PENN STATE LAW

CENTER FOR THE STUDY OF M&A

WEBINAR: THE TREASURY AND IRS 2015 NOTICE ON TAX INVERSION

A GUIDE TO THE IRS/TREASURY NOTICE 2015-79 ON INVERSIONS

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I INTRODUCTION TO THIS PAPER AND TO THE COMPANION SLIDES

This paper summarizes the major principles set out in IRS/Treasury Notice 2015-79 on Inversions, which was issued on November 19, 2015 (the 2015 Inversion Notice). This Notice builds on many of the principles set out in IRS/Treasury Notice 2014-52 on Inversions, which was issued in September 2014 (the 2014 Inversion Notice).

This paper focuses on the basic transactions and not on all of the combinations and permutations of the transactions that could be affected by the 2015 Inversion Notice, and where appropriate this paper discusses applicable provisions of the 2014 Inversion Notice. The paper contains excerpts from the IRS Fact Sheet on Notice 2015-79 (Nov. 19, 2015) (2015 Inversion Fact Sheet), which "Outlin[ed] Forthcoming Guidance on Corporate Inversions."

This paper refers to a companion set of slides entitled:
Slides Illustrating (1) a Prototypical Inversion Transaction, and (2) the Impact of Treasury and IRS Notice 2015-79. These slides are at the end of the paper.

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

This paper contains many direct quotes from the two Inversion Notices.

II THE PROTOTYPICAL INVERSION

A. DISCUSSION IN THE 2015 INVERSION FACT SHEET OF PROTOTYPICAL INVERSIONS AND THE TAX CONCERNS OF SUCH TRANSACTIONS

"What is a corporate inversion?

"A corporate inversion is a transaction in which a U.S. based multinational restructures so that the U.S. parent is replaced by a foreign parent, in order to avoid U.S. taxes. Current law subjects many inversions that appear to be based primarily on tax considerations to certain potentially adverse tax consequences. However, the continued occurrence of these transactions indicates that for many corporations these consequences are acceptable in light of the potential tax benefits.

Under current law, an inverted company is subject to potential adverse tax consequences if, after the transaction: (1) less than 25 percent of the new multinational entity's business activity is in

the home country of the new foreign parent, and (2) the shareholders of the former U.S. parent end up owning at least 60 percent of the shares of the new foreign parent. If these criteria are met, the tax consequences depend on the size of the continuing ownership stake of the shareholders of the former U.S. parent. If the continuing ownership stake is 80 percent or more, the new foreign parent is treated as a U.S. corporation (despite the new corporate address), thereby nullifying the corporate inversion for tax purposes. If the continuing ownership stake is at least 60 but less than 80 percent, U.S. tax law respects the foreign status of the new foreign parent but other potentially adverse tax consequences may follow. The notice being issued today involves transactions in this continuing ownership range of 60 to 80 percent.

"Only legislation can decisively stop inversions. The Administration has been working together with Congress for several years in an effort to reform our business tax system, make it simpler and more pro-growth, and address the incentives that encourage companies to engage in inversions.

"In the absence of legislative action, on September 22, 2014, Treasury announced guidance that both made it more difficult for U.S. companies to invert and reduced the tax benefits of doing so by eliminating techniques used by inverted companies to access overseas earnings without paying U.S. tax. Today, Treasury is taking additional actions to make it more difficult for U.S. companies to invert and to further reduce the tax benefits of inversions."

B. SLIDES ILLUSTRATING A PROTOTYPICAL INVERSION

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

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

III INTRODUCTION TO THE 2015 INVERSION NOTICE

There are three substantive sections to the 2015 Inversion Notice. Section 2 of the 2015 Inversion Notice sets out measures designed to "make it more difficult for U.S. companies to invert." These measures apply to deals that close on or after November 19, 2015 and are discussed in Section IV of this paper.

Section 3 of the 2015 Inversion Notice sets out measures designed to "reduce the benefit of inversions." These measures apply to inversions completed "on or after September 22, 2014, the date of issuance of the 2014 Inversion Notice. They are discussed in Section V of this paper.

Section 4 of the 2015 Inversion Notice makes corrections to the 2014 Inversion Notice, and these measures are discussed in Section VI of this paper.

The sections of the 2015 Inversion Notice are discussed in this paper in the order in which they are addressed in the 2015 Inversion Fact Sheet

IV SECTION 2 OF THE 2015 INVERSION NOTICE: MEASURES DESIGNED TO "MAKE IT MORE DIFFICULT FOR U.S. COMPANIES TO INVERT"

A. STRENGTHENING THE REQUIREMENT THAT THE FORMER OWNERS OF A U.S. COMPANY OWN LESS THAN 80 PERCENT OF THE NEW COMBINED ENTITY

1. THE THIRD COUNTRY- ANTI-CHERRY PICKING RULE, SECTION 2.02(b) OF THE 2015 INVERSION NOTICE

a. FACT SHEET INTRODUCTION TO THE THIRD COUNTRY RULE

The Fact Sheet introduces this rule as follows:

"Limit the ability of U.S. companies to combine with foreign entities when the new foreign parent is located in a "third country" (Action under section 7874 of the code)

- In certain inversion transactions, a U.S. company combines with a smaller existing foreign corporation using a new foreign parent whose tax residence is different from that of the existing foreign corporation. In other words, the new foreign parent will be a tax resident of a "third country." The third country chosen generally will have a favorable tax system and income tax treaty with the United States. The decision to locate the tax residence of the new foreign parent outside of both the United States and the jurisdiction in which the existing foreign corporation is a tax resident generally is made to facilitate U.S. tax avoidance after the inversion transaction.
- Today's notice provides that in certain cases when the foreign parent is a tax resident of a third country, stock of the foreign parent issued to the shareholders of the existing foreign corporation is disregarded for purposes of the ownership requirement, thereby raising the ownership attributable to the shareholders of the U.S. entity, possibly above the 80 percent threshold **[thereby causing the foreign parent to be treated as a U.S. corporation].**
- The rule addressing "third country" inversions will prevent U.S. firms from essentially cherry-picking a tax-friendly country in which to locate their tax residence."

b. SECTION 2.02(b), "THIRD COUNTRY TRANSACTIONS" OF THE 2015 INVERSION NOTICE

".02 Transactions at Issue and Regulations to be Issued * * *

"(b) Third-Country Transactions

"The Treasury Department and the IRS are aware that certain acquisitions in which a domestic entity combines with an existing foreign corporation are structured by establishing a new foreign parent corporation for the combined group with a tax residence that is different from that of the existing foreign corporation. In other words, the parent corporation of the combined group will be a tax resident of a "third country." In such transactions, the stock or assets of the existing foreign corporation are acquired by the new third-country parent, and the shareholders of the

existing foreign corporation receive more than 20 percent of the stock of the new third-country parent. Similarly, the stock or assets of the domestic entity are acquired by the new third-country parent, and the shareholders of the domestic entity receive less than 80 percent of the stock of the new third-country parent.

