Report No. 1308

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

TEMPORARY REGULATIONS UNDER SECTION 7874

SEPTEMBER 5, 2014

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NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Report on Temporary Regulations Under Section 7874[*]

September 5, 2014

I. Introduction

This Report discusses temporary regulations issued in January 2014 (the "Temporary Regulations")[1] under Section 7874 of the Internal Revenue Code (the "Code") that generally exclude shares from the denominator in calculating the percentage (the "Ownership Fraction") of shares of a foreign acquiror corporation ("Foreign Acquiror") treated as owned by former shareholders of a domestic target corporation or partnership ("DE") for purposes of Section 7874(a)(2)(B)(ii). The Temporary Regulations interpret Section 7874(c)(2)(B), which provides that stock of a Foreign Acquiror that is sold in a public offering related to the acquisition of DE is not taken into account in determining the Ownership Fraction (the "Statutory Public Offering Exclusion Rule").[2]

The Temporary Regulations and the Statutory Public Offering Exclusion Rule are intended to advance the policy of Section 7874 to curtail inversions that "permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion."[3] An inversion should not escape Section 7874 by reason of a contemporaneous public offering pursuant to which investors acquire sufficient shares in the Foreign Acquiror to

[*] The principal author of this Report is Deborah L. Paul. Substantial assistance was provided by Sehj Vather. Helpful comments were received from Kimberly S. Blanchard, Peter J. Connors, Michael Farber, Kathleen L. Ferrell, Edward E. Gonzalez, Stephen B. Land, Richard L. Reinhold, Michael L. Schler, David H. Schnabel, Peter F. G. Schuur and David R. Sicular. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of its Executive Committee or its House of Delegates.

[1] Temp. Treas. Reg. § 1.7874-4T, -5T (as issued by T.D. 9654, 79 Fed. Reg. 3094 (Jan. 17, 2014)).

[2] *See* Temp. Treas. Reg. § 1.7874-4T(i)(9). *See also* Code § 7874(c)(2).

[3] S. Rep. No. 192, 108th Cong., 1st Sess. (Nov. 7, 2003), 142; Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05) (May 2005), 343.

depress the Ownership Fraction below the 80% or 60% thresholds of Section 7874.[4] According to the Preamble to the Temporary Regulations:

> Absent the statutory public offering rule, the purposes of section 7874 could be avoided by having the foreign acquiring corporation issue stock to the public in exchange for cash in order to reduce the Ownership Fraction while not significantly altering the manner in which the domestic entity did business before the inversion transaction.[5]

The Internal Revenue Service (the "IRS") has adopted the view that transfers, related to the acquisition of DE, of Foreign Acquiror stock in exchange for cash or certain other types of property, even if not part of a public offering, can inappropriately reduce the Ownership Fraction.[6] The Temporary Regulations, and their precursor, Notice 2009-78[7] issued in September 2009, exclude from the denominator of the Ownership Fraction Foreign Acquiror shares issued for cash or certain other types of property, regardless of whether the issuance is part of a public offering. As an example, the Temporary Regulations would exclude from the denominator shares of Foreign Acquiror issued in a private placement for cash in a transaction related to the acquisition of DE. We agree that the concerns raised by issuances of Foreign Acquiror shares in public offerings can also be presented by issuances of Foreign Acquiror shares outside the scope of public offerings and that such shares are appropriate candidates for exclusion from the denominator of the Ownership Fraction.

We do, however, have comments on the scope and framework of the Temporary Regulations and responses to the requests for comments in the Preamble to the Temporary Regulations.

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[4] *See* Code §§ 7874(a)(2)(B)(ii) (60 percent threshold) and 7874(b) (80 percent threshold).

[5] T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014).

[6] *Id*, Preamble (Explanation of Provisions ¶ A).

[7] 2009-40 I.R.B. 452 (September 17, 2009).

Part IV of this Report recommends that the *de minimis* exception contained in the Temporary Regulations apply at a 20%, rather than a 5%, level. The *de minimis* exception serves to differentiate between transactions that embody the continuity of ownership that is a linchpin of Section 7874 and those that do not. Acquisitions of DEs involving consideration that is nearly all cash should not be brought within the ambit of Section 7874 merely by reason of a small share-for-share exchange. While the Temporary Regulations appear to agree with that principle, we believe that a 20% threshold more appropriately captures the concept.

Part V of this Report responds to a request in the Preamble for comments involving scenarios where a parent corporation receives Foreign Acquiror stock and then disposes of Foreign Acquiror stock pursuant to a plan. If the parent corporation is foreign, we believe Section 7874 should not apply. The foreign parent corporation owns DE before the transaction, and Foreign Acquiror owns DE after the transaction. No inversion has occurred, because DE was already owned by a foreign parent. The considerations are different if the parent corporation is domestic. In that circumstance, the transaction is an appropriate candidate for Section 7874, because DE was historically owned by a domestic parent and is owned by Foreign Acquiror after the transaction. The rules appear to reach anomalous results, however, by excluding in certain cases the shares retained by the domestic parent corporation from the numerator and denominator of the Ownership Fraction. We believe that the rule that would exclude Foreign Acquiror shares received by the domestic parent from the numerator and denominator should generally not apply where domestic parent is the historic owner of DE.

Part VI discusses a disparity in the Temporary Regulations between acquisitions by Foreign Acquiror of assets of a foreign corporation and acquisitions by Foreign Acquiror of stock of a foreign corporation, in each case, in a transaction related to Foreign Acquiror's acquisition of DE. The Preamble acknowledges that the distinction is formalistic. In the context of publicly traded foreign corporations, the distinction should be eliminated. Whether Foreign Acquiror acquires assets or stock of a foreign publicly traded target corporation should make no difference, because in neither case are taxpayers choosing to stuff cash or other nonqualified property into Foreign Acquiror. An acquisition of the assets of a foreign publicly traded target does not raise the stuffing concerns that lie behind Section 7874(c)(2)(B) any more so than an acquisition of the shares of the foreign target does. The treatment of the two cases should be conformed. As discussed below, absent a principal purpose to circumvent Section 7874, neither case should be subject to a "look through" test. That is, neither test should lead to the exclusion of Foreign Acquiror shares by reference to constituent assets of the foreign publicly traded corporation being cash or other nonqualified property.

Part VII analyzes rules relating to obligations contained in the Temporary Regulations. Part VIII discusses certain other mechanical issues.

