provisions of any other law or rule of law which would otherwise prevent such assessment.

(B) Pre-inversion year For purposes of subparagraph (A), the term “pre-inversion year” means any taxable year if—

(i) any portion of the applicable period is included in such taxable year, and

(ii) such year ends before the taxable year in which the acquisition described in subsection (a)(2)(B)(i) is completed.

(f) Special rule for treaties

Nothing in section 894 or 7852(d) or in any other provision of law shall be construed as permitting an exemption, by reason of any treaty obligation of the United States heretofore or hereafter entered into, from the provisions of this section.

(g) Regulations The Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through—

(1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or

(2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.

#  INTRODUCTION TO THE 2016 INVERSION AND RELATED TRANSACTIONS REGULATIONS

## GENERAL SCOPE OF THE REGULATION

The Summary of the 2016 General Inversion Regs gives the following guidance on the scope of the regulations:

This document contains temporary regulations that address transactions that are structured to avoid the purposes of Sections 7874 and 367 of the Internal Revenue Code (the Code) and certain post-inversion tax avoidance transactions. These regulations affect certain domestic corporations and domestic partnerships whose assets are directly or indirectly acquired by a foreign corporation and certain persons related to such domestic corporations and domestic partnerships. The text of the temporary regulations also serves as the text of the proposed regulations set forth in the notice of proposed rulemaking on this subject in the Proposed Rules Section of this issue of the Federal Register.

This Section discusses these regulations in the order in which the particular Sections of the regulations are discussed in the preamble to the regulations.

## INTRODUCTION TO THE SIGNIFICANCE OF THE OWNERSHIP PERCENTAGE, RIGHT SIZING, AND PFIZER’S ABANDONED INVERSION WITH ALLERGAN

The “Ownership Percentage” of the U.S. shareholders is central under both Sections 7874 and 367(a). Under Section 7874, the “Ownership Percentage,” is the percentage of the stock (by vote or value) of the foreign acquiring corporation that is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation (the “Domestic Shareholders’ by-Reason-of-Stock”). The fraction used to calculate the Ownership Percentage is referred to at times as the “Ownership Fraction.”

The numerator of the Ownership Fraction is the Domestic Shareholders’ by-Reason-of-Stock in the foreign acquiring corporation, and the denominator is all of the outstanding stock of the foreign acquiring corporation. Thus, for example,

1. if the Ownership Percentage is 80% or more, the foreign acquiring corporation is treated as a domestic corporation under Section 7874(b);
2. if the Ownership Percentage is at least 60% and less than 80%, then (a) the Inversion Gain Rule under Section 7874(a) applies, which subjects certain transactions to tax without regard to the availability of net operating losses and credits, and (b) the Anti-Hop Scotch Loan Rule, discussed below, applies;
3. if the Ownership Percentage is more than 50% but less but less than 80% the Section 367(a) Gain Recognition Rule, which requires the shareholders of the domestic corporation to recognize gain but not loss, applies; and
4. if the Ownership Percentage is 50% or less, none of the above rules applies.

Thus, in order to receive any benefit from an inversion, the Ownership Percentage must be less than 80%, because otherwise the foreign acquiring corporation is treated as a domestic corporation. And, in order to avoid the Inversion Gain Rule and the Anti-Hop Scotch Loan Rule, the Ownership Percentage must be less than 60%. And, to avoid the Section 367(a) Gain Recognition Rule, the Ownership Percentage must be not more than 50%.

Since these Ownership Percentage rules are dependent on the relative sizes of the domestic corporation and the foreign acquiring corporation and its foreign subs, it can be expected that companies contemplating an inversion will take measures before the inversion to get the domestic corporation and the foreign acquiring corporation in the “right relative size.” This type of “right sizing” will normally involve either (1) reducing the size of the domestic corporation (*i.e.,* slimming down the domestic corporation), or (2) increasing the size of the foreign corporation (*i.e.,* bulking up the foreign acquiring corporation). Many aspects of both the 2014 and 2015 Inversion Notices address this right sizing issue, and the 2016 Temporary Regulations also address the issue. As noted below, one surprising “right sizing” aspect of the 2016 Temporary Regulations caused Pfizer to abandon its inversion with Ireland’s Allergan, just two days after the issuance of these regulations.

Although the regulations deal with acquisitions of both corporations and partnerships, this Section focuses only on inversions involving the acquisition of domestic corporations.

## MULTIPLE-STEP ACQUISITION OF PROPERTY OF A DOMESTIC ENTITY, § 1.7874-2T(c)(4)

The preamble of the 2016 General Inversion Regs provides the following background on direct and indirect acquisitions of a domestic entity:

Section 1.7874-2(c) provides guidance on the types of transactions that constitute a direct or indirect acquisition by a foreign corporation of properties held directly or indirectly by a domestic entity and that therefore potentially result in a domestic entity acquisition. Section 1.7874-2(c)(1) sets forth a non-exclusive list of the types of transactions that generally result in an indirect acquisition of properties of a domestic entity.[[5]](#footnote-5)

The preamble then points out as follows that an acquisition by a foreign corporation of a foreign corporation that owns a U.S. corporation is not subject to Section 7874:

[S]ection 1.7874-2(c)(2) provides that when a foreign corporation acquires stock of another foreign corporation, which, in turn, directly or indirectly owns stock . . . in a domestic entity, the acquisition by the foreign corporation does not constitute an indirect acquisition of any properties held by the domestic entity. Absent §1.7874-2(c)(2), the foreign corporation’s acquisition of the stock of the other foreign corporation would be an indirect acquisition of properties of the domestic entity. However, because the domestic entity had a foreign parent before the acquisition, these types of transactions typically do not give rise to the policy concerns that motivated Congress to enact section 7874, and therefore they generally are not treated as indirect acquisitions of properties of a domestic entity. This rule does not, however, address multiple related acquisitions of the properties of a domestic entity.[[6]](#footnote-6)

The preamble then expressed concern with the following multiple related acquisitions: pursuant to a plan, a foreign “initial acquiring corporation” first makes an acquisition of a domestic corporation and that transaction is followed by an acquisition of the initial acquiring corporation by a foreign “subsequent acquiring corporation. The preamble elaborates as follows:

The Treasury Department and the IRS are concerned that taxpayers may take the position that certain transactions are not domestic entity acquisitions even though the transactions give rise to the policy concerns that motivated Congress to enact section 7874. This could occur, for example, when a foreign corporation (initial acquiring corporation) acquires substantially all of the properties held by a domestic entity (the initial acquisition) in a transaction that does not result in the initial acquiring corporation being treated as a domestic corporation under section 7874(b) (for example, because the ownership percentage is less than 80 or because the EAG purports to meet the substantial business activities exception in §1.7874-3), and, pursuant to a plan that includes the initial acquisition (or a series of related transactions), another foreign corporation (subsequent acquiring corporation) acquires substantially all of the properties of the initial acquiring corporation (the subsequent acquisition). In these cases, a taxpayer may take the position that the form of the transactions is respected for U.S. federal income tax purposes and that §1.7874-2(c)(2) prevents the subsequent acquiring corporation from being considered to have indirectly acquired the properties of the domestic entity pursuant to the subsequent acquisition. Under this position, although the initial acquisition would be a domestic entity acquisition and the initial acquiring corporation would be a foreign acquiring corporation, the subsequent acquisition would not be a domestic entity acquisition, and the subsequent acquiring corporation would not be a foreign acquiring corporation. Moreover, for purposes of computing the ownership percentage, a taxpayer may assert that former domestic entity shareholders do not hold stock of the subsequent acquiring corporation by reason of holding stock in the domestic entity and, instead, hold stock of the subsequent acquiring corporation only by reason of holding stock in the initial acquiring corporation.

In certain cases, these positions are contrary to the purposes of section 7874, including the purposes of (i) the third-country rule set forth in §1.7874-9T . . . , if the subsequent acquiring corporation and the initial acquiring corporation are subject to tax as residents of different foreign countries, or (ii) the substantial business activities exception in §1.7874-3 if the EAG has substantial business activities in the foreign country in which, or under the laws of which, the initial acquiring corporation is created or organized but does not have substantial business activities in the foreign country in which, or under the laws of which, the subsequent acquiring corporation is created or organized.[[7]](#footnote-7)

The Multiple-Step Acquisition Rule in Section §1.7874-2T(c)(4) addresses this issue. The rule sets out the following definitions that are key to understanding the rule: .

1. Initial acquisition means “with respect to a subsequent acquisition, a domestic entity acquisition occurring, pursuant to a plan that includes the subsequent acquisition . . . before the subsequent acquisition.”
2. Subsequent acquisition means “with respect to an initial acquisition, a transaction occurring, pursuant to a plan that includes the initial acquisition . . . after the initial acquisition in which a foreign corporation [the second acquiring corporation] directly or indirectly acquires . . . substantially all of the properties held directly or indirectly by the initial acquiring corporation [*i.e*., the foreign acquiring corporation that makes the initial acquisition].

The preamble summarizes the rule as follows:

To address the concerns . . . the temporary regulations provide a rule (the multiple-step acquisition rule) that treats the subsequent acquisition as a domestic entity acquisition and the subsequent acquiring corporation as a foreign acquiring corporation. §1.7874-2T(c)(4)(i). When the multiple-step acquisition rule applies, the temporary regulations treat stock of the subsequent acquiring corporation received, pursuant to the subsequent acquisition, in exchange for stock of the initial acquiring corporation described in section 7874(a)(2)(B)(ii) (that is, stock of the initial acquiring corporation that, as a result of the initial acquisition, is by-reason-of stock) as stock of the subsequent acquiring corporation held by reason of holding stock in the domestic entity. §1.7874-2T(f)(1)(iv).

## CLARIFICATION OF THE CALCULATION OF THE OWNERSHIP PERCENTAGE: IMPLEMENTING THE ANTI-STUFFING PROVISIONS OF THE 2015 NOTICE, § 1.7874-4T

The preamble of the 2016 General Inversion Regs provides the following background and description to the clarification of §1.7874-4T on the calculation of the ownership percentage, which implements an Anti-Stuffing provision of the 2015 Inversion Notice:

Under Section 7874(c)(2)(B) (statutory public offering rule), stock of a foreign acquiring corporation that is sold in a public offering related to a domestic entity acquisition described in Section 7874(a)(2)(B)(i) is excluded from the denominator of the ownership fraction. The statutory public offering rule furthers the policy that Section 7874 is intended to curtail domestic entity acquisitions that “permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion.” S. Rep. No. 192, 108th Cong., 1st. Sess., at 142 (2003); JCT Explanation, at 343.

Section 1.7874-4T modifies the statutory public offering rule. The preamble to §1.7874-4T provides that “the IRS and the Treasury Department believe that stock of the foreign acquiring corporation transferred in exchange for certain property in a transaction related to the acquisition, but not through a public offering, presents the same opportunity to inappropriately reduce the ownership fraction.” . . . Accordingly, §1.7874-4T(b) provides that, subject to a *de minimis* exception, “disqualified stock” is not included in the denominator of the ownership fraction. Disqualified stock generally includes stock of the foreign acquiring corporation that is transferred to a person (other than the domestic entity) in exchange for “nonqualified property.” The term “nonqualified property” means (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations (for example, obligations owed by members of the EAG [Expanded Affiliated Group]), or (iv) any other property acquired in a transaction (or series of transactions) related to the domestic entity acquisition with a principal purpose of avoiding the purposes of Section 7874. This preamble refers at times to the property described in clauses (i), (ii), and (iii) of the preceding sentence collectively as “specified nonqualified property” and to the property described in clause (iv) as “avoidance property.” . . .

b. Clarification

Section 2.03(b) of the 2015 notice provides that §1.7874-4T will be clarified in certain respects. The temporary regulations implement these clarifications. Accordingly, with respect to the definition of nonqualified property, the temporary regulations clarify that avoidance property means any property (other than specified nonqualified property) acquired with a principal purpose of avoiding the purposes of Section 7874, regardless of whether the transaction involves an indirect transfer of specified nonqualified property. See §1.7874-4T(j), Example 3. Second, the temporary regulations remove the phrase “in a transaction (or series of transactions) related to the acquisition” from the definition of avoidance property. See §1.7874-4T(i)(7)(iv). Third, the temporary regulations remove the phrase “unless a principal purpose for acquiring such stock or partnership interest is to avoid the purposes of Section 7874” from the definition of “marketable securities.” See §1.7874-4T(i)(6). Finally, the temporary regulations clarify Example 1 and Example 2 of §1.7874-4T(j) by including a reference to Section 7874(c)(4).

In addition, the temporary regulations update the *de minimis* exception in §1.7874-4T(d)(1) to reflect the passive assets rule (described in Section 2 of this Part I.B) and the NOCD [Non-Ordinary Course Distribution] rule (described in Section 5 of this Part I.B), and to also conform the exception to the *de minimis* exceptions in §§1.7874-7T(c) and 1.7874-10T(d).[[8]](#footnote-8)

Example 3 under § 1.7874-4T(j) illustrates the above principles:

Example 3. Stock transferred in exchange for property acquired with a principal purpose of avoiding the purposes of section 7874. (i) Facts. DT is a publicly traded corporation. PRS is a foreign partnership that is unrelated to DT. PRS transfers certain business assets (PRS properties) to FA, a newly formed foreign corporation, in exchange solely for 25 shares of FA stock. The shareholders of DT transfer all of their DT stock to FA in exchange solely for the remaining 75 shares of FA stock. None of the PRS properties is property described in paragraph (i)(7)(i) through (iii) of this section, but FA acquires the PRS properties with a principal purpose of avoiding the purposes of section 7874.

(ii) Analysis. Under paragraph (i)(7)(iv) of this section **[the principal purpose rule]**, the PRS properties transferred to FA constitute nonqualified property, because FA acquires the PRS properties in a transaction related to the acquisition of the DT stock with a principal purpose of avoiding the purposes of section 7874. Accordingly, the 25 shares of FA stock transferred by FA to PRS in exchange for the PRS properties constitute disqualified stock described in paragraph (c)(1)(i) of this section. Paragraph (c)(2) of this section does not apply to reduce the amount of disqualified stock described in paragraph (c)(1)(i) of this section because the transfer of FA stock in exchange for the PRS properties increases the fair market value of FA’s assets by the fair market value of the PRS properties. Accordingly, pursuant to paragraph (b) of this section, the 25 shares of FA stock transferred to PRS in exchange for the PRS properties are not included in the denominator of the ownership fraction. Furthermore, even in the absence of paragraph (i)(7)(iv) of this section, the transfer of the PRS properties to FA would be disregarded pursuant to section 7874(c)(4). Therefore, the only FA stock included in the ownership fraction is the FA stock transferred to DT’s former shareholders in exchange for their DT stock, and that FA stock is included in both the numerator and the denominator of the ownership fraction. Thus, the ownership fraction is 75/75. **[And, FA is treated as domestic.]**

The above principles are illustrated in SLIDE # 5 ANTI-STUFFING RULES, REG. §1.7874-4T, EXAMPLE 3.

## CALCULATION OF THE OWNERSHIP PERCENTAGE: THE PASSIVE ASSET RULE, WHICH IS THE ANTI-CASH BOX RULE OF THE 2014 NOTICE, § 1.7874-7T

The preamble to the 2016 General Inversion Regs sets forth as follows the background of the “passive assets rule,” which is based on the Anti-Cash Box rule of the 2014 Notice:

Section 2.01(b) of the 2014 notice announced that future regulations would include a rule (the passive assets rule) that would exclude from the denominator of the ownership fraction stock of a foreign acquiring corporation that is attributable to certain passive assets, but only if, after the domestic entity acquisition and all related transactions are complete, more than 50 percent of the gross value of all foreign group property constitutes certain passive assets (referred to in the notice and temporary regulations as “foreign group nonqualified property”). See Section b of this Part I.B.2 for the definition of foreign group property and foreign group nonqualified property. The temporary regulations implement the passive assets rule described in the 2014 notice, subject to the modifications described in Section c of this Part I.B.2.

The 2014 notice provides that the amount of stock that will be excluded under the passive assets rule is equal to the product of (i) the value of the stock of the foreign acquiring corporation, other than stock that is described in Section 7874(a)(2)(B)(ii) (that is, by-reason-of stock) and stock that is excluded from the denominator of the ownership fraction under either §1.7874-1(b) (because it is held by a member of the EAG) or §1.7874-4T(b) (because it is disqualified stock); and (ii) the foreign group nonqualified property fraction. The numerator of the foreign group nonqualified property fraction is the gross value of all foreign group nonqualified property, and the denominator is the gross value of all foreign group property.[[9]](#footnote-9)

Subject to a *de minimis* exception, Section 1.7874-7T(b) implements the above rule with the following general rule:

 (b) *General rule*. If, on the completion date [i.e., the date the domestic corporation is acquired], more than fifty percent of the gross value of all foreign group property constitutes foreign group nonqualified property [i.e., certain passive assets], then stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the product of—

(1) The value of [subject to certain exceptions] the stock of the foreign acquiring corporation . . .; and

(2) The foreign group nonqualified property fraction [i.e., the nonqualified property over all property].

The above principles are illustrated in Example 1 of §1.7874-7T(g):

Example 1. Application of general rule--(i) *Facts*. Individual A owns all 20 shares of the sole class of stock of FA, a foreign corporation. FA acquires all the stock of DT, a domestic corporation, solely in exchange for 76 shares of newly issued FA stock (DT acquisition). In a transaction related to the DT acquisition, FA issues 4 shares of stock to Individual A in exchange for Asset A, which has a gross value of $50x. On the completion date, in addition to the DT stock and Asset A, FA holds Asset B, which has a gross value of $150x, and Asset C, which has a gross value of $100x. Assets A and B, but not Asset C, are nonqualified property (within the meaning of §1.7874-4T(i)(7)). Further, Asset C was not acquired in a transaction related to the DT acquisition.

(ii) Analysis. The 4 shares of FA stock issued to Individual A in exchange for Asset A are disqualified stock under §1.7874-4T(c) and are excluded from the denominator of the ownership fraction pursuant to §1.7874-4T(b). Furthermore, additional shares of FA stock are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section. This is because on the completion date, the gross value of all foreign group property is $300x (the sum of the gross values of Assets A, B, and C), the gross value of all foreign group nonqualified property is $200x (the sum of the gross values of Assets A and B), and thus 66.67% of the gross value of all foreign group property constitutes foreign group nonqualified property ($200x/$300x). Because FA has only one class of stock outstanding, the shares of FA stock that are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section are calculated by multiplying 20 shares of FA stock (100 shares less the 76 shares described in section 7874(a)(2)(B)(ii) and the 4 shares of disqualified stock) by the foreign group nonqualified property fraction. The numerator of the foreign group nonqualified property fraction is $150x (the gross value of Asset B) and the denominator is $250x (the sum of the gross values of Assets B and C). Accordingly, 12 shares of FA stock are excluded from the denominator of the ownership fraction pursuant to paragraph (b) of this section (20 shares multiplied by $150x/$250x). Thus, a total of 16 shares are excluded from the denominator of the ownership fraction (4 + 12). As a result, the ownership fraction is 76/84.

The above principles are illustrated in SLIDE #6 THE ANTI-CASH BOX RULE, REG § 1.7874-7T.

## CALCULATION OF THE OWNERSHIP PERCENTAGE: THE ACQUISITION OF MULTIPLE DOMESTIC ENTITIES RULE, THE PFIZER RULE, § 1.7874-8T

Section 1.7874-8T of the 2016 General Inversion Regs, which has no comparable part in the 2014 and 2015 Notices, is directed at transactions like the Pfizer-Allergan inversion. Allergan, which is based in Ireland, was the “right size” so that the merger with Pfizer would give the Pfizer shareholders an Ownership Percentage of approximately 53% of the stock of the resulting firm, thereby avoiding Section 7874, although still subject to the Gain Recognition Rule of Section 367(a).

Allergan had grown to be the “right size” for a merger with Pfizer through the acquisition of U.S. corporations in inversions. As a result of the rule in § 1.7874-8T, which is titled “Disregard of certain stock attributable to multiple domestic entity acquisitions,” the stock issued by Allergan in the prior inversions was not included in the denominator of the Ownership Fraction. Consequently, Allergan was no longer the “right size.” Rather, the Pfizer shareholders would have an Ownership Percentage of approximately 70%, and as a consequence, both the inversion gain rule and the Anti-Hop Scotch rule, discussed below would apply. Also, even without § 1.7874-8T, the 2016 Section 385 Regs would have applied to any efforts by Pfizer to enter into interest stripping transactions. Thus, as a result of the issuance on April 4 of the 2016 General Inversion Regs and the 2016 Section 385 Regs, Pfizer terminated the inversion on April 6, 2016. The Pfizer press release announcing the termination stated:

Pfizer Inc. (NYSE: PFE) today announced that the merger agreement between Pfizer and Allergan plc (NYSE: AGN) has been terminated by mutual agreement of the companies. The decision was driven by the actions announced by the U.S. Department of Treasury on April 4, 2016, which the companies concluded qualified as an “Adverse Tax Law Change” under the merger agreement.

The preamble to the 2016 General Inversion Regs discusses as follows the background of § 1.7874-8T:

3. Acquisitions of Multiple Domestic Entities

a. Transactions at issue

The Treasury Department and the IRS are concerned that a single foreign acquiring corporation may avoid the application of Section 7874 by completing multiple domestic entity acquisitions over a relatively short period of time, in circumstances where Section 7874 would otherwise have applied if the acquisitions had been made at the same time or pursuant to a plan (or series of related transactions). In these situations, the value of the foreign acquiring corporation increases to the extent it issues stock in connection with each successive domestic entity acquisition, thereby enabling the foreign acquiring corporation to complete another, potentially larger, domestic entity acquisition to which Section 7874 will not apply. In some cases, a substantial portion of the value of a foreign acquiring corporation may be attributable to its completion of multiple domestic entity acquisitions over the span of just a few years, with that value serving as a platform to complete still larger subsequent domestic entity acquisitions that avoid the application of Section 7874. That is, the ownership percentage determined with respect to a subsequent domestic entity acquisition may be less than 60, or less than 80, if the shares of the foreign acquiring corporation issued in prior domestic entity acquisitions are respected as outstanding (thus, included in the denominator but not the numerator) when determining the ownership fraction.

Section 7874 is intended to address transactions in which a domestic parent corporation of a multinational group is replaced with a foreign parent corporation while “permit[ting] corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion.” S. Rep. No. 192, at 142 (2003); JCT Explanation, at 343. To further this policy, various rules under Section 7874 exclude from the denominator of the ownership fraction stock of the foreign acquiring corporation that otherwise would inappropriately reduce the ownership fraction. For example, the statutory public offering rule of Section 7874(a)(2)(B) excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation that is sold for cash in a public offering related to the domestic entity acquisition. For the same reason, rules under §§1.7874-4T and 1.7874-7T exclude from the denominator of the ownership fraction certain stock of the foreign acquiring corporation that is transferred in exchange for, or otherwise attributable to, passive assets or other nonqualified property.

The Treasury Department and the IRS have concluded that it is not consistent with the purposes of Section 7874 to permit a foreign acquiring corporation to reduce the ownership fraction for a domestic entity acquisition by including stock issued in connection with other recent domestic entity acquisitions. Moreover, the Treasury Department and the IRS do not believe that the application of Section 7874 in these circumstances should depend on whether there was a demonstrable plan to undertake the subsequent domestic entity acquisition at the time of the prior domestic entity acquisitions. Therefore, and consistent with the policies underlying the other stock exclusion rules under Section 7874, the Treasury Department and the IRS have determined that stock of the foreign acquiring corporation that was issued in connection with certain prior domestic entity acquisitions occurring within a 36-month look-back period should be excluded from the denominator of the ownership fraction.[[10]](#footnote-10)

The basic rule is set out as follows in §1.7874-8T(a) and (b), which became effective on April 4, 2016:

§1.7874-8T Disregard of certain stock attributable to multiple domestic entity

acquisitions (temporary).

(a) *Scope.* This Section identifies stock of a foreign acquiring corporation that is disregarded in determining an ownership fraction by value because it is attributable to certain prior domestic entity acquisitions. Paragraph (b) of this Section sets forth the general rule regarding the amount of stock of a foreign acquiring corporation that is excluded from the denominator of the ownership fraction by value under this Section[.]

(b) *General rule*. This paragraph (b) applies to a domestic entity acquisition (relevant domestic entity acquisition) **[*i.e*., an acquisition of a domestic corporation “that occurred within the 36-month period ending on the signing date of the relevant domestic entity acquisition”]** when the foreign acquiring corporation . . . has completed one or more prior domestic entity acquisitions. When this paragraph (b) applies, then, for purposes of determining the ownership percentage by value (but not vote) described in Section 7874(a)(2)(B)(ii), stock of the foreign acquiring corporation is excluded from the denominator of the ownership fraction in an amount equal to the sum of the excluded amounts computed separately with respect to each prior domestic entity acquisition and each relevant share class.

Example 1 of § 1.7874-8T(h) provides the following illustration of the basic rule:

*Example 1*. *Application of general rule*--(i) Facts*.* Individual A wholly owns DT1, a domestic corporation. Individual B owns all 100 shares of the sole class of stock of FA, a foreign corporation. In Year 1, FA acquires all the stock of DT1 solely in exchange for 100 shares of newly issued FA stock (DT1 acquisition). On the completion date with respect to the DT1 acquisition, the fair market value of each share of FA stock is $1x. In Year 3, FA enters into a binding contract to acquire all the stock of DT2, a domestic corporation wholly owned by Individual C. Thereafter, FA acquires all the stock of DT2 solely in exchange for 150 shares of newly issued FA stock (DT2 acquisition). On the completion date with respect to the DT2 acquisition, the fair market value of each share of FA stock is $1.50x. FA did not complete the DT1 acquisition and DT2 acquisition pursuant to a plan (or series of related transactions) for purposes of applying §1.7874-2(e). In addition, there have been no redemptions of FA stock subsequent to the DT1 acquisition.

(ii) *Analysis*. The DT1 acquisition is a prior domestic entity acquisition with respect to the DT2 acquisition (the relevant domestic entity acquisition) because the DT1 acquisition occurred within the 36-month period ending on the signing date with respect to the DT2 acquisition. Accordingly, paragraph (b) of this Section applies to the DT2 acquisition. As a result, and because there were no redemptions of FA stock, the excluded amount is $150x (calculated as 100, the total number of prior acquisition

shares, multiplied by $1.50x, the fair market value of a single class of FA stock on the completion date with respect to the DT2 acquisition). Accordingly, the numerator of the ownership fraction by value is $225x (the fair market value of the stock of FA that, with respect to the DT2 acquisition, is described in Section 7874(a)(2)(B)(ii)). In addition, the denominator of the ownership fraction is $375x (calculated as $525x, the fair market value of all shares of FA stock as of the completion date with respect to the DT2 acquisition, less $150x, the excluded amount). Therefore, the ownership percentage by

value is 60. **[Consequently, the transaction is subject to Section 7874.]**

While some observers will question whether the Treasury has the authority to issue these regulations, in my view there is more than ample authority in Section 7874(g), which provides, in part:

The Secretary shall provide such regulations as are necessary to carry out this Section, including regulations providing for such adjustments to the application of this Section as are necessary **to prevent the avoidance of the purposes of this Section . . . .**

## CALCULATION OF THE OWNERSHIP PERCENTAGE: THE THIRD COUNTRY RULE, § 1.7874-9T

The preamble to the 2016 General Inversion Regs introduces as follows the Third Country Rule, which first appeared in the 2015 Notice and is reflected in § 1.7874-9T:

4. Third-Country Rule

a. Background

Section 2.02(b) of the 2015 notice announces that the Treasury Department and the IRS intend to issue regulations providing a rule (the third-country rule) that will apply to certain domestic entity acquisitions in which a domestic entity combines with an existing foreign corporation under a foreign parent corporation that is a tax resident of a “third country” (that is, a foreign country other than the foreign country of which the existing foreign corporation is subject to tax as a resident). The 2015 notice provides that the third-country rule will apply when four requirements are satisfied. First, in a transaction (referred to in the 2015 notice as a “foreign target acquisition” but in this preamble and the temporary regulations as a “foreign acquisition”) related to the domestic entity acquisition, the foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by another foreign corporation (the acquired foreign corporation). Second, the gross value of all property directly or indirectly acquired by the foreign acquiring corporation in the foreign acquisition exceeds 60 percent of the gross value of all foreign group property, other than foreign group nonqualified property, held by the EAG on the completion date (the gross value requirement). Third, the tax residence of the foreign acquiring corporation is not the same as that of the acquired foreign corporation, as determined before the foreign acquisition and any related transaction (the tax residency requirement). And fourth, the ownership percentage, determined without regard to the third-country rule, must be at least 60 but less than 80 (the domestic entity ownership requirement). . . . [T]he temporary regulations retain the first, third, and fourth requirements described in the 2015 notice but replace the second requirement with [the following new requirement: “[A] continuity of interest requirement (referred to as the “foreign ownership percentage”), . . . [which generally] is satisfied if at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation is held by former shareholders of the acquired foreign corporation by reason of holding stock in the acquired foreign corporation[.]].[[11]](#footnote-11)

The above principles are illustrated in the Example in § 1.7874-9T(f), and in Slide #7. .

## CALCULATION OF THE OWNERSHIP PERCENTAGE: THE NON-ORDINARY COURSE DISTRIBUTIONS (NOCD) RULE, § 1.7874-10T

While all of the provisions discussed thus far dealing with the “Calculation of the Ownership Percentage” have addressed the “right sizing” or bulking up of the foreign acquiror, this Non-Ordinary Course Distributions (NOCD) Rule deals with the “right sizing” or slimming down of the U.S. firm. This concept was first set forth in the 2014 Notice. The preamble to the 2016 General Inversion Regs gives the following introduction to the issue and general description of the approach of this very elaborate set of regulations:

5. Non-Ordinary Course Distributions (NOCD) Rule

a. Overview

The 2014 notice announced that the Treasury Department and the IRS intend to include in future regulations under Section 7874 a rule (the NOCD rule) that disregards certain distributions made by a domestic entity before being acquired by a foreign acquiring corporation that otherwise would reduce the numerator of the ownership fraction. Specifically, Section 2.02(b) of the 2014 notice provides that, for purposes of applying Section 7874(c)(4), NOCDs made by the domestic entity . . . during the 36-month period ending on the completion date will be treated as part of a plan a principal purpose of which is to avoid the purposes of Section 7874.

The 2014 notice defines NOCDs as the excess of all distributions made during a taxable year by the domestic entity with respect to its stock . . . over 110 percent of the average of such distributions during the thirty-six month period immediately preceding such taxable year. The 2014 notice defines distribution, in relevant part, to mean any distribution, regardless of whether it is treated as a dividend or whether, for example, it qualifies under Section 355.

Section 4.02(b) of the 2015 notice provides that the future regulations incorporating the NOCD rule will include a *de minimis* exception. . . .

The 2015 notice provides that, when a domestic entity acquisition satisfies the requirements of the *de minimis* exception, no distributions will be treated as NOCDs that are disregarded under the NOCD rule. . . .

Further, the 2014 notice provides that §1.367(a)-3(c) (concerning outbound transfers of stock or securities of a domestic corporation) will be modified to include a rule that incorporates the principles of the NOCD rule for purposes of the substantiality test, which, in general, requires that the value of the foreign acquiring corporation be equal to or greater than the value of the domestic target corporation.

b. Regulations implementing the NOCD rule

Section 1.7874-10T sets forth the NOCD rule as described in the 2014 notice and the 2015 notice, subject to certain modifications, in part, to address comments received. Section 1.367(a)-3T(c)(3)(iii)(C) sets forth a similar rule for purposes of the substantiality test under §1.367(a)-3(c).[[12]](#footnote-12)

The “General Rule Regarding NOCDs” is in § 1.7874-10T(b), which, subject to certain exceptions, provides:

[F]or purposes of determining the **ownership percentage** by value (but not vote) described in section 7874(a)(2)(B)(ii), former domestic entity shareholders . . . are treated as receiving, **by reason of** holding stock . . . in a domestic entity, stock of the foreign acquiring corporation with a fair market value equal to the amount of the non-ordinary course distributions (NOCDs), determined as of the date of the distributions, made by the domestic entity during the look-back period **[the 36 month period ending on the completion date]**. The stock of the foreign acquiring corporation treated as received under this paragraph (b) is in addition to stock of the foreign acquiring corporation otherwise treated as received by the former domestic entity shareholders . . . by reason of holding stock . . . in the domestic entity.

*See* Slide #8 for an illustration of slimming down NOCDs.

## APPLICATION OF THE EAG RULES WHEN THERE IS A RELATED TRANSFER OF STOCK OF THE FOREIGN ACQUIRING CORPORATION, THE SPINVERSION RULE, § 1.7874-6T

### INTRODUCTION

This highly complex provision is only introduced here. The preamble to the 2016 General Inversion Regs gives the following general description of the rule, which is based on a provision of the 2014 Notice:

Section 2.03(b) of the 2014 notice provides a rule concerning the interaction of

§1.7874-5T and the EAG [Expanded Affiliate Group] rules. Subject to two exceptions, the 2014 notice provides that certain stock, referred to as “transferred stock,” is not treated as held by a member of the EAG for purposes of applying the EAG rules. As a result, transferred stock generally is included in both the numerator and the denominator of the ownership fraction. See §1.7874-5T(a). For this purpose, transferred stock is stock of a foreign acquiring corporation described in Section 7874(a)(2)(B)(ii) (that is, by-reason-of stock) that is received by a former domestic entity shareholder . . . that is a corporation (transferring corporation), and, in a transaction (or series of transactions) related to the domestic entity acquisition, is subsequently transferred.

The 2014 notice also described two exceptions to this rule: the U.S.-parented group [an affiliated group that has a domestic corporation as a common parent] exception and the foreign-parented group [an affiliated group that has a foreign corporation as a common parent] exception. When either of these exceptions applies, transferred stock is treated as held by members of the EAG for purposes of applying the EAG rules. In these cases, transferred stock is excluded from the numerator of the ownership fraction and, depending on the application of §1.7874-1(c), may be excluded from the denominator of the ownership fraction. See §1.7874-1(b) and (c).

The U.S.-parented group exception applies if: (i) before and after the domestic entity acquisition, the transferring corporation (or its successor) is a member of a U.S.-parented group, and (ii) after the domestic entity acquisition, both the person that holds the transferred stock after all related transfers of the transferred stock are complete and the foreign acquiring corporation are members of the U.S.-parented group referred to in (i).

The foreign-parented group exception applies if: (i) before the domestic entity acquisition, the transferring corporation and the domestic entity are members of the

same foreign-parented group, and (ii) after the domestic entity acquisition, the transferring corporation is a member of the EAG, or would be a member of the EAG absent the subsequent transfer of any stock of the foreign acquiring corporation by a member of the foreign-parented group in a transaction related to the domestic entity acquisition (but taking into account all other transactions related to such acquisition).

The 2014 notice defines a U.S.-parented group as an affiliated group that has a domestic corporation as the common parent corporation, and a foreign-parented group as an affiliated group that has a foreign corporation as the common parent corporation.

For this purpose, the term “affiliated group” means an affiliated group as defined in Section 1504(a) but without regard to Section 1504(b)(3), except that Section 1504(a) is applied by substituting the term “more than 50 percent” for the term “at least 80 percent” each place it appears. Finally, the 2014 notice provides that, except as provided in the foreign-parented group exception, all transactions related to the domestic entity acquisition must be taken into account for purposes of determining an EAG, a U.S.-parented group, and a foreign-parented group.

3. Regulations Implementing the Rule

Section 1.7874-6T sets forth the rule concerning the interaction of §1.7874-5T and the EAG rules, as described in the 2014 notice, subject to [certain] modifications[.][[13]](#footnote-13)

Section 1.7874-6T(b), which implements this provision, subject to certain exceptions provides:

[T]ransferred stock [*i.e*., “stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) that is received by a transferring corporation and, in a transaction . . . related to the domestic entity acquisition, is subsequently transferred”] is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) **[excluding stock held by members of the EAG from the Ownership FractioN]** and §1.7874-1. Transferred stock that is not treated as held by members of the EAG for purposes of applying section 7874(c)(2)(A) and §1.7874-1 is included in the numerator and the denominator of the ownership fraction. See §1.7874-5T(a).

### THE SPINVERSION EXAMPLE

The above principles are illustrated in the Example 1 of §1.7874-6T(g), which is based on a “Spinversion” example in the 2014 Notice. In reading this Spinversion example, which is set out here, notice how the rule prevents the use of a spin-off as a way of setting up an inversion: :

*Example 1*. *U.S.-parented group exception not available*--(i) *Facts*. USP, a domestic corporation wholly owned by Individual A, owns all the stock of DT, a domestic corporation, as well as other property. The DT stock does not represent substantially all of the property of USP for purposes of Section 7874. Pursuant to a reorganization described in Section 368(a)(1)(D), USP transfers all the DT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to Individual A pursuant to Section 361(c)(1).

(ii) *Analysis*. The 100 FA shares received by USP are stock of a foreign acquiring corporation described in Section 7874(a)(2)(B)(ii) and, under §1.7874-5T(a), the shares retain their status as such even though USP subsequently distributes the shares to Individual A pursuant to Section 361(c)(1). Thus, the 100 FA shares are included in the ownership fraction, unless the shares are treated as held by members of the EAG for purposes of applying Section 7874(c)(2)(A) and §1.7874-1 and are excluded from the ownership fraction under those rules. For purposes of applying Section 7874(c)(2)(A) and §1.7874-1, the 100 FA shares, which constitute transferred stock under paragraph (f)(2) of this Section, are treated as held by members of the EAG only if an exception in paragraph (c) of this Section applies. See paragraph (b) of this Section. The U.S.-parented group exception described in paragraph (c)(1) of this Section does not apply. Although before the DT acquisition, USP (the transferring corporation) is a member of a U.S.-parented group of which USP is the common parent, after the DT acquisition, and taking into account all transactions related to the acquisition, each of USP, Individual A (the person that holds the transferred stock), and FA (the foreign acquiring corporation) are not members of a U.S.-parented group described in paragraph (c)(1)(ii)(A) or (B) of this Section. Accordingly, because the 100 FA shares are not treated as held by members of the EAG, those shares are included in the numerator and the denominator of the ownership fraction. Therefore, the ownership fraction is 100/100.

The basic principles in this example are illustrated in the following slides 9-11:

SLIDE #9 SPINVERSION, BEFORE, REG § 1.7874-6T(g), EXAMPLE 1,

SLIDE #10 SPINVERSION, THE SPIN, REG § 1.7874-6T(g), EXP 1, USP SPINS OFF DT TO FA and,

SLIDE #11 SPINVERSION, AFTER, REG § 1.7874-6T(g), EXAMPLE 1, DT HAS INVERTED AS SUB OF FA.

Slide #9 shows a completely domestic structure, with DT corp owned by domestic USP corp, which is owned by individual A. USP owns other assets. Slide #10 show USP transferring the stock of DT to FA in exchange for stock of FA, and then distributing the stock of FA to individual A. This spinoff, may or may not qualify under Section 355. Slide 11 shows that when the dust settles on this transaction, FA owns DT, and DT has in essence been inverted. The diagram does not show any other shareholders of FA, but in a normal inversion there would be sufficient other shareholders of prevent FA from being a CFC.

## THE SUBSTANTIAL BUSINESS ACTIVITIES TEST, THE SUBJECT TO TAX RULE, § 1.7874-3T(b)(4)

The preamble to the 2016 General Inversion Regs gives the following description of this substantial business activities test and the Subject-to-tax rule, which was added by the 2015 Notice:

D. The substantial business activities test

1. The Subject-to-Tax Rule

Section 2.02(a) of the 2015 notice provides a rule (the subject-to-tax rule) that addresses domestic entity acquisitions in which a taxpayer asserts that its EAG has substantial business activities in the relevant foreign country when compared to the EAG’s total business activities even though the foreign acquiring corporation is not subject to tax as a resident of the relevant foreign country. Under the subject-to-tax rule, an EAG cannot have substantial business activities in the relevant foreign country when compared to the EAG’s total business activities unless the foreign acquiring corporation is subject to tax as a resident of the relevant foreign country.

The temporary regulations implement the subject-to-tax rule described in the

2015 notice without making any substantive changes. See §1.7874-3T(b)(4).[[14]](#footnote-14)

## CLARIFICATION OF GROUP INCOME FOR PURPOSES OF THE SUBSTANTIAL BUSINESS ACTIVITIES TEST, § 1.7874-3

Section 7874(a) does not apply unless there is an “expatriated entity,” which is defined in Section 7874(a)(2) as a domestic corporation with respect to which a foreign corporation is a “surrogate foreign corporation.” The term “surrogate foreign corporation” is defined in Section 7874(a)(2)(B) as a foreign corporation with respect to which, in general, the following three conditions are satisfied:

(1) the foreign corporation acquires a U.S. corporation;

(2) in the acquisition the shareholders of the U.S. corporation “by reason of” holding stock in the U.S. corporation hold, by vote or value, at least 60% of the stock of the foreign corporation, and

(3) after the acquisition the expanded affiliated group (EAG) does not have **“substantial business activities”** in the foreign country in which the foreign corporation is organized.

The preamble to the 2016 General Inversion Regs gives the following introduction to the substantial business activities test: “Under §1.7874-3, an EAG is considered to have substantial business activities in the relevant foreign country only if at least 25 percent of its group employees, group assets, and group income are located or derived in the relevant foreign country.”[[15]](#footnote-15) The preamble goes on to give the following guidance regarding the determination of group income:

In general, group income is gross income from transactions occurring in the ordinary course of business with unrelated customers, as determined consistently under either federal tax principles or as reflected in the EAG’s financial statements. . . . The temporary regulations clarify that financial reporting principles are only relevant for determining the amount of items of income that are taken into account, as an EAG must take into account all items that its members (as determined based on the definition of EAG set forth in §1.7874-3(d)(4)) recognized for financial accounting purposes during the testing period.[[16]](#footnote-16)

## THE ANTI-HOPSCOTCH LOAN RULE, SECTION §1.956-2T(a)(4)

The starting point for understanding this Anti-Hopscotch Loan rule is an understanding of the purposes of Section 956. The background and purpose of Section 956 are set out as follows in the 2014 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.’

The preamble to the 2016 General Inversion Regs gives the following introduction to the basic principles of the Anti-Hopscotch Loan provisions under Section 956:

A. United States property rule

1. Overview

As described in Section 3.01(a) of the 2014 notice, an inversion transaction may permit the new foreign parent of the inverted group, a group still principally comprised of United States shareholders and their CFCs, to avoid Section 956 by accessing the untaxed earnings and profits of the CFCs without a current U.S. federal income tax to the United States shareholders. This is a result that the United States shareholders could not achieve before the inversion transaction. 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 United States shareholders, thereby circumventing the purposes of Section 956.

In order to prevent this avoidance of Section 956, Section 3.01(b) of the 2014 notice announces that future regulations will include a rule (the United States property rule) providing that, solely for purposes of Section 956, any obligation or stock of a non-CFC foreign related person (generally, either the foreign acquiring corporation or a foreign affiliate of the foreign acquiring corporation that is not an expatriated foreign subsidiary) is 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 **[*i.e*., a CFC whose U.S. parent has been acquired in an inversion] during the applicable period [the 10 year period after the inversion].** . . .

2. Regulations Implementing the United States Property Rule

These temporary regulations include the rules described in the 2014 notice, with certain modifications, in part, to address comments received.[[17]](#footnote-17)

There are several exceptions to the rule that are not addressed here. The basic principles are illustrated in Example (1) of § 1.956-2T(a)(4)(iv). For purposes of the example the following is a description of the parties:

FA, a foreign corporation, wholly owns DT, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation that is a controlled foreign corporation. FA also wholly owns FS, a foreign corporation. FA acquired DT in an inversion transaction that was completed on January 1, 2015. **[Note that there was an inversion.]**

The example is as follows:

*Example* 1. (A) Facts. FT [a CFC] acquired an obligation of FS [a wholly owned sub of FA, a foreign corporation] on January 31, 2015.

(B) Analysis. Pursuant to §1.7874-12T, DT is a domestic entity, FT is an expatriated foreign subsidiary, and FS is a non-CFC foreign related person. In addition FT acquired the FS obligation during the applicable period. Thus, as of January 31, 2015, the obligation of FS is United States property with respect to FT for purposes of Section 956(a) and §1.956-2(a).

The basic Anti-Hopscotch Loan rules are illustrated in SLIDE #12 ANTI-HOPSCOTCH LOAN RULE, REG § 1.956-2T(a)(4).

It should be noted that this rule only applies where there is an inversion within the meaning of Section 7874. Thus, in an acquisition by a foreign corporation of a U.S. target in a non-inversion transaction there is no prohibition against the making of Hopscotch Loans.

## THE SECTION 7701(l) RECHARACTERIZATION RULE, SECTION §1.7701(l)-4T

The following is a short excerpt from the discussion of the recharacterization rule under Section 7701(l) that is set out in the preamble to the 2016 General Inversion Regs:

1. Section 7701(l) Recharacterization Rule

a. Overview

As described in the 2014 notice, after an inversion transaction, the inverted group may cause an expatriated foreign subsidiary to cease to be a CFC using certain transactions that do not give rise to U.S. federal income tax, so as to avoid U.S. federal income tax on the CFC's pre-inversion transaction earnings and profits. Additionally, even if the foreign acquiring corporation were to acquire less stock of an expatriated foreign subsidiary, such that the expatriated foreign subsidiary remained a CFC, it could nevertheless substantially dilute a United States shareholder's ownership of the CFC. As a result, the United States shareholder could avoid U.S. federal income tax on the CFC's pre-inversion transaction earnings and profits[.]

In order to prevent the use of these transactions to avoid U.S. federal income tax, the 2014 notice announces that the Treasury Department and the IRS intend to issue regulations under Section 7701(l) that will recharacterize specified transactions completed during the applicable period (the Section 7701(l) recharacterization rule). A specified transaction is defined in Section 3.02(e)(i) of the 2014 notice as a transaction in which stock in an expatriated foreign subsidiary (specified stock) is transferred (including by issuance) to a specified related person. A specified related person [includes] a non-CFC foreign related person[.]

Section 3.02(e)(i)(A) of the 2014 notice provides that a specified transaction 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 and one or more Section 958(a) U.S. shareholders of the expatriated foreign subsidiary. . . .

b. Regulations implementing the Section 7701(l) recharacterization rule

These temporary regulations implement the Section 7701(l) recharacterization rule described in the 2014 notice, subject to certain modifications[.][[18]](#footnote-18)

These regulations are designed to prevent the post-inversion de-control of CFCs, and any such transaction will have to run the gauntlet set out in these very complicated regulations. The basic principles are illustrated in SLIDE #13 ANTI-DECONTROL OF CFC RULE, REG § 1.7701-1(l)

## THE SECTION 367(b) STOCK DILUTION RULE, SECTION §1.367(b)--4T(e)

The 2016 General Inversion Regs contain a “Section 367(b) Stock Dilution Rule.” Under Section 367(b), the Treasury is authorized to write regulations providing for recognition of gain in certain inbound and foreign-to-foreign reorganizations. The preamble to The 2016 General Inversion Regs sets out the following description of the basic rules:

a. Overview

Section 3.02(e)(ii) of the 2014 notice provides a rule (the Section 367(b) stock dilution rule) that addresses certain post-inversion transaction exchanges that dilute the interest of a United States shareholder in a CFC and, absent the rule, could allow the United States shareholder to avoid U.S. federal income tax on earnings and profits of the CFC that exist at the time of the exchange. Specifically, the Section 367(b) stock dilution rule, as described in the 2014 notice, provides that when certain requirements are satisfied with respect to an exchange . . . , the exchanging shareholder is generally required to include in income as a deemed dividend the Section 1248 amount with respect to the stock exchanged. . . .

b. Application of the Section 367(b) stock dilution rule to unrealized appreciation

The 2015 notice expands the consequences of being subject to the Section 367(b) stock dilution rule. The 2015 notice provides that, when an exchanging shareholder is required under the Section 367(b) stock dilution rule to include in income as a deemed dividend the Section 1248 amount (if any) with respect to the stock exchanged, the exchanging shareholder must also, after taking into account any increase in basis provided in §1.367(b)-2(e)(3)(ii) resulting from the deemed dividend, recognize all realized gain with respect to the stock that is not otherwise recognized. The 2015 notice explains that this result is necessary to prevent a United States shareholder of a CFC from potentially avoiding U.S. federal income tax on net unrealized built-in-gain in property held by the CFC at the time of the exchange of the stock of the CFC. See Section 3.02(b) of the 2015 notice.

The 2015 notice also states that a conforming change will be made to the regulations described in Section 3.02(e)(i) of the 2014 notice. . . .

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c. Regulations implementing the Section 367(b) stock dilution rule The temporary regulations implement the Section 367(b) stock dilution rule as described in the 2014 notice and the 2015 notice, subject to certain modifications.[[19]](#footnote-19)

Section 1.367(b)-4T(b) sets out the following general “Income Inclusion” rule:

(e) *Income inclusion and gain recognition in certain exchanges following an inversion transaction*--(1) General rule. If a foreign corporation (the transferee foreign corporation) acquires stock of a foreign corporation in an exchange described in section 351 or stock or assets of a foreign corporation in a reorganization described in section 368(a)(1) (in either case, the foreign acquired corporation), then an exchanging shareholder [generally] must, if its exchange is a specified exchange **[*i.e*., certain post inversion intercompany transfers]** . . . --

(i) Include in income as a deemed dividend the section 1248 amount attributable to the stock that it exchanges; and

 (ii) After taking into account the increase in basis provided in §1.367(b)-2(e)(3)(ii) resulting from the deemed dividend (if any), recognize all realized gain with respect to the stock that would not otherwise be recognized.

The basic principles in this regulation are illustrated in SLIDE # 14 CFC STOCK DILUTION RULE, REG. § 1.367(b)-4T(e).

## THE SECTION 367(b) ASSET DILUTION RULE, SECTION §1.367(b)--4T(f)

The 2016 General Inversion Regs also contain a “Section 367(b) Asset Dilution Rule.” As indicated above, under Section 367(b), the Treasury is authorized to write regulations providing for recognition of gain in certain inbound and foreign-to-foreign reorganizations. The preamble to the 2016 General Inversion Regs sets out the following description of the basic rules:

3. Section 367(b) Asset Dilution Rule

a. Transactions at issue

For reasons similar to those discussed in Section 3.02(d) of the 2014 notice and Section 3.02(b) of the 2015 notice, the Treasury Department and the IRS have determined that, upon a transfer by an expatriated foreign subsidiary [i.e., a CFC after an inversion] of property . . . to a transferee foreign corporation in certain Section 351 exchanges, the expatriated foreign subsidiary should be required to recognize all realized gain in the property that is not otherwise recognized. Absent such a rule, the transfer could dilute a United States shareholder’s indirect interest in the property and, as a result, could allow the United States shareholder to avoid U.S. federal income tax on realized gain that is not recognized at the time of the transfer. . . .

b. Regulations implementing the Section 367(b) asset dilution rule

The temporary regulations provide a rule (the Section 367(b) asset dilution rule) that applies when an expatriated foreign subsidiary transfers specified property to a foreign transferee corporation in an exchange described in Section 351 that occurs within the applicable period. §1.367(b)-4T(f)(1). When the Section 367(b) asset dilution rule applies, the expatriated foreign subsidiary must recognize all realized gain (but not loss) with respect to the specified property that is not otherwise recognized, unless an exception applies. §1.367(b)-4T(f)(1). For this purpose, specified property means any property other than stock of a lower-tier expatriated foreign subsidiary. §1.367(b)-4T(g)(5).[[20]](#footnote-20)

## THE SECTION 304 RULES, SECTION §1.304--7T

The 2016 General Inversion Regs contain an amendment to the Section 304 regulations, which deal with purchases by a corporation of the stock of a related corporation. The preamble to the 2016 General Inversion Regs sets out the following description of the basic rules:

The Section 304 Rules

a. Transactions at issue

Section 3.03(b) of the 2014 notice explains how 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. The Treasury Department and the IRS understand that taxpayers may interpret Section 304(b)(5)(B) to not apply when 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. federal income tax.

b. Overview

To address [these] concerns . . . Section 3.03(b) of the 2014 notice provides rules (the Section 304 rules) that apply for purposes of Section 304(b)(5)(B). In particular, the Section 304 rules provide that 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 is 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). . . .

c. Regulations implementing the Section 304 rules

Section 1.304-7T sets forth regulations implementing the Section 304 rules as described in the 2014 notice.[[21]](#footnote-21) .

The general principles in this very complex reg are illustrated in SLIDE #15 ANTI-SECTION 304 AVOIDANCE RULE, REG. §1 304-7T.. .

## THE INVERSION GAIN RULE, SECTION §1.7874-11T

The 2016 General Inversion Regs contain the following discussion of the treatment of inversion gains under §1.7874-11T:

C. Inversion gain rule

1. In General

Section 7874(a)(1), together with Section 7874(e)(1) (which prevents the use of certain credits to offset U.S. federal income tax on inversion gain), ensures that an expatriated entity [i.e., the domestic parent that is acquired in the inversion] generally pays current U.S. federal income tax with respect to inversion gain. These rules are intended to ensure that an appropriate “toll charge” is paid on transactions that accompany or follow an inversion transaction and are designed to “remove income from foreign operations from the U.S. taxing jurisdiction.” See H.R. Conf. Rep. No. 755, at 568, 574 (2004); JCT Explanation, at 342, 345.

Section 3.01(b) of the 2015 notice announces that the Treasury Department and the IRS intend to issue regulations that will provide a rule (the inversion gain rule) to address certain indirect transfers by an expatriated entity that, absent the rule, could have the effect of removing foreign earnings from the U.S. taxing jurisdiction while avoiding current U.S. federal income tax. As described in the 2015 notice, the inversion gain rule provides that inversion gain includes income or gain recognized by an expatriated entity from an indirect transfer or license of property, such as an expatriated entity’s Section 951(a)(1)(A) gross income inclusions taken into account during the applicable period that are attributable to a transfer of stock or other properties or a license of property, either: (i) as part of the acquisition, or (ii) after such acquisition if the transfer or license is to a specified related person. However, clause (ii) of the preceding sentence generally does not apply to transfers or licenses of property that is inventory in the hands of the transferor or licensor. . . .

2. Regulations Implementing the Inversion Gain Rule

Section 1.7874-11T sets forth the inversion gain rule as described in the 2015

notice, subject to [a] modification.[[22]](#footnote-22)

#  THE 2016 TREASURY INTEREST STRIPPING REGULATIONS UNDER SECTION 385

## INTRODUCTION TO THE 2016 TREASURY REGULATIONS (1) IMPLEMENTING THE 2014 AND 2015 TREASURY NOTICES, AND (2) PROMULGATING REGULATIONS UNDER SECTION 385

As discussed above, in September 2014, the Treasury and IRS issued a notice on inversions (the 2014 Inversion Notice), and in December 2015, the Treasury and IRS issued an additional notice on inversions (the 2015 Inversion Notice), which supplements and modifies this 2014 Inversion Notice.

In April 2016, the Treasury issued two sets of regulations addressing inversions. One set of regulations implements the concepts discussed in the 2014 and 2015 notices, and this set of regulations, which is titled *Inversions and Related Transactions*, is discussed in Section 1.2. The second set of regulations, which is discussed in this Section 1.3, is issued under Section 385, which authorizes the Treasury to issue regulations dealing with debt-equity issues. Among other things, this set of regulations, which is titled “*Treatment of Certain Interest in Corporations as Stock or Indebtedness*” (the 2016 Section 385 Regs)[[23]](#footnote-23) treats as stock certain debt instruments issued to related parties in transactions, including inversions, which can be used for interest stripping. This regulation is generally applicable as of the date of issuance, April 4, 2016. This Section explores the basic principles in these proposed Section 385 regulations. It must be emphasized that this is merely a basic summary of these very detailed regulations, which are issued in a 136 page Notice of Proposed Rulemaking.

## ILLUSTRATION OF A PRE-SECTION 385 INTEREST STRIPPING TRANSACTION

In order to interest strip, it is necessary to have a domestic corporation issue its debt instrument to a related foreign corporation that is not subject to the CFC rules. If the CFC rules were to apply, the interest would be foreign personal holding company income that that would be subject to imputation back to the U.S. firm.

One of the major reasons for inversions is to set up a structure that is conducive to interest stripping. For example, in looking at SLIDE #16 POTENTIAL POST-INVERSION INTEREST STRIPPING, neither the New Foreign Holding Company nor the Foreign Inversion Target are CFCs. Consequently, the Domestic Inverter could issue an interest stripping note to the New Foreign Holding Company. As will be seen below, subject to certain exceptions, under Reg. § 1.385-3, the type of note issued in Slide # 16 would be treated as equity.

## SECTION 385 AND THE TREASURY’S AUTHORITY

### INTRODUCTION

Before starting the analysis it is helpful to look at the words of Section 385 and to consider if the Treasury has the authority to issue the proposed Section 385 regulations.

### SECTION 385: TREATMENT OF CERTAIN INTERESTS IN CORPORATIONS AS STOCK OR INDEBTEDNESS

Section 385, which was enacted in 1969, provides:

(a) *Authority to prescribe regulations*

The Secretary is authorized to prescribe such regulations **as may be necessary or appropriate** to determine whether an **interest in a corporation is to be treated for purposes of this title as stock or indebtedness (or as in part stock and in part indebtedness).**

(b) *Factors* The regulations prescribed under this Section **shall set forth factors** which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists. The factors so set forth in the regulations **may include among other factors**:

(1) whether there is a written unconditional promise to pay on demand or on a specified date a sum certain in money in return for an adequate consideration in money or money’s worth, and to pay a fixed rate of interest,

(2) whether there is subordination to or preference over any indebtedness of the corporation,

(3) the ratio of debt to equity of the corporation,

(4) whether there is convertibility into the stock of the corporation, and

(5) **the relationship between holdings of stock in the corporation and holdings of the interest in question.**

(c) *Effect of classification by issuer*

(1) *In general*

The characterization (as of the time of issuance) by the issuer as to whether an interest in a corporation is stock or indebtedness shall be binding on such issuer and on all holders of such interest (but shall not be binding on the Secretary).

(2) *Notification of inconsistent treatment*

Except as provided in regulations, paragraph (1) shall not apply to any holder of an interest if such holder on his return discloses that he is treating such interest in a manner inconsistent with the characterization referred to in paragraph (1).

(3) *Regulations*

The Secretary is authorized to require **such information as the Secretary determines to be necessary** to carry out the provisions of this subsection.

### BASIC OBSERVATIONS ON SECTION 385

Prior to the issuance of these regulations, there were no regulations under Section 385. Regulations had been issued in the 1980s, but they were withdrawn.

Note that Section 385(a) specifically grants the Treasury broad authority to:

(1) issue debt-equity regulations that “**may be necessary or appropriate;”**

(2)treat instruments as **“in part stock and in part indebtedness,”** which is one of the approaches taken in these proposed regulations, and

(3) require **“such information as the Secretary determines to be necessary,”** which isthe approach taken with the documentation requirement.

Also, Section 385(b) provides: “The regulations prescribed under this Section **shall set forth factors** which are to be taken into account in determining with respect to a particular factual situation whether a debtor-creditor relationship exists or a corporation-shareholder relationship exists.”

### DOES THE TREASURY HAVE THE AUTHORITY TO ISSUE THE SECTION 385 REGULATIONS?

While lawyers generally try to see both sides of a story, frankly, in view of the words of Section 385, I cannot see an argument that the Treasury does not have the authority to issue the 2016 Section 385 Regs. A quick survey of some of the discussion of the authority issue, seems to show that most commentators reach the same conclusion. To start with Professor Steve Shay of the Harvard Law School, who was the first to urge the Treasury to use its authority under Section 385 says:

Treasury should be commended for using its regulatory authority under section 385 to take action on earnings stripping. [The] proposed regs would target related-party financial leveraging transactions connected to foreign acquisitions of U.S. companies that go beyond inversions, [and he added] that "the debt reclassification as equity is aimed at cases where the new 'debt' would not result in increased real investment in the United States." . . .

[T]he important thing is that Treasury has acted. "Even if after a close read there's more to be done, the fact that they have moved in that area, they have applied section 385, that's just a big move[,]"[[24]](#footnote-24)

And reporting on the annual KPMG LLP international tax conference at New York University School of Law, Lee Sheppard of Tax Notes, says:

There was general agreement that Section 385 grants broad authority to make the proposed rules. "It's broad enough to justify where they are going," said [David] Rosenbloom [of Caplin & Drysdale and a former International Tax Counsel], who would go further. "I basically don't think there is such a thing as related-party debt. Debt requires friction and countervailing interests on both sides." He noted that U.S. law has been "way too generous" to foreign-parented companies, which are not audited by the IRS unless they are banks.[[25]](#footnote-25)

Jack Cummings of Alston & Bird LLP, is reported to have said:

Treasury has finally taken out its meat cleaver, instead of trying to create delicate, finely balanced rules, and "definitely pushed the boundaries of its authority" regarding earnings stripping through interest deduction provisions. However, . . . if faced with a legal challenge, the regs would likely be sustained.[[26]](#footnote-26)

On the other hand, in criticizing the regulations as being beyond the Treasury’s authority, Scott Semer of Torys, in referring to this “shall set forth factors” language, argued:

Rather than provide a safe harbor or follow the clear congressional directive in Section 385(b) to “set forth factors” that are to be taken into account in determining whether a debtor-creditor relationship exists, the regulations instead impose a fairly onerous set of record-keeping requirements that are necessary, at a minimum, for an instrument to be treated as debt.[[27]](#footnote-27)

By directing the Treasury to “set forth factors” does not prevent the Treasury from focusing on one factor where appropriate.

Finally, in an April 18, 2016 letter to the Secretary of the Treasury, a “bipartisan group of former Treasury officials,” led by former Secretary George P. Shultz, urged Secretary Lew to “reconsider” the release of the inversion and Section 385 regulations. While they argue that the remedy to inversions is not to erect “higher barriers,” the letter does not in any way argue that the Treasrury does not have the authority to take the action it has taken. It would appear that if there were a credible argument that the Treasury does not have the authority, this bipartisan group would have made it.

## INTRODUCTION TO THE 2016 TREATMENT OF CERTAIN INTEREST IN CORPORATIONS AS STOCK OR INDEBTEDNESS REGULATIONS

The Summary of the 2016 Section 385 Regs gives the following guidance on the scope of the regulations:

SUMMARY: This document contains proposed regulations under Section 385 of the Internal Revenue Code (Code) that would authorize the Commissioner to treat certain related-party interests in a corporation as indebtedness in part and stock in part for federal tax purposes, and establish threshold documentation requirements that must be satisfied in order for certain related-party interests in a corporation to be treated as indebtedness for federal tax purposes. The proposed regulations also would treat as stock certain related-party interests that otherwise would be treated as indebtedness for federal tax purposes. The proposed regulations generally affect corporations that issue purported indebtedness to related corporations or partnerships.

Although the effective date provisions of these 2016 Section 385 Regs is complex, as a general matter the document requirement provisions are not effective until the final regulations become effective, but the other provisions of the regulations are generally effective on the date the regulations were published in the Federal Register, that is. April 4, 2016.

The following is a summary of the Sections of these proposed regulations:

1. §1.385-1 General provisions;
2. §1.385-2 Treatment of certain interests between members of an expanded group;
3. §1.385-3 Certain distributions of debt instruments and similar transactions; and
4. §1.385-4 Treatment of consolidated groups; and

This Section discusses these regulations in the order in which the particular Sections of the regulations are discussed in the preamble to the regulations. The preamble and the regulations run for over 130 pages; therefore, this discussion merely touches on the basic principles with the purpose of alerting the reader to the issues.

## OVERVIEW OF THE 2016 SECTION 385 REGS

The preamble to the 2016 Section 385 Regs gives the following “Overview” of these proposed regulations:

I. Overview

The proposed regulations provide guidance regarding substantiation of the treatment of certain interests issued between related parties as indebtedness for federal tax purposes, the treatment of certain interests in a corporation as in part indebtedness and in part stock, and the treatment of distributions of debt instruments and similar transactions that frequently have only limited non-tax effects. More specifically, the proposed regulations are set forth in four Sections. First, proposed §1.385-1 prescribes definitions and operating rules applicable to the regulations under Section 385 generally including a rule treating members of a consolidated group, as defined in §1.1502-1(h), as one corporation. Proposed §1.385-1(d) also provides that the Commissioner has the discretion to treat certain interests in a corporation for federal tax purposes as indebtedness in part and stock in part. Second, proposed §1.385-2 addresses the documentation and information that taxpayers must prepare and maintain within required timeframes to substantiate the treatment of an interest issued between related parties as indebtedness for federal tax purposes. Such substantiation is necessary, but not sufficient, for a purported debt interest that is within the scope of these rules to be characterized as indebtedness; general federal income tax principles also apply in making such a determination. Third, if the application of proposed §1.385-2 and general federal income tax principles otherwise would result in treating an interest issued to a related party as indebtedness for federal tax purposes, proposed §1.385-3 provides additional rules that may treat the interest, in whole or in part, as stock for federal tax purposes if it is issued in a distribution or other transaction that is identified as frequently having only limited non-tax effect, or is issued to fund such a transaction. Finally, proposed §1.385-4 provides operating rules for applying proposed §1.385-3 to interests that cease to be between members of the same consolidated group or interests that become interests between members of the same consolidated group.[[28]](#footnote-28)

## THE SUBSTANTIATION OF RELATED-PARTY INDEBTEDNESS REQUIREMENT, PROPOSED REG. §1.385-2

The preamble to the 2016 Section 385 Regs provides the following basic description of the substantiation requirement:

Proposed §1.385-2 reflects the importance of contemporaneous documentation in identifying the rights, obligations, and intent of the parties to an instrument that is purported to be indebtedness for federal tax purposes. Such documentation is particularly important to the analysis of instruments issued between related parties. In recognition of this importance, the Treasury Department and the IRS are exercising authority granted under Section 385(a) to treat the timely preparation and maintenance of such documentation as necessary factors to be taken into account in determining whether certain interests are properly characterized as stock or indebtedness.

Accordingly, the proposed regulations first prescribe the nature of the documentation necessary to substantiate the treatment of related-party instruments as indebtedness and, second, require that such documentation be timely prepared and maintained. The proposed regulations further provide that, if the specified documentation is not provided to the Commissioner upon request, the Commissioner will treat the preparation and maintenance requirements as not satisfied and will treat the instrument as stock for federal tax purposes. The type of stock (for example, common stock or preferred stock, Section 306 stock, stock described in Section 1504(a)(4)) that the instrument will be treated as for federal tax purposes is determined by taking into account the terms of the instrument (for example, voting and conversion rights and rights relating to dividends, redemption, liquidation, and other distributions).

Satisfaction of the requirements of the proposed regulations does not establish that a related-party instrument is indebtedness. Rather, satisfaction of the proposed regulations acts as a threshold test for allowing the possibility of indebtedness treatment after the determination of an instrument’s character is made under federal tax principles developed under applicable case law. If the requirements of the proposed regulations are not satisfied, the purported indebtedness would be recharacterized as stock. In such a case, any federal tax benefit claimed by the taxpayer with respect to the treatment of the interest as indebtedness will be disallowed.[[29]](#footnote-29)

As indicated above, this documentation requirement would not become effective until the regulations are published as final regulations.

## CERTAIN DISTRIBUTIONS OF DEBT INSTRUMENTS AND SIMILAR TRANSACTIONS, PROPOSED REG. §1.385-3

### THE BASIC DEBT-TREATED-AS-STOCK RULES

#### INTRODUCTION TO THE THREE PRONGS OF THE BASIC RULES

The most revolutionary and potentially effective anti-interest stripping initiative is taken in Prop. Regs. §1.385-3, which sets out certain *per se* rules under which certain inter-company debt will be treated as stock, that is, the Basic Debt-Treated-As-Stock Rules. The preamble to the 2016 Section 385 Regs provides the following summary of these rules:

Proposed §§1.385-3 . . . provide[s] rules that treat as stock certain interests that otherwise would be treated as indebtedness for federal income tax purposes. Proposed §1.385-3 applies to debt instruments that are within the meaning of Section 1275(a) and §1.1275-1(d) **[*i.e*., “a bond, debenture, note, or certificate or other evidence of indebtedness”]**, as determined without regard to the application of proposed §1.385-3. Section 1275(a) and §1.1275-1(d) generally define a debt instrument as any instrument or contractual arrangement that constitutes indebtedness under general principles of federal income tax law. Thus, the term debt instrument for purposes of proposed §§1.385-3 and 1.385-4 means an instrument that satisfies the requirements of proposed §§1.385-1 and 1.385-2 **[the documentation rules]** and that is indebtedness under general principles of federal income tax law. . . .

Specifically, proposed §1.385-3 treats as stock certain debt instruments issued by one member of an expanded group **[*i.e*., pursuant to §1.385-1(b)(3), basically a consolidated group (*e.g*., parent and its direct and indirect 80% owned subs) plus foreign and tax-exempt corporations, as well as corporations held indirectly, for example, through partnerships]** to another member of the same group (expanded group debt instrument) in the [following three circumstances specified in §1.385-3(b)(2):] , , ,

(1) **[Distribution]** in a distribution **[*e.g*., a domestic sub of a foreign parent, distributes to the parent a debt instrument of the sub as a dividend]**;

(2) **[Exchange]** in exchange for expanded group stock, other than in an exempt

exchange . . . **[*e.g*., a domestic sub of a foreign parent, transfers its debt instrument to the parent in exchange for parent stock]**; or

(3) **[Internal Asset Reorganization]** in exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer’s expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation.[[30]](#footnote-30)

Thus, there are three prongs to the Basic Debt-Treated- As-Stock rules in §1.385-3(b)(2): Distribution, Exchange, and Internal Asset Reorganization.

#### THE FIRST PRONG, DISTRIBUTION

##### GENERAL PRINCIPLES

The preamble to the 2016 Section 385 Regs elaborates as follows on the first prong, which is in §1.385-3(b)(2)(i), the Distribution prong:

For purposes of the first prong of the general rule, the term distribution is broadly defined as any distribution by a corporation to a member of the corporation’s expanded group with respect to the distributing corporation’s stock, regardless of whether the distribution is treated as a dividend within the meaning of Section 316. Thus, a debt instrument issued in exchange for stock of the issuer of the debt instrument (that is, in a redemption under corporate law) is a distribution that is covered by the first prong of the general rule and an acquisition of expanded group stock covered by the second prong of the general rule.[[31]](#footnote-31)

##### ILLUSTRATION OF THE FIRST PRONG

Assume that a U.S. sub of a foreign parent distributed a debt instrument of the sub to the parent as a dividend. Under the First Prong, the debt would automatically be treated as stock, assuming the current E&P exception, which is discussed below, did not apply.

#### THE SECOND PRONG, EXCHANGE

##### GENERAL PRINCIPLES

The preamble to the 2016 Section 385 Regs elaborates as follows on the second prong, which is in §1.385-3(b)(2)(ii), the Exchange prong, and its relationship to the Internal Reorganization Prong:

The second prong of the general rule – addressing debt instruments issued in exchange for expanded group stock – applies regardless of whether the expanded group stock is acquired from a shareholder of the issuer of the expanded group stock, or directly from the issuer. . . .

For purposes of the second prong of the general rule, the term exempt exchange means an acquisition of expanded group stock in which the transferor and transferee of the stock are parties to a reorganization that is an asset reorganization, and either (i) Section 361(a) or (b) applies to the transferor of the expanded group stock and the stock is not transferred by issuance; or (ii) Section 1032 or §1.1032-2 applies to the transferor of the expanded group stock and the stock is distributed by the transferee pursuant to the plan of reorganization. As a result, the second prong of the general rule generally does not apply to a debt instrument that is issued in exchange for expanded group stock when Section 361(a) or (b) applies to the transferor of such stock. This limitation has the effect of causing exchanges of expanded group stock that are part of an asset reorganization to be covered only by the third prong of the general rule, which, . . . imposes limitations on the application of the general rule to exchanges that are part of an asset reorganization.[[32]](#footnote-32)

##### ILLUSTRATIONS OF THE SECOND PRONG

##### EXAMPLE 3

The Exchange prong is illustrated as follows in Example 3 of §1.385-3(g)(3):

Example 3. *Issuance of a note in exchange for expanded group stock*. (i) *Facts*.

On Date A in Year 1, USS1 **[a domestic wholly owned sub of FP, a foreign corporation that has no current E&P]** issues USS1 Note to FP in exchange for 40 percent of the FS **[a wholly owned foreign sub of FP]** stock owned by FP **[note that because USS1 is acquiring stock of a sister sub, Section 304 would normally apply]**.

(ii) *Analysis*. (A) Because USS1 and FP are both members of the FP expanded

group, USS1 Note is treated as stock when it is issued by USS1 to FP in exchange for

FS stock on Date A in Year 1 under paragraphs (b)(2)(ii) **[an exchange for expanded group stock]** and (d)(1)(i) **[the debt instrument is treated as stock when issued]** of this Section.

The exchange of USS1 Note for FS stock is not an exempt exchange within the meaning of paragraph (f)(5) of this Section because USS1 and FP are not parties to a reorganization.

(B) Because USS1 Note is treated as stock for federal tax purposes when it is issued by USS1, USS1 Note is not treated as property for purposes of Section 304(a) because it is not property within the meaning specified in Section 317(a). Therefore, USS1’s acquisition of FS stock from FP in exchange for USS1 Note is not an acquisition described in Section 304(a)(1).

© Because USS1 Note is treated as stock for federal tax purposes when it is issued by USS1, USS1 Note is not treated as indebtedness for purposes of applying paragraph (b)(3) of this Section.

##### THE ENDO NOTE FOR STOCK INVERSION

Another illustration of how the second prong operates can be seen from a review of the 2014 inversion in which Endo, a publicly held U.S. corporation, and Paladin, a publicly held Canadian corporation, were combined under a newly formed Irish holding corporation, New Endo.[[33]](#footnote-33) The Arrangement Agreement in the Endo inversion,[[34]](#footnote-34) which was the combination agreement, provided for the acquisition by a newly formed Irish holding company (IrishCo a.k.a. New Endo) of:

(1) Paladin pursuant to an “arrangement” under Canadian law, and

(2) Endo through a triangular B reorganization under Section 368(a)(1)(B).

Pursuant to the arrangement, the public shareholders of Paladin received approximately 23% of the stock of New Endo. This part of the transaction is not discussed further here.

The triangular B reorganization was implemented by Section 2.2 of the Arrangement Agreement, which is entitled “Merger.” Under this provision, the stock of Endo was acquired by DE,Inc. (a.k.a. Endo U.S. Inc.), a Delaware corporation and wholly owned sub of New Endo, the Irish holding company. As a first step, Endo U.S. Inc. issued its note to New Endo in exchange for the stock of New Endo. This note for stock issue is discussed further below.

The acquisition of Endo by Endo U.S. Inc. was effectuated by a reverse subsidiary merger in which Merger Sub, a Delaware LLC that was wholly owned by Endo U.S. Inc., merged into Endo with (1) the public shareholders of Endo receiving for their Endo shares voting shares of New Endo, and (2) Endo U.S. Inc. holding all of the shares of Endo. Thus, when the dust settled on the Endo side of the transaction, (1) Endo became a wholly-owned subsidiary of Endo U.S. Inc., which is a wholly-owned subsidiary of New Endo, the Irish holding company, and (2) the public shareholders of Endo ended up owning approximately 77% of the stock of New Endo.

Since, the Endo shareholders owned less than 80%, New Endo was not treated under Section 7874 as a U.S. corporation; however, since the Endo shareholders owned more than 60% of the stock of New Endo, the inversion gain rule of Section 7874 applied. As pointed out in my *Joe Fraizer Left Hook* article, Endo, through the use of the Killer B regulations, presumably was able to avoid the Section 367(a) gain recognition rule for its shareholders (which generally applies when the U.S. shareholders own more than 50% and less than 80% of the new foreign holding company). This issue is not discussed further here.

The transaction presumably qualified as a triangular (B) reorganization under the parenthetical under Section 368(a)(1)(B) because the consideration paid by Endo U.S. Inc. in the merger of Merger Sub, an LLC, into Endo was solely voting stock of New Endo, the parent of Endo U.S. Inc.

The only apparent reason for the issuance by Endo U.S. of its note for the stock of New Endo was to set up the potential for interest stripping. The triangular (B) reorganization could have been completed with New Endo either (1) issuing its stock for stock of Endo U.S., which would then have caused that New Endo stock to be issued in the reverse subsidiary merger, or (2) issuing its stock directly to the shareholders of Endo in the reverse subsidiary merger. The issuance of the note was not integral to the triangular (B). If this transaction were to take place today, under the Exchange Prong of the Basic Debt-Treated- As-Stock rules, this note would be treated as stock assuming that neither the current E&P nor Threshold exceptions applied.

The Endo Proxy/Prospectus gives the following thinly veiled tax avoidance explanations (including of the note issued by Endo U.S.) for incorporating the holding company in Ireland:

|  |  |  |
| --- | --- | --- |
|  | A | Incorporating New Endo in Ireland is expected to result in significant benefits to New Endo. These benefits include enhanced global cash management flexibility **[*i.e.,* hop scotch loans]** and associated financial benefits to the combined enterprise **[*e.g*., interest stripping]**, as well as increased global liquidity and cash flow among the various entities of the combined enterprise. In addition, Ireland is a beneficial location for establishing a differentiated platform for further international expansion through an operating base in Ireland and a strong financial profile to support expansion into international markets **[*i.e*., future avoidance of the CFC provisions]**. Also, Endo estimates that New Endo is expected to realize $75 million of post-tax synergies on a twelve-month basis at some point following the close of the transactions.[[35]](#footnote-35) |

#### THE THIRD PRONG, INTERNAL REORGANIZATION

##### GENERAL PRINCIPLES

The preamble to the 2016 Section 385 Regs elaborates as follows on the third prong, which is in §1.385-3(b)(2)(iii), the Internal Reorganization prong:

The third prong of the general rule applies to asset reorganizations among corporations that are members of the same expanded group. **[Thus, it does not apply to asset reorganizations between unrelated corporations.]** An asset reorganization is a reorganization within the meaning of Section 368(a)(1)(A), (C), (D), (F), or (G). Specifically, the third prong of the general rule applies to a debt instrument issued in exchange for property in an asset reorganization, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer’s expanded group immediately before the reorganization receives the debt instrument with respect to its stock in the transferor corporation. The second step receipt of the debt instrument by the expanded group shareholder could be in the form of a distribution of the debt instrument to shareholders of the distributing corporation in a divisive asset reorganization, or in redemption of the shareholder’s stock in the transferor corporation in an acquisitive asset reorganization. Because the third prong of the general rule applies only to a debt instrument that is received by a shareholder with respect to its stock in the transferor corporation, that debt instrument would, absent the application of §1.385-3, be treated as “other property” within the meaning of Section 356.

The third prong of the general rule is limited to debt instruments distributed to shareholders pursuant to the reorganization, and does not apply to debt instruments exchanged for securities or other debt interests because, in that latter case, the newly issued debt instrument is exchanged for existing debt interests and thus no additional debt is incurred by the parties to the reorganization.[[36]](#footnote-36)

##### ILLUSTRATION OF THE THIRD PRONG

The following is an illustration of how this Internal Reorganization prong applies. Assume that Foreign Parent owns all of the stock of U.S. Sub 1 and U.S. Sub 2. In an internal reorganization under Section 368(a)(1)(C), U.S. Sub 1 transfers all of its assets and liabilities to U.S. Sub 2 in exchange for stock of U.S. Sub 2 and a note of U.S. Sub 2. Pursuant to the reorganization, U.S. Sub 1 then liquidates, distributing the stock and note of U.S. Sub 2 to Foreign Parent. In such case, the note is treated a stock, because as stated in the above excerpt from the preamble: “[T]he third prong of the general rule applies to a debt instrument **[*i.e*., U.S. Sub 2’s note]** issued in exchange for property in an asset reorganization **[*i.e*., U.S. Sub 1’s assets]**, but only to the extent that, pursuant to the plan of reorganization, a shareholder that is a member of the issuer’s expanded group immediately before the reorganization **[*i.e*., Foreign Parent]** receives the debt instrument **[*i.e*., U.S. Sub 2’s note]** with respect to its stock in the transferor corporation **[*i.e*., U.S. Sub 1]**.

### TREATED AS COMMON OR PREFERRED STOCK FOR ALL PURPOSES

The preamble to the 2016 Section 385 Regs discusses as follows the impact of the Basic Debt-Treated- As-Stock rules:

To the extent proposed §1.385-3 treats an interest as stock, the interest is treated as stock for all federal tax purposes. Consistent with the traditional case law debt-equity analysis, when a debt instrument is treated as stock under proposed §1.385-3, the terms of the debt instrument (for example, voting rights or conversion features) are taken into account for purposes of determining the type of stock resulting from the recharacterization, including whether such stock is preferred stock or common stock.[[37]](#footnote-37)

### THE E&P AND THRESHOLD EXCEPTIONS TO THE BASIC DEBT-TREATED-AS-STOCK RULES RULE

#### INTRODUCTION

Section 1.385-3(b)(2) says that the Basic Debt-Treated-As-Stock Rules apply “[e]xcept as provided in paragraphs (c) **[exceptions for current year E&P, threshold, and certain funded acquisitions of a sub’s stock]** and (e) **[no affirmative use]** of this section and in §1.385-4 **[treatment of consolidated groups]**[.].” Only the current year E&P and the threshold exceptions are discussed here because they relate specifically to the Basic Debt-Treated-As-Stock Rules.

#### THE E&P AND THRESHOLD EXCEPTIONS IN 1.385-3(b)(2)(c)

Section 1.385-3(c) sets out three exceptions, two of which are exceptions to the Basic Debt-Treated-As-Stock Rules of §1.385-3(b)(2). The preamble to the 2016 Section 385 Regs gives the following basic description of the two exceptions to the Basic-Debt-Treated-As-Stock Rules:

1. Exception for Current Year Earnings and Profits

[P]roposed §1.385-3(c)(1) includes an exception pursuant to which distributions and acquisitions described in proposed §1.385-3(b)(2) (the general rule) or proposed §1.385-3(b)(3)(ii) (the funding rule) that do not exceed current year earnings and profits (as described in Section 316(a)(2)) of the distributing or acquiring corporation are not treated as distributions or acquisitions for purposes of the general rule or the funding rule. . . .

2. Threshold Exception

A second exception provides that an expanded group debt instrument will not be treated as stock if, when the debt instrument is issued, the aggregate issue price of all expanded group debt instruments that otherwise would be treated as stock under the proposed regulations does not exceed $50 million (the threshold exception). If the expanded group’s debt instruments that otherwise would be treated as stock later exceed $50 million, then all expanded group debt instruments that, but for the threshold exception, would have been treated as stock are treated as stock, rather than only the amount that exceeds $50 million.[[38]](#footnote-38)

The rationale behind the Threshold Exception appears clear: it is designed to exempt relatively small issuances of debt from the Basic-Debt-Treated-As-Stock Rules. However, the rationale for the current year E&P exception is less clear, and the preamble does not explain the reason behind the exception.

## THE FUNDING EXCEPTION RULE AND THE EXCEPTION TO THE FUNDING EXCEPTION RULE

### GENERAL EXCEPTION FOR A TRUE FUNDING

The Basic-Debt-Treated-As-Stock Rules do not apply to a funding transaction where, for example, a foreign parent sets up a new domestic sub and contributes to the sub cash in exchange for both stock and debt of the sub. As long at the documentation requirements of §1.385-2 are satisfied and the debt is otherwise treated as debt under general debt-equity analysis, the debt will be treated as debt. However, in such case, the Section 163(j) interest stripping limitation could apply to the debt instrument. As discussed below, this funding exception could be used as a way of avoiding the Basic Debt-Treated- As-Stock rules, and for this reason, the set out an exception to the funding exception.

### EXCEPTION TO THE FUNDING EXCEPTION RULE

Under an anti-abuse “Funding rule” in §1.385-3(b)(3), “an expanded group debt instrument that is issued with a principal purpose of funding a transaction described in the general rule **[*i.e*., Distribution, Exchange, or Internal Asset Reorganization]** (principal purpose debt instrument)” is treated as stock. This funding rule would apply where, for example, (1) a domestic sub of a foreign parent issues a note to a sister foreign sub in exchange for cash in what appears to be a funding transaction that would not be covered by §1.385-3 , and (2) the domestic sub then distributes the cash to the common foreign parent. In such case, the note would be a principal purpose debt instrument, and as a consequence, the note would be treated as stock.

The preamble to the 2016 Section 385 Regs gives the following basic description of this funding rule:

The funding rule treats as stock an expanded group debt instrument that is issued with a principal purpose of funding a transaction described in the general rule (principal purpose debt instrument). Specifically, a principal purpose debt instrument is a debt instrument issued by a corporation (funded member) **[*e.g*., a domestic sub of a foreign parent]** to another member of the funded member’s expanded group **[*e.g*., a foreign sister sub]** in exchange for property **[e.g., cash]** with a principal purpose of **[subject to certain exceptions not discussed here]** funding (1) a distribution of property **[e.g., the cash]** by the funded member **[*e.g*., the domestic sub of the foreign parent]**  to a member of the funded member’s expanded group **[*e.g*., the foreign parent]** . . . (2) an acquisition of expanded group stock, other than in an exempt exchange, by the funded member **[*e.g*., the domestic sub of the foreign parent]** from a member of the funded member’s expanded group **[*e.g*., the foreign parent]** in exchange for property **[*e.g*., the cash]** other than expanded group stock; or (3) the acquisition of property by the funded member in an asset reorganization[.] . . .

Prongs (1) through (3) of the funding rule are referred to in this Section 2 as “distributions or acquisitions.” Proposed §1.385-3(b)(3)(iii) provides that, if all or a portion of a distribution or acquisition by a funded member is described in more than one prong of the funding rule, the funded member is treated as engaging in only a single distribution or acquisition for purposes of applying the funding rule. The funding rule addresses transactions that, when viewed together, present similar policy concerns as the transactions that are subject to the general rule.[[39]](#footnote-39)

The preamble to the 2016 Section 385 Regs discusses as follows (1) the rules for determining whether a debt instrument is issued for the “*Principal Purpose of Funding a Distribution or Acquisition*,” (2) a “*Non-Rebuttable Presumption During the 72-Month Period*,” and (3) an “*Exception to Non-Rebuttable Presumption for Ordinary Course Debt Instruments*:”

b. *Determining Whether a Debt Instrument Is Issued with a Principal Purpose of*

*Funding a Distribution or Acquisition*

The determination as to whether a debt instrument is issued with a principal purpose of funding a distribution or acquisition is based on all of the facts and circumstances. A debt instrument may be treated as issued with such a principal purpose whether it is issued before or after a distribution or acquisition.

i. *Non-Rebuttable Presumption During the 72-Month Period*

Proposed §1.385-3 also establishes a non-rebuttable presumption that certain expanded group debt instruments are issued with a principal purpose of funding a distribution or acquisition by the funded member. Specifically, such a principal purpose is deemed to exist if the expanded group debt instrument is issued by the funded member during the period beginning 36 months before the funded member makes a distribution or acquisition and ending 36 months after the distribution or acquisition (the 72-month period). This per se rule does not create a safe harbor. Accordingly, a debt instrument issued outside the 72-month period may be treated as having a principal purpose of funding a distribution or acquisition, based on the facts and circumstances. . . .

ii. *Exception to Non-Rebuttable Presumption for Ordinary Course Debt Instruments*

An exception to this *per se* rule applies to ordinary course debt instruments. . . . This exception is intended to apply to debt instruments that arise in connection with the purchase of property or the receipt of services between members of the same expanded group in the ordinary course of the purchaser’s or recipient’s trade or business, and is not intended to apply to intercompany financing or treasury center activities or to capital expenditures. An ordinary course debt instrument is not subject to the *per se* rule; however, it may be treated as having a principal purpose of funding a distribution or acquisition by the issuer, based on the facts and circumstances.[[40]](#footnote-40)

An ordering rule provides that “when two or more debt instruments may be treated as potentially funding the same acquisition or distribution, the debt instruments are tested based on the order in which they were issued.”[[41]](#footnote-41)

## GENERAL ANTI-ABUSE RULE

Proposed §1.385-3(b)(4) sets out a general anti-abuse rule which “provides that a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of the proposed regulations.[[42]](#footnote-42)

## NO AFFIRMATIVE USE

The preamble to the 2016 Section 385 Regs discusses as follows the rule that prohibits the affirmative use of these regulations by taxpayers:

Under proposed §1.385-3(e), proposed §§1.385-3 and 1.385-4 do not apply to the extent a person enters into a transaction that otherwise would be subject to the proposed regulations with a principal purpose of reducing its federal tax liability or the federal tax liability of another person by disregarding the treatment of the debt instrument that would occur without regard to the proposed regulations.[[43]](#footnote-43)

## TREATMENT OF NOTES ISSUED WITHIN A CONSOLIDATED GROUP, PROPOSED REG. §1.385-4

Under the consolidated return provisions, only domestic corporations can file a joint consolidated return, which will include the income and loss of the separate corporations in one return. Under Section 1504, only domestic corporations can be members of a consolidated group and, for example, at least 80%, measured by vote and value, of a subs stock must be held by the parent in order for the sub and the parent to be in a consolidated group.

The preamble to the 2016 Section 385 Regs points out that “many of the concerns regarding related-party indebtedness are not present in the case of indebtedness between members of a consolidated group.”[[44]](#footnote-44) The preamble goes on to explain:

Accordingly, the proposed regulations under Section 385 do not apply to interests between members of a consolidated group, although general federal tax principles continue to apply. Proposed §1.385-1(e) achieves this result by treating a consolidated group as one corporation.[[45]](#footnote-45)

Of course, a debt instrument that is held by a member of a consolidated group one day, will not be held by a member of the consolidated group the next day if for some reason the member leaves the consolidated group. Prop. Reg. §1.385-4 addresses this and related issues by setting out “rules for applying §1.385-3 to consolidated groups when an interest ceases to be a consolidated group debt instrument or becomes a consolidated group debt instrument.”[[46]](#footnote-46) .

## MY TAKE ON THE 2016 SECTION 385 REGS

I commend the Treasury for proposing the 2016 Section 385 Regs. The heart of the regulations, §1.385-3, is a revolutionary approach to dealing with debt-equity issues in that it does not rely on some “facts and circumstances” analysis of transactions, which was at the center of the prior proposed regulations under Section 385, which were withdrawn.

Rather, §1.385-3 takes a bright line approach to one of the most vexing issues in international tax: how to curtail interest stripping. If finally adopted, I believe that these regulations will to a substantial extent curtail abuse of the system not just for inversions but for all situations in which a foreign parent controls a U.S. sub. There will obviously be a need for refinements as creative tax professionals seek ways around the general rule.

If these regulations had been in effect at the time of the Endo inversion, which is discussed Section 22:7.1[G], the note that was issued by Endo U.S. for stock of the Irish inversion parent would have been treated as stock and could not have been used to set up an interesting play.

This approach is consistent with an approach I argue for in Section 22:7.2[B][4], where in discussing the need for the Treasury to take action under Section 385, I say:

By focusing on inversions, the regulations would be primarily concerned with artificial debt instruments issued in an inversion or related transaction by a U.S corporation to its new foreign parent or related party, and not “a [situation where a] long-term foreign parent [has] made a real loan of funds to [its] U.S. subsidiary and therefore [is] entitled to repayment with interest.”

Indeed, the 2016 Section 385 regulations properly take aim not only at debt issued in inversions but at all debt issued by U.S. subs to foreign parents in transactions that are not real loans. For the reasons stated above I think it is clear that the Treasury has the authority under Section 385 to issue these regulations.

1. I want to thank the following Penn State Law students who are my Research Assistants for their helpful comments on this paper and assistance in the preparation of the slides: (1) Ying Zeng, and (2) Zachary Burley. [↑](#footnote-ref-1)
2. These Notices are also discussed in Chapter 22 of Thompson, Mergers, Acquisitions, and Tender Offers (PLI, 2010, updated semi-annually [hereinafter Thompson, *MATO*]. Chapter 22 also contains a brief discussion of the April 2016 regulations. [↑](#footnote-ref-2)
3. TD 9761, Inversions and Related Transactions, Final and Temporary Regulations (April 4, 2016) [the 2016 General Inversion Regs]. [↑](#footnote-ref-3)
4. REG-108060-15, Treatment of Certain Interests in Corporations as Stock or Indebtedness, Notice of Proposed Rulemaking (April 4, 2016) [the 2016 Section 385 Regs.]. [↑](#footnote-ref-4)
5. *Supra* note 3, at 17.. [↑](#footnote-ref-5)
6. *Id*. at [↑](#footnote-ref-6)
7. *Id*. at 18-19 [↑](#footnote-ref-7)
8. The 2016 General Inversion Regs, supra at 21-23. [↑](#footnote-ref-8)
9. *Id*. at 23-24. [↑](#footnote-ref-9)
10. Id. at 31-33. [↑](#footnote-ref-10)
11. *Id*. at 37-38. [↑](#footnote-ref-11)
12. *Id*. at 40-41. [↑](#footnote-ref-12)
13. *Id* at 58-60. [↑](#footnote-ref-13)
14. *Id*. at 63. [↑](#footnote-ref-14)
15. *Id*. at 64. [↑](#footnote-ref-15)
16. *Id*. [↑](#footnote-ref-16)
17. *Id*. at 65-66. [↑](#footnote-ref-17)
18. *Id*. at 73-77. [↑](#footnote-ref-18)
19. *Id*. at 86-87. [↑](#footnote-ref-19)
20. Id. at 90-91.. [↑](#footnote-ref-20)
21. *Id*. at 92-93. [↑](#footnote-ref-21)
22. Id. at 94-95. [↑](#footnote-ref-22)
23. REG-108060-15, *Treatment of Certain Interests in Corporations as Stock or Indebtedness*, Notice of Proposed Rulemaking (April 4, 2016) [the 2016 Section 385 Regs.]. [↑](#footnote-ref-23)
24. Andrew Velarde, U.S. *Moves on Earnings Stripping*, 82 Tax Notes Int'l 130 (Apr. 11, 2016). [↑](#footnote-ref-24)
25. Lee A Sheppard, *Stack Defends Debt and Equity Rules, State Aid Stance*, 2016 Tax Notes Today 76-1 (April 19, 2016).  [↑](#footnote-ref-25)
26. Andrew Velarde and Amanda Athanasiou, *Earnings Stripping Regs Usher in Brave New World*, 82 Tax Notes Int'l 132 (Apr. 11, 2016). [↑](#footnote-ref-26)
27. Scott L. Semer, *How to Enact New Tax Laws Without Involving Congress: Analyzing the Proposed Section 385 Regulations* Bloomberg, BNA, Daily Tax Report (April 15, 2016). [↑](#footnote-ref-27)
28. *Id*. at 31-32. [↑](#footnote-ref-28)
29. Id. at 35-36. [↑](#footnote-ref-29)
30. *Id*. at 44-46. [↑](#footnote-ref-30)
31. *Id*. at 46-47. [↑](#footnote-ref-31)
32. *Id*. at 48. [↑](#footnote-ref-32)
33. This illustration is based on a discussion in Samuel C. Thompson, Jr. *New Inversions, the ‘Joe Frazier Left Hook,’ the IRS Notice, and Pfizer*, Tax Notes, 1413 (June 23, 2014). [↑](#footnote-ref-33)
34. Appendix 22C of Thompson, *MATO*, *supra* note 2, contains excerpts from the following documents used in the Endo transaction: (1) the Arrangement Agreement, which was entered into on November 5, 2013, and (2) the Proxy/Prospectus on Form S-4, which was issued on January 24, 2014. [↑](#footnote-ref-34)
35. *See* §III.A.1 of Appendix 22C of Thompson, *MATO*, *supra* note 2.

 [↑](#footnote-ref-35)
36. *Id*. at 47-48. [↑](#footnote-ref-36)
37. *Id*. at 45-46. [↑](#footnote-ref-37)
38. *Id*. at 5859 [↑](#footnote-ref-38)
39. *Id*. at 43-44. [↑](#footnote-ref-39)
40. *Id*. at 51-53. [↑](#footnote-ref-40)
41. *Id*. at 53. [↑](#footnote-ref-41)
42. *Id*. at 55. [↑](#footnote-ref-42)
43. *Id*. at 68. [↑](#footnote-ref-43)
44. *Id*. at 35. [↑](#footnote-ref-44)
45. *Id*. [↑](#footnote-ref-45)
46. Prop. Reg. §1.385-4(a). [↑](#footnote-ref-46)