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Client Alert

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IRS Tightens Rules on Corporate Expatriations – New Regulations Require High Threshold of Foreign Business Activity

> "The highlight of the new rules, which are certain to generate significant commentary in international tax circles, is a rigorous, bright-line new test that a foreign group must meet in order to be treated as having substantial business activities in a foreign country and thus avoid the US anti-inversion rules."

On June 7, 2012, Treasury and the IRS issued temporary regulations (the 2012 Temporary Regulations) and final regulations (the 2012 Final Regulations, and together with the 2012 Temporary Regulations, the 2012 Regulations) under Section 7874[1] addressing a number of issues with respect to corporate inversions or expatriations. The rules are effective as of June 12, 2012.

The highlight of the new rules, which are certain to generate significant commentary in international tax circles, is a rigorous, bright-line new test (discussed below) that a foreign group must meet in order to be treated as having "substantial business activities" in a foreign country and thus avoid the US anti-inversion rules. A number of relatively less important points are also addressed in the new rules.

Section 7874 was enacted in 2004 under the American Jobs Creation Act to curb what Congress perceived to be a wave of corporate expatriations by major public companies. Section 7874 applies to an acquisition of a US corporation or partnership (or substantially all of its assets) by a "surrogate foreign corporation." Unless excluded based on the "substantial business activities" test (discussed below), a foreign corporation is treated as a surrogate foreign corporation if it meets either of the following criteria:

1. The former owners of the US corporation or partnership own 80 percent or more (by vote or value) of the acquiring foreign corporation by reason of their former ownership in the US corporation or partnership. In such case, the acquiring foreign corporation is treated as a US corporation for all purposes of the Code.
2. The former owners of the US corporation or partnership own 60 percent or more but less than 80 percent (by vote or value) of the acquiring foreign corporation by reason of their former ownership in the US corporation or partnership. In such case, the acquiring foreign corporation is respected as a foreign corporation, but the US corporation or partnership (and their affiliates) will recognize any "inversion gain" and will be restricted in their ability to offset the gain with tax attributes such as net operating losses, credits and other income offsets.

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In 2006, Treasury issued temporary regulations under Section 7874 (the 2006 Regulations). Then Treasury issued new temporary regulations in 2009 (the 2009 Temporary Regulations), withdrawing the 2006 Regulations. The 2012 Regulations provide a set of rules on certain issues that yet again differ from the 2006 Regulations and the 2009 Temporary Regulations, but leave a number of others still open and uncertain.

Substantial Business Activities Guidance

Section 7874(a)(2)(B)(iii) provides a comprehensive exception from the treatment as a surrogate foreign corporation where the acquiring foreign corporation that would otherwise be treated as a surrogate foreign corporation has, directly or through its "expanded affiliated group"[2] (EAG), substantial business activities within its jurisdiction of organization. The government's interpretation of this exception has undergone several significant revisions over the past six years, and the rigorous bright-line test in the 2012 Regulations will certainly make it more difficult for many taxpayers to qualify for the exception.

The 2006 Regulations provided a facts and circumstances test and a quantitative safe harbor (the 2006 Safe Harbor") for purposes of determining whether an EAG has substantial business activities in a particular country. The facts and circumstances test looked at a number of factors such as: (i) the historical conduct of continuous business activities in the foreign country by the EAG, (ii) the conduct of continuous business activities in the foreign country by the EAG in the ordinary course of one or more active trades or businesses involving property, performance of services and sales of goods to customers, (iii) the performance in the foreign country of substantial managerial activities by officers and employees of the EAG who are based in the foreign country, (iv) a substantial degree of ownership of the EAG by investors resident in the foreign country and (v) business activities in the foreign country that are material to the achievement of the overall business objectives of the EAG.

The 2006 Safe Harbor provided a three-factor formula under which the substantial business activities test was treated as satisfied if at least 10 percent of the EAG's worldwide employees, assets and sales were located in the relevant foreign jurisdiction. Subsequently, under the 2009 Temporary Regulations, Treasury withdrew the 2006 Safe Harbor based on a concern that the safe harbor could apply to transactions that are inconsistent with the purpose of Section 7874, and retained only the facts and circumstances test.

Since the repeal of the 2006 Safe Harbor, a handful of public companies expatriated, based on opinions of counsel that the company met the facts and circumstances test in the jurisdiction of the new holding company. It has been known that several companies that undertook an inversion since then looked to the fact that they would have satisfied the repealed 2006 Safe Harbor as a positive factor in concluding that their expatriation satisfied the "facts and circumstances" substantial business activities test.

The 2012 Temporary Regulations now completely revoke the facts and circumstances test of the 2006 Regulations and replace it with a bright-line test that must be met in order for the foreign acquiring company to meet the substantial business activities test. Specifically, in order to meet the substantial business activities test, the acquiring foreign corporation or its EAG must meet each of the following three tests:

1. The number of EAG employees based in the relevant foreign country is at least 25 percent of the total number of all EAG employees on the "applicable date" and the employee compensation incurred with respect to EAG employees based in the relevant foreign country is at least 25 percent of the total employee compensation incurred with respect to all EAG employees during the "testing period." For this purpose:
   - The "applicable date" is either the date of the expatriation transaction or the last day of the month immediately preceding the expatriation transaction, and the "testing period" is the one year period ending on the applicable date.
   - The term "employee compensation" means all amounts incurred by the EAG that directly relate to services performed by EAG employees, including, for example, wages, salaries, deferred compensation, employee benefits and employer payroll taxes.
2. The value of EAG assets located in the relevant foreign country is at least 25 percent of the total value of all EAG assets on the applicable date. For this purpose:
   - Assets include tangible personal property or real property used or held for use in the active conduct of a trade or business by the EAG.
   - An asset is considered to be located in the relevant foreign country only if the asset was physically present in such country as of the date of the expatriation transaction and for more time than in any other country during the testing period.
   - Assets are valued on a gross basis, and any rented property is valued at eight times the annual rent.
3. The EAG's income derived in the relevant foreign country is at least 25 percent of the total EAG income during the testing period. For this purpose:
   - Income means gross income from transactions occurring in the ordinary course of business with customers that are not related persons.
   - Income is considered derived in the relevant foreign country only if it is derived from a transaction with a customer located in such country.

The 2012 Temporary Regulations also provide a number of limitations designed to ignore assets, employees or income that are transferred to the relevant foreign country as part of a plan with "a principal purpose" of avoiding the purposes of Section 7874, or for which there is a plan to transfer group assets or group employees out of the relevant foreign country.

Treasury and the IRS faced controversy and criticism in the wake of the repeal of the 2006 Safe Harbor. By completely replacing the facts and circumstances test of the 2006 Regulations with a bright line test in the 2012 Regulations based upon 25 percent of employees (by number and compensation), assets and income from transactions with customers in the relevant country, Treasury and the IRS may face additional controversy for making it significantly more difficult to avoid being subject to the expatriation rules of Section 7874. Even companies that have a relatively large "footprint" outside of the US would typically find it difficult to meet a 25 percent threshold with respect to these factors. For example, a group with perhaps 80 percent of its assets, employees and sales outside of the US, but only 24 percent of any one of these criteria in any particular country (the UK, Ireland and Singapore being the typical examples) would not qualify under the new test.

The pace of globalization, the continuing political gridlock over reforming what many consider to be an outdated international tax regime and the enactment of favorable international tax regimes in other countries had caused many domestic companies to consider their ability to qualify under the prior facts and circumstances test for determining substantial business activities. The new 25 percent bright line test under the 2012 Regulations will now restrict the number of companies that can seriously consider a corporate expatriation.

Other Changes: Final Regulations

The 2012 Final Regulations address a number of issues in determining whether a foreign acquiring company meets (or fails) the percentage of ownership requirement for a "surrogate foreign corporation."

As noted above, the test for determining whether a foreign acquiring company is a surrogate foreign corporation is based in part upon the threshold of stock ownership in such foreign company by former owners of the acquired US corporation or partnership by reason of their ownership in such US corporation or partnership. Section 7874 and the 2009 Temporary Regulations provided guidance on a number of issues relating to the definition of a surrogate foreign corporation. The 2012 Final Regulations in large part follow the 2009 Temporary Regulations.

1. Options

The 2009 Temporary Regulations generally provide that, for purposes of Section 7874, an option or similar interest is treated as stock of the corporation with a value equal to the holder's claim on the equity of the corporation. For this purpose, the holder's claim on the equity does not include the value of any property the holder of the option would be required to provide to the corporation upon exercise of such option. Thus, only the "in the money" component of the option would be treated as stock. The 2012 Final Regulations maintain this rule. The 2009 Temporary Regulations do not address the effect of options on voting power. The 2012 Final Regulations adopt an anti-abuse rule regarding the voting power, under which, for purposes of determining voting power under Section 7874, an option will be treated as exercised if a principal purpose of the option's issuance or acquisition is to avoid treating the foreign corporation as a surrogate foreign corporation. In all other cases, options are ignored for purposes of determining voting power of stock under Section 7874.

2. Insolvent Entities

The 2009 Temporary Regulations provide that for purposes of Section 7874, the creditors of an insolvent or bankrupt corporation are treated as owning the stock of such corporation. The 2012 Final Regulations maintain this rule.

3. Acquisition of or by Multiple Entities

The 2009 Temporary Regulations address situations involving the acquisition of multiple domestic corporations or partnerships. The concern was that a new foreign holding company could acquire the stock of two unrelated domestic corporations, with the shareholders of each domestic corporation receiving, in the aggregate, less than 60 percent of the stock of the foreign acquiring company "by reason of" their former ownership in the relevant US corporation, thereby circumventing the rules of Section 7874. To address this concern, the 2009 Temporary Regulations generally provide that if, pursuant to a plan, a foreign corporation completes two or more

acquisitions involving domestic entities, the acquisitions are treated as a single acquisition of a domestic entity for purposes of Section 7874, thus resulting in the foreign holding company in the above example being treated as a surrogate foreign corporation. The 2012 Final Regulations maintain this rule.

In addition, under the 2012 Final Regulations, where multiple foreign corporations collectively acquire a domestic entity pursuant to a plan, each foreign corporation is treated as completing the entire acquisition for purposes of determining whether such foreign corporation is a surrogate foreign corporation.

4. Notice 2009-78 Transactions

Under Section 7874(c)(2)(B), stock issued in a public offering related to an expatriation transaction is disregarded for purposes of the 60 percent/80 percent ownership test of Section 7874 discussed previously. For example, if the shareholders of a US corporation transfer their shares to a foreign company in exchange for stock of the latter, and the foreign company issues 21 percent of its stock to the public in an offering, the former shareholders of the US corporation would, for purposes of Section 7874, continue to be treated as owning 100 percent of the stock of the foreign company "by reason of" their prior ownership in the US corporation. In Notice 2009-78, Treasury and the IRS significantly expanded this rule to cover situations where shareholders transfer cash or other liquid assets in exchange for additional shares to a foreign acquiring company in connection with an expatriation transaction. In such case, notwithstanding that the additional shares issued are not issued in a public offering, the shares are disregarded for purposes of the Section 7874 ownership test. Notice 2009-78 has been criticized for the breadth of its application (which can include many common forms of buyouts where management of the target rolls over shares into the acquiring entity) and the fact that the relevant statute refers only to "public offerings." Nevertheless, Treasury and the IRS have previously maintained their regulatory authority under various provisions of the statute and their position that regulations will be issued to address the Notice 2009-78 situations, with an effective date going back to September 17, 2009.

The 2012 Final Regulations make note of the continuing relevance of Notice 2009-78 and state that Treasury and the IRS are studying the manner in which various rules under Section 7874, including Section 7874(c)(2)(B), should apply. Thus, no further guidance is provided with respect to these issues.

Endnotes

[1] All section references in this *Client Alert* are to the Internal Revenue Code of 1986, as amended (the Code).

[2] Generally, a more than 50 percent affiliate.

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