A central theme of the report is that certain changes should be made to the current regulations to allow for more consistent treatment under Section 7874 among transactions that are economically equivalent (or at least very similar). While we recognize that tax laws sometimes depart from this ideal, discrepancies in the tax treatment of two transactions that arrive at the same economic result lead to traps for the unwary and have a distortionary effect on taxpayer decisions. By way of example, we believe that the following two fact patterns should be treated the same: first, a scenario in which the historic holders of DE contribute DE to Foreign Acquiror in exchange for Foreign Acquiror stock and then sell a portion of the shares of Foreign Acquiror for cash (a "drop and sell" structure) and, second, a scenario in which investors form Foreign Acquiror for cash and then Foreign Acquiror acquires DE for a combination of cash and Foreign Acquiror shares. The goal of treating these two scenarios the same (and other economically identical transactions the same as one another) seems worthwhile to us to avoid arbitrariness despite the fact that Section 7874 on its face distinguishes in certain ways among like transactions. Compare, on the one hand, a transaction in which Foreign Acquiror issues stock to investors for cash in a public offering and then uses such cash to purchase qualified property with, on the other hand, a transaction in which the investors first acquire the qualified property and then contribute it to Foreign Acquiror in exchange for stock. Although both transactions are economically identical, the Foreign Acquiror stock issued in the former case is excluded from the denominator of the Ownership Fraction under the Statutory Public Offering Exclusion Rule, while, in the latter case, the Foreign Acquiror stock is generally included in the denominator. The rationale for this difference in treatment may relate to the difficulty of tracing cash that is contributed to Foreign Acquiror. Thus, while we accept that in some instances a degree of formality in the application of Section 7874 may be necessary for reasons of practicality, we nonetheless assume in this Report that like transactions should generally be treated alike.

Inversions have received a great deal of attention recently. Secretary of the Treasury Jacob J. Lew, in a letter to Dave Camp, Chairman of the House Ways and Means Committee, called for immediate retroactive legislation to stem inversions.[8] Secretary Lew also referred to President Obama's Fiscal Year 2015 Budget, in which the Department of the Treasury proposed, among other things, to reduce the 80% test of Section 7874(b) to 50%.[9] In addition, earlier this year, draft legislation was introduced in both the Senate and the House proposing, among other

[8] Letter dated July 15, 2014.

[9] *General Explanations of the Administration's Fiscal Year 2015 Revenue Proposals*, Department of the Treasury (March 2014), 64-65.

things, to reduce the 80% test to 50%, again with retroactive effect.[10] This Report does not discuss the larger policy questions relating to inversions (many of which have been discussed in our prior reports)[11] or any legislative proposals. Rather, our comments in this Report focus on mechanical issues within the existing Section 7874 framework (including the Temporary Regulations). We note, however, that many of the comments made in this Report would be equally applicable if the proposed legislation were enacted.

II. Summary of the Temporary Regulations

The Temporary Regulations exclude "disqualified stock" from the denominator of the Ownership Fraction.[12] In general, disqualified stock is Foreign Acquiror stock that is transferred in an exchange that is related to the acquisition of DE where either (i) the Foreign Acquiror stock is transferred to a person other than DE in exchange for "nonqualified property" (the "Nonqualified Property Exclusion Rule") or (ii) the Foreign Acquiror stock is transferred in exchange for property and, pursuant to the same plan or series of related transactions, the transferee subsequently transfers such stock in exchange for the satisfaction or assumption of an obligation associated with the property exchanged (the "Associated Obligation Exclusion

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[10] *Stop Corporate Inversions Act of 2014* (Senate), introduced by Sen. Carl Levin; *Stop Corporate Inversions Act of 2014* (House), introduced by Rep. Sander Levin.

[11] This is our eighth report on inversion related issues. *See Report on Substantial Business Activities Test Under Temporary Section 7874 Regulations*, N.Y. St. B.A. Tax Section, Nov. 20, 2012; *Report on the Management and Control Provisions of the "International Tax Competitiveness Act of 2011"*, N.Y. St. B.A. Tax Section, January 21, 2011; *Report on Certain Issues Under Section 7874*, N.Y. St. B.A. Tax Section, May 3, 2010 (hereinafter, the "2010 NYSBA Report"); *Report on Temporary Treasury Regulations Section 1.7874-1T*, N.Y. St. B.A. Tax Section, March 22, 2006 (hereinafter, the "2006 NYSBA Report"); *Report with Respect to Regs. § 1.367(a)-3(c)*, N.Y. St. B.A. Tax Section, April 26, 2005; *Report on Outbound Inversion Transactions*, N.Y. St. B.A. Tax Section, May 24, 2002 (hereinafter, the "2002 NYSBA Report"); *Report on Notice 94-93 ("Inversion Transactions") and Rev. Proc. 94-76 ("Downstream Reorganizations")*, N.Y. St. B.A. Tax Section, January 31, 1995.

[12] Temp. Treas. Reg. § 1.7874-4T(b).

Rule").[13] We refer to the Nonqualified Property Exclusion Rule and the Associated Obligation Exclusion Rule together as the "Exclusion Rule".[14]

Nonqualified property means cash, cash equivalents, marketable securities and obligations owed by members of the expanded affiliated group ("EAG") that includes Foreign Acquiror ("Foreign Acquiror's EAG") or by former owners of DE.[15] Nonqualified property also includes obligations owed by a person that either owns stock or a partnership interest in a member of Foreign Acquiror's EAG or a former owner of DE, or is related to a member of Foreign Acquiror's EAG or a former owner of DE.[16] Further, any other property is nonqualified property if it is acquired in a transaction (or series of transactions) related to the acquisition of DE with a principal purpose of avoiding the purposes of Section 7874.[17]

Further, the Temporary Regulations treat Foreign Acquiror stock as if it were transferred for cash if, in a transaction related to the acquisition of DE, Foreign Acquiror stock is transferred to a person other than DE in exchange for the satisfaction or assumption of an obligation of the transferor (the "Transferor Obligation Rule").[18]

The Temporary Regulations provide a *de minimis* exception to the Exclusion Rule. Under the "De Minimis Exception," provided that the Foreign Acquiror stock is not transferred with a principal purpose of avoiding the purposes of Section 7874, Foreign Acquiror stock is not excluded under the Exclusion Rule if (i) the Ownership Fraction determined without regard to the Exclusion Rule is less than five percent by vote and value (the "By Reason Of Prong") and

[13] Temp. Treas. Reg. § 1.7874-4T(c).

