

Corporate Inversions: The Re-Making of Section 7874?

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Background/Overview

- Added by AJCA of 2004
 - To prevent inversions of U.S. corporations into foreign corporations.
 - Benefit would be advantaged tax regime and potential for earnings stripping (notwithstanding potential 367 hit).
- Section 7874 applies if pursuant to a plan or series of related transactions three things occur:
 - A foreign corporation acquires, directly or indirectly, substantially all of the properties held directly or indirectly by a U.S. corporation (or substantially all of the properties constituting a trade or business of a domestic partnership);
 - The expanded affiliated group (“EAG”) which includes the foreign acquiring corporation (based on a > 50% common ownership) does not have substantial business activities in the foreign country in which the foreign corporation is organized (in relation to total activities of EAG), and

Background/Overview

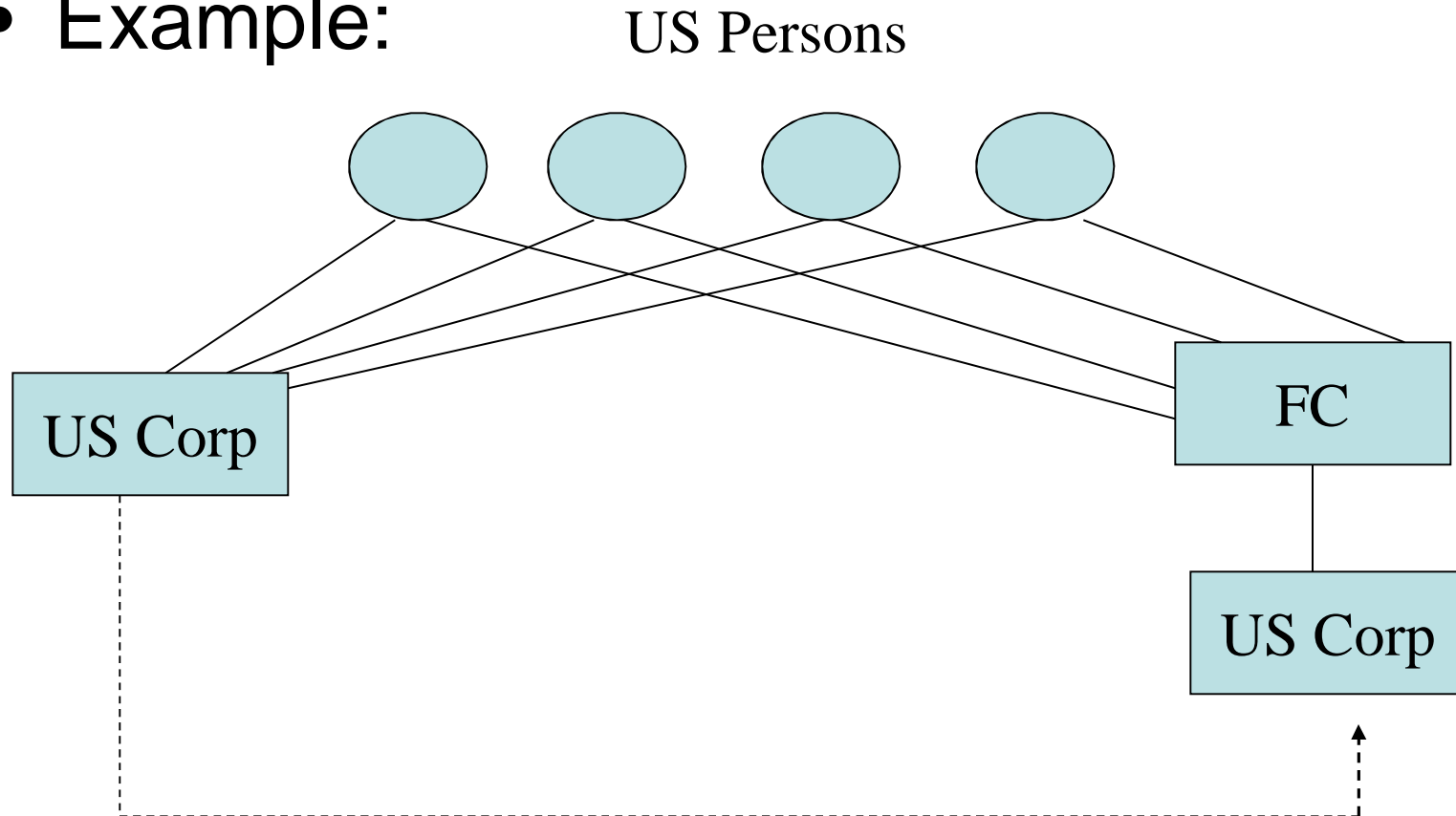
- Immediately after the transaction, the former shareholders of the U.S. corporation own at least 60% (vote or value) of the foreign corporation by reason of holding stock in the domestic corporation.
- If tests are met
 - U.S. target prevented during the next 10 years from using tax attributes to offset inversion related gain realized on the transfer of stock or assets (304, 311(b), 367, 1001, 1248), including by way of license, to a foreign related person (except inventory).
 - Inversion gain is U.S. source income (for foreign tax credit purposes).

Background/Overview

- If former shareholders own 80% or more, the foreign acquiring corporation is treated as a domestic corporation for all U.S. tax purposes.
 - Not eligible to elect non-corporate status;
 - Section 367 is applicable to the deemed F reorganization (but not with respect to share transfers by U.S. shareholders to the foreign corporation);
 - Continues to be domestic corporation even if tests later met.
- Stock ownership test disregards:
 - Stock owned by members of the EAG which includes the foreign corporation;
 - Stock of the foreign corporation which is sold in a public offering related to the acquisition.

Background/Overview

- Example:



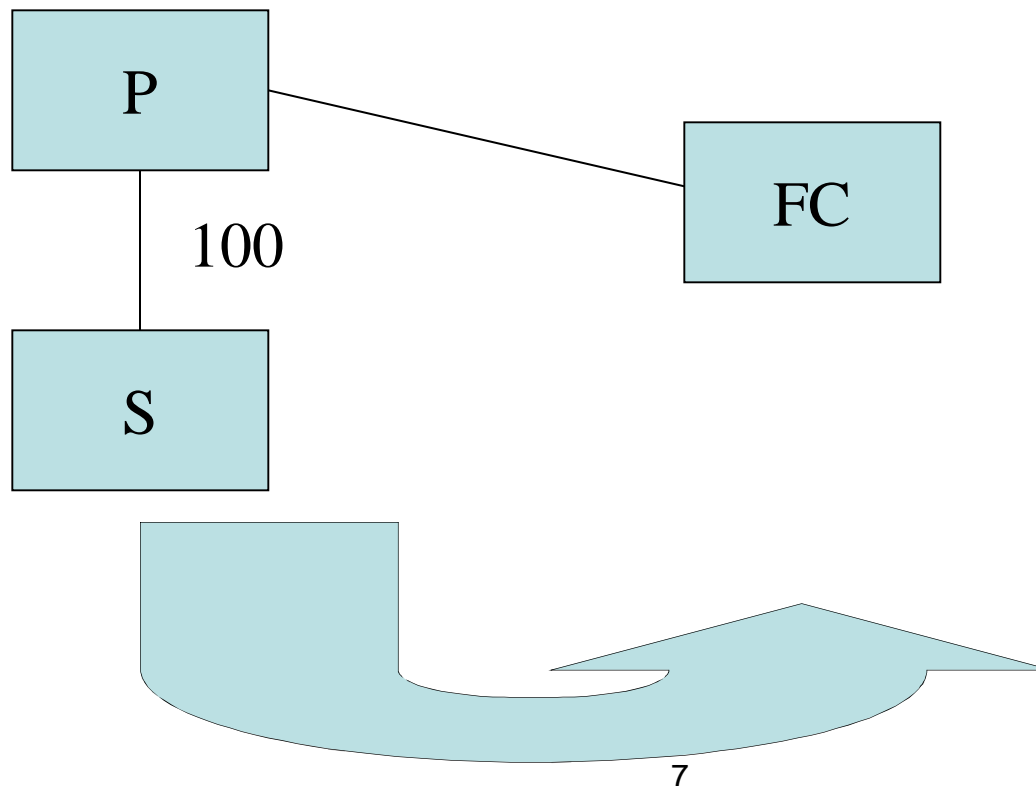
- Inversion (assuming no substantial business activities.)

The Final -1 Reg (Disregard of Affiliate Owned Stock)

- Addresses broad reach of statute regarding internal restructurings and certain acquisitions.
- Deals with when stock of EAG is counted in either the numerator or denominator of the fraction determining level of ownership changes.

The Final -1 Reg (Disregard of Affiliate Owned Stock)

- Example – Base Case

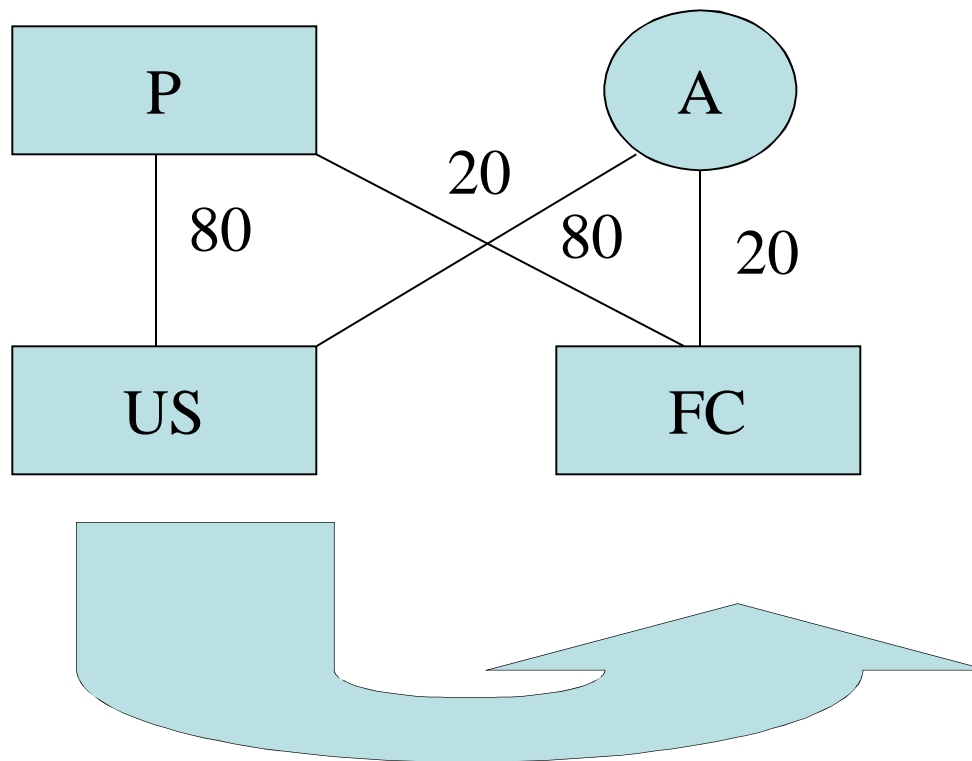


EAG Rule

- Stock disregarded in numerator and denominator
- No inversion

The Final -1 Reg (Disregard of Affiliate Owned Stock)

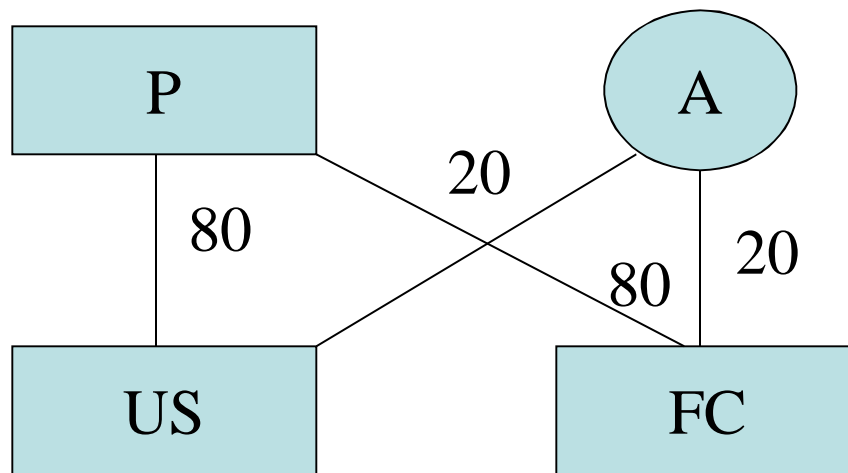
- Problem Case



But for relief: EAG Rule
-P Stock disregarded totally
- A owns $10/10 = 100\%$
- Inversion (assume no substantial business activities)

The Final -1 Reg (Disregard of Affiliate Owned Stock)

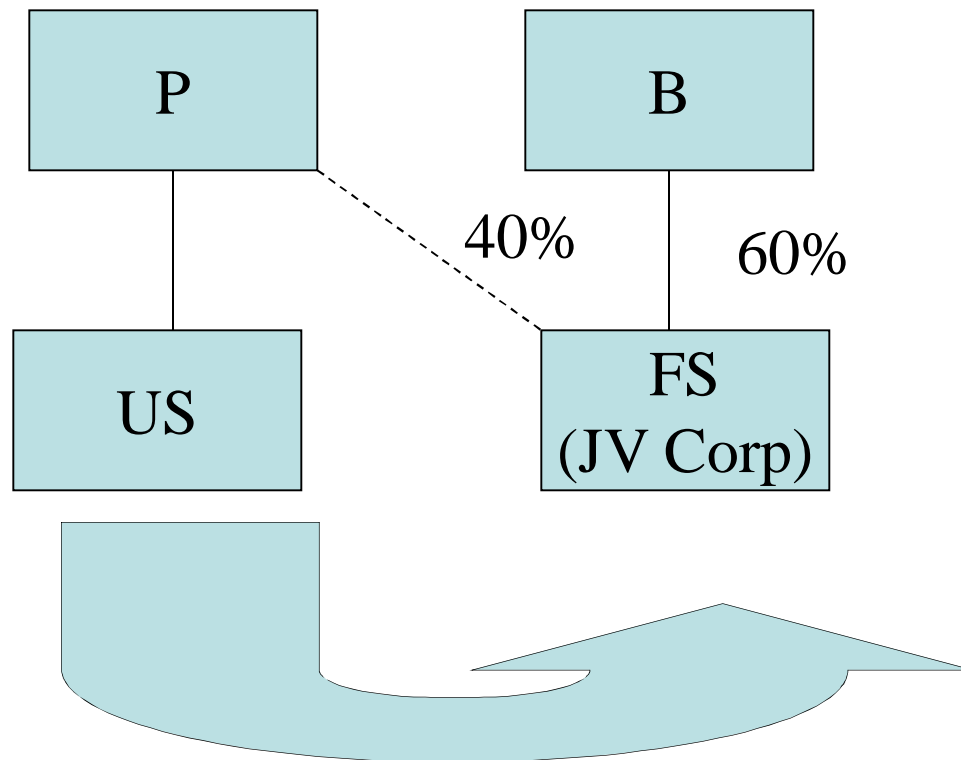
- Case to the Rescue (internal restructuring)



- Exception if common parent of EAG owns at least 80% before and after.
- Stock of EAG member counts in denominator (although not in numerator).
- No inversion (only 20%).

The Final -1 Reg (Disregard of Affiliate Owned Stock)

- Case to the Rescue (loss of control transaction)



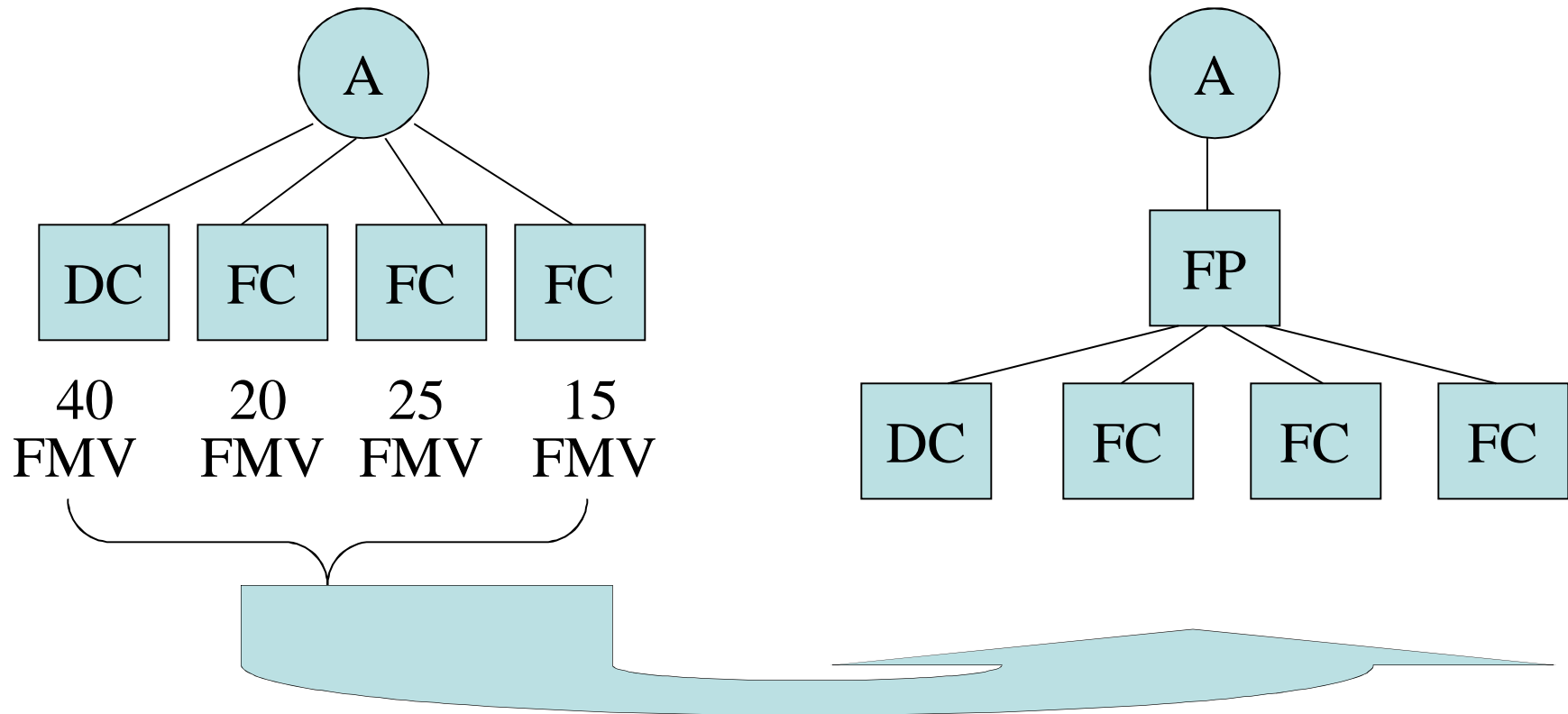
-Unrelated P transfers US to JV Corp. for a 40% interest
-Exception allows B's shares to be counted in denominator (even though it constitutes stock owned by EAG).

The Final -2 Reg (Surrogate Foreign Corporation)

- Indirect acquisition of U.S. properties:
 - Acquisition of stock of foreign corp. not within Sec. 7874
- Stock held “by reason of holding stock in the domestic corporation”:
 - Generally, based on relative value of the property in exchange for which the foreign corp.'s stock was issued.

The Final -2 Reg (Surrogate Foreign Corporation)

- Example:



- A holds (only) 40% of FP by reason of holding stock in DC.
- No inversion.

The Final -2 Reg (Surrogate Foreign Corporation)

- Acquisition by publicly traded foreign partnership (traded on established market or tradable on secondary markets).
 - Treated as foreign corporation organized in foreign country in which partnership was organized (even if Sec. 7704(c) exemption applies, i.e., 90% or more of gross income is passive).
 - Treated as such if would be treated as a corporation at the time of the acquisition or anytime after if pursuant to a plan (deemed plan for 2 years after acquisition).
 - Then, tested under Sec. 7874 for required stock ownership percentage.
 - If between 60 – 79%, treated as partnership with inversion gain rule.
 - If $\geq 80\%$, foreign partnership considered a domestic corporation.

The Final -2 Reg (Surrogate Foreign Corporation)

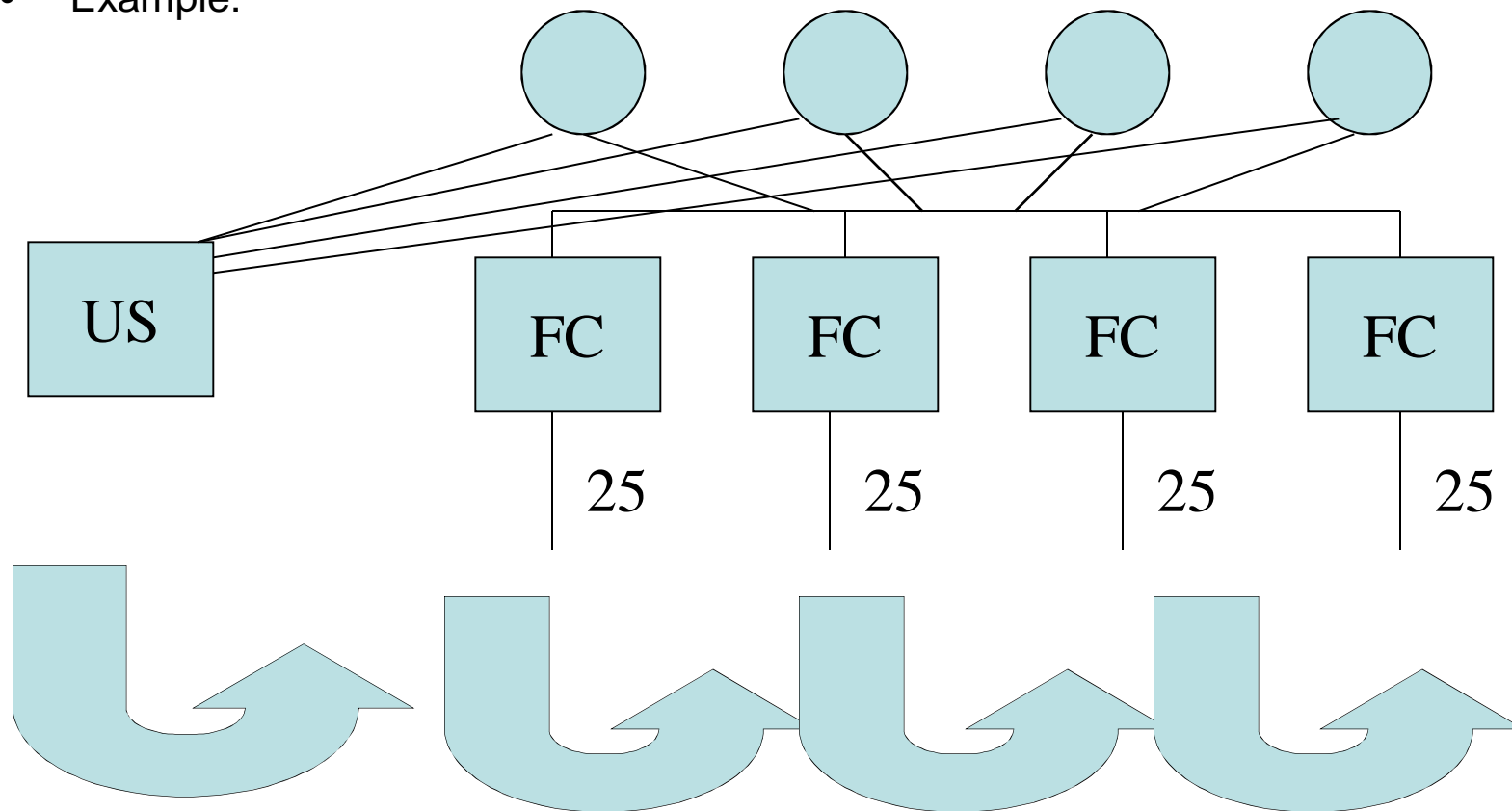
- Substantial business activities (in country of incorporation)
 - Facts and circumstances test (in relation to total business activities of EAG),
 - Nonexclusive list:
 - EAG's local employees, property and sales in that country.
 - EAG's historic continuous business presence.
 - Substantial management activities.
 - Substantial ownership by resident investors.
 - Business activities that are material to achievement of business objectives of EAG.
 - No minimum percentage requirements.
 - Certain factors not considered:
 - Transfers disregarded under Sec. 7874(c)(4).
 - Assets, activities, employees with principal purpose of avoiding Sec. 7874.
 - Problem: Substantial business activities spread across multiple jurisdictions, e.g., within the EU, but with headquarters established in one country, e.g., Netherlands or Luxembourg, would result in failure to meet the substantial business activities test.

The Final -2 Reg (Surrogate Foreign Corporation)

- Prior safe harbor tests (similar to treaties) were eliminated (10% employees by headcount and compensation; 10% value of tangible assets; 10% sales (gross receipts)).
- Prior examples were eliminated.

The Final -2 Reg (Surrogate Foreign Corporation)

- Acquisition of a domestic corporation by multiple foreign corporations.
- Example:

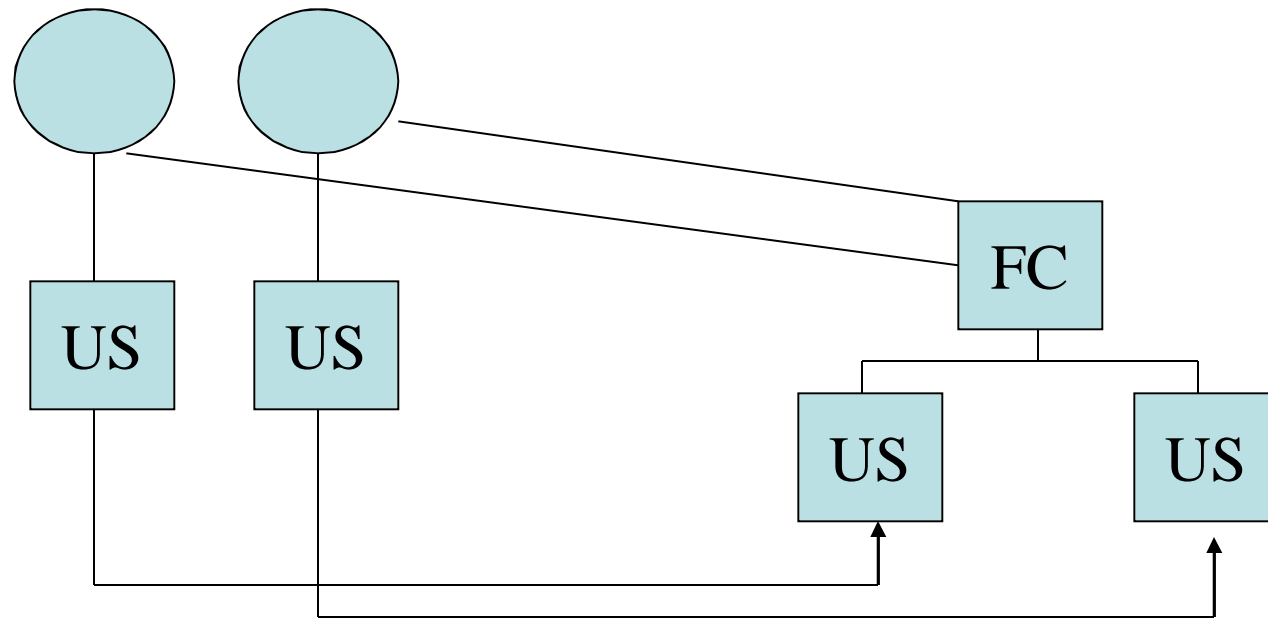


The Final -2 Reg (Surrogate Foreign Corporation)

- Each foreign corporation is treated as surrogate foreign corporation if done pursuant to overall plan.
- Can't claim that each, separately, has not acquired "substantially all" of the properties of the U.S. target.

The Final -2 Reg (Surrogate Foreign Corporation)

- Acquisition by a single foreign corporation of multiple domestic entities.
- Example:



The Final -2 Reg (Surrogate Foreign Corporation)

- Treated as the acquisition of a single entity if pursuant to a plan.
- Can't argue that the ownership percentage is computed separately with respect to each domestic corp.

The Final -2 Reg (Surrogate Foreign Corporation)

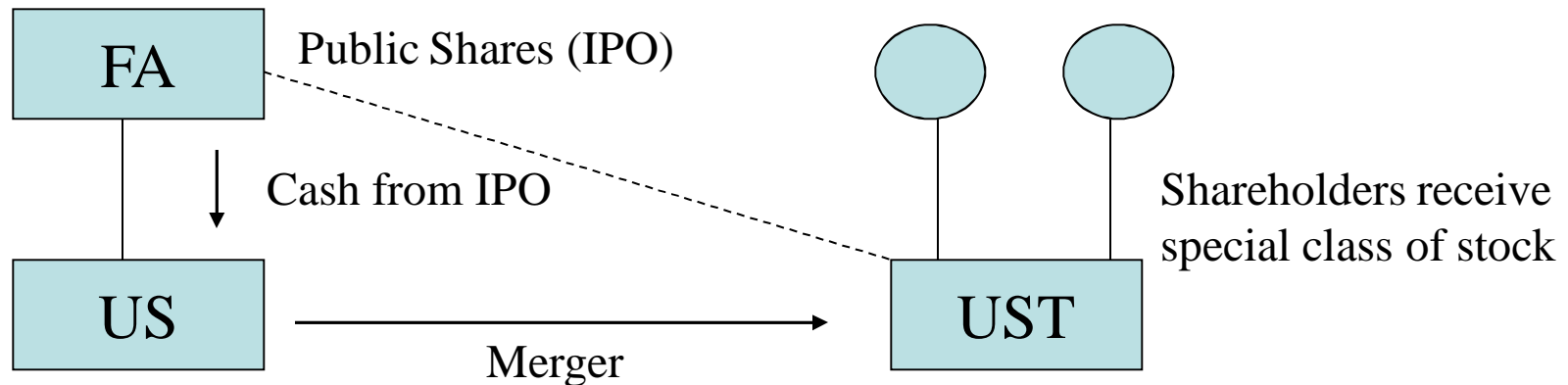
- Options and similar interests
 - Option with respect to a domestic corp. treated as stock with value equal to holder's claim on the equity of the corp. immediately before the acquisition (excluding amount of any property the holder would be required to provide on exercise thereof).
 - Option with respect to a foreign corp. treated as stock of the foreign corp. with value equal to holder's claim on equity of the corp. immediately after the acquisition.
 - Similar interests include warrants, convertible debt, etc.

The Final -2 Reg (Surrogate Foreign Corporation)

- Interests treated as stock of a foreign corporation
 - If an interest (not otherwise treated as stock of a foreign corporation) provides distribution rights substantially similar to those provided by stock in the foreign corporation, and treating this interest as stock in a foreign corporation has effect of treating the foreign corporation as a surrogate foreign corporation, then such interest is treated as stock in the foreign corporation.

The Final -2 Reg (Surrogate Foreign Corporation)

- Example: Newly formed publicly traded corporation acquires stock of a domestic target. U.S. shareholders receive special class of stock in the U.S. target. Special class provides for dividend distributions similar to distributions made to shareholders of foreign corp. Also provides for mandatory redemption features. Only asset of FA is UST. Treated as if shareholders of the U.S. corp. are shareholders of the foreign corp.



The Final -2 Reg (Surrogate Foreign Corporation)

- In Title 11 or insolvency, creditors treated as shareholders of U.S. target company who receive stock in the foreign corporation “by reason of holding stock in the domestic corporation”.

H.R. 2937 (June 28, 2007) – Neal Bill

- Management and administrative activities (including location of corporate headquarters) would not be taken into account regarding “substantial business activities” in the foreign country.
 - Includes both corporate management and management activities relating to operational units.
- See facts and circumstances test of -2T regs.

Further Corporate Expatriations

- New round – from Bermuda to Ireland or Switzerland
 - Foster Wheeler Ltd. (Switzerland).
 - Tyco International Ltd. (Switzerland).
 - Covidien Ltd. (Ireland).
 - Others
- Relatively little adverse tax consequences in U.S.
 - Sec. 7874 not implicated since already in foreign sphere.
 - Tax free non-recognition transaction for the corporation.
 - For 5% U.S. shareholders, gain recognition agreements.
 - For foreign shareholders, no tax unless ETB or present in U.S. for 183 days.
 - No FIRPTA since its stock of foreign corporation.
 - Possibly qualify for 15% dividend rate going forward if received from “qualified foreign corporation” (if treaty available and not a PFIC).

Further Corporate Expatriations

- Advantages

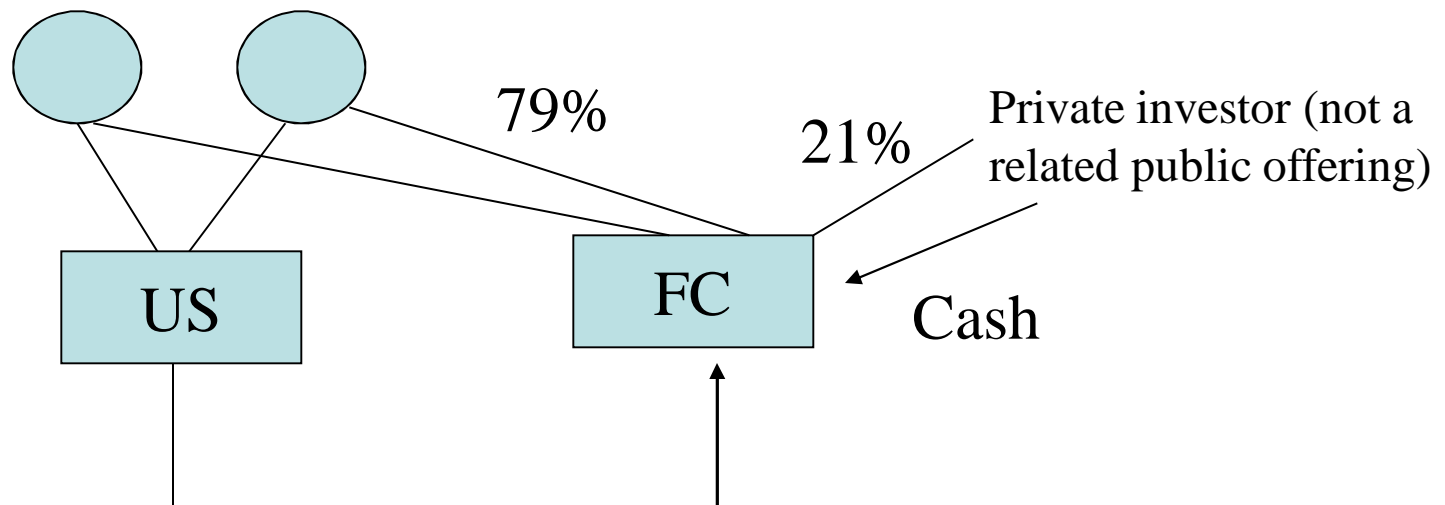
- Concern about treaty availability and Congressional bills to provide “super LOB”.
- Political and tax stability and infrastructure.
- Moving principal executive officers and management headquarters.
 - “Substantial Presence” requirements of treaties for publicly traded exception to LOB.
 - Concern regarding “management and control” issue in U.S. for foreign corporations.

Notice 2009-78

- Under Sec. 7874(c)(2), stock of the foreign corporation sold in a public offering related to the acquisition / inversion, is not taken into account in determining whether threshold stock tests are met.
 - Negative implication is that stock issued in a private placement is taken into account in determining stock ownership.
- Alleged abuse: transfers of cash or other property to the foreign corporation in order to dilute ownership of former U.S. target shareholders in the foreign acquiring corporation.

Notice 2009-78

- Example: Shareholders of U.S. target transfer shares to foreign corporation for 79% of the stock and an investor transfers cash for 21%.
 - Expectation of parties is that cash transfer is counted in the denominator (because not sold in a public offering) and not disregarded as part of a plan to avoid Sec. 7874.
 - Notice 2009-78 appears in conflict with the statute and the legislative history.



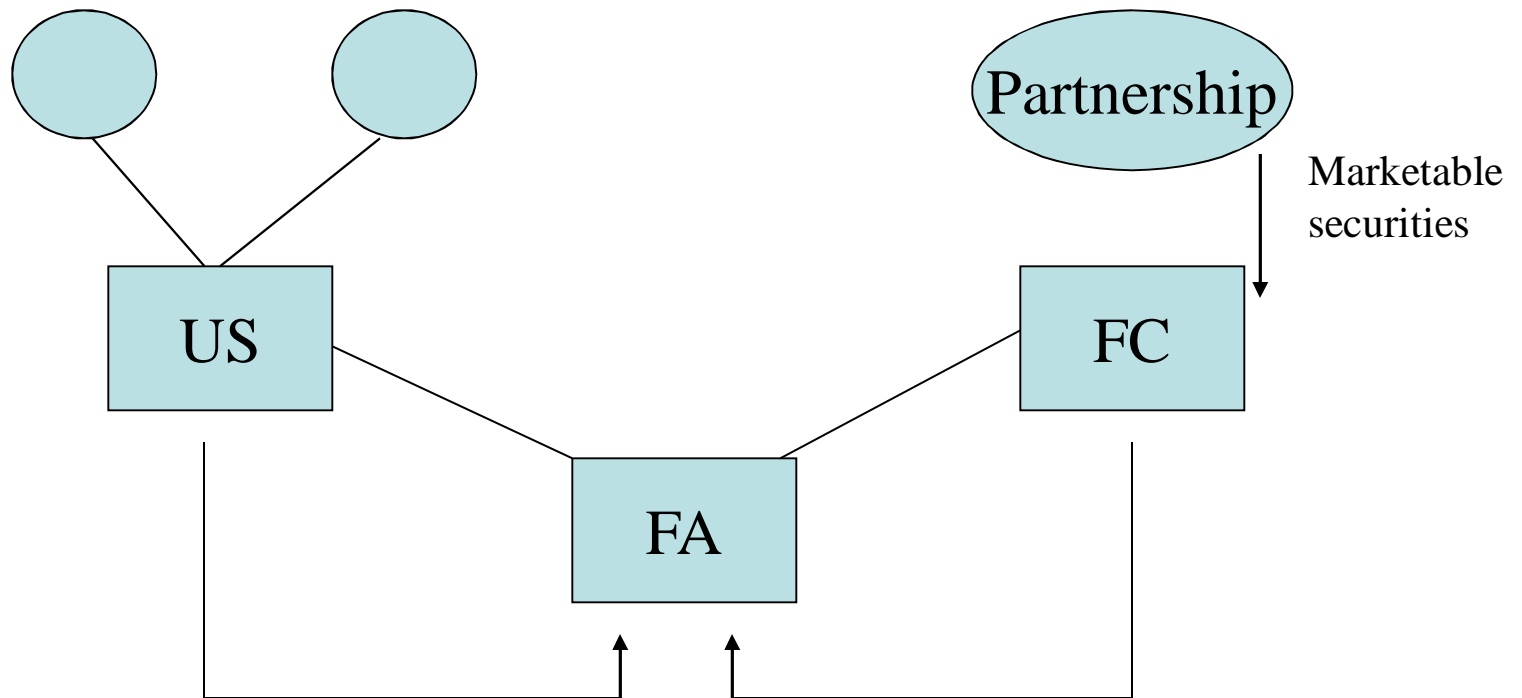
Notice 2009-78

- Area of concern: shareholders of publicly traded foreign corporation and publicly traded U.S. corporation exchange shares for shares of an acquiring foreign corporation.
 - Concern that stock issued to foreign shareholders could be treated as “sold in a public offering”, leaving U.S. shareholders as owning 100%, with inversion.
- IRS response
 - Stock of the foreign corporation issued in exchange for “nonqualified property” in a related transaction is not taken into account for purposes of the threshold stock amounts.
 - Nonqualified property means cash or cash equivalents, marketable securities and any other property acquired in a transaction the principal purpose of which is to avoid the purposes of Sec. 7874.
 - Stock or a partnership interest issued by a member of the EAG that after the acquisition includes the foreign acquiring corporation is not considered nonqualified property unless tax avoidance purpose.

Notice 2009-78

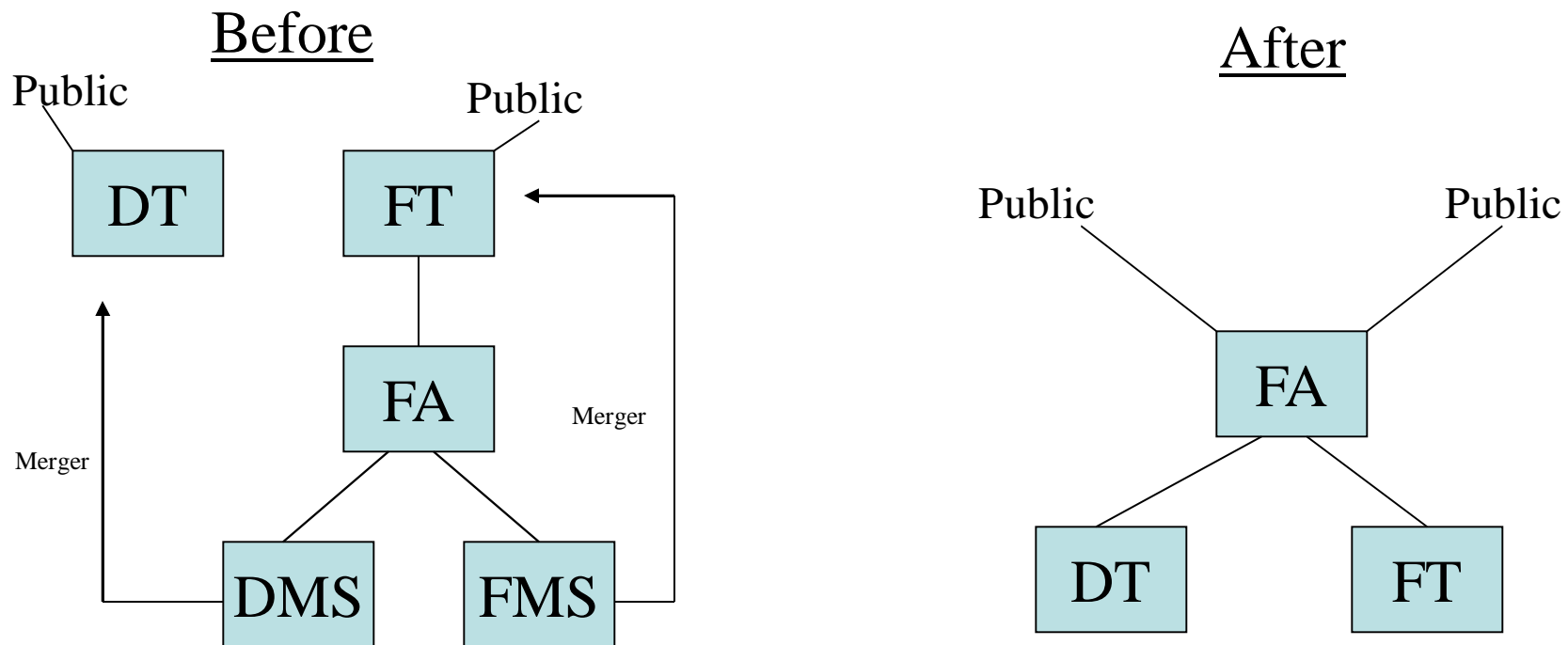
- Example: Individual transfers U.S. stock to foreign corporation in exchange for shares of foreign corporation. In a related transaction, a partnership also transfers marketable securities to the foreign corporation in exchange for stock.
 - The foreign corporation's stock issued to the domestic partnership is not counted resulting in an inversion (assuming no substantial activities). See page 28 diagram.
- Example: In a related transaction, a partnership transfers marketable securities to a newly formed foreign corporation whose stock is then transferred to the foreign acquiring corporation.
 - The foreign acquiring corporation's stock issued to the partnership in exchange for the stock of the newly formed target foreign corporation is not counted because the principal purpose is the avoidance of the purposes of Sec. 7874.

Notice 2009-78



Notice 2009-78

- Example: FT, publicly traded, forms FA. FA forms DMS and FMS. FMS merges into FT with FT surviving. FT shareholders exchange FT stock for FA stock. Then DMS merges into DT, publicly traded, with DT surviving. DT shareholders exchange stock of DT for FA stock. At the end of the day, FA owns FT and DT.



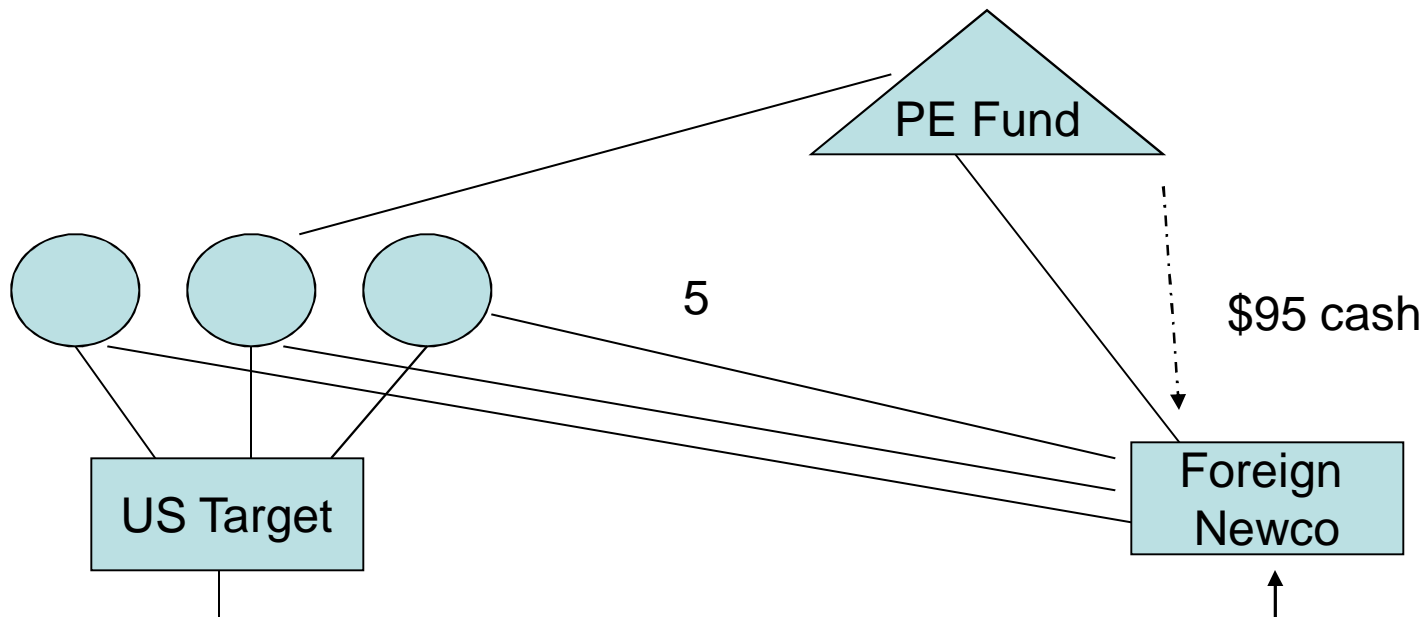
•After the FMS/FT merger, FT is a member of the EAG that includes FA. Therefore, the shares of FT stock are not treated as marketable securities and are not “nonqualified property”. Thus, FA stock issued for FT stock is taken into account for purposes of the threshold stock ownership tests.

Notice 2009-78

- If, instead, FT merges into FA with FA surviving. FT does not hold nonqualified property. FT shareholders exchange FT stock for FA stock. Because properties transferred by FT to FA are not nonqualified property, the FA stock issued will be taken into account.

Notice 2009-78

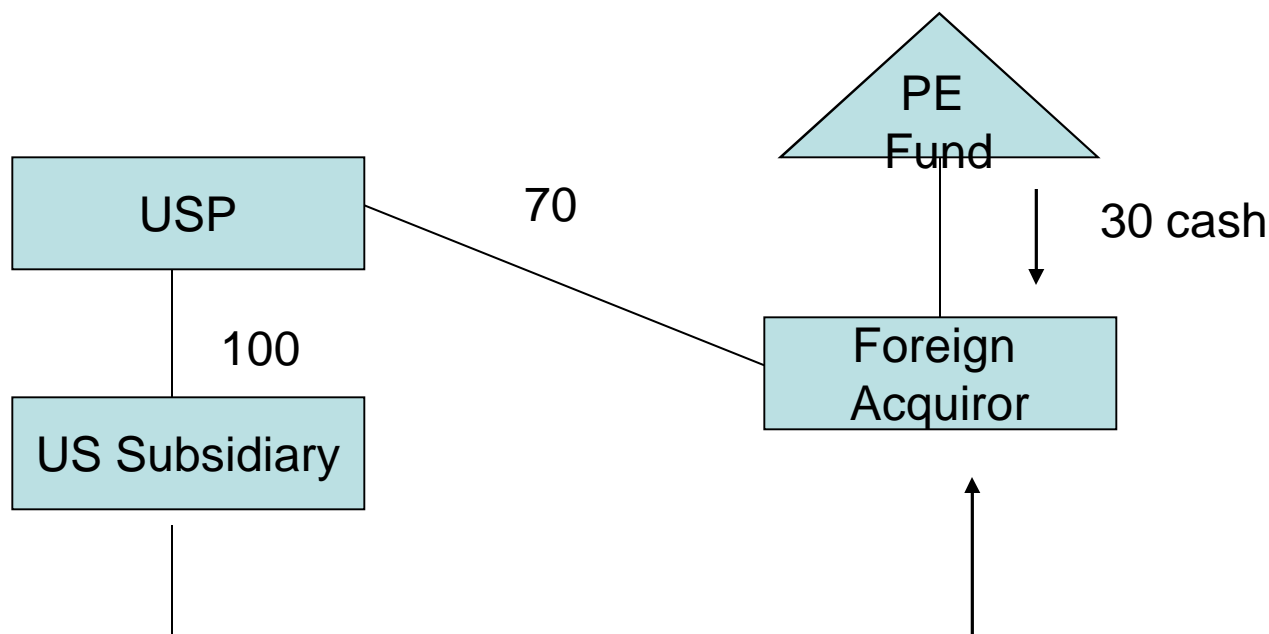
- Variations on the theme:



- PE Fund forms Foreign Newco funding it with \$95 cash
- Foreign Newco acquires shares of U.S. Target for \$95 plus 5 shares of Foreign Newco stock.
- Under Notice 2009-78, cash not taken into account.
- Result: Both numerator and denominator = 5, or 100%..
- Results in Sec. 7874 corporate inversion
- Analysis: Should this be a purchase or a Sec. 7874 inversion?
- Does it depend on whether T is related or unrelated?
- What if, pre-acquisition, US Target borrows \$95 and distributes to shareholders and then Foreign Newco acquires U.S. target for 5 shares?

Notice 2009-78

- Variations on the theme:



- P transfers US Subsidiary to Foreign Acquiror for 70% stock of Foreign Acquisition and PE Fund puts in \$30 cash?
- Interaction and coordination with EAG rule:
 - If disregard \$30, does internal restructuring rule come to the rescue?
- Notice 2009-78 provides that the rules described in the Notice are not intended to affect the application of Section 7874(c)(2)(A), Treas. Reg. § 1.7874-1 or Section 7874(c)(4).
 - What does this mean?