"In enacting section 7874, Congress believed that certain transactions in which a U.S. parent corporation is replaced with a new foreign parent corporation have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes, while in other cases such transactions may have sufficient non-tax effect and purpose to be respected, but warrant that any applicable corporate-level "toll charges" for establishing the inverted structure not be offset by tax attributes such as net operating losses or foreign tax credits. See Senate Report at 142, 143; JCT Explanation at 343. The Treasury Department and the IRS have considered whether certain stock issued in an acquisition structured with a third-country parent should be disregarded pursuant to the authority under sections 7874(c)(6) and (g) in order to effectuate this general purpose. In particular, the Treasury Department and the IRS are concerned that a decision to locate the tax residence of a new foreign parent corporation outside of both the United States and the jurisdiction in which the existing foreign corporation is tax resident generally is driven by tax planning, including the facilitation of U.S. tax avoidance following the acquisition. For example, the third country may have a more favorable income tax treaty with the United States than the country in which the existing foreign corporation is tax resident, with the result that U.S. withholding taxes on dividends, interest, and royalties paid by the domestic entity may be reduced or eliminated. The third country may also have a more favorable tax system than the country in which the existing foreign parent corporation is tax resident, including a less restrictive regime for controlled foreign corporations than the country in which the existing foreign corporation is tax resident. Thus, a third-country parent typically is chosen to facilitate the use of low- or no-taxed entities to erode the U.S. tax base following the acquisition.

"The Senate Report and the JCT Explanation indicate that the 80-percent threshold under section 7874(b) for treating a foreign acquiring corporation as a domestic corporation reflects an assumption that, when the existing foreign corporation's shareholders will own more than 20 percent of the interests in the combined group, there is a sufficient likelihood of a non-tax business purpose for replacing the U.S. parent with a foreign parent to warrant respecting the new foreign parent. However, the Treasury Department and the IRS have concluded that, when a domestic entity combines with an existing foreign corporation by establishing a new parent for the combined group that is tax resident in a third country, the likelihood that there is a sufficient non-tax business purpose for replacing the U.S. parent with a foreign parent is significantly lower than Congress assumed in establishing the 80-percent threshold.

"The Treasury Department and the IRS have accordingly determined that, in certain circumstances, the use of a third-country parent is contrary to the policy underlying the 80-percent threshold of section 7874(b) and is an appropriate circumstance for the exercise of regulatory authority under sections 7874(c)(6) and (g). The Treasury Department and the IRS therefore intend to issue regulations under sections 7874(c)(6) and (g) to address these transactions by disregarding certain stock of a foreign acquiring corporation that is issued to the shareholders of the existing foreign corporation for purposes of determining whether the 80-

percent threshold is met. The regulations will apply to an acquisition that satisfies four requirements.

"**[THE FOUR REQUIREMENTS]** *First*, in a transaction related to the acquisition (referred to in this notice as the "foreign target acquisition"), the foreign acquiring corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by another foreign corporation (foreign target corporation). For purposes of determining if there is a foreign target acquisition with respect to a foreign corporation, the principles of section 7874(a)(2)(B)(i) (defining an acquisition) and §1.7874-2(c) (regarding acquisitions of properties of a domestic entity and stock of a foreign corporation) apply with the following modifications: (i) the principles of §1.7874-2(c)(1) (providing rules for determining whether there is an indirect acquisition of properties of a domestic entity) shall be applied by substituting the term "foreign target" for "domestic" wherever it appears, and (ii) the principles of §1.7874-2(c)(2) (regarding acquisitions of stock of a foreign corporation that owns a domestic corporation or partnership) shall be applied by substituting the term "domestic" for "foreign" and the term "foreign" for "domestic" wherever such terms appear. Furthermore, except as provided in this paragraph, if there is a foreign target acquisition of a foreign corporation (upper-tier foreign corporation) that owns directly stock of another foreign corporation (lower-tier foreign corporation), for purposes of this section 2.02(b) there is not also a foreign target acquisition with respect to the lower-tier foreign corporation (or any foreign corporation owned directly or indirectly by the lower-tier foreign corporation). However, if the upper-tier foreign corporation acquired the stock of the lower-tier foreign corporation in a transaction related to the acquisition, then there would also be a foreign target acquisition with respect to the lower-tier foreign corporation (which would be treated as an upper-tier foreign corporation for purposes of further applying the rules of this paragraph).

"*Second*, the gross value of all property directly or indirectly acquired by the foreign acquiring corporation in the foreign target acquisition exceeds 60 percent of the gross value of all foreign group property (as defined in section 2.01(b) of Notice 2014-52), but, for this purpose, gross value shall not include any property that is foreign group nonqualified property (as defined in section 2.01(b) of Notice 2014-52, but taking into account the corrections to the definition of foreign group nonqualified property described in section 4.01(b) of this notice).

"*Third*, the tax residence of the foreign acquiring corporation is not the same as that of the foreign target corporation, as determined before the foreign target acquisition and any transaction related to the foreign target acquisition. A change in the location of the management and control of a foreign target corporation is treated as a transaction for this purpose.

"*Fourth*, not taking into account the rules announced in this section 2.02(b), the ownership percentage is at least 60 but less than 80.

"When these four requirements are satisfied, the regulations will provide that stock of the foreign acquiring corporation that otherwise would be included in the denominator of the ownership fraction will be excluded from the denominator to the extent the stock is held by former owners

of the foreign target corporation by reason of holding stock in the foreign target corporation (based on the principles of section 7874(a)(2)(B)(ii)).

"If, in one or more transactions related to the acquisition described in section 7874(a)(2)(B)(i), the foreign acquiring corporation directly or indirectly acquires multiple foreign target corporations that are tax residents of the same foreign country, then, for purposes of applying the regulations described in this section 2.02(b), all such transactions that otherwise would separately qualify as a foreign target acquisition will be treated as a single foreign target acquisition and those foreign target corporations will be treated as a single entity.

"The following examples illustrate the regulations described in this section 2.02(b):

"*Example 1.* **[*See* Slide # 5, Third Country Transaction]** (i) *Facts*. FA, a newly formed foreign corporation that is a tax resident of Country Y, acquires all the stock of DT, a domestic corporation that is wholly owned by Individual A, solely in exchange for 65 shares of newly issued FA stock (DT acquisition). In a transaction related to the DT acquisition, FA acquires all the stock of FT, a foreign corporation that is a tax resident of Country X and wholly owned by Individual B, solely in exchange for the remaining 35 shares of newly issued FA stock (FT acquisition).

"(ii) *Analysis*. A portion of the FA stock is excluded from the denominator of the ownership fraction because the DT acquisition satisfies the four requirements set forth in section 2.02(b) of this notice. The first requirement is satisfied because under the principles of section 7874(a)(2)(B)(i) and §1.7874-2(c) (as modified by section 2.02(b) of this notice), FA is treated as acquiring 100 percent of the properties held by FT as a result of the FT acquisition. Therefore, the FT acquisition is a foreign target acquisition with respect to FT. The second requirement (that the gross value of all property directly or indirectly acquired in the FT acquisition exceeds 60 percent of the gross value of all foreign group property) is also satisfied because the foreign group property is comprised solely of the property acquired in the FT acquisition. The third requirement is satisfied because the foreign country in which FA is a tax resident (Country Y) is not the foreign country in which FT is a tax resident (Country X). Finally, the fourth requirement is satisfied because, absent the rules described in section 2.02(b) of this notice, the ownership fraction would be 65/100 and the ownership percentage would be 65. Accordingly, section 2.02(b) of this notice excludes from the denominator of the ownership fraction the 35 shares of FA stock held by the former shareholder of FT by reason of holding stock in FT. As a result, the ownership fraction is 65/65 and the ownership percentage is 100. The result would be the same if FA instead had directly acquired all of the properties held by FT in exchange for FA stock, for example, in a transaction that would qualify for U.S. income tax purposes as an asset reorganization under section 368.

"*Example 2.* **[*See* Slide # 5, Third Country Transaction]** (i) Facts. The facts are the same as in Example 1 except that, before the FT acquisition, but in a transaction related to the FT acquisition, FT reincorporates in Country Y and, consequently, becomes a tax resident of Country Y.

"(ii) Analysis. The analysis is the same as in Example 1 with respect to the first, second, and fourth requirements set forth in section 2.02(b) of this notice. The third requirement is applied by comparing the foreign country in which FA is a tax resident, which is Country Y, to the country in which FT was a tax resident prior to the FT acquisition and any transaction related to the FT acquisition, which is Country X. As a result, the third requirement is also satisfied because FA and FT are not tax residents of the same country for this purpose. Accordingly, section 2.02(b) of this notice excludes from the denominator of the ownership fraction the 35 shares of FA stock held by the former shareholder of FT by reason of holding stock in FT. Consequently, the ownership fraction is 65/65 and the ownership percentage is 100."

2. THE "ANTI-STUFFING OF THE FOREIGN TARGET" RULE, SECTION 2.03 OF THE 2015 INVERSION NOTICE

a. FACT SHEET INTRODUCTION TO THE ANTI-STUFFING RULE

The Fact Sheet introduces this rule as follows:

"Limit the ability of U.S. companies to inflate the new foreign parent corporation's size and therefore avoid the 80-percent rule. (Action under section 7874 of the code)

- Companies can successfully invert when a U.S. company has, for example, a value of 79 percent, and the foreign "acquirer" has a value of 21 percent of the combined group. However, in some inversion transactions, the foreign acquirer's size may be inflated by "stuffing" assets into the foreign acquirer as part of the inversion transaction in order to avoid the 80-percent rule.
- Current law disregards the stock of the foreign parent corporation that is attributable to such assets, thereby raising the U.S. entity's ownership, possibly above the 80-percent threshold. However, certain taxpayers may be narrowly interpreting the anti-stuffing rules to apply only to passive assets.
- Today's notice clarifies that the anti-stuffing rules apply to any assets acquired with a principal purpose of avoiding the 80-percent rule, regardless of whether the assets are passive assets."

b. SECTION 2.03, "ANTI-STUFFING OF THE FOREIGN TARGET" RULE" OF THE 2015 INVERSION NOTICE

".03 Clarification of Regulations under §1.7874-4T That Disregard Certain Stock Transferred in Exchange for Nonqualified Property

"(a) Background

Under section 7874(c)(2)(B) (statutory public offering rule), stock of the foreign acquiring corporation that is sold in a public offering related to the acquisition is excluded from the denominator of the ownership fraction. Section 1.7874-4T modifies the statutory public offering rule. Specifically, §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 in exchange for

"nonqualified property" when that exchange is related to the acquisition. Section 1.7874-4T(i)(7) provides that 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 that includes the foreign acquiring corporation), or (iv) any other property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of section 7874. Section 1.7874-4T(i)(6) provides that, for this purpose, the term marketable securities has the meaning set forth in section 453(f)(2), except that the term does not include stock of a corporation or an interest in a partnership that becomes a member of the expanded affiliated group that includes the foreign acquiring corporation in a transaction (or series of transactions) related to the acquisition, unless a principal purpose for acquiring such stock or partnership interest is to avoid the purposes of section 7874. This notice refers at times to the property described in clauses (i), (ii), and (iii) of this paragraph collectively as "specified nonqualified property" and to the property described in clause (iv) as "avoidance property." Example 2 of §1.7874-4T(j) illustrates a transfer of stock of the foreign acquiring corporation in exchange for avoidance property. In this example, PRS, a partnership with individual partners, transfers marketable securities to FT, a newly formed foreign corporation, in exchange solely for all of the FT stock. PRS then transfers the FT stock to FA, a newly formed foreign corporation, in exchange solely for 25 shares of FA stock. Individual A, who is unrelated to PRS, transfers all of the stock of DT, a domestic corporation of which Individual A is the sole shareholder, to FA in exchange solely for 75 shares of FA stock. The facts of the example state that FA acquires the FT stock with a principal purpose of avoiding the purposes of section 7874. Accordingly, the example concludes that the FT stock is nonqualified property, and, therefore, that the 25 shares of FA stock transferred to PRS in exchange for the FT stock are disqualified stock and are not included in the denominator of the ownership fraction.

"(b) Transactions at Issue and Regulations to be Issued

The Treasury Department and the IRS are concerned that some taxpayers may be narrowly interpreting the definition of avoidance property. In particular, taxpayers may be asserting that avoidance property is limited to property, such as stock, that is used to indirectly transfer specified nonqualified property to the foreign acquiring corporation, as in the transaction described in Example 2 of §1.7874-4T(j).

"This interpretation of §1.7874-4T is inconsistent with both the plain language and purpose of the regulation. In addition, section 7874(c)(4) separately provides that a transfer of properties or liabilities is disregarded if the transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874. Accordingly, the Treasury Department and the IRS intend to issue regulations that will clarify §1.7874-4T to provide 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. Furthermore, the regulations will remove the phrase "in a transaction (or series of transactions) related to the acquisition" from the definition of avoidance property. The inclusion of that phrase in the definition is redundant with language contained in the operative rule in §1.7874-4T(c)(1) for identifying disqualified stock, which itself requires, in relevant part, that there be an exchange of nonqualified property for stock of the foreign acquiring corporation in a transaction that is related to the acquisition. The regulations also will

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. The inclusion of that phrase in the definition is redundant with the rule for avoidance property, because if stock of a corporation or a partnership interest described in section 453(f)(2) does not constitute marketable securities due to the corporation or partnership becoming a member of the EAG, the stock or partnership interest is not specified nonqualified property and, therefore, may be avoidance property under §1.7874-4T(i)(7)(iv).

"In addition, Example 1 and Example 2 of §1.7874-4T(j) (which illustrate transfers of stock of the foreign acquiring corporation in exchange for marketable securities and avoidance property, respectively) will be clarified to include a reference to section 7874(c)(4). Finally, in light of section 2.02(b) of this notice, which applies to certain third-country transactions, all the examples described in §1.7874-4T(j) will be modified to provide that, unless otherwise indicated, FA, FMS, FS, and FT are tax residents of the same foreign country.
The following example illustrates the clarification described in this section 2.03(b):

"***Example.*** **[*See* Slide # 6 Anti-Stuffing Rules Strengthened, §2.03]** (i) *Facts*. DT is a publicly traded domestic 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 specified nonqualified property, but FA acquires the PRS properties with a principal purpose of avoiding the purposes of section 7874.

(ii) *Analysis*. Under §1.7874-4T(i)(7)(iv), the PRS properties transferred to FA are nonqualified property, because FA acquires the PRS properties in a transaction related to the DT acquisition 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 are disqualified stock described in §1.7874-4T(c)(1)(i). Section 1.7874-4T(c)(2) does not apply to reduce the amount of disqualified stock described in §1.7874-4T(c)(1)(i) 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 §1.7874-4T(b), 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 §1.7874-4T(i)(7)(iv), 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."

B. THE "STRENGTHING OF THE SUBSTANTIAL BUSINESS ACTIVITIES EXCEPTION" RULE, SECTION 2.02(a) OF THE 2015 INVERSION NOTICE

1. FACT SHEET INTRODUCTION TO THE SUBSTANTIAL BUSINESS ACTIVITIES EXCEPTION RULE

The Fact Sheet introduces this rule as follows:

"Strengthening the substantial business activities exception (Action under section 7874 of the code)

- Under current law, a U.S. company can successfully invert if, after the transaction, at least 25 percent of the combined group's business activity is in the foreign country in which the new foreign parent is created or organized. This is the case regardless of whether the new foreign parent is a tax resident of that foreign country.
- The standard for determining tax residence of a corporation for U.S. income tax purposes is where the entity is created or organized. Thus, a corporation is treated as domestic if it is created or organized under the law of the United States or of any State and as foreign if it is created or organized under the law of a foreign country. This standard, however, may not align with standards of foreign countries, which, for example, may be based on criteria such as the location in which the entity is managed or controlled.
- Today's notice provides that the combined group cannot satisfy the 25-percent business activities exception unless the new foreign parent is a tax resident in the foreign country in which it is created or organized. Thus, this rule will limit the ability of a U.S. multinational to replace its U.S. tax residence with tax residence in another country in which it does not have substantial business activities."

2. SECTION 2.02(a), "SUBSTANTIAL BUSINESS ACTIVITIES EXCEPTION" RULE

".02 Transactions at Issue and Regulations to be Issued

"(a) Substantial Business Activities of a Foreign Acquiring Corporation that is not Subject to Tax as a Resident of the Relevant Foreign Country

The Treasury Department and the IRS are aware of transactions in which the taxpayer asserts that the EAG has substantial business activities in the relevant foreign country (that is, the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized) when compared to the EAG's total business activities, but the foreign acquiring corporation is not subject to income taxation in the relevant foreign country as a resident. This could occur, for example, if the relevant foreign country determines the tax residency of an entity based on criteria other than the place of creation or formation, such as the location in which the entity is managed or controlled. If the foreign acquiring corporation is managed and controlled in a third country, the foreign acquiring corporation may not be subject to tax as a resident of the relevant foreign country (or, in some cases, of any foreign country). Alternatively, the foreign

acquiring corporation may not be subject to tax as a resident of the relevant foreign country because of disparate entity classification rules in the United States and the relevant foreign country. For example, the foreign acquiring corporation may be treated as a corporation for U.S. tax purposes under the entity classification regulations promulgated under section 7701 (including by reason of a "check-the-box" election), but as a fiscally transparent entity under the tax law of the relevant foreign country. In such a case, the foreign acquiring corporation would not be subject to tax as a resident of the relevant foreign country.

"The Treasury Department and the IRS have determined that the policy underlying the exception to section 7874 when there are substantial business activities in the relevant foreign country is premised on the foreign acquiring corporation being subject to tax as a resident of the relevant foreign country. For this purpose, the statute's reference to country of creation or organization reflects the U.S. standard for determining tax residency. However, the U.S. standard for determining tax residency does not always align with foreign countries' standards. Allowing the exception to apply when the foreign acquiring corporation is not subject to tax as a resident of the relevant foreign country effectively permits an EAG to replace its U.S. tax residence with tax residence in any other country (or, in certain cases, in no other country), without regard to the location of any substantial business activities conducted by the EAG. The Treasury Department and the IRS believe that this result is contrary to the policy underlying the substantial business activities test.

"Accordingly, the Treasury Department and the IRS intend to issue regulations under section 7874 to provide that 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." **[See Slide # 7, The Tax Resident Rule, § 2.02(a)]**

V SECTION 3 OF THE 2015 INVERSION NOTICE: REDUCING THE TAX BENEFITS OF INVERSIONS WITH MEASURES "PREVENTING INVERTED COMPANIES FROM TRANSFERRING FOREIGN OPERATIONS 'OUT FROM UNDER' THE U.S. TAX NET WITHOUT PAYING CURRENT U.S. TAX"

A. EXPAND THE SCOPE OF INVERSION GAIN FOR WHICH CURRENT U.S. TAX MUST BE PAID (ACTION UNDER SECTION 7874 OF THE CODE)—INVERSION GAIN PROVISION

1. FACT SHEET INTRODUCTION TO EXPANSION OF THE SCOPE OF INVERSION GAIN

The Fact Sheet introduces this rule as follows:

“Expand the scope of inversion gain for which current U.S. tax must be paid (Action under section 7874 of the code)

- Under current law, U.S. multinationals owe U.S. tax on the profits of their controlled foreign corporations (CFCs), although they do not usually have to pay the tax until those profits are paid to the U.S. parent as a dividend. Profits that have not yet been repatriated are known as deferred earnings. However, to the extent a CFC has passive income the U.S. parent is treated as if it received a taxable deemed dividend from the CFC.
- Under current law, an inverted company must pay current U.S. tax on inversion gain (the gain recognized when the inverted company transfers stock in its CFCs or other property to the new foreign parent) without the benefit of otherwise applicable tax attributes (such as net operating loss carryovers) to offset the gain. Thus, these rules impose penalties on post-inversion transactions that are designed to remove income from foreign operations from the U.S. taxing jurisdiction.
- Today's notice expands the scope of inversion gain to include certain taxable deemed dividends recognized by an inverted company. Specifically when that dividend is attributable to passive income recognized by a CFC when the CFC that transfers foreign operations to the new foreign parent.”

2. SECTION 3.01, “REGULATIONS UNDER SECTION 7874 DEFINING INVERSION GAIN”

“SECTION 3. REGULATIONS TO ADDRESS POST-INVERSION TAX AVOIDANCE TRANSACTIONS

“.01 Regulations under Section 7874 Defining Inversion Gain

“(a) Background

“If an acquisition is an inversion transaction, section 7874(a)(1) requires that the taxable income of an “expatriated entity” for any taxable year that includes any portion of the “applicable period” be no less than the “inversion gain” of the entity for the taxable year. Section 7874(a)(2)(A) provides that the term “expatriated entity” means a domestic corporation or a domestic partnership referred to in section 7874(a)(2)(B)(i) (which describes the acquisition) or any U.S. person that is related (within the meaning of section 267(b) or 707(b)(1)) to such domestic corporation or domestic partnership. Section 7874(d)(1) defines the term “applicable period” as the period beginning on the first date properties are acquired as part of the acquisition, and ending on the date that is 10 years after the last date properties are acquired as part of the acquisition. In addition, section 7874(d)(2) provides that 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), however, does not apply to property described in section 1221(a)(1) (generally, property that is inventory) in the hands of the expatriated entity.

"Section 7874(d)(3) provides that the term "foreign related person" means, with respect to any expatriated entity, a foreign person that is (i) related (within the meaning of section 267(b) or 707(b)(1)) to the entity, or (ii) under the same common control (within the meaning of section 482) as the entity.

"Finally, section 7874(e)(2)(A) provides that, in the case of an expatriated entity that is a partnership, section 7874(a)(1) shall apply at the partner rather than the partnership level. Section 7874(a)(1), together with section 7874(e)(1) (which prevents the use of certain credits to offset U.S. tax on inversion gain), ensure that an expatriated entity generally pays current U.S. 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. Rep. No. 755, 108th Cong., 2nd Sess. 568, 574 (2004) (Conf. Rep.); JCT Explanation at 342, 345.

"(b) Transactions at Issue and Regulations to be Issued

The Treasury Department and the IRS are concerned that certain indirect transfers of stock or other property by an expatriated entity (rather than direct transfers by the expatriated entity itself) may have the effect of removing foreign operations from U.S. taxing jurisdiction while avoiding current U.S. tax, contrary to the policy underlying sections 7874(a)(1) and (e)(1). This is because under current law the income is not inversion gain and therefore could be offset by tax attributes. For example, following an inversion transaction, an expatriated entity that wholly owns a CFC could cause the CFC to transfer property (including stock of a lower-tier CFC) to a specified related person (as defined in section 3.02(e)(i) of Notice 2014-52) in a fully taxable transaction. Gain from the transfer may be subpart F income of the transferor CFC and, as a result, the expatriated entity may have an income inclusion under section 951(a)(1)(A) attributable to the transfer. However, such an inclusion is not inversion gain under current law, and therefore the expatriated entity's income can be offset by tax attributes (such as net operating losses). Similar concerns arise in connection with a license of property by a CFC of an expatriated entity to a specified related person.

"The Treasury Department and the IRS have determined that it is inconsistent with the purposes of sections 7874(a)(1) and (e) to exclude from the definition of inversion gain income or gain recognized by an expatriated entity from an indirect transfer or license of property in circumstances analogous to those set forth in sections 7874(d)(2)(A) and (B). Accordingly, the Treasury Department and the IRS intend to issue regulations under section 7874(g) that will provide 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 will not apply to property described in section 1221(a)(1) in the hands of the CFC.

"In addition, the Treasury Department and the IRS intend to issue regulations that will provide that, if a partnership that is a foreign related person transfers or licenses property, a partner of the partnership shall be treated as having transferred or licensed its proportionate share of that property, as determined under the rules and principles of sections 701 through 777, for purposes of determining inversion gain.

"The following example illustrates the regulations described in this section 3.01(b):

"**Example.** [*See* **Slide # 8 Defining Inversion Gain, § 3.01**] *(i) Facts.* On July 1, 2016, FA, a foreign corporation, acquires all the stock of DT, a domestic corporation, in an inversion transaction. When the inversion transaction occurred, DT wholly owned FS, a foreign corporation that is a CFC. During the applicable period, FS sells to FA property that is not described in section 1221(a)(1) in the hands of FS. Under section 951(a)(1)(A), DT has a $100x gross income inclusion that is attributable to FS's sale of the property.

(ii) Analysis. Pursuant to section 7874(a)(2)(A), DT is an expatriated entity. Under section 3.01(b) of this notice, DT's $100x gross income inclusion under section 951(a)(1)(A) is inversion gain, because it is taken into account during the applicable period and is attributable to a transfer of property after the inversion transaction to a specified related person (FA). Sections 7874(a)(1) and (e) therefore prevent the use of certain tax attributes (such as net operating losses) to reduce the U.S. tax owed with respect to DT's $100x gross income inclusion under section 951(a)(1)(A)."

B. EXPAND THE SCOPE OF INVERSION GAIN FOR WHICH CURRENT U.S. TAX MUST BE PAID (ACTION UNDER SECTION 7874 OF THE CODE)—BUILT-IN GAIN PROVISION

1. FACT SHEET INTRODUCTION TO REQUIREMENT TO RECOGNIZE ALL BUILT-IN GAIN

The Fact Sheet introduces this rule as follows:

"Require that all built-in gain in CFC stock be recognized, without regard to the amount of deferred earnings, upon a restructuring of the CFC (Action under section 367 of the code)

- After an inversion transaction, the new foreign parent may acquire CFC stock held by the former U.S.-parented group, with the result that the CFC is no longer under the U.S. tax net. Under current law, the former U.S. parent must recognize built-in gain in the CFC stock as a result of the transfer, but not in excess of the deferred earnings of the CFC.
- Today's notice provides that all the built-in gain in the CFC stock must be recognized as a result of the post-inversion transfer, regardless of the amount of the CFC's deferred earnings, thereby potentially increasing the amount of current U.S. tax paid as a result of the transfer."

2. SECTION 3.02, REGULATIONS UNDER SECTION 367(b) REGARDING CERTAIN EXCHANGES OF STOCK OF AN EXPATRIATED FOREIGN SUB

".02 Regulations under Section 367(b) Regarding Certain Exchanges of Stock of an Expatriated Foreign Subsidiary

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

"In general, current regulations under §1.367(b)-4(b), without regard to the regulations described in Notice 2014-52, require a shareholder that exchanges stock of a foreign corporation in an exchange subject to section 367(b) to include in income as a deemed dividend the section 1248 amount (as defined in §1.367(b)-2(c)(1)) with respect to the stock exchanged if the exchange results in either a loss of CFC status of the foreign corporation whose stock is exchanged or a loss of section 1248 shareholder status of the exchanging shareholder (or of a shareholder of the exchanging shareholder when there is an exchange of stock of a lower-tier CFC). See §1.367(b)-4(b)(1)(i)(A) and (B), which describe an exchanging shareholder subject to these regulations and the conditions under which an income inclusion is required, respectively.

"Notice 2014-52 announced that the regulations under §1.367(b)-4(b) would be amended to require an income inclusion in certain nonrecognition transactions that occur after an inversion transaction and that dilute the interest of a U.S. shareholder in a CFC, because such transactions could allow the U.S. shareholder to avoid tax on the CFC's earnings and profits. Specifically, subject to a de minimis rule, section 3.02(e)(ii) of Notice 2014-52 provides that an exchanging shareholder described in §1.367(b)-4(b)(1)(i)(A) will be required to include in income as a deemed dividend the section 1248 amount with respect to stock of an expatriated foreign subsidiary that is exchanged in a specified exchange during the applicable period, without regard to whether any condition of §1.367(b)-4(b)(1)(i)(B) is satisfied. The terms "expatriated foreign subsidiary" and "specified exchange" are defined in sections 3.01(b) and 3.02(e)(ii), respectively, of Notice 2014-52.

"(b) Transactions at Issue and Regulations to be Issued

The Treasury Department and the IRS are concerned that certain nonrecognition transactions that dilute a U.S. shareholder's ownership of an expatriated foreign subsidiary may allow the U.S. shareholder to avoid U.S. tax on unrealized appreciation in property held by the expatriated foreign subsidiary at the time of the exchange. This could occur when the amount of realized gain in the stock of the expatriated foreign subsidiary that is exchanged in the specified exchange exceeds the earnings and profits attributable to such stock for purposes of section 1248. For example, at the time of the exchange, the expatriated foreign subsidiary could hold valuable self-developed intangible property that has not yet been brought to market and therefore has not generated any significant earnings and profits. Any unrealized appreciation in the intangible property, when recognized by the expatriated foreign subsidiary after the exchange, would create earnings and profits that are attributable to gain that economically had accrued at the time of the exchange.

"The Treasury Department and the IRS have determined that net unrealized built-in gain in property held by an expatriated foreign subsidiary at the time of the exchange gives rise to the same policy concerns that arise with respect to earnings and profits of the expatriated foreign subsidiary that exist at the time of the exchange. Therefore, to prevent the avoidance of U.S. tax on such net unrealized gain, it is appropriate to require the exchanging shareholder to recognize all of the gain in the stock of the expatriated foreign subsidiary that is exchanged, without regard to the amount of the expatriated foreign subsidiary's undistributed earnings and profits. Accordingly, the Treasury Department and the IRS intend to amend the regulations under section 367(b) to provide that, if an exchanging shareholder would be required under the rules announced in section 3.02(e)(ii) of Notice 2014-52 to include in income as a deemed dividend the section 1248 amount (if any) with respect to stock of an expatriated foreign subsidiary, the exchanging shareholder also must recognize all realized gain with respect to such stock, after taking into account any increase in basis resulting from a deemed dividend with respect to the exchange provided in §1.367(b)-2(e)(3)(ii). For this purpose, the amount of realized gain that would be recognized is reduced by the amount of gain recognized under other applicable provisions of the Code, such as section 356.

"Furthermore, a conforming change will be made to the regulations described in section 3.02(e)(i) of Notice 2014-52, which will recharacterize under section 7701(l) certain transfers of "specified stock" (as defined in section 3.02(e)(i) of Notice 2014-52), subject to the exceptions described in section 3.02(e)(i)(C) of Notice 2014-52. Specifically, the first exception described in section 3.02(e)(i)(C) applies either when a transfer of specified stock gives rise to a deemed dividend to the exchanging shareholder under §1.367(b)-4 (including by reason of the regulations described in section 3.02(e)(ii) of Notice 2014-52), or when the exchanging shareholder is required to recognize and include in income all of the gain in the specified stock. Consistent with the modification described in this section 3.02(b), when the regulations described in Notice 2014-52 are issued, the first exception described in section 3.02(e)(i)(C) will be modified to be applicable only if, as a result of the transfer, all the gain in the specified stock is recognized. See section 4.03 of this notice for additional discussion of the application of this notice and Notice 2014-52 to transfers of specified stock.

"The following example illustrates the regulations described in this section 3.02(b):

"Example 1. **[*See* Slide # 9 Exchanges of Stock of Expatriated Foreign Subsidiary, § 3.02]**
(i) *Facts*. FA, a foreign corporation, wholly owns DT, a domestic corporation, which in turn, wholly owns FT, a foreign corporation that is a CFC. FA wholly owns FS, a foreign corporation. FA acquired all the stock of DT in an inversion transaction that was completed on July 1, 2016. Accordingly, DT is a domestic entity, FT is an expatriated foreign subsidiary, and FA and FS are each a specified related person with respect to FT. During the applicable period, DT transfers to FS all of the stock of FT solely in exchange for FS voting stock representing 60% of the outstanding stock of FS, pursuant to a reorganization described in section 368(a)(1)(B). Immediately before the exchange, FT is a CFC in which DT is a section 1248 shareholder. Immediately after the exchange, FS and FT are CFCs in which DT is a section 1248 shareholder. At the time of the exchange, the FT stock owned by DT has a fair market value of $150x and a tax basis of $50x (such that the FT stock has a built-in gain of $100x). In addition, the earnings and profits of FT attributable to DT's FT stock is $60x and therefore the section 1248 amount with respect to the FT stock is $60x (the lesser of the $60x of earnings and profits attributable to the FT stock and the $100x gain in the FT stock).

(ii) Analysis. Under §1.367(b)-4(b)(1)(i), as modified by the regulations described in section 3.02(e)(ii) of Notice 2014-52, DT must include in income as a deemed dividend $60x, the section 1248 amount with respect to its FT stock. Because DT is required to include in income as a deemed dividend the section 1248 amount, if any, with respect to its FT stock under section 3.02(e)(ii) of Notice 2014-52, the rules in section 3.02(b) of this notice apply. As a result, DT must also recognize all realized gain with respect to its FT stock after taking into account the $60x increase in basis in the FT stock under §1.367(b)-2(e)(3)(ii), or $40x ($150x – ($50x + $60x)). If instead the section 1248 amount with respect to the FT stock were zero (because, for example, FT had no earnings and profits), DT would recognize all $100x of realized gain with respect to its FT stock."

VI SECTION 4 OF THE 2015 INVERSION NOTICE: CORRECTIONS TO THE 2014 INVERSION NOTICE

A. INTRODUCTION TO THE ANTI-CASH BOX AND ANTI-SLIMMING DOWN RULES OF THE 2014 INVERSION NOTICE

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

The parties could engage in pre-inversion "right sizing" transactions to ensure the U.S.-79%, Foreign-21% Ownership Split is satisfied. In many cases this will entail either (1) finding a Foreign Inversion Target bulked up with passive assets, or (2) slimming down a Domestic Inverter. The 2014 Inversion Notice addresses these two potential tailoring strategies in the

Anti-Cash Box rule and Anti-Slimming Down rule. The 2015 Inversion Notice makes corrections to these two rules.

To facilitate an understanding of the rules and the changes, the rules in the 2014 Inversion Notice are discussed first and then the changes in the 2014 Inversion Notice are examined.

B. ANTI-"CASH BOX" REGS:

1. SECTION 2.01 OF THE 2014 INVERSION NOTICE, DISREGARDING CERTAIN STOCK OF A FOREIGN ACQUIRING CORP ATTRIBUTABLE TO PASSIVE ASSETS—REGS UNDER SECTION 7874

a. TRANSACTION OF CONCERN

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

b. GENERAL RULE SET OUT IN THE NOTICE

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

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

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

denominator of which is the gross value of all foreign group property. Solely for purposes of the preceding sentence, property received by the foreign acquiring corporation that gives rise to disqualified stock (within the meaning of §1.7874-4T (c)) that is excluded from the denominator of the ownership fraction pursuant to §1.7874-4T (b) is excluded from both the numerator and the denominator of the foreign group nonqualified property fraction."

c. ILLUSTRATION SEE SLIDE #10 ANTI-CASH BOX RULE, § 2.01 OF 2014 NOTICE

d. IMPACT

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

2. THE 2015 INVERSION NOTICE AMENDMENTS TO THE CASH-BOX RULES

a. THE FACT SHEET DISCUSSION OF THE AMENDMENT

The Fact Sheet introduces this rule as follows:

"Limit the ability of companies to count passive assets that are not part of the entity's daily business functions in order to inflate the new foreign parent's size and therefore evade the 80 percent rule – known as using a "cash box." (Action under section 7874 of the code)

- Today's notice corrects the "cash box" rule that disregards stock of the foreign parent that is attributable to existing passive assets in the context of the 80-percent threshold. The correction ensures that assets used in an active insurance business are not treated as passive assets."

b. SECTION 4.01 OF THE 2015 INVERSION NOTICE, DEALING WITH STOCK ATTRIBUTABLE TO PASSIVE ASETS

".01 Regulations under Section 7874 to Disregard Certain Stock Attributable to Passive Assets

"(a) Background

Notice 2014-52 announced that the Treasury Department and the IRS intend to issue regulations under section 7874(c)(6) that will exclude from the denominator of the ownership fraction certain stock of a foreign acquiring corporation that is attributable to passive assets. Specifically, section 2.01(b) of Notice 2014-52 provides that a portion of the stock of a foreign acquiring corporation will be excluded from the denominator of the ownership fraction when more than 50 percent of the gross value of all "foreign group property" is "foreign group nonqualified property." For this purpose, section 2.01(b) of Notice 2014-52 provides the general rule that foreign group nonqualified property is foreign group property (as defined in section 2.01(b) of Notice 2014-52) that is described in §1.7874-4T(i)(7), other than property that gives rise to income described in section 1297(b)(2)(A) (PFIC banking exception) or section 954(h) or (i) (subpart F exceptions for qualified banking or financing income and for qualified insurance income, respectively, determined by substituting the term "foreign corporation" for the term "controlled foreign corporation"). In addition, a special rule treats certain property (referred to as

"substitute property") that would not be foreign group nonqualified property under the general rule as foreign group nonqualified property if, in a transaction related to the acquisition, such property is acquired in exchange for other property that would be foreign group nonqualified property under the general rule.

"(b) Modification of the General Definition of Foreign Group Nonqualified Property

(i) Exclusion for property that gives rise to income described in section 1297(b)(2)(B)

Notice 2014-52 did not exclude property that gives rise to income described in section 1297(b)(2)(B) (PFIC insurance exception) from the general definition of foreign group nonqualified property. Commenters have noted that certain insurance companies may not be able to satisfy the requirements of the subpart F exception for qualified insurance income under section 954(i), which is a narrower provision than section 1297(b)(2)(B). The Treasury Department and the IRS have determined that the rule described in Notice 2014-52 with respect to insurance companies can lead to inappropriate results in certain cases. Accordingly, the regulations described in section 2.01(b) of Notice 2014-52 will provide that property that gives rise to income described in the PFIC insurance exception will be excluded from the general definition of foreign group nonqualified property, but such property will be subject to the special rule for substitute property. Nevertheless, the Treasury Department and the IRS have significant concerns about certain corporations that do not conduct a bona fide active insurance business or whose investment assets exceed the amount necessary to meet their obligations under insurance and annuity contracts, but that nonetheless take the position that they earn income described in section 1297(b)(2)(B) with respect to all of their activities and investment assets. In this regard, on April 24, 2015, proposed regulations under §1.1297-4 were published in the Federal Register (REG-108214-15) to provide guidance on when a foreign insurance company's income is excluded from the definition of passive income under the PFIC insurance exception. In the preamble to those proposed regulations, the Treasury Department and the IRS requested comments on appropriate methodologies for determining the extent to which assets are held to meet obligations under insurance and annuity contracts. Accordingly, the Treasury Department and the IRS expect to issue separate guidance under section 1297(b)(2)(B) to prevent companies from inappropriately applying the PFIC insurance exception.

(ii) Exclusion of property held by certain domestic corporations

Commenters have noted that the general definition of foreign group nonqualified property in Notice 2014-52 includes certain property held by domestic corporations engaged in the active conduct of a banking or insurance business. This could occur, for example, if a foreign acquiring corporation held all the stock of a domestic corporation prior to an acquisition. The Treasury Department and the IRS have determined that this definition may lead to inappropriate results in certain cases. Consequently, the regulations described in section 2.01(b) of Notice 2014-52 will provide that the general definition of foreign group nonqualified property does not include property held by a domestic corporation that is subject to tax as an insurance company under subchapter L, provided that the property is required to support, or is substantially related to, the active conduct of an insurance business. Furthermore, the regulations will provide that the general definition of foreign group nonqualified property does not include property held by a domestic corporation if that property gives rise to income described in section 954(h), determined by substituting the term "domestic corporation" for the term "controlled foreign

corporation" and without regard to the phrase "located in a country other than the United States" in section 954(h)(3)(A)(ii)(I) and without regard to any inference that the tests in section 954(h) should be calculated or determined without taking into account transactions with customers located in the United States. In these cases, however, the special rule for substitute property will apply. **[*See* Slide #11 Passive Assets Clarification, § 4.01]**

C. ANTI-"SLIMMING DOWN" REGS:

1. SECTION 2.02 OF THE 2014 INVERSION NOTICE, DISREGARDING CERTAIN DISTRIBUTIONS BY THE DOMESTIC TARGET- REGS UNDER SECTIONS 7874 AND 367

a. TRANSACTIONS OF CONCERN

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

b. GENERAL RULE FOR SECTION 7874 SET OUT IN THE NOTICE

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

"For purposes of this notice, non-ordinary course distributions mean the excess of all distributions made during a taxable year by the domestic entity with respect to its stock or partnership interests, as applicable, over 110 percent of the average of such distributions during the thirty-six month period immediately preceding such taxable year. A distribution means any distribution, regardless of whether it is treated as a dividend or whether, for example, it qualifies under section 355. Thus, a distribution includes any distribution made by the domestic entity in redemption of its stock, such as a distribution to which section 302 (a) applies. A distribution also includes a transfer of money or other property to the owners of the domestic entity that is made in connection with the acquisition described in section 7874 (a) (2) (B) (i) to the extent the money or other property is directly or indirectly provided by the domestic entity. For example, if the acquisition of the domestic entity by the foreign acquiring corporation qualifies as a reorganization under section 368 (a) and the shareholders of the domestic entity receive other property or "boot" (within the meaning of section 356) in connection with the reorganization, then, to the extent the boot is directly or indirectly provided by the domestic entity for purposes

of section 356, the domestic entity is treated as having made a distribution in the amount of that boot for purposes of this section 2.02 (b))."

c. GENERAL RULE FOR SECTION 367 SET OUT IN THE NOTICE

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

d. ILLUSTRATION SEE SLIDE #12 THE N0-SLIMMING DOWN RULE. § 2.02 OF 2014 NOTICE

e. OBSERVATION OF THE SIGNIFICANCE OF THE ANTI-SLIMMING DOWN RULE

i. *IMPACT ON SECTION 7874*

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

ii. *IMPACT ON SECTION 367*

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

2. THE 2015 INVERSION NOTICE AMENDMENTS TO THE SLIMMING DOWN RULES

a. THE FACT SHEET DISCUSSION OF THE AMENDMENT

The Fact Sheet introduces this rule as follows:

"Prevent U.S. companies from reducing their size by making extraordinary dividends. (Action under section 7874 of the code)

- Today's notice corrects the rule that would disregard certain pre-inversion extraordinary dividends for purposes of the ownership requirement. The correction ensures that the extraordinary dividend rule does not apply when a foreign corporation acquires a U.S. company in an all-cash or mostly cash acquisition."

b. SECTION 4.02 OF THE 2015 INVERSION NOTICE RELATING TO "DISREGARD[ING] CERTAIN DISTRIBUTIONS BY DOMESTIC ENTITY"

".02 Regulations under Section 7874 to Disregard Certain Distributions by the Domestic Entity

"(a) Background
Notice 2014-52 announced that the Treasury Department and the IRS intend to issue regulations under section 7874 that disregard certain distributions made by a domestic entity before being acquired by a foreign acquiring corporation. Specifically, section 2.02(b) of Notice 2014-52 provides that non-ordinary course distributions (as defined in section 2.02(b) of Notice 2014-52) made by a domestic entity (including a predecessor) during the 36-month period ending on the acquisition date (within the meaning of §1.7874-3T(d)(1)) are disregarded for purposes of section 7874.

"(b) Addition of a De Minimis Exception
Commenters have noted that the rules announced in section 2.02(b) of Notice 2014-52 could cause section 7874 to apply to an acquisition even though the former owners of the domestic entity actually own no, or only a de minimis amount of, stock in the foreign acquiring corporation after the acquisition. In general, this could occur when stock of the foreign acquiring corporation is disregarded for purposes of section 7874. For example, assume that, pursuant to a plan to purchase the stock of a domestic corporation, which made a non-ordinary course distribution, the purchaser forms a newly formed foreign acquiring corporation with cash and the foreign acquiring corporation uses the cash to purchase the stock of the domestic corporation. In applying the ownership percentage, the stock held by the shareholders of the foreign acquiring corporation is disregarded under §1.7874-4T(b) (which disregards certain stock of the foreign acquiring corporation received in exchange for nonqualified property). This result is similar to a result that could occur under §1.7874-4T(b), absent the de minimis exception provided in §1.7874-4T(d)(1), when the former shareholders of the domestic entity in fact acquire a small interest in the foreign acquiring corporation by reason of having held an interest in the domestic entity. The Treasury Department and the IRS have determined that the policy reasons for providing the de minimis exception in §1.7874-4T are equally applicable to the regulations described in section 2.02(b) of Notice 2014-52.

"Accordingly, the Treasury Department and the IRS intend to include in the regulations described in section 2.02(b) of Notice 2014-52 a de minimis exception that will implement this policy. This exception will apply to an acquisition that meets two requirements. First, the ownership percentage, determined without regard to the application of §1.7874-4T(b) and the rules announced in sections 2.01(b) and 2.02(b) of Notice 2014-52, must be less than five (by vote and value). Second, after the acquisition and all transactions related to the acquisition are completed, former shareholders (within the meaning of §1.7874-2(b)(2)) or former partners (within the meaning of §1.7874-2(b)(3)), as applicable, of the domestic entity, in the aggregate, must own (applying the attribution rules of section 318(a) with the modifications described in section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) any member of the EAG that includes the foreign acquiring corporation. If these two requirements are satisfied, the rules announced in section 2.02(b) of Notice 2014-52 will not

apply to the acquisition and, as a result, no distributions will be treated as non-ordinary course distributions that are disregarded under those rules. However, any distributions that are part of a plan a principal purpose of which is to avoid the purposes of section 7874 will be disregarded under section 7874(c)(4)." [*See* **Slide # 13 De Minimis Exception, § 4.02**]

D. THE ANTI-DE-CONTROL OF CFC's RULE

1. INTRODUCTION TO THE ANTI-DE-CONTROLLING OF CFCs RULES IN THE 2014 INVERSION NOTICE

a. SECTION 3.02 OF THE 2014 INVERSION NOTICE, REGULATIONS TO ADDRESS TRANSACTIONS TO DE-CONTROL OR SIGNIFICANTLY DILUTE CFCS

b. THE DECONTROL AVOIDANCE PROBLEM AS DESCRIBED IN THE 2014 INVERSION NOTICE

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

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

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

c. THE 2014 INVERSION NOTICE DESCRIPTION OF THE REGULATIONS TO BE ISSUED UNDER SECTION 7701(l) (RELATING TO CONDUIT ARRANGEMENTS), SECTION 3.02(E)(I)

i. *DEFINITION OF "SPECIFIED TRANSACTION" AND "SPECIFIED RELATED PERSON"*

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

ii. *SUMMARY OF THE DEFINITION OF A "SPECIFIED TRANSACTION" AND "SPECIFIED RELATED PERSON"*

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

iii. *RECHARACTERIZATION OF A "SPECIFIED TRANSACTION:" THE BASIC RECHARACTERIZATION RULE*

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

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

(i) the property transferred by the specified related person **[*e.g.* the Foreign Holding Company]** to acquire the specified stock **[*e.g.*, stock of DI's CFC # 2]** (transferred property) will be treated as having been transferred by the specified related person **[*e.g.* Foreign Holding Company]** to the section 958 (a) U.S. shareholder(s) **[*e.g.*, Domestic Inverter]** of the expatriated foreign subsidiary **[*e.g.*, DI's CFC # 2]** in exchange for instruments deemed issued by the section 958 (a) U.S. shareholder(s) **[*e.g*, Domestic Inverter]** (deemed instrument(s)); and

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

d. EXAMPLE OF THE BASIC RECHARACTERIZATION RULE

i. *PARTIES TO THE EXAMPLE*

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

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

ii. *RECHARACTERIZATION EXAMPLE 1, ILLUSTRATION OF THE BASIC RECHARACTERIZATION RULE*

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

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

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

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

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

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

e. ILLUSTRATION SEE SLIDE #14 ANTI-DECONTROL OF CFC RULE, § 3.02 (e) (i) ON 2014 INVERSION NOTICE

f. QUESTIONS AND OBSERVATIONS RE RECHARACTERIZATION

g. IMPACT OF THE RECAHARCTERIZATION RULE

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

h. AUTHORITY

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

i. CORRECT POLICY ANSWER TO A DE-CONTROL GENERALLY

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

2. SECTION 4.03 OF 2015 INVERSION NOTICE PROVISION RELATING TO "REGULATIONS TO ADDRESS TRANSACTIONS TO DE-CONTROL OR SIGNIFICANTLY DILUTE OWNERSHIP OF CERTAIN CFCs"

".03 Regulations to Address Transactions to De-Control or Significantly Dilute Ownership of Certain CFCs

"(a) Background

Notice 2014-52 announced that the Treasury Department and the IRS intend to issue regulations under section 7701(l) that will recharacterize certain post-inversion transactions that otherwise would de-control or significantly dilute a U.S. shareholder's ownership of a CFC that is an expatriated foreign subsidiary. The general rule in section 3.02(e)(i) of Notice 2014-52 provides that a specified transaction completed during the applicable period is recharacterized under

section 7701(l) in the manner described in section 3.02(e)(i)(A) of Notice 2014-52. For this purpose, a specified transaction is a transaction in which stock in an expatriated foreign subsidiary, referred to as "specified stock," is transferred (including by issuance) to a specified related person. The term "expatriated foreign subsidiary" is defined in section 3.01(b) of Notice 2014-52, and the terms "specified transaction," "specified stock," and "specified related party" are defined in section 3.02(e)(i) of Notice 2014-52.

"This general rule is subject to two exceptions described in section 3.02(e)(i)(C) of Notice 2014-52. The first exception is discussed in section 3.02(b) of this notice. The second exception (small dilution exception) applies if (i) the expatriated foreign subsidiary is a CFC immediately after the specified transaction and all related transactions and (ii) the amount of stock (by value) in the expatriated foreign subsidiary (and any lower-tier expatriated foreign subsidiary) that is owned, in the aggregate, directly or indirectly by the section 958(a) U.S. shareholders (as defined in section 3.02(e)(i)(A) of Notice 2014-52) of the expatriated foreign subsidiary immediately before the specified transaction and any transactions related to the specified transaction does not decrease by more than 10 percent as a result of the specified transaction and any related transactions.

"Example 1 of section 3.02(e)(iii) of Notice 2014-52 illustrates a specified transaction in which neither exception applies and therefore the transaction is recharacterized in the manner described in section 3.02(e)(i)(A) of Notice 2014-52. In the example, FA is a foreign corporation that wholly owns DT, a domestic corporation acquired by FA in an inversion transaction completed on January 1, 2015. In addition, DT wholly owns FT, a foreign corporation that is a CFC and an expatriated foreign subsidiary, and FA wholly owns FS, a foreign corporation that is a specified related person with respect to FT. Shortly after the inversion transaction, FA acquires $10x of FT stock from FT, representing 60 percent of total voting power and value of the stock of FT, in exchange for $10x of cash.

"The example states that FA's acquisition of the FT stock from FT is a specified transaction that must be recharacterized. The small dilution exception is not applicable because the amount of FT stock (by value) that is owned (within the meaning of section 958(a)), in the aggregate, by DT before the specified transaction decreases by more than 10 percent (in fact, by 60 percent, from 100 percent to 40 percent) as a result of the specified transaction.

"(b) Clarifying Change to Small Dilution Exception

The Treasury Department and the IRS are concerned that some taxpayers may be inappropriately interpreting the small dilution exception. In particular, some taxpayers may be comparing the value of the stock of an expatriated foreign subsidiary owned by a section 958(a) U.S. shareholder immediately before a specified transaction with the value of the stock owned by the section 958(a) U.S. shareholder immediately after the specified transaction, rather than comparing the percentage of the stock owned (by value) by the section 958(a) U.S. shareholder before and after the specified transaction. This interpretation is plainly inconsistent with the purpose of the rules described in section 3.02(e)(i) of Notice 2014-52 and the small dilution exception, as well as the analysis in Example 1 of section 3.02(e)(iii) of Notice 2014-52. Accordingly, the regulations will clarify the application of the small dilution exception by

substituting the phrase "the percentage of stock (by value)" for the phrase "the amount of stock (by value)." A similar clarification will be made to the exception described in section 3.02(e)(ii) of Notice 2014-52 (relating to the circumstances in which an exchanging shareholder is required under section 367(b) to include in income as a deemed dividend the section 1248 amount with respect to stock exchanged in a specified exchange)." **[*See* Slide # 15 Small Dilution Exception Clarification Rule, §4.03]**