[14] The Exclusion Rule is separate, however, from the "EAG Exclusion Rule," discussed below in the text accompanying fns. 25-26.

[15] Temp. Treas. Reg. § 1.7874-4T(i)(7).

[16] *Id.*

[17] *Id.*

[18] Temp. Treas. Reg. § 1.7874-4T(e).

(ii) after the acquisition, former shareholders or partners of DE in the aggregate own (applying the Section 318 attribution rules as modified by Section 304(c)(3)(B)) less than five percent by vote and value of the stock of or a partnership interest in any member of the Foreign Acquiror's EAG (the "Ownership Prong").[19]

As mentioned, the Exclusion Rule hinges on the "transfer" of Foreign Acquiror stock. A transfer includes but is not limited to an issuance. According to the Preamble, a transfer by means of "issuance, sale, distribution, exchange or any other type of disposition and regardless of whether the stock is transferred by the foreign acquiring corporation or another person" potentially gives rise to disqualified stock.[20] But the Temporary Regulations narrow the scope of disqualified stock by providing that stock is disqualified only to the extent that the transfer of the Foreign Acquiror stock in the exchange increases the fair market value of the assets of Foreign Acquiror or decreases its liabilities (the "Net Asset Requirement").[21] For this purpose, whether a transfer of Foreign Acquiror stock increases the net assets of Foreign Acquiror is determined on a transfer-by-transfer basis.[22] If one transfer increases the fair market value of the assets of the Foreign Acquiror and another decreases (e.g., by means of a distribution) the fair market value of the assets of the Foreign Acquiror, the latter is not taken into account in analyzing the effect of the former.[23] Moreover, in the case of a transaction potentially subject to the Associated Obligation Exclusion Rule, the Net Asset Requirement is tested only with respect to the transfer of the Foreign Acquiror stock in exchange for property, not with respect to the subsequent

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[19] Temp. Treas. Reg. § 1.7874-4T(d).

[20] Temp. Treas. Reg. § 1.7874-4T(c)(1); T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ A).

[21] Temp. Treas. Reg. § 1.7874-4T(c)(2).

[22] *Id*.

[23] T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ B.1).

transfer of the Foreign Acquiror stock in exchange for the satisfaction or assumption of an obligation.[24]

Stock excluded from the denominator under the Exclusion Rule is nonetheless taken into account for purposes of determining whether an entity is a member of Foreign Acquiror's EAG for purposes of applying Section 7874(c)(2)(A), which provides that Foreign Acquiror stock held by members of the EAG that includes Foreign Acquiror is generally not taken into account in determining the Ownership Fraction (the "EAG Exclusion Rule"), or for purposes of applying two exceptions to the EAG Exclusion Rule, namely, the internal group restructuring ("IGR") rule of Treasury Regulations § 1.7874-1(c)(2) and the loss of control rule of Treasury Regulations § 1.7874-1(c)(3).[25] Under the IGR exception, stock held by an EAG member is included in the denominator, but not the numerator, of the Ownership Fraction if (i) before the acquisition, 80 percent or more of the stock (by vote and value) or capital and profits interests of DE was held directly or indirectly by the entity that is the common parent of the EAG after the acquisition and (ii) after the acquisition, 80 percent or more of the stock (by vote and value) of Foreign Acquiror is held directly or indirectly by such common parent. Thus, while in general stock owned by EAG members is excluded from the numerator and the denominator,[26] in the case of an IGR, stock held by EAG members is excluded from the numerator only.

Foreign Acquiror stock that would otherwise be included in the numerator of the Ownership Fraction does not cease to be so included by reason of a subsequent disposition of such stock by a former shareholder or partner of DE, even if the subsequent disposition is pursuant to a binding commitment entered into in connection with Foreign Acquiror's

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[24] *Id*, Preamble (Explanation of Provisions ¶ B.2(b)).

[25] A loss of control occurs where the former owners of DE lose control of (that is, own 50% or less of the stock of) Foreign Acquiror or any member of its EAG post-inversion.

[26] Treas. Reg. § 1.7874-1(b).

acquisition of DE or is otherwise related to Foreign Acquiror's acquisition of DE (the "Frozen Numerator Rule").[27] Thus, the step transaction doctrine cannot be invoked, even where the former shareholder or partner of DE holds Foreign Acquiror stock as a transitory step, to reduce the number of shares in the numerator to account for sales or other transfers by former DE shareholders or partners that occur in connection with the acquisition of DE.

III. Recommendations

Our recommendations are as follows:

1. The De Minimis Exception, which applies at a threshold of five percent in the Temporary Regulations, should be expanded to apply at a threshold of 20%. Consideration should also be given to eliminating or refining the Ownership Prong of the De Minimis Exception.

2. Section 7874 should not apply to a scenario where a publicly traded domestic corporation becomes a publicly traded foreign corporation over time in the fact pattern described in the Preamble to the Temporary Regulations.

3. The benefit of the De Minimis Exception should be extended to transactions subject to the Frozen Numerator Rule.

4. In the case of temporary ownership by a corporation of Foreign Acquiror stock — that is, where a corporate parent of DE exchanges DE stock for Foreign Acquiror stock and, pursuant to a plan, subsequently disposes of the Foreign Acquiror stock — different results should apply depending on whether the corporate parent that temporarily owns the stock of the Foreign Acquiror is domestic or foreign.

[27] Temp. Treas. Reg. § 1.7874-5T.

a. If the corporation that temporarily holds Foreign Acquiror stock is foreign, Section 7874 should not apply, because no inversion has occurred. DE was already owned by a foreign parent. A special exception to Section 7874 should be provided in cases where DE is owned before the transaction by a foreign parent corporation.

b. If the corporation that temporarily holds Foreign Acquiror stock is domestic, in the case of a spin-off, the stock issued by the Foreign Acquiror to the domestic parent should be counted in the numerator (and the denominator) of the Ownership Fraction, the Frozen Numerator Rule should apply and the IGR exception should not apply.

c. If the corporation that temporarily holds Foreign Acquiror stock is domestic, if the domestic parent corporation winds up owning less than 80% of Foreign Acquiror, then any shares owned by the domestic parent after the transaction that are received for DE stock or partnership interests should be included in the numerator and the denominator of the Ownership Fraction. The EAG Exclusion Rule should not apply. The IGR exception should also not apply.

5. If a publicly-traded foreign target corporation is merged into Foreign Acquiror (or if a publicly-traded foreign target corporation transfers substantially all its assets to Foreign Acquiror and liquidates), none of the foreign target's property should be treated as nonqualified property unless such property was acquired with a principal purpose of avoiding Section 7874.

6. The application of the Associated Obligation Exclusion Rule should be limited to transfers by DE and transfers by transferors that transfer substantially all their assets to Foreign Acquiror.

7. Intercompany obligations should not be considered nonqualified property.

8. Obligations issued by persons that own less than a specified ownership threshold in DE or in certain other persons should not be considered nonqualified property.

9. The regulations should expressly provide that any Foreign Acquiror shares included in the numerator of the Ownership Fraction are included in the denominator as well, even if the Exclusion Rule would otherwise exclude such shares from the denominator.

10. The regulations should include examples demonstrating how the Exclusion Rule applies to transfers other than issuances and (if the Net Asset Requirement is retained, see Recommendation 12 below) how the exchange-by-exchange application of the Net Asset Requirement works.

11. In the case of a transfer (other than an issuance) of Foreign Acquiror shares, consideration should be given to including the Foreign Acquiror shares so transferred in the denominator of the Ownership Fraction notwithstanding the Exclusion Rule, if Foreign Acquiror's ownership of the transferor of the Foreign Acquiror shares is below a certain threshold.

12. The Exclusion Rule should apply only to transfers of hook stock and direct issuances of stock (rather than applying to all transfers, subject to the Net Asset Requirement).

IV. The De Minimis Exception

We believe that the De Minimis Exception should be expanded. Instead of applying at a threshold of five percent, we believe the threshold should be 20%. Section 7874 seeks to deter expatriations in which the former owners of DE retain 60% (and deter more forcefully expatriations in which the former owners of DE retain 80%) of Foreign Acquiror. We believe that transactions involving the purchase of DE for all or mostly cash should not be covered by Section 7874, and this principle is presumably behind the adoption of a *de minimis* exception in the Temporary Regulations. However, we believe that the five percent threshold applicable under the De Minimis Exception is too low, as transactions involving a 20 percent rollover are a long way from the transactions Congress had in mind in adopting the 60% and 80% thresholds under Section 7874. The five percent threshold goes well beyond what is needed to serve the anti-stuffing purpose of the Nonqualified Property Exclusion Rule. If 80% of DE's indirect owners are new, the former shareholders no longer control DE and it becomes difficult to argue that DE is able to continue to conduct business as it did before the transaction.[28] Indeed, one could make the same argument if only 51% of DE's indirect owners are new, as, at that level as well, the former shareholders would generally no longer control DE. Thus, we recommend what we believe is a conservative threshold for the De Minimis Exception, 20%.

A. Legislative History and Prior NYSBA Commentary

The De Minimis Exception was promulgated in the context of a debate about the scope of the Nonqualified Property Exclusion Rule — specifically, whether certain major transactions have sufficient independent economic significance such that it would not subvert the policies of Section 7874 to include the Foreign Acquiror shares transferred in these exchanges in the Ownership Fraction denominator.

In 2002, we issued a report commenting on a proposed version of Section 7874,[29] which excluded from the denominator of the Ownership Fraction stock sold in a public offering "related to" the inversion transaction. While we appreciated the need to safeguard the anti-inversion provisions from concurrent public offerings intended to reduce the Ownership Fraction below the statutory threshold, we questioned whether:

[28] *See* text accompanying fns. 3-5 above.

[29] *See* the 2002 NYSBA Report (commenting on a Bill entitled *Reversing the Expatriation of Profits Offshore Act*, S. 2119 (Sen. Baucus and Sen. Grassley, April 11, 2002)). In 2002, numerous Bills were introduced in the House of Representatives and in the Senate intended to combat inversion transactions: H.R. 3857 (Rep. McInnis, March 6, 2002); H.R. 3884 (Rep. Neal et al., March 6, 2002); H.R. 3922 (Rep. Maloney, March 11, 2002); H.R. 4756 (Rep. Johnson, May 16, 2002); S. 2050 (Sen. Wellstone et al., March 21, 2002); S. 2119 (Sen. Baucus and Sen. Grassley, April 11, 2002). Code § 7874 was enacted pursuant to Section 801 of the *American Jobs Creation Act of 2004*.

> a *substantial* public offering that brings a *substantial* new amount of capital into the business is the type of transaction that should be disregarded, as it has meaningful independent economic significance.[30]

We also questioned whether different rules should apply to public offerings, as compared with private issuances, of Foreign Acquiror stock.[31]

Section 7874 was enacted in 2004. In December 2005, Treasury Decision 9238 requested comments on the treatment of stock sold in a public offering related to an inversion.[32] We responded in 2006:

> that the purposes of Section 7874 are best served if not all public offerings that are contemporaneous with an acquisition are treated as related to that acquisition. In particular, if the public offering is sufficiently large, it should be treated as a stand-alone transaction for this purpose. To that end, we encourage … Treasury to create a public offering exception…. Under this exception, public offerings would not be considered "related to" an acquisition, and stock issued in such an offering would be included in the denominator but not the numerator of the ownership fraction if, after the acquisition, at least 80 percent of FC is owned directly or indirectly by holders who received their FC stock in a public offering.[33]

We also noted that the classic inversion transaction that Section 7874 seeks to combat is one that replaces a domestic parent of a multinational group with a foreign parent, without a significant change in the ultimate ownership of the group:[34]

> The substantial continuity of interest, direct or indirect, by former DE shareholders is fundamental to Congress's concerns…. Accordingly, we believe that a public offering, which by definition alters the ultimate group ownership, should be considered 'related to' the covered acquisition only if it is ancillary to such acquisition. If a public offering is large enough, it would not be ancillary to, and should not be considered 'related to', the covered acquisition; it would be the principal acquisition….[35]

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[30] 2002 NYSBA Report, 52. (Emphasis added.)

[31] *Id*.

[32] T.D. 9238, 70 Fed. Reg. 76685 (December 28, 2005), 76687.

[33] *See* the 2006 NYSBA Report at 14.

[34] *Id*, citing T.D. 9238, 70 Fed. Reg. 76685 (December 28, 2005).

[35] *Id*, 14-15.

Notice 2009-78 in turn stated that the IRS intended to implement the Statutory Public Offering Exclusion Rule broadly by applying it to public offerings and private placements alike. Under the Notice, any Foreign Acquiror stock issued for cash or marketable securities would be disregarded from the denominator of the Ownership Fraction (to the extent such issuance was related to the inversion transaction).[36] The Notice did not set forth a *de minimis* exception or any other rule that would address the "independent economic significance" concerns described above.

We issued a report in 2010 that discussed anomalous results that could arise from such an expansive application of the Statutory Public Offering Exclusion Rule.[37] The 2010 NYSBA Report suggested a middle ground under which capital infusions would be treated as presumptively, rather than categorically, abusive, affording taxpayers the opportunity to rebut the presumption by establishing a valid non-tax business purpose.[38] But, in the Preamble to the Temporary Regulations, the IRS stated that "neither the statute nor the legislative history indicates that Congress intended for the statutory public offering rule to apply based on the use of the proceeds."[39] Thus, the Temporary Regulations do not take account of the purposes of the exchange of Foreign Acquiror stock for property.

The 2010 NYSBA Report also recommended a "Large Primary Issuance Exception" and a "Large Secondary Sale Exception". Under the former, if newly issued Foreign Acquiror shares represented at least a threshold proportion (e.g., 80%) of the post-transaction pool of shares of Foreign Acquiror, the Foreign Acquiror shares would not be excluded from the denominator.

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[36] 2009-40 I.R.B. 452 (September 17, 2009), ¶ 4.

[37] *See* the 2010 NYSBA Report at 40, 42.

[38] *Id*, 41-42.

[39] T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ B 2.(a)).

Under the Large Secondary Sale Exception, the exclusion rule would not apply if the former owners of DE retained less than a certain percentage (e.g., 40%) of their interest in DE after the acquisition and other investors acquired at least a threshold percentage (e.g., 50%) interest in DE.[40]

We noted in the 2010 NYSBA Report that where the magnitude of a private placement renders the transaction as primarily one of a sale or joint venture, attacking the transaction through regulations promulgated under a "public offering" anti-abuse statute "would severely test the limits" of Treasury's authority.[41] And in the context of a sizeable public offering, we remained "convinced that this is not the kind of 'public offering *related to* the acquisition' that Congress had in mind."[42]

B. Scope of the *De Minimis* Exception

The De Minimis Exception responds to concerns expressed in the 2010 NYSBA Report, described above, regarding applying the Statutory Public Offering Exclusion Rule to transactions in which the historic holders' percentage interest in DE in fact drops dramatically. The five percent threshold contained in the De Minimis Exception is too low. We believe a threshold of 20% better targets transactions intended to be covered by Section 7874. If the Ownership Fraction is less than 20%, the former DE shareholders no longer control DE. A major ownership change has occurred. As discussed in the 2010 NYSBA Report, the 60% and 80% thresholds in Section 7874 imply that Section 7874 should be interpreted to apply only to transactions involving a substantial continuity of ownership.

[40] 2010 NYSBA Report, 46-47.

[41] *Id*, 42.

[42] *Id*. (Emphasis added.)

A five percent threshold means that transactions involving mostly cash consideration could result in a 100% Ownership Fraction. Consider the following transaction in which all the former DE shareholders exchange their DE shares for Foreign Acquiror stock but Foreign Acquiror winds up owned 90% by new investors:

> **Example 1 (Rollover by All Shareholders).** Foreign Acquiror, a newly formed corporation, issues 90 shares of Foreign Acquiror stock to a group of investors for cash. The DE shareholders exchange all their DE shares for 10 Foreign Acquiror shares.

Under the Temporary Regulations, the Ownership Fraction in Example 1 would be 100%, because the stock issued to the investors in exchange for cash would be excluded under the Nonqualified Property Exclusion Rule. The De Minimis Exception, as written, would not apply, because absent the Exclusion Rule the Ownership Fraction would be 10%, which exceeds 5%. We view Example 1 as significantly different from the transactions at which Section 7874 aims. The amount of Foreign Acquiror shares received by the former DE shareholders in the example is far lower than in a classic inversion transaction. Also, it is reasonable to conclude that the business of DE generally will not continue in the same manner as before where a new set of shareholders exercises control. Moreover, the influx of cash in Example 1 would have a transformative impact, as cash of that magnitude is likely to be used for major capital expenditures, an acquisition or repayment of substantial amounts of debt.[43] We are not suggesting that issuances of Foreign Acquiror stock for cash should be tested based on the use of the cash. But such a sizable amount of cash, relative to the value of DE, implies that the cash infusion is fundamentally different from the stuffing of cash with which the Nonqualified Property Exclusion Rule ought to be concerned.

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[43] If the investors had first used the cash to acquire qualified property and then contributed the qualified property to Foreign Acquiror, the shares issued to the investors generally would not be excluded under the Nonqualified Property Exclusion Rule. But because, instead, the cash was first contributed to Foreign Acquiror and then used to acquire qualified property, the result under the Temporary Regulations is different, notwithstanding the economic equivalence of the two alternatives.

A common technique for motivating management of DE in the case of an acquisition of DE by a private equity fund is to have the acquiring company issue shares to management in exchange for their DE shares. In such a case, management will often wind up owning more than five percent of the stock of Foreign Acquiror:

> **Example 2 (Management Rollover).** DE has 100 shares of stock outstanding. 10 are held by management. Foreign Acquiror, a newly formed corporation, issues 90 shares of Foreign Acquiror stock to a group of investors for cash. Foreign Acquiror uses the cash to buy the 90 DE shares not held by management. The 10 DE shares held by management are exchanged for 10 Foreign Acquiror shares.

In Example 2, the Exclusion Rule would exclude the 90 shares issued to the investors from the denominator of the Ownership Fraction because they were issued for cash. Thus, the Ownership Fraction would be 10/10, or 100%. As written, the De Minimis Exception would not apply, because, without regard to the Exclusion Rule, the Ownership Fraction would be 10/100, or 10%, which exceeds five percent.

One could argue that Section 7874 is properly invoked here, because DE will be able to "continue to conduct business in the same manner as . . . prior to the inversion" on account of the facts that the only new assets in the system — the cash — are used to purchase DE and that the historic managers continue to manage the company. But these concerns do not seem sufficient to cause Section 7874 to apply. Control of DE has shifted to new investors as 90% of the old shareholders have cashed out with only 10% remaining. Management has a new set of shareholders to answer to.[44] Absent the Exclusion Rule, the Ownership Fraction is nowhere near the 60% and 80% thresholds legislated by Congress, thresholds well above majority control. It seems artificial to treat the transaction as if the Ownership Fraction is that high when, in fact, there has been a major ownership change.

[44] In one scenario, the shift in control is not as dramatic, namely, where a new public invests cash in Foreign Acquiror, which cash is used to buy out a historic group of public shareholders. Consideration could be given to having an exception to the De Minimis Exception in this scenario.

One could also argue that the fact that the managers remain as managers suggests that the business will continue to be conducted as before despite the change in control. But, the application of Section 7874 does not turn on who the managers are. Moreover, the fact that DE's management remain as managers is independent of their exchanging the 10 DE shares for Foreign Acquiror shares. DE's management could have continued to manage the business without any such rollover of management shares. Further, in light of the 60% and 80% thresholds in the statute, it seems far from clear that Congress intended to capture a management rollover of 5 to 20%, as such a small rollover is incidental and does not implicate the inversion concerns of Section 7874 any more than such concerns would have been implicated in the absence of such a rollover.

A further argument for a 20% *de minimis* exception stems from the IGR exception.[45] As noted, the IGR exception overrides the EAG Exclusion Rule in the case of an internal group restructuring, which occurs when the 80% parent of DE remains the 80% parent of Foreign Acquiror. One could arguably circumvent a *de minimis* exception of less than 20% by reliance on the IGR exception. Suppose that a historic foreign corporation ("Historic Foreign Corporation") acquires 80% of DE for cash, and then that the Historic Foreign Corporation and the owners of the remaining 20% of DE contribute DE to a new foreign corporation (Foreign Acquiror). Depending on the application of the step transaction doctrine, one could view Historic Foreign Corporation as the 80% common parent before and after the transaction. If so, the IGR exception would exclude Foreign Acquiror stock held by Historic Foreign Corporation from the numerator of the Ownership Fraction while including it in the denominator, resulting in

[45] *See* DiFronzo, Cousin and Collins, "An Order of Rice Cakes: The Impact of Public Offerings and Private Placements on § 7874" 43 *Tax Mgmt Int'l J.* 6 (June 2014).

an Ownership Fraction of 20%.[46] This transaction is economically equivalent to a transaction in which Historic Foreign Corporation first contributes cash to Foreign Acquiror for 80 shares, and Foreign Acquiror then acquires DE 80% for cash and 20% for 20 Foreign Acquiror shares. In the latter scenario, the five percent De Minimis Exception would not apply and the 80 Foreign Acquiror shares issued to Historic Foreign Corporation for cash would therefore be excluded from the denominator, resulting in an Ownership Fraction of 100%. For consistency with the IGR exception, a 20% threshold for the De Minimis Exception would seem appropriate.

On a separate note, we question the need for the Ownership Prong of the De Minimis Exception that tests ownership by former shareholders or former partners of DE,[47] as distinguished from the By Reason Of Prong that tests how much Foreign Acquiror stock was received by such former shareholders or former partners by reason of holding DE shares or partnership interests.[48] As drafted, the Ownership Prong states that a transaction is not eligible for the De Minimis Exception if former shareholders or former partners in the aggregate own, after the transaction, five percent or more (by vote or value) of the stock of, or a partnership interest in, any member of Foreign Acquiror's EAG (regardless of how much of that ownership was received by reason of holding DE shares or partnership interests). Thus, for example, if former shareholders of DE exchange DE shares for Foreign Acquiror stock representing less than five percent of Foreign Acquiror, the transaction nonetheless fails the De Minimis Exception if any such former shareholder (even one that owns a tiny percentage of DE) separately contributes cash or other assets to Foreign Acquiror in exchange for Foreign Acquiror stock, or is a

[46] Treas. Reg. § 1.7874-1(c)(1).

[47] Treas. Reg. § 1.7874-1(d)(1)(ii).

[48] Treas. Reg. § 1.7874-1(d)(1)(i).

preexisting shareholder of Foreign Acquiror, in circumstances that bring the Ownership Fraction to five percent or more.

It is not clear to us why cash contributed by a former DE shareholder, especially a very small former DE shareholder, should be treated differently for purposes of determining whether the De Minimis Exception applies from cash contributed by persons that were not former DE shareholders. Nor arguably does it seem appropriate to take into account preexisting Foreign Acquiror stock owned by a former DE shareholder. Furthermore, it seems imprecise to test the De Minimis Exception by reference to the percentage of stock held by former owners of DE in *any* member of Foreign Acquiror's EAG. If former owners of DE own more than a *de minimis* amount of stock in an insignificant member of Foreign Acquiror's EAG, the De Minimis Exception would not apply in circumstances where it probably should.

As the overall thrust of Section 7874 is to measure how much of Foreign Acquiror is received by reason of holding stock or partnership interests in DE, it seems appropriate that the De Minimis Exception be determined by reference to the same standard, as is the case in the By Reason Of Prong. It is true that we have argued for a 20% *de minimis* threshold on the grounds that the former DE shareholders no longer control DE and that the Ownership Prong confirms that the former DE shareholders no longer control DE. One could argue against eliminating the Ownership Prong on that basis. However, 20% is itself a long way from control. If there is a concern that historic DE shareholders may own "old and cold" Foreign Acquiror shares or that they may acquire Foreign Acquiror shares for consideration other than DE shares to such an extent that the De Minimis Exception should not apply, then perhaps the Ownership Prong should be retained but a higher *de minimis* threshold should be considered for such scenarios. If the Ownership Prong is retained, we would suggest refinements to address the concerns addressed above.

C. Publicly Traded Domestic to Publicly Traded Foreign Corporation

The IRS requested comments regarding a scenario where over time, a publicly traded domestic corporation could become a publicly traded foreign corporation. The IRS expressed concern that the De Minimis Exception may facilitate such a transaction in a way that implicates the policies of Section 7874. Specifically:

> in connection with the buyout of a publicly traded domestic corporation . . . the buyer may contribute cash to a newly formed foreign acquiring corporation that uses such cash, along with the proceeds from borrowings and a small amount of its stock, to acquire all of the stock of a publicly traded domestic corporation. The small amount of stock of the foreign acquiring corporation often is issued to the management of the domestic corporation. After a period of time, the buyer may sell its stock of the foreign acquiring corporation pursuant to a public offering. The public offering of the stock of the foreign acquiring corporation may have been one of the intended exit strategies of the buyer when it organized the foreign acquiring corporation to acquire the stock of the domestic corporation.[49]

We believe that the scope of Section 7874 should not be expanded by regulations to cover the transaction described above. First, even where the buyer's intentions to exit the investment are relatively fixed, whether that exit can be accomplished by a public offering is a matter of speculation and uncertainty until very close to the time that it actually occurs. Thus, no aspect of the step transaction doctrine, or the principles that motivate that doctrine, would support, in our view, an application of Section 7874 to the transaction.

Second, the essence of the acquisition of DE in this situation is an acquisition for cash. The exchange of management shares for Foreign Acquiror shares is incidental. As mentioned

[49] *See* T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ G). Although the EAG Exclusion Rule would, at first glance, apply to these facts to exclude from the Ownership Fraction Foreign Acquiror stock held by the buyer (assuming the buyer is itself a corporation), the loss of control exception of Treas. Reg. § 1.7874-1(c)(3) to the EAG Exclusion Rule would apply to reinstate such stock in the denominator of the Ownership Fraction, because, following Foreign Acquiror's acquisition of DE, the former shareholders of DE hold 50% or less of the stock of Foreign Acquiror or of any member of its EAG.

above in Part IV.B., we do not believe that transactions of this type should be caught by Section 7874 where a significant change in ownership occurs.

Third, while one could argue that an acquisition of DE by a newly formed Foreign Acquiror for cash, without any rollover, is a concern from a tax policy perspective, that concern is far broader than the legislated target of Section 7874. It is true that if newly formed Foreign Acquiror acquires DE for cash, the operation of DE may not change at all, and DE may be able to enjoy certain benefits that arise from having a foreign parent. But Section 7874 does not reach this transaction, as Section 7874 requires continuity of ownership of 60% or 80%. Congress left all-cash acquisitions for another day. Section 7874 by its terms does not apply to all-cash acquisitions.[50] As such, we do not believe that regulations should interpret Section 7874 in a manner that causes a management rollover (or a relatively small non-management rollover) to trigger Section 7874, even if the owners of Foreign Acquiror eventually exit the investment by way of a public offering of Foreign Acquiror stock. If the policies of Section 7874 are not violated by an all-cash acquisition, we do not see how they are violated by an acquisition that includes a small, incidental rollover and, after a period of time, a public offering.

D. The Frozen Numerator Rule

The Frozen Numerator Rule appears to stem from concerns that taxpayers will avoid the Nonqualified Property Exclusion Rule by reversing the order of steps.[51] This is a legitimate concern, but the benefit of the De Minimis Exception should be extended to transactions subject to the Frozen Numerator Rule:

> **Example 3 (DE Shareholders form Foreign Acquiror).** DE has 100 shares of stock outstanding held by 10 equal shareholders. The shareholders of DE contribute their

[50] *See also* discussion in Part IV.B., above.

[51] T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ E). *See* Temp. Treas. Reg. § 1.7874-5T.

> shares to newly-formed Foreign Acquiror in exchange for 100 shares of Foreign Acquiror and then, pursuant to a binding commitment, each of the 10 shareholders sells 9 Foreign Acquiror shares (an aggregate of 90 shares sold) to a group of investors and each retains one Foreign Acquiror share (an aggregate of 10 shares retained). Under the Frozen Numerator Rule, the Ownership Fraction would be 100/100, or 100%, because the sale of the 90 shares would be disregarded.

The Frozen Numerator Rule turns off any application of the step transaction doctrine for purposes of counting the number of Foreign Acquiror shares in the numerator of the Ownership Fraction. If step transaction principles applied, the sale of the 90 Foreign Acquiror shares in Example 3 would presumably be taken into account in determining the Ownership Fraction, resulting in an Ownership Fraction of 10/100, or 10%. The Frozen Numerator Rule is likely motivated by a concern that the steps in Example 3 could be reversed, resulting in a transaction that does arguably raise Section 7874 concerns:

> **Example 4 (Investors Form Foreign Acquiror).** A group of investors forms Foreign Acquiror by contributing cash to Foreign Acquiror in exchange for 90 shares of Foreign Acquiror. Then Foreign Acquiror acquires DE for cash and 10 shares of Foreign Acquiror stock.

The Frozen Numerator Rule ensures that the result in Example 3 is the same as in Example 4. In both cases, the historic shareholders of DE own 10 shares of Foreign Acquiror stock and cash, the new investors own 90 shares of Foreign Acquiror, and Foreign Acquiror owns DE. Under the alternative steps of Example 4, the ownership fraction would be 10/10. The 90 shares of Foreign Acquiror issued to the new investors would be excluded under the Nonqualified Property Exclusion Rule because they were issued for cash.

We agree that the results for these economically identical transactions, Examples 3 and 4, should be the same, as taxpayers should not be able to change the Ownership Fraction simply by reversing the order of the transaction steps. Indeed, on these facts the result in Examples 3 and 4 is the same, an Ownership Fraction of 100%. However, suppose that in the Examples, the new investors wind up with 96 shares of Foreign Acquiror while the historic owners of DE wind up with four shares of Foreign Acquiror. If the steps are executed as in Example 4 (such that the new investors form Foreign Acquiror for cash, and Foreign Acquiror then acquires DE for cash and stock), the De Minimis Exception would result in an Ownership Fraction of 4/100, or four percent. If instead the steps are executed as in Example 3 (such that the owners of DE drop DE into Foreign Acquiror and then sell a portion of their Foreign Acquiror stock), the Ownership Fraction would be 100% under the Frozen Numerator Rule. There appears to be no mechanism in the Temporary Regulations for applying the De Minimis Exception to cases in which the historic owners of DE, pursuant to a plan, contribute DE to Foreign Acquiror and then dispose of all but a *de minimis* amount of their Foreign Acquiror stock. Indeed, if in Example 3 the historic owners sold all the shares of Foreign Acquiror, retaining nothing, under the Frozen Numerator Rule the Ownership Fraction would be 100%, as ownership would be tested prior to the sale of the Foreign Acquiror shares. The Frozen Numerator Rule should be modified so that transactions following the pattern of Example 3 are eligible for the De Minimis Exception.

If the foregoing recommendation is adopted, a rule may be needed to determine the conditions under which the second step in Example 3 (the former owners of DE disposing of all but a *de minimis* amount of their Foreign Acquiror stock) is sufficiently connected to the first step (the owners of DE contributing DE to Foreign Acquiror) to warrant the invocation of the De Minimis Exception.

V. Subsequent Transfers of Foreign Acquiror Stock and the EAG Rules

Paragraph E of the Preamble to the Temporary Regulations states that the IRS is studying the extent to which subsequent transfers of stock of a Foreign Acquiror should be taken into account in applying the EAG Exclusion Rule. Recall that, under the EAG Exclusion Rule, Foreign Acquiror stock held by members of Foreign Acquiror's EAG is excluded from both the numerator and denominator of the Ownership Fraction. Likewise, the IRS states that it is studying the extent to which subsequent transfers of stock of a Foreign Acquiror should be taken into account in applying the IGR and "loss of control" exceptions to the EAG Exclusion Rule set forth in Treasury Regulations § 1.7874-1. The Preamble to the Temporary Regulations notes that the Preamble to regulations promulgated in 2009 (the "2009 Preamble") raised these issues in the context of an IGR followed by a divisive spin-off.[52] The 2009 Preamble stated that the IRS would promulgate regulations preventing the IGR exception from applying where, pursuant to the same plan (or series of related transactions) that includes the acquisition of DE, all or part of the stock of Foreign Acquiror is transferred outside the EAG.

The Preamble to the Temporary Regulations notes that similar issues to those arising in the case of a divisive spin-off can arise in the context of a sale by a corporation of the stock of Foreign Acquiror or a Section 368 acquisitive asset reorganization. As described in the Preamble, in these cases, "a corporation receives and only temporarily holds the stock of the foreign acquiring corporation, and, after the transfer of such stock, the corporation no longer is a member of the expanded affiliated group that includes the foreign acquiring corporation."[53] Comments were requested on whether different results should apply depending on whether the corporation that temporarily holds shares in Foreign Acquiror is foreign or domestic.

We believe that different results should apply depending on whether the corporation that temporarily owns the stock of Foreign Acquiror is foreign or domestic. In general, as discussed below, if the corporation that temporarily holds the Foreign Acquiror stock is foreign, we believe Section 7874 should not apply, because no inversion has occurred. DE was already held by a foreign parent corporation ("Foreign Parent") before the transaction.[54] Indeed, this appears to be

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[52] *See* T.D. 9453, 2009-28 I.R.B. 114 (June 12, 2009).

[53] T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ E).

[54] For purposes of this discussion, "parent" means a corporation that owns 80% or more of the relevant entity.

the rationale of Treasury Regulations § 1.7874-2(c)(2), which turns off Section 7874 in the case of an acquisition of stock of a foreign corporation that directly or indirectly owns DE.[55]

If the corporation that temporarily holds Foreign Acquiror stock is domestic ("Domestic Parent"), we believe that, in cases where Domestic Parent owns less than 80% of Foreign Acquiror at the end of the transaction, the stock in Foreign Acquiror held by Domestic Parent after the transaction that is received for DE stock or partnership interests should be counted in the numerator (and the denominator) of the Ownership Fraction. Thus, in such circumstances, we believe that the EAG Exclusion Rule should not apply even if Domestic Parent is a member of the EAG that includes Foreign Acquiror after the transaction.

We consider in turn cases involving a Foreign Parent and then cases involving a Domestic Parent of DE.

A. Foreign Parent

If Foreign Parent owns DE, an acquisition of DE by Foreign Acquiror should be outside the province of Section 7874 because DE is already inverted. We would recommend a general rule exempting transactions from Section 7874 where a foreign corporation owns at least 80% of the stock or partnership interests in DE before the transaction:

> **Example 5 (Foreign Parent—Section 355).** Foreign Parent owns DE. Foreign Parent contributes DE to a foreign corporation ("Foreign Controlled") and then spins off Foreign Controlled to the shareholders of Foreign Parent in a transaction covered by Section 355.

Example 5 does not present an example of an inversion that should generally be of concern from a Section 7874 perspective. Although DE is owned by Foreign Controlled after the transaction, DE was owned by Foreign Parent before the transaction. Moreover, qualification under Section 355 is not relevant to this analysis.

[55] *See also* Treas. Reg. § 1.7874-2(k), Example 4, in which an acquisition by Foreign Acquiror of the stock of Foreign Parent, which wholly owns a domestic corporation, is outside the scope of Section 7874 pursuant to Treas. Reg. § 1.7874-2(c)(2).

The same analysis would apply if Foreign Parent merged into Foreign Acquiror:

> **Example 6 (Foreign Parent—Forward Merger).** Suppose Foreign Parent owns DE. Foreign Parent merges into Foreign Acquiror in exchange for Foreign Acquiror stock and distributes the stock of Foreign Acquiror to the Foreign Parent shareholders.

In Example 6, DE is owned initially by Foreign Parent and subsequently by Foreign Acquiror. As in Example 5, no inversion of DE has occurred.

The same logic would also apply if Foreign Parent receives cash or other nonqualified property in exchange for the Foreign Acquiror shares:

> **Example 7 (Foreign Parent—Sale).** Foreign Parent contributes DE to Foreign Acquiror and then sells the stock of Foreign Acquiror to a group of investors for cash.

Example 7, like Examples 5 and 6, does not raise inversion concerns. DE was owned by Foreign Parent initially and by Foreign Acquiror after the transaction. Moreover, if the steps were reversed, such that the investors formed Foreign Acquiror, the De Minimis Exception would apply. (Our Recommendation 3 would apply the De Minimis Exception to Example 7.)

By the same token, if Foreign Parent makes a partial sale of Foreign Acquiror shares, the transaction does not generally raise inversion concerns because DE is owned by Foreign Parent before the transaction and by Foreign Acquiror after the transaction:

> **Example 8 (Foreign Parent—Partial Sale).** Same as Example 7, except that Foreign Parent retains 40% of the shares of Foreign Acquiror and sells 60% of the shares of Foreign Acquiror to a group of investors.

> **Example 9 (Foreign Parent—Investors Form Foreign Acquiror).** Suppose that a group of investors forms Foreign Acquiror for cash. Then, Foreign Acquiror acquires DE from Foreign Parent in exchange for cash and Foreign Acquiror shares representing 40% of Foreign Acