Initial analysis of regulations addressing inversions

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KPMG report: Initial analysis of regulations addressing “inversions”

The Treasury Department and IRS on April 4, 2016, released final and temporary regulations addressing certain “inversions”—the generic term for a domestic corporation’s adoption of a foreign-parented corporate structure—and certain post-inversion restructuring transactions.

These regulations primarily address matters described in Notice 2014-52 [PDF 119 KB] and Notice 2015-79 [PDF 85 KB] or “the Notices”) by providing detailed rules regarding the application of the matters described therein.

The regulations also include new anti-inversion rules regarding:

- Identifying a “Foreign Acquiring” when a “Domestic Entity Acquisition” (each as defined below) is effected through multiple steps
- Disregarding Foreign Acquiring stock attributable to certain prior Domestic Entity Acquisitions
- Requiring a CFC (as defined below) to recognize gain upon the transfer of assets to certain foreign affiliates
- Clarifying the application of certain aspects of the SBA Exception (as defined below)

Finally, the regulations include provisions regarding the application of the short-term liquidity exception to section 956 to certain post-inversion related-party loans.

The regulations, which total over 200 pages in length, were issued in connection with proposed regulations under section 385 regarding the treatment of certain related-party corporate interests as debt or equity for U.S. federal income tax purposes and, together, mark the Treasury Department’s and the IRS’s most comprehensive anti-inversion measures to date.

I. Background

Section 7874 applies to the direct or indirect acquisition by a foreign corporation (the “Foreign Acquiring”) of substantially all of either (i) the properties directly or indirectly held by a domestic corporation or (ii) the properties of a trade or business of a domestic partnership (such corporation or partnership, the “Domestic Entity” and such acquisition, the “Domestic Entity Acquisition”), in each case, if:

- Immediately after the Domestic Entity Acquisition, the former Domestic
Entity shareholders or partners, as applicable, have a certain percentage of continued ownership (by vote or value) in the Foreign Acquiring by reason of owning their interests in the Domestic Entity (if expressed as a fraction, the “Ownership Fraction,” and if expressed as a percentage, the “Ownership Percentage”); and

- The Foreign Acquiring's expanded affiliated group (“EAG”) does not have substantial business activities in the Foreign Acquiring’s country of creation or organization as compared to the EAG’s worldwide business activities (the “SBA Exception”); an EAG is generally defined as a section 1504(a) affiliated group determined (i) without regard to the section 1504(b)(3)’s prohibition on the inclusion of foreign corporations in the group, and (ii) by reducing the applicable ownership requirement from at least 80%, as measured by vote and value, to more than 50%, as measured by vote and value.

If the Ownership Percentage is at least 80%, section 7874 considers the Foreign Acquiring a “surrogate foreign corporation” that is treated as a domestic corporation for all purposes of the Internal Revenue Code—i.e., section 7874 essentially prevents an inversion from occurring for U.S. federal income tax purposes.

If, however, the Ownership Percentage is at least 60% but less than 80%, section 7874 considers the Foreign Acquiring a surrogate foreign corporation that is respected as a foreign corporation for U.S. federal income tax purposes, but the Domestic Entity and certain related U.S. persons are considered “Expatriated Entities” and, as a result, are limited in using losses and other U.S. federal income tax attributes with respect to income or gain recognized on certain property transfers and licenses during the inversion and the following 10 years (such income or gain, the “Inversion Gain” and such period, the “Applicable Period”).

II. Regulations Addressing Certain Transactions Structured to Avoid the Purposes of Section 7874

a. Multiple-Step Acquisition of Domestic Entity Property

The acquisition of stock of a foreign corporation that directly or indirectly owns stock of a domestic corporation or domestic partnership generally does not constitute an indirect acquisition of any properties held by the domestic corporation or domestic partnership. The new regulations in Treas. Reg. § 1.7874-2T(c)(4), however, include an exception to this rule that generally provides that when (i) a foreign corporation (the “Initial Acquiring Corporation”) directly or indirectly acquires substantially all of the properties held directly or indirectly by the Domestic Entity (the “Initial Acquisition”), and (ii) pursuant to the same plan or series or related transactions as the Initial Acquisition, a foreign corporation (the “Subsequent Acquiring Corporation”) directly or indirectly acquires substantially all of the properties held directly or indirectly by the Initial Acquiring Corporation (the
“Subsequent Acquisition”), then the Subsequent Acquisition is treated as a Domestic Entity Acquisition and the Subsequent Acquiring Corporation is treated as the Foreign Acquiring.

For purposes of determining if section 7874 applies to the Subsequent Acquisition, stock of the Subsequent Acquiring Corporation received by shareholders of the Initial Acquiring Corporation in the Subsequent Acquisition by reason of holding stock in the Initial Acquiring Corporation is treated as held by reason of holding stock or partnership interests in the Domestic Entity, but only to the extent such Initial Acquiring Corporation stock was held by reason of holding stock or partnership interests in the Domestic Entity.

If there is more than one Subsequent Acquisition (i.e., another foreign corporation directly or indirectly acquires, pursuant to the same plan or series of related transactions as the Subsequent Acquisition, substantially all the properties held directly or indirectly by the Subsequent Acquiring Corporation), the rules of Treas. Reg. § 1.7874-2T apply to each of the acquisitions.

The rules in Treas. Reg. § 1.7874-2T do not affect the potential application of section 7874 to the Initial Acquisition (i.e., in determining whether section 7874 applies to the Initial Acquisition, the Subsequent Acquisition and all related transactions after the Subsequent Acquisition are not taken into account). Furthermore, if the Subsequent Acquiring Corporation is a surrogate foreign corporation that is respected as a foreign corporation for federal income tax purposes, the Applicable Period begins on the first date that properties were acquired as part of the Initial Acquisition. Determinations relating to whether or not a Subsequent Acquisition has occurred are made by reference to the rules applicable to determining whether a Domestic Entity Acquisition has occurred.


**KPMG observation**

The rules of Treas. Reg. § 1.7874-2T were not contemplated by the Notices or other prior guidance and are intended to address concerns that Subsequent Acquisitions are not Domestic Entity Acquisitions, even though the Treasury Department and the IRS believe that Subsequent Acquisitions raise the same policy concerns that motivated Congress to enact section 7874. The Treasury Department and the IRS specifically identified possible abuses of the SBA Exception (e.g., where the Initial Acquisition satisfies the SBA Exception, but the Subsequent Acquisition does not) and the Third-Country Rule (e.g., where the Initial Acquiring Corporation and the Subsequent Acquiring Corporation are not tax residents of the same country) as reasons for these new rules—the Third-Country Rule is discussed below in detail.
b. Calculation of the Ownership Percentage
   i. Clarifying the Rules Regarding Disqualified Foreign Acquiring Stock

Treas. Reg. § 1.7874-4T, subject to a de minimis rule, generally provides that Foreign Acquiring stock is “Disqualified Stock” and, thus, disregarded from the Ownership Fraction, to the extent it is transferred in exchange for “nonqualified property” in a transaction related to a Domestic Entity Acquisition. Nonqualified property is defined to include several specified types of passive assets—e.g., cash and marketable securities—and any property acquired with a principal purpose of avoiding the purposes of section 7874 (“Avoidance Property”). Additionally, section 7874(c)(4) provides that a transfer of properties or liabilities (including by contribution and distribution) is disregarded if it is part of a plan the principal purpose of which is to avoid the purposes of section 7874.

The new regulations in Treas. Reg. § 1.7874-4T(i) and (j), as announced in the 2015 Notice, clarify Treas. Reg. § 1.7874-4T to address concerns that taxpayers were inappropriately interpreting Avoidance Property to be limited to property used to indirectly transfer specified types of nonqualified property to the Foreign Acquiring. The new regulations, to this end, provide that Avoidance Property can be any type of property and is not limited to property used to indirectly transfer specified types of nonqualified property to the Foreign Acquiring. The clarifications are illustrated by an example included in the 2015 Notice that provides the Foreign Acquiring stock issued in exchange for business assets is disregarded as Disqualified Stock where the Foreign Acquiring acquired the assets with a principal purpose of avoiding the purposes of section 7874.

The new regulations also make several conforming changes to the Treas. Reg. § 1.7874-4T de minimis rule to account for new rules regarding the Foreign Acquiring stock issued in exchange for “Foreign Group Nonqualified Property” and so-called “non-ordinary course distributions” (“NOCDs”), each as discussed below.

The regulations clarifying the application of Treas. Reg. § 1.7874-4T generally apply to Domestic Entity Acquisitions completed on or after November 19, 2015. The conforming changes to the de minimis rule, however, apply to Domestic Entity Acquisitions completed on or after April 4, 2016, but taxpayers can elect to apply the changes to Domestic Entity Acquisitions completed on or after September 22, 2014, and before April 4, 2016.

KPMG observation

The new regulations’ clarifications to Treas. Reg. § 1.7874-4T are consistent with the rules described in the 2015 Notice. Section 7874(c)(4), as noted above, provides that a transfer of properties or liabilities is disregarded if the transfer is part of a plan that has a principal purpose to avoid the purposes of section 7874.
Accordingly, it appears that section 7874(c)(4) could have applied to disregard the contribution of Avoidance Property to the Foreign Acquiring irrespective of whether such property indirectly transferred specified nonqualified property to the Foreign Acquiring.

ii. Disregarding Foreign Acquiring Stock Attributable to Excessive Passive Assets

Prior to the 2014 Notice, certain inversions were effected through a domestic corporation's combination with a foreign corporation, the primary assets of which were cash or other liquid assets. The basic effect of these so-called “cash-box inversions” was that the domestic corporation inverted with minimal disruption to its business activities and the shareholder of the foreign cash-box received a premium for serving as an inversion vehicle. The 2014 Notice announced regulations would be issued to limit the ability of domestic corporations to invert through a combination with a foreign cash-box by disregarding the Foreign Acquiring stock for purposes of the Ownership Fraction to the extent it is attributable to Foreign Group Nonqualified Property. The 2015 Notice made certain modifications to the 2014 Notice’s Foreign Group Nonqualified Property definition to address several comments received by the Treasury Department and the IRS regarding the excessive passive asset rules’ inappropriate application to certain insurance companies.

Treas. Reg. § 1.7874-7T generally follows the 2014 Notice’s excessive passive asset rules, as modified by the 2015 Notice. In particular, the new regulations provide a general rule that if on the date the Domestic Entity Acquisition and all related transactions are completed, more than 50% of the gross value of all “Foreign Group Property” is Foreign Group Nonqualified Property, then the Foreign Acquiring stock is excluded from the Ownership Fraction denominator in an amount equal to (i) the value of the Foreign Acquiring stock (not including the Foreign Acquiring stock received by reason of the Domestic Entity stock or partnership interests (as applicable), stock excluded under section 7874(c)(2)(A) and the related regulations (the “EAG Rules”), and Disqualified Stock), multiplied by (ii) the “Foreign Group Nonqualified Property Fraction” (generally the ratio of the Foreign Group Nonqualified Property to the Foreign Group Property, in each case, not taking into account property that gives rise to Disqualified Stock). Foreign Group Property is generally defined as any property held by the “Modified Expanded Affiliated Group” other than property directly or indirectly acquired in the Domestic Entity Acquisition and, to avoid double-counting, stock or an interest in or an obligation of a Modified Expanded Affiliated Group member.

The Modified Expanded Affiliated Group with respect to a Domestic Entity Acquisition is the EAG, if the Foreign Acquiring common parent of the EAG, or if the Foreign Acquiring is not the common parent of the EAG, the EAG determined as if the Foreign Acquiring was the common parent—i.e., upstream affiliates are not part of a lower-tier Foreign Acquiring’s Modified Expanded Affiliated Group.
In addition, Foreign Group Nonqualified Property generally is Foreign Group Property described as nonqualified property for purposes of Treas. Reg. § 1.7874-4T. Foreign Acquiring stock disregarded under Treas. Reg. § 1.7874-7T, consistent with the 2014 Notice, is taken into account for purposes of applying the EAG Rules, although the EAG Rules cannot add back to the Ownership Fraction denominator stock disregarded under Treas. Reg. § 1.7874-7T.

Treas. Reg. § 1.7874-7T’s excessive passive asset rules, as detailed above, aim to (i) identify when the Foreign Acquiring has a relatively large amount of passive assets (i.e., a Foreign Acquiring with a Foreign Group Nonqualified Property Fraction greater than 50%), and (ii) disregard for purposes of the Ownership Fraction an amount of the Foreign Acquiring’s pre-inversion value directly or indirectly attributable to such property. In this regard, it should be noted that the new regulations introduce the Modified Expanded Affiliated Group concept to ensure that only assets directly or indirectly owned by the Foreign Acquiring are taken into account—i.e., property owned by the Foreign Acquiring’s parent corporation is not considered notwithstanding that both corporations are in the same EAG; the Modified Expanded Affiliated Group rules also include provisions regarding the treatment of certain partnerships as members of the group.

The new temporary regulations also add a de minimis rule that provides Treas. Reg. § 1.7874-7T’s excessive passive asset rules do not apply if (i) the former Domestic Entity shareholders or partners, as applicable, own less than 5% of the Foreign Acquiring (by vote and value) by reason of owning stock or partnership interests in the Domestic Entity (determined without regard the application of the Disqualified Stock rules of Treas. Reg. § 1.7874-4T(b), and the NOCD rules (discussed in detail below)), and (ii) after the Domestic Entity Acquisition and all related transactions are completed, the former Domestic Entity shareholders or partners, as applicable, own, in the aggregate (applying the section 318 attribution rules, as modified by section 304(c)(3)(B)), less than 5% of the stock or partnership interest in any Foreign Acquiring EAG member (as measured by vote and value).

Treas. Reg. § 1.7874-7T generally applies to Domestic Entity Acquisitions completed on or after September 22, 2012. The de minimis rule and the Modified Expanded Affiliated Group rules, however, apply to Domestic Entity Acquisitions completed on or after April 4, 2016, though taxpayers that completed Domestic Entity Acquisitions on or after September 22, 2014, and before April 4, 2016, can elect to apply either of these rules. Treas. Reg. § 1.7874-7T expires on April 4, 2019.

iii. Disregarding Foreign Acquiring Stock in Serial Inversions

In the case of multiple Domestic Entity Acquisitions by the same Foreign Acquiring, the determination of whether or not section 7874 applies to the acquisitions is generally made on an acquisition-by-acquisition basis unless such
acquisitions occur pursuant to the same plan, in which case such acquisitions are treated as a single Domestic Entity Acquisition. The new temporary regulations in Treas. Reg. § 1.7874-8T apply to disregard certain stock of the Foreign Acquiring received in the Domestic Entity Acquisition (the “Relevant Domestic Entity Acquisition”) for purposes of computing the Ownership Percentage where the Foreign Acquiring (including a predecessor) has completed one or more prior Domestic Entity Acquisitions (each, a “Prior Domestic Entity Acquisition”), regardless of whether such acquisitions were pursuant to the same plan.

The new regulations define a Prior Domestic Entity Acquisition as a Domestic Entity Acquisition that occurs within the 36-month period ending on the first date on which the contract to effect the Relevant Domestic Entity Acquisition is a “binding contract” (i.e., when the contract becomes enforceable under the applicable law against the parties). Note that there is a de minimis exception to this definition where (i) the Ownership Percentage in the Prior Domestic Entity Acquisition was less than 5%, and (ii) the fair market value of the stock of the Foreign Acquiring held by the former shareholders or partners of the Domestic Entity by reason of their Domestic Entity stock or partnership interests, as applicable, is less than $50 million.

Where there has been a Prior Domestic Entity Acquisition, stock of the Foreign Acquiring is excluded (the “Excluded Amount”) from the denominator of the Ownership Fraction for purposes of determining the Ownership Percentage (by value, not vote) in the Relevant Domestic Entity Acquisition based on the current value of the Foreign Acquiring shares that were issued in the Prior Domestic Entity Acquisition (adjusted to take into account intervening stock redemptions, stock splits, stock distributions, recapitalizations, and similar transactions). The Excluded Amount is calculated separately for each Prior Domestic Entity Acquisition and each legal class of shares in the Foreign Acquiring held by former shareholders or partners of the Domestic Entity in such Prior Domestic Entity Acquisition by reason of their ownership of such Domestic Entity (the “Prior Acquisition Shares”). The Excluded Amount for each legal class of shares is generally the product of the total number of Prior Acquisition Shares (adjusted to account for certain redemptions and other capital structure changes mentioned above) and the fair market value of a single share of the relevant legal class of shares on the date the Relevant Domestic Entity Acquisition and all related transactions are completed.

Treas. Reg. § 1.7874-8T generally applies to Domestic Entity Acquisitions completed on or after April 4, 2016, without regard to when a Prior Domestic Entity Acquisition was completed. Treas. Reg. § 1.7874-8T expires on April 4, 2019.

KPMG observation

Treas. Reg. § 1.7874-8T was not contemplated by the Notices or other prior
guidance and is aimed at reducing the potential for a Foreign Acquiring to complete multiple Domestic Entity Acquisitions in a relative short period of time without being subject to the existing rules relating to acquisitions of multiple Domestic Entities pursuant to the same plan (i.e., serial inversions). These regulations limit the ability for the Foreign Acquiring to increase its size in relation to a new potential Domestic Entity through other Domestic Entity Acquisitions that were not carried out pursuant to the same plan. While including a de minimis exception, the broad application of this rule could reach more than serial inversion transactions—indeed, a Prior Domestic Entity Acquisition does not have to result in an Ownership Percentage of at least 60%—and, thus, taxpayers considering a Domestic Entity Acquisition should consider the regulations’ effect on the Ownership Fraction as a result of prior acquisitions of U.S. businesses by the Foreign Acquiring before entering into a binding agreement to make the Domestic Entity Acquisition.

iv. Third-Country Transactions

Prior to the 2015 Notice and the new regulations, when an inversion was effected through the Foreign Acquiring’s acquisition of the Domestic Entity and the stock or property of another foreign corporation, the Foreign Acquiring stock owned by the former shareholders of the other foreign corporation by reason of owning their foreign corporation stock was generally included in the Ownership Fraction denominator (i.e., it reduced the Ownership Percentage). This was the case irrespective of whether the other foreign corporation and the Foreign Acquiring were tax residents of the same foreign country.

The new regulations in Treas. Reg. § 1.7874-9T provide that if a Domestic Entity Acquisition is a “Third Country Transaction,” stock of the Foreign Acquiring held by reason of holding “Acquired Foreign Corporation” stock that would otherwise be included in the Ownership Fraction is excluded from the denominator of the Ownership Fraction—i.e., the Ownership Percentage is increased. A Domestic Entity Acquisition is a Third Country Transaction if (i) Foreign Acquiring completes a “Covered Foreign Acquisition” (as defined below) pursuant to a plan or series of related transactions that includes the Domestic Entity Acquisition, (ii) after the Covered Foreign Acquisition and all related transactions, Foreign Acquiring is not subject to tax as a resident in the foreign country in which the Acquired Foreign Corporation was subject to tax as a resident before the Covered Foreign Acquisition and all related transactions, and (iii) the Ownership Percentage is at least 60% (determined without regard to the rules of Treas. Reg. § 1.7874-9T(b)). Note that a change in the country of tax residence (e.g., through a change of place of management) is treated as a transaction; thus, any such change in anticipation of a Covered Foreign Acquisition is a related transaction and the tax residency of the Acquired Foreign Corporation prior to such tax residency change is the relevant jurisdiction for this test.

An Acquired Foreign Corporation is a foreign corporation that is acquired in a
transaction in which the Foreign Acquiring directly or indirectly acquires substantially all of the properties held directly or indirectly by an Acquired Foreign Corporation (“Foreign Acquisition”). A Covered Foreign Acquisition means a Foreign Acquisition in which, following the Foreign Acquisition and all related transactions (but not the Domestic Entity Acquisition), the former shareholders of the Acquired Foreign Corporation own at least 60% (by vote or value) of the Foreign Acquiring.

If the Foreign Acquiring completes, pursuant to a plan or series of related transactions, Foreign Acquisitions of multiple Acquired Foreign Corporations that are subject to tax as residents of the same foreign country before the Foreign Acquisitions and all related transactions, such Acquired Foreign Corporations are treated as a single corporation acquired in a single Foreign Acquisition.

Determinations relating to whether a Foreign Acquisition has occurred and whether stock of the Foreign Acquiring is held by reason of holding stock in an Acquired Foreign Corporation are made by reference to the rules applicable to making such determinations in the context of a Domestic Entity Acquisition. Similarly, with certain exceptions, the rules for determining the Ownership Percentage apply in determining the percentage ownership of the Foreign Acquiring held by the former shareholders of the Acquired Foreign Corporation.

The rules of Treas. Reg. § 1.7874-9T are substantially similar to the rules described in the 2015 Notice. Treas. Reg. § 1.7874-9T, however, defines a Covered Foreign Acquisition by reference to the percentage ownership of the Foreign Acquiring held by the former shareholders of the Acquired Foreign Corporation. In contrast, the 2015 Notice defined a similar condition, but with reference to the gross value of the assets acquired in the Foreign Acquisition as compared to the gross value of all of the Foreign Acquiring’s Foreign Group Property, excluding Foreign Group Nonqualified Property. Additionally, where Treas. Reg. § 1.7874-9T states as a condition that Foreign Acquiring not be subject to tax as a resident in the foreign country in which the Acquired Foreign Corporation was subject to tax as a resident before the Covered Foreign Acquisition and all related transactions, the 2015 Notice instead articulated a condition that the tax residence of the Foreign Acquiring is not the same as that of the Acquired Foreign Corporation as determined before the Foreign Acquisition and any related transaction.

Treas. Reg. § 1.7874-9T generally applies to Domestic Entity Acquisitions completed on or after November 19, 2015. However, for Domestic Entity Acquisitions completed on or after November 19, 2015, and before April 4, 2016, taxpayers may elect to define a Covered Foreign Acquisition by reference to the gross value of the assets acquired in the Foreign Acquisition as compared to the gross value of the Foreign Acquiring’s Foreign Group Property (as defined in Treas. Reg. § 1.7874-7T(f)(1), but substituting “EAG” for “Modified Expanded Affiliated Group”), excluding Foreign Group Nonqualified Property (as defined in
Treas. Reg. § 1.7874-7T(f)(2)—i.e., taxpayers can elect to apply the standard in the 2015 Notice rather than the standard in the regulations. Additionally, for Domestic Entity Acquisitions completed on or after November 19, 2015, but before April 4, 2016, taxpayers may substitute the condition that the Foreign Acquiring is not subject to tax as a resident in the foreign country in which the Acquired Foreign Corporation was subject to tax as a resident before the Covered Foreign Acquisition and all related transactions, with the condition that the tax residence of the Foreign Acquiring is not the same as that of the Acquired Foreign Corporation, as determined before the Foreign Acquisition and any related transaction. Treas. Reg. § 1.7874-9T expires on April 4, 2019.

**KPMG observation**

Inversions have frequently included the formation of a new foreign parent company that is located in a jurisdiction other than the foreign combination partner—i.e., a Third-Country Transaction. While these regulations do not completely prevent the use of a new parent company as the Foreign Acquiring, such new foreign parent company must be a tax resident of the same country as the Acquired Foreign Corporation. Treas. Reg. § 1.7874-9T reflects the Treasury Department’s and the IRS’s position, as stated in the 2015 Notice, that Third-Country Transactions are generally driven by tax planning rather than non-tax business purposes and is intended to limit the effectiveness of a Domestic Entity Acquisition in certain transactions where the Foreign Acquiring is located in a third jurisdiction. It is worth noting that the Third-Country Rules does not include a rebuttable presumption that the move from the jurisdiction in which the Acquired Foreign Corporation is a tax resident is motivated by non-tax business purposes, such as a desire of the combined company to operate in a more advantageous legal or regulatory environment.

**v. NOCDs**

**1. Section 7874**

As contemplated by the 2014 Notice and for purposes of determining the Ownership Percentage (by value, but not by vote), new Treas. Reg. § 1.7874-10T provides that former shareholders or partners of the Domestic Entity are treated as receiving, by reason of holding stock or partnership interests in the Domestic Entity, stock of the Foreign Acquiring (in addition to stock of the Foreign Acquiring actually received by the former shareholders or partners of the Domestic Entity) with a fair market value equal to the amount of NOCDs during the “Look-Back Period.”

The Look-Back Period is generally the 36-month period ending on the date the Domestic Entity Acquisition and are related transactions are completed (but can be shorter if the Domestic Entity was not in existence for the full 36-month period preceding the Domestic Entity Acquisition). Similarly, a “Look-Back Year” generally is one the 12-month periods that comprise the Look-Back Period (e.g., if
the Look-Back Period is 36 months, the three consecutive 12-month periods preceding the Domestic Entity Acquisition are Look-Back Years).

With respect to a Look-Back Year, NOCDs mean the excess of all distributions made during the Look-Back Year over the “NOCD Threshold” for the Look-Back Year. The NOCD Threshold for a Look-Back Year is generally equal to 110% of the sum of all distributions made during the “Distribution History Period” with respect to the Look-Back Year, multiplied by a fraction, the numerator of which is the number of days in the Look-Back Year and the denominator of which is the number of days in the Distribution History Period with respect to the Look-Back Year.

For these purposes, a Distribution History Period means, with respect to each Look-Back Year, the 36-month period preceding the start of the Look-Back Year (but can be shorter if Domestic Target was not formed prior to the 36-month period preceding the Domestic Entity Acquisition). Moreover, where the Domestic Entity was formed less than 12 months before the Look-Back Year, there is no Distribution History Period for that Look-Back Year and, thus, the NOCD Threshold for that Look-Back Year will be zero.

Notably, the rules of Treas. Reg. § 1.7874-10T for determining the Domestic Entity’s NOCDs are premised on months, irrespective of whether such periods cross tax years. The 2014 Notice, in contrast (i) disregarded NOCDs during the 36-month period ending on the date of the Domestic Entity Acquisition (the “Notice Look-Back Period”), and (ii) defined an NOCD as excess of all distributions made during a tax year of the Domestic Entity over 110% of the average of such distributions during the 36-month period immediately preceding such tax year.

Presumably, the approach taken in Treas. Reg. § 1.7874-10T is meant to address the 2014 Notice’s ambiguity with respect to computing the NOCD amount where the Domestic Entity Acquisition was in the middle of the Domestic Entity’s tax year. In these situations, since NOCDs were defined by reference to distributions during a tax year and the Notice Look-Back Period was determined by reference to months, the amount of the Domestic Entity’s NOCDs for the portions of the Notice Look-Back Period that spanned tax years of the Domestic Entity was uncertain where the Domestic Entity made distributions during such tax years both within and without the Notice Look-Back Period (e.g., whether the NOCD amount for one of these years was prorated among all distributions during such year or first allocated to distributions in the Notice Look-Back Period).

Also for these purposes, a “distribution” is defined as (i) any distribution by a corporation with respect to its stock (with specific exceptions), (ii) any distribution by a partnership, (iii) a transfer of money or other property to former shareholders or partners of the Domestic Entity that is made in connection with the Domestic Entity Acquisition to the extent the money or other property was provided directly
or indirectly by the Domestic Entity, and (iv) in the case of a “Predecessor,” a transfer of money or other property that is made in connection with the “Predecessor Acquisition” to the extent the money or other property is directly or indirectly provided by the Predecessor. The new regulations except from the definition of distribution a stock distribution to which section 305 applies, a distribution to which section 304(a)(1) applies, and certain distributions pursuant to section 361(c)(1) not otherwise described as a distribution above; these distributions are excluded because they do not reduce the Domestic Entity’s value.

The rules of Treas. Reg. § 1.7874-10T also apply to distributions made by a Predecessor. A corporation or partnership (a “Tentative Predecessor”) is a Predecessor if (i) a corporation or partnership (the “Relevant Entity”) directly or indirectly acquires directly or indirectly substantially all of the properties held directly or indirectly by the Tentative Predecessor (a “Predecessor Acquisition”), and (ii) after the Predecessor Acquisition and all related transactions, the former shareholders or partners of the Tentative Predecessor hold, by reason of holding stock or partnership interests in the Tentative Predecessor, at least 10% (by value) of the stock or partnership interests of the Relevant Entity. Determinations relating to whether or not a Predecessor Acquisition has occurred and whether or not the former shareholders or partners of the Tentative Predecessor own the relevant 10% (by value) of the stock or partnership interests of the Relevant Entity are made by reference to the rules applicable to making such determinations with respect to a Domestic Entity Acquisition. If, however, the Predecessor directly or indirectly held the stock or partnership interests in another entity before the Predecessor Acquisition and all related transactions, the Relevant Entity is not treated as making a Predecessor Acquisition with respect to such lower-tier entities.

Treas. Reg. § 1.7874-10T also has a special rule relating to the directionality of a distribution under section 355. Specifically, if (i) a corporation (the “Distributing Corporation”) distributes the stock of another corporation (the “Controlled Corporation”) in a distribution qualifying under section 355, and (ii) immediately before the distribution, the fair market value of the Controlled Corporation stock represents more than 50% of the fair market value of the Distributing Corporation stock, then, for purposes of Treas. Reg. § 1.7874-10T, the Controlled Corporation is treated as distributing the stock of the Distributing Corporation. This issue of directionality in a section 355 distribution is something that was not discussed in either of the Notices.

Treas. Reg. § 1.7874-10T also contains a de minimis rule that prevents the regulation from applying if (i) the Ownership Percentage, determined prior to application of the NOCD rules, the Disqualified Stock rules, and rules disregarding the Foreign Acquiring stock attributable to excessive passive assets, is less than 5% (by vote or value), and (ii) on the date the Domestic Entity Acquisition and all related transactions are completed, former shareholders or partners of the
Domestic Entity own, in the aggregate and by reference to the section 318 constructive ownership rules (as modified by section 304(c)(3)(B)), less than 5% (by vote or value) of the stock or partnership interests of each member of Foreign Acquiring’s EAG.

Treas. Reg. § 1.7874-10T also makes clear that even if a distribution (or a portion thereof) does not fall within the definition of a NOCD, section 7874(c)(4) may still apply to the distribution (or portion thereof).

Treas. Reg. § 1.7874-10T generally applies to Domestic Entity Acquisitions completed on or after September 22, 2014. However, the rules in Treas. Reg. § 1.7874-10T relating to the directionality of a section 355 distribution apply to Domestic Entity Acquisitions completed on or after April 4, 2016. The de minimis rule applies to Domestic Entity Acquisitions completed on or after November 19, 2015, but taxpayers may elect to apply such rule to Domestic Entity Acquisitions completed on or after September 22, 2014, and before November 19, 2015. Additionally, for Domestic Entity Acquisitions completed on or after September 22, 2014, and before April 4, 2016, taxpayers may elect to determine the Distribution History Period by reference to tax years instead of 12-month periods. Treas. Reg. § 1.7874-10T expires on April 4, 2019.

**KPMG observation**

The purpose of Treas. Reg. § 1.7874-10T is to prevent the Domestic Entity from distributing assets to its shareholders to reduce the value of the Domestic Entity relative to Foreign Acquiring in an effort to reduce the Ownership Percentage. The net effect of these rules, therefore, is to increase the Ownership Percentage, as determined by value. The rules of Treas. Reg. § 1.7874-10T are generally consistent with the description of such rules in the 2014 Notice and, with respect to the de minimis rule, the 2015 Notice. Also, Treas. Reg. § 1.7874-10T is limited to determining the Ownership Percentage by value; the 2014 Notice merely stated that such distributions would be disregarded, raising questions of how the rules would apply for purposes of determining voting power. Additionally, the new regulations confirm that section 7874(c)(4) can apply regardless of the NOCD rule—i.e., the NOCD rule should not be viewed as a safe harbor from the application of the section 7874(c)(4) general anti-abuse rule. In addition, the new regulations clarify the meaning of “Predecessor” and provide rules regarding the directionality of section 355 distributions.

2. **Section 367(a)**

Treas. Reg. § 1.367(a)-3(c) provides an exception to the general rule that gain must be recognized by a U.S. person on the outbound transfer of stock of a domestic corporation to a foreign corporation in a nonrecognition transaction. Among other requirements that must be met to qualify for the exception, the fair market value of the transferee foreign corporation must be at least equal to the
The fair market value of the domestic corporation at the time of the outbound transfer. New Treas. Reg. § 1.367(a)-3T(c)(3)(iii)(C) provides that for purposes of determining the value of the domestic corporation, the fair market value of the domestic corporation includes the aggregate amount of NOCDs made by the domestic corporation. The rules of Treas. Reg. § 1.7874-10T (including the de minimis rule) apply for purposes of determining the aggregate amount of NOCDs. New Treas. Reg. § 1.367(a)-3T(c)(3)(iii)(C) generally applies to transfers completed on or after September 22, 2014. The de minimis rule applies to transfers completed on or after November 19, 2015, but taxpayers may elect to apply such rule to transfers completed on or after September 22, 2014, and before November 19, 2015. Treas. Reg. § 1.367(a)-3T(c)(3)(iii)(C) expires on April 4, 2019.

KPMG observation

Treas. Reg. § 1.367(a)-3T addresses concerns that the domestic corporation could distribute assets to its shareholders and, by reducing its value relative to the transferee foreign corporation, satisfy the exception in Treas. Reg. § 1.367(a)-3(c). The rules in Treas. Reg. § 1.367(a)-3T(c)(3)(iii)(C) are generally consistent with the description of such rules in the 2014 Notice and, with respect to the de minimis rule, the 2015 Notice.

c. Application of the EAG Rules to Subsequent Transfers of Foreign Acquiring Stock

Treas. Reg. § 1.7874-5T provides that Foreign Acquiring stock retains its “by reason of” status if the stock is subsequently transferred, even if the subsequent transfer is related to the Domestic Entity Acquisition. Under this rule, the subsequently transferred Foreign Acquiring stock is included in the Ownership Fraction, unless the EAG Rules apply to disregard the Foreign Acquiring stock from either the numerator and denominator or, in certain circumstances, just the numerator of the Ownership Fraction. The 2014 Notice announced regulations that would, subject to two exceptions, make the EAG Rules inapplicable to subsequently transferred Foreign Acquiring stock. The two exceptions, the “U.S.-Parented Group Exception” and the “Foreign-Parented Group Exception,” generally are intended to allow the EAG Rules to apply to subsequently transferred Foreign Acquiring stock where such application is not contrary to section 7874 policy: (i) in the case of the U.S.-Parented Group Exception, Foreign Acquiring continues to be ultimately owned in a domestic-parented structure after the Domestic Entity Acquisition; and (ii) in the case of the Foreign-Parented Group Exception, the Domestic Entity was owned in a foreign-parented structure prior to the Domestic Entity Acquisition.

New Treas. Reg. § 1.7874-6T reflects the 2014 Notice’s U.S.-Parented Group Exception and the Foreign-Parented Group Exception rules with certain modifications. Under the new regulations’ U.S.-Parented Group Exception,
subsequently transferred Foreign Acquiring stock is treated as held by an EAG member for purposes of the EAG Rules if:

(i) Before the Domestic Entity Acquisition, the corporation transferring such Foreign Acquiring stock is a member of a “U.S.-Parented Group” (i.e., an EAG with a domestic common parent corporation), and

(ii) After the Domestic Entity Acquisition, each of the transferring corporation (or its successor), any person that holds the transferred Foreign Acquiring stock, and Foreign Acquiring are members of a U.S.-Parented Group, the common parent of which is either:

(A) A member of the U.S.-Parented Group referenced in clause (i) before the Domestic Entity Acquisition (i.e., a pre-existing member of the Domestic Entity’s U.S.-Parented Group), or

(B) A corporation formed in a transaction related to the Domestic Entity Acquisition, if immediately after the formation, such corporation was a member of the U.S.-Parented Group referenced in clause (i) (i.e., a domestic corporation formed to in connection with Domestic Entity Acquisition).

Under the new regulations’ Foreign-Parented Group Exception, subsequently transferred Foreign Acquiring stock is treated as held by an EAG member for purposes of the EAG Rules if:

(i) Before the Domestic Entity Acquisition, the corporation transferring such Foreign Acquiring stock and the Domestic Entity are members of the same “Foreign-Parented Group” (i.e., an EAG with a foreign common parent corporation), and

(ii) After the Domestic Entity Acquisition, the transferring corporation:

(A) Is a member of the Foreign Acquiring’s EAG, or

(B) Would be a member of the Foreign Acquiring’s EAG absent one or more transfers (other than by issuance) in a transaction (or series of transactions) after and related to the Domestic Entity Acquisition, of the Foreign Acquiring stock by one or more members of the Foreign-Parented Group referenced in clause (i).

The new regulations modify the 2014 Notice’s version of the U.S.-Parented Group Exception by allowing the common parent of the U.S.-Parented Group to be a different corporation before and after the Domestic Entity Acquisition—a taxpayer-favorable rule. The regulations also provide a pro rata rule to identify the subsequently transferred Foreign Acquiring stock in instances where the transferring corporation previously owned Foreign Acquiring stock identical to the Foreign Acquiring stock received in the Domestic Entity Acquisition (i.e., “by reason of” stock) and subsequently transfers less than all of the Foreign Acquiring stock. This pro rata rule was not included in the 2014 Notice and is intended to address the issue that the transferring corporation’s Foreign Acquiring stock is fungible, but only certain shares were received in the Domestic Entity Acquisition.
The new regulations also provide rules addressing the EAG treatment of certain partnerships.

These rules generally apply to Domestic Entity Acquisitions completed on or after September 22, 2014. The new rules (i) allowing for a different common parent of a U.S.-Parented Group before and after the Domestic Entity Acquisition, and (ii) providing for pro rata allocation of subsequently transferred Foreign Acquiring stock in certain cases apply to Domestic Entity Acquisitions completed on or after April 4, 2016. Treas. Reg. § 1.7874-6T expires on April 4, 2019.

KPMG observation

These rules are generally consistent with rules announced in the 2014 Notice, but add the pro rata method to be used in identifying subsequently transferred stock and loosen the restrictions of the U.S.-Parented Group Exception. Unfortunately, new Treas. Reg. § 1.7874-6T includes the example from the 2014 Notice that infers that a foreign-to-foreign acquisitive asset reorganization of an existing foreign parent corporation followed by a related capital raise in exchange for cash (i.e., nonqualified property) can trigger the application of section 7874 where the foreign parent corporation directly owns the stock of a first-tier domestic corporation. Accordingly, foreign corporations with first-tier domestic subsidiaries should consider the potential application section 7874 to future public and private equity placements.

d. SBA Exception

The SBA Exception, as described above, can turn off the application of section 7874 regardless of the Ownership Percentage. Satisfying the SBA Exception generally requires that at least 25% of employees, assets, and income of the Foreign Acquiring and its EAG are located or derived in, as applicable, the Foreign Acquiring’s jurisdiction of incorporation during a relevant testing period. As explained in more detail in the 2015 Notice, the Treasury Department believes that the SBA Exception is premised on the Foreign Acquiring being a tax resident of its country of creation or organization. The new regulations in Treas. Reg. § 1.7874-3T(b)(4), to this end, impose an additional requirement to satisfy the SBA Exception. Specifically, to satisfy the SBA Exception, the Foreign Acquiring must be subject to tax as a resident of its country of creation or organization.

Treas. Reg. § 1.7874-3(d)(7) generally provides that the group income of the Foreign Acquiring’s EAG must be determined consistently under either U.S. federal income tax principles or as reflected in “relevant financial statements.” In response to a comment about the scope for which the financial reporting principles are to be used in making the determination of whether the SBA Exception is met, Treas. Reg. § 1.7874-3T(d)(10) modifies the definition of “relevant financial statements” for purposes of determining the Foreign Acquiring EAG’s group income. The modification clarifies that financial reporting principles
are only relevant for purposes of determining the amount of items of income that are taken into account. More specifically, it provides that the Foreign Acquiring’s EAG must take into account all items of income generated by all members of the EAG for the entire testing period.

Treas. Reg. § 1.7874-3T(b)(4) applies to Domestic Entity Acquisitions completed on or after November 19, 2015. The modification to the definition of relevant financial statements applies to Domestic Entity Acquisitions completed on or after April 4, 2016. If a Domestic Entity Acquisition is completed on or after June 3, 2015, and before April 4, 2016, taxpayers may elect to apply the modified definition. Treas. Reg. §§ 1.7874-3T(b)(4) and (d)(10) expire on April 4, 2019.

KPMG observation

Treas. Reg. § 1.7874-3T(b)(4) is consistent with the rules discussed in the 2015 Notice and is intended to prevent satisfaction of the SBA Exception when Foreign Acquiring is not a tax resident of its country of creation or organization. This provision is interesting for two reasons: (i) it places importance on the Foreign Acquiring’s tax nexus with its country of organization or incorporation; and (ii) it disregards the fact that the business activities of the Foreign Acquiring’s EAG may actually be subject to local country tax. Accordingly, this provision would prevent the SBA Exception from being satisfied where the Domestic Entity inverted to a foreign jurisdiction but kept its management and control in the United States when the foreign jurisdiction uses a management and control standard for tax residency. The modification to the definition of relevant financial statements was not discussed in the Notices or prior guidance and was intended to clarify ambiguities involving International Financial Reporting Standards in the context of the SBA Exception.

III. Regulations Addressing Certain Post-Inversion Tax Avoidance Transactions
   a. Application of Section 956 to Certain Post-Inversion Investments

A U.S. shareholder, as defined by section 951(b) (a “U.S. Shareholder”), of a controlled foreign corporation, as defined by section 957 (a “CFC”), generally is subject to U.S. federal income tax on the CFC’s earnings and profits (“E&P”) when repatriated. The Code’s subpart F regime is an exception to this rule and generally requires a U.S. Shareholder to currently include as income its share of a CFC’s subpart F income—generally highly mobile, passive income—and E&P invested in certain items of U.S. property, which generally includes loans to, or investing in stock of, the U.S. Shareholder or its domestic affiliates. Section 956, the provision of the Code’s subpart F regime governing CFC investments in U.S. property, historically has not applied to a CFC’s loan or investment in a non-CFC foreign affiliate—e.g., a so-called “hopscotch” loan to the Foreign Acquiring after the Domestic Entity Acquisition.
The 2014 Notice identified as abusive the Foreign Acquiring’s ability to access an Expatriated Entity’s CFC’s E&P through debt and equity investment in the Foreign Acquiring and its non-CFC foreign affiliates. The 2014 Notice announced that these investments would be treated as U.S. property for section 956 purposes. New Treas. Reg. § 1.956-2T, to this end, treats as U.S. property an obligation or stock of a foreign person if:

(i) The obligation or stock is held by an “Expatriated Foreign Subsidiary” regardless of whether the acquirer was a CFC or an Expatriated Foreign Subsidiary when the obligation or stock was acquired;
(ii) The foreign person is a “Non-CFC Foreign Related Person” regardless of whether the foreign person was a Non-CFC Foreign Related Person when the obligation or stock was acquired; and
(iii) The obligation or stock was acquired during the Applicable Period or in a transaction related to the “Inversion Transaction,” which is defined as a Domestic Entity Acquisition in which Foreign Acquiring is considered a surrogate foreign corporation that is respected as a foreign corporation for U.S. federal income tax purposes—i.e., an inversion with an Ownership Percentage of at least 60% but less than 80%).

An Expatriated Foreign Subsidiary generally is a CFC in which an Expatriated Entity is a U.S. Shareholder. The new regulations, however, generally provide that a foreign corporation will not be (and cannot become) an Expatriated Foreign Subsidiary and will instead be a Non-CFC Foreign Related Person if, after the Domestic Entity Acquisition and all related transactions, the corporation is a CFC and a member of the Foreign Acquiring’s EAG, and the Domestic Entity was not a U.S. Shareholder of the foreign corporation prior to the Domestic Entity Acquisition.

A Non-CFC Foreign Related Person is a “Foreign Related Person” that is not an Expatriated Foreign Subsidiary. With respect to an Inversion Transaction, a Foreign Related Person is a foreign person that is either related to (under sections 267(b) or 707(b)(1)) or under the same common control as (under section 482) an Expatriated Entity with respect to such Inversion Transaction.

The new regulations also extend the current section 956 provisions regarding pledges and guarantees to instances where an Expatriated Entity directly or indirectly serves as a security for a Non-CFC Foreign Related Person’s obligation. The new regulations provide exceptions for certain ordinary course obligations owed by a Non-CFC Foreign Related Person to an Expatriated Foreign Subsidiary. The regulations, however, prohibit the application of the U.S. property exceptions for certain short-term obligations from applying to loans by an Expatriated Foreign Subsidiary to a Non-CFC Foreign Related Person—these provisions are discussed below in detail.
The new section 956 regulations generally apply to obligations or stock acquired or to pledges or guarantees entered into, or treated as entered into, on or after September 22, 2014, with respect to Inversion Transactions completed on or after September 22, 2014. Certain aspects of the rules intended to address perceived loopholes in the 2014 Notice, however, apply to obligations acquired or entered into after April 4, 2016, with respect to Inversion Transactions completed on or after September 22, 2014. Treas. Reg. § 1.956-2T expires on April 4, 2019.

**KPMG observation**

The rules described in the 2014 Notice and adopted by the new regulations rely on authority provided in section 956(e) for the Treasury Department to provide regulations “as may be necessary to carry out the purposes of this section, including regulations to prevent the avoidance of the provisions of this section through reorganizations or otherwise.” Hopscotch transactions do not put cash into the hands of a CFC’s U.S. Shareholders and, therefore, the rules appear to be an expansion of commonly held views of section 956 policy. The rules would only apply where Foreign Acquiring is a surrogate foreign corporation that is respected as a foreign corporation for U.S. federal income tax purposes and would not apply to hopscotch loans or equity investments involving foreign-parented groups that were either originally foreign-founded, established in a Domestic Entity Acquisition in which the Ownership Percentage was not at least 60%, or established in a Domestic Entity Acquisition that satisfies the SBA Exception. In addition, the new regulations expand the application of the rules in the 2014 Notice to apply to pre-Inversion Transaction investments in stock or obligations of a prospective Foreign Acquiring and its foreign affiliates.

**b. Anti-Dilution Provisions**

A U.S. Shareholder, as noted above, is subject to U.S. federal income tax on its share of a CFC’s offshore E&P: either when repatriated or currently under the Code’s subpart F regime. In contrast to the U.S. worldwide tax system, which, subject to a foreign tax credit, taxes residents on offshore earnings, most developed countries use a territorial tax system that exempts, in whole or in substantial part, a resident’s offshore earnings. Prior to the 2014 Notice, the Foreign Acquiring’s EAG typically engaged in post-inversion restructuring transactions designed to dilute an Expatriated Entity’s ownership in its CFCs either to access the CFCs’ E&P without the imposition of U.S. federal income tax or to make it so the CFC was no longer a “CFC” and, thus, not subject to the Code’s subpart F provisions. The 2014 Notice announced two sets of rules, under sections 7701(l) and 367(b), intended to prevent these dilution transactions to directly or indirectly access CFC E&P without the imposition of U.S. federal income tax.

**i. Section 7701(l): Re-characterizing Specified Transactions**

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Section 7701(l) provides the Treasury Department regulatory authority to issue regulations re-characterizing a multiple-party financing transaction as directly between any two or more parties if it is determined the re-characterization is appropriate to prevent U.S. tax avoidance. The 2014 Notice announced regulations would be issued under section 7701(l) that would re-characterize, for all purposes of the Code, post-Inversion Transaction investments by a “Specified Related Person” (generally defined as a Non-CFC Foreign Related Person and certain pass-through entities with Non-CFC Foreign Related Persons as partners or beneficiaries, as applicable) in an Expatriated Foreign Subsidiary that “de-control” the subsidiary as a direct investment by the Specified Related Person in the Expatriated Foreign Subsidiary’s “Section 958(a) Shareholders” (defined as the U.S. Shareholders that own the Expatriated Foreign Subsidiary directly or indirectly through foreign entities). That is, the 2014 Notice’s re-characterization completely disregards the effect of the de-control transaction and, as a result, the Expatriated Foreign Subsidiary retains CFC status and the Section 958(a) Shareholders remain subject to tax on the subsidiary’s deferred E&P (either upon repatriation or currently under the Code’s subpart F regime).

The new regulations adopt the re-characterization described in the 2014 Notice with certain modifications. Specifically, Treas. Reg. § 1.7701(l)-4T provides a general rule that re-characterizes a “Specified Transaction” until the re-characterization is altered or terminated in accordance with Treas. Reg. § 1.7701(l)-4T(d). A Specified Transaction generally is a transaction that occurs during the Applicable Period in which stock of an Expatriated Foreign Subsidiary is issued or transferred to a person that, immediately before such issuance or transfer, is a Specified Related Person. A Specified Transaction, however, does not include transactions that result in a de minimis shift of the Expatriated Foreign Subsidiary’s ownership and certain transactions covered elsewhere, most notably a Specified Exchange (as defined below) in which the exchanging shareholder has a full income inclusion under the below-discussed section 367(b) regulations.

The new section 7701(l) regulations provide two re-characterization regimes depending on whether the Specified Transaction is an issuance or shareholder transfer of Expatriated Foreign Subsidiary stock (the “Specified Stock”). In the case of an issuance, the property actually transferred by the Specified Related Person in exchange for the Specified Stock is deemed contributed by the Specified Related Person to the Section 958(a) Shareholders in exchange for “deemed instruments” (with the same terms as the Specified Stock) and then contributed by the Section 958(a) Shareholders (through any intervening entities for equity) to the Expatriated Foreign Subsidiary in exchange for stock. In the case of a shareholder transfer, the property actually transferred by the Specified Related Person to the transferring shareholder is deemed contributed to the Section 958(a) Shareholders for deemed instruments (with the same terms as the Specified Stock) and then contributed by the Section 958(a) Shareholders (through any intervening entities for equity) to transferring shareholder in exchange for stock.
Both re-characterizations are deemed to occur for all U.S. federal income tax purposes as of the date of the Specified Transaction. Additionally, when a distribution is made on the Expatriated Foreign Subsidiary stock legally owned by the Specified Related Person, matching seriatim distributions are deemed made to the Section 958(a) Shareholders (through any intervening entities, as necessary) and then on the deemed instruments. The Expatriated Foreign Subsidiary serves as the Section 958(a) Shareholders’ paying agent with respect to the deemed instruments.

In general, the new section 7701 regulations apply to Specified Transactions completed on or after September 22, 2014, where the Inversion Transaction was completed on or after September 22, 2014. However, the new rules in the regulations are applicable to Specified Transactions completed on or after April 4, 2016, where the Inversion Transaction was completed on or after September 22, 2014, unless the taxpayer elects to apply these rules to Specified Transactions completed before April 4, 2016, where the Inversion Transaction was completed on or after September 22, 2014. Treas. Reg. § 1.7701(l)-4T expires on April 4, 2019.

KPMG observation

The new section 7701(l) regulations’ re-characterizations can have a number of collateral U.S. federal income tax consequences. For example, if the Non-CFC Foreign Related Person that acquired the Specified Stock was “brother-sister” to a Section 958(a) Shareholder that was a member of a U.S. consolidated group, deemed instruments issued by the Section 958(a) Shareholder could cause the shareholder to become de-consolidated. Also, the Section 958(a) Shareholder’s deemed distributions with respect to the deemed instruments generally would be subject to U.S. withholding tax, subject to the application of an in-force U.S. income tax treaty.

ii. Section 367(b): Income Recognition in a Specified Exchange

Historically, section 367(b) has served as a backstop to section 1248, generally by requiring a deemed dividend inclusion equal to a foreign corporation’s “section 1248 amount” if an otherwise tax-free nonrecognition transaction results in a loss of section 1248 shareholder status. A foreign corporation’s section 1248 amount is generally the amount of gain that would be re-characterized as a dividend under section 1248 had the foreign corporation’s stock been sold. The 2014 Notice expanded this historic section 367(b) policy objective by requiring the inclusion of the section 1248 amount upon the exchange of an Expatriated Foreign Subsidiary’s stock in an acquisitive nonrecognition transaction even where section 1248 was preserved—e.g., the Expatriated Foreign Subsidiary retained CFC status. The 2015 Notice further expanded the principles of the 2014 Notice by requiring the recognition of the unrealized appreciation in an
Expatriated Foreign Subsidiary’s stock—i.e., built-in gain in excess of the subsidiary’s section 1248 amount—upon the occurrence of an acquisitive nonrecognition transaction, irrespective of whether section 1248 is preserved.

New Treas. Reg. § 1.367(b)-4T(e), consistent with the Notices, provides a general rule that if a foreign corporation acquires, in a “Specified Exchange,” the stock of a foreign corporation in a section 351 exchange or the stock or assets of a foreign corporation in an acquisitive asset reorganization, the exchanging shareholder must (i) include in income a deemed dividend equal to the section 1248 amount attributable to the exchanged stock, and (ii) after increasing the basis in the exchanged stock for the deemed dividend inclusion, recognize all realized gain with respect to the exchanged stock that would not otherwise be recognized. An exchange generally is a Specified Exchange if (i) immediately before the exchange, the foreign target corporation is an Expatriated Foreign Subsidiary and the exchanging shareholder is either an Expatriated Entity or an Expatriated Foreign Subsidiary, (ii) the exchanging shareholder receives stock of a foreign corporation in exchange for its foreign target corporation stock, and (iii) the exchange occurs during the Applicable Period.

The new regulations provide two exceptions to the above-discussed general rule. First, an exception is provided in the case of Specified Exchanges where the exchanging shareholder is neither an Expatriated Entity nor an Expatriated Foreign Subsidiary (the “Exchanging Shareholder Exception”). Second, an exception is provided where, after the Specified Exchange, the Expatriated Foreign Subsidiary (or the transferee corporation in an asset reorganization) is a CFC and there is only a de minimis shift of ownership to Non-CFC Foreign Related Persons.

New Treas. Reg. § 1.367(b)-4T(f) provides a general rule that if an Expatriated Foreign Subsidiary transfers “Specified Property” (i.e., any property other than the stock of an Expatriated Foreign Subsidiary) to a foreign corporation in an exchange described in section 351, then the Expatriated Foreign Subsidiary must recognize all gain with respect to the Specified Property. Similar to Treas. Reg. § 1.367(b)-4T(e), the new regulations provide an exception where, after the transfer of Specified Property, the transferee foreign corporation is a CFC and there is only a de minimis shift of ownership to Non-CFC Foreign Related Person. Neither of the Notices described rules similar to those in Treas. Reg. § 1.367(b)-4T(f).

The new section 367(b) regulations generally only apply if the Inversion Transaction was completed on or after September 22, 2014, with the rules announced in the 2014 Notice applying to exchanges occurring on or after September 22, 2014, and the rules announced in the 2015 Notice applying to exchanges occurring on or after November 19 2015. Further, the rules added or modified by the new regulations apply to transfers completed on or after April 4, 2016, but only if the Inversion Transaction was completed on or after September 22, 2014. The regulations, however, allow a taxpayer to elect to apply the
Exchanging Shareholder Exception to exchanges completed on or after September 22, 2014 and prior to April 4, 2016. Treas. Reg. § 1.367(b)-4T expires on April 4, 2019.

KPMG observation

New Treas. Reg. § 1.367(b)-4T is a sharp departure from the historical section 367(b) policy objectives of preserving section 1248 in foreign-to-foreign nonrecognition transactions. Indeed, as noted above, the new regulations generally require that an exchanging shareholder in a Specified Exchange recognize: (i) a section 1248 E&P, irrespective of whether section 1248 is preserved in the exchange, and (ii) any built-in gain in the exchanged stock in excess of any section 1248 E&P.

Taxpayers should be aware of the combined application of the new rule in Treas. Reg. § 1.367(b)-4T(f) and the new rules in Treas. Reg. § 1.956-2T to an Expatriated Foreign Subsidiary’s transfer of Specified Property to a Non-CFC Foreign Related Person. Treas. Reg. § 1.367(b)-4T(f) requires the Expatriated Foreign Subsidiary to recognize gain on the section 351 exchange of the Specified Property, which results in the Expatriated Foreign Subsidiary having a fair market value basis in the stock of the Non-CFC Foreign Related Person. The new rules in Treas. Reg. § 1.956-2T treat the Non-CFC Foreign Related Person’s stock as a U.S. property investment by the Expatriated Foreign Subsidiary. The Expatriated Foreign Subsidiary, therefore (i) recognizes all the gain in the Specified Property, which generates E&P, and (ii) owns an amount of U.S. property equal to the full fair market value of the Specified Property (section 956 measures the amount of U.S. property by reference to the property's basis). Accordingly, if the transfer of the Specified Property generates non-subpart F E&P (i) the amount of gain recognized on the transfer will be currently included by the Expatriated Foreign Subsidiary’s U.S. Shareholders, and (ii) an amount equal to the Expatriated Foreign Subsidiary's basis in the Specified Property will be included as the Expatriated Foreign Subsidiary generates non-subpart F E&P (assuming such E&P does not already exist).

c. Section 304

Section 304 re-characterizes certain related party stock sales as a deemed redemption of the acquiring corporation’s stock. If this deemed redemption is a dividend-equivalent redemption under section 302(d), the deemed redemption is generally characterized as a dividend: first to the extent of the acquiring corporation’s E&P, and then to the extent of the target corporation’s E&P. In the context of a so-called “parent-subsidiary” section 304 sale—i.e., a subsidiary’s purchase of its parent corporation’s stock from the parent corporation’s shareholders—the deemed dividend attributable to the subsidiary’s E&P is treated as though paid directly to the parent corporation’s shareholders. The distribution, therefore, is not considered paid to the parent corporation shareholders through
any intervening entities—an opportunity for foreign-parented groups to access CFC E&P without residual U.S. tax, for example, by selling stock of the CFC’s U.S. Shareholder to the CFC for cash. Section 304(b)(5)(B) limits this opportunity by prohibiting a deemed redemption of a foreign acquiring corporation’s stock that results from a section 304 sale from being characterized as a dividend by reference to the foreign acquiring corporation’s E&P unless more than 50% of the deemed distribution from the sale would otherwise be subject to U.S. federal income tax or includible in the E&P of a CFC.

The section 304 rules in the 2014 Notice also provide that if a partnership, option (or similar interest, or other arrangement is used with a principal purpose of avoiding the application of the section 304 rules in the 2014 Notice, then the partnership, option, or other arrangement will be disregarded for purposes of applying the section 304 rules.


**KPMG Observation**

Like the 2014 Notice, the regulations read ambiguity into the mechanics of the statute’s 50% threshold and don’t interpret or clarify the phrase "subject to tax" so that it requires the imposition of U.S. withholding tax at the full 30% statutory rate and so that a dividend subject to a treaty-reduced rate would only be partially “subject to tax” (for example, section 163(j)(5)(B)). Presumably, the Treasury Department and the IRS are leery of taxpayers accepting a 15% effective tax rate (that is, 30% on the U.S.-source portion of the deemed dividend) to remove untaxed E&P of CFC out from under the U.S. tax net.

d. Application of Inversion Gain Regime to Certain Indirect Dispositions.

Prior to the 2015 Notice, Inversion Gain was limited to income or gain recognized as a result of a property transfer or license directly by an Expatriated Entity. As explained in the 2015 Notice, the Treasury Department and the IRS believed that an expanded definition of Inversion Gain was more consistent with the purposes of section 7874(a)(1), which is intended to serve as a corporate toll on transactions that remove income producing assets outside of the U.S. taxing jurisdiction. The 2015 Notice, to this end, announced regulations that extended the Inversion Gain regime to income recognized by an Expatriated Entity as a result of certain indirect transfers—e.g., subpart F income generated by an Expatriated Entity’s CFCs on a disposition of property to the Foreign Acquiring.

The new regulations in Treas. Reg. § 1.7874-11T(b)(1), consistent with the 2015
Notice, expands the definition of Inversion Gain to include income (including an amount treated as a dividend under section 78) or gain recognized with respect to certain indirect property transfers or licenses that are analogous to the current definition of Inversion Gain. Treas. Reg. § 1.7874-11T(e) provides an example that treats as Inversion Gain the subpart F income (including the amount treated as a deemed dividend under section 78) recognized by the Domestic Entity as a result of an indirect transfer of property by its CFC during the Applicable Period.

The new regulations provide a special rule for transfers or licenses by certain foreign partnerships. Specifically, a transfer or license of property by a partnership that is a Foreign Related Person is treated as a transfer or license by a partner in the partnership of its proportionate share of the property, determined under the rules and principles of Subchapter K of the Code.

The rules described in the new regulations are generally consistent with those described in the 2015 Notice. Unlike the 2015 Notice, which did not refer to the amount treated as a dividend under section 78 as included within the expanded definition of Inversion Gain, Treas. Reg. § 1.7874-11T specifically includes the amount treated as a dividend under section 78 in the definition of income. The preamble to the new regulations states that the specific inclusion of an amount treated as a dividend under section 78 was in response to a comment.

Treas. Reg. § 1.7874-11T generally applies to transfers or licenses of property completed on or after November 19, 2015, but only if the Inversion Transaction was completed on or after September 22, 2014. However, for Inversion Transactions completed on or after September 22, 2014, taxpayers may elect to apply Treas. Reg. § 1.7874-11T(b) by excluding the phrase “(including an amount treated as a dividend under section 78)” for transfers and licenses of property completed on or after November 19, 2015, and before April 4, 2016. Treas. Reg. § 1.7874-11T expires on April 4, 2019.

KPMG observation

These provisions do not appear to apply to an indirect transfer or license of property that does not produce subpart F income, but the earnings of which are eventually repatriated to an Expatriated Entity in the form of a dividend. If this is the case, the earnings would be considered U.S. source income for foreign tax credit purposes.

IV. Miscellaneous

a. Inapplicability of Section 956 Short-Term Liquidity Exceptions to CFC Loans to Non-CFC Foreign Related Persons

In Notice 88-108, the Treasury Department and the IRS announced that they would issue regulations under section 956 that would exclude from the definition of the term “obligation,” for purposes of section 956, obligations that are collected...
within 30 days if the CFC does not have loans to related U.S. persons that would constitute U.S. property outstanding during the year for 60 or more days (the “30/60 Day Exception”). In Notice 2008-91, the Treasury Department and the IRS expanded the time period to cover obligations collected within 60 days if the CFC does not have outstanding loans to related U.S. persons for 180 or more days (the “60/180 Day Exception”). Notice 2008-91 applies for the first two tax years of a foreign corporation ending after October 3, 2008, but does not apply to tax years beginning after December 31, 2009. A CFC could choose to apply either the 30/60 Day Exception or the 60/180 Day Exception in years when the 60/180 Day Exception is applicable. Notice 2009-10 and Notice 2010-12 extended the application of these rules in certain cases.

The purpose of these exceptions was to allow U.S. multinationals to use quarter-end loans from their CFCs to reduce third-party debt without triggering income inclusions under section 956. The repayment of third-party debt was intended to reduce the U.S. parent’s debt-to-equity ratios and provide a boost to their financial statements; however, there is no requirement to use the loaned funds for this purpose.

The new regulations in Treas. Reg. § 1.956-2T(d) generally adopt the rules announced in the above-mentioned notices. These exceptions apply only to obligations of U.S. persons; they do not apply to an obligation of a Non-CFC Foreign Related Person that is treated as U.S. property under the new regulations (discussed above).

Under the new regulations, the 30/60 Day Exception generally only applies to obligations held on or after September 16, 1988, whereas the 60/180 Day Exception generally applies to the first three tax years of a foreign corporation ending after October 3, 2008, other than tax years beginning on or after January 1, 2011, as well as the fourth tax year of a foreign corporation, if any, when the foreign corporation’s third tax year (including any short tax year) ended after October 3, 2008 and on or before December 31, 2009.

KPMG observation

The new regulations limiting the various short-term liquidity exceptions to section 956 are not unexpected, because extending these exceptions to loans to Non-CFC Foreign Related Persons would be counter to the Treasury Department’s and the IRS’s general approach to “hopscotch” investments in the other portions of new Treas. Reg. § 1.956-2T.

V. Conclusion

The new anti-inversion regulation package is largely consistent with the regulations announced by the Notices, with a few additions—most notably the provisions addressing serial inversions. These regulations (i) significantly restrict
a Domestic Entity’s ability to invert without being subject to section 7874, and (ii) remove the benefits typically associated with post-inversion restructuring transactions. The proposed section 385 regulations, which were issued in connection with the above-discussed regulations and address the debt/equity treatment of certain related-party financing transactions, however, may prove to be an even more effective inversion deterrent than the regulations issued in response to the Notices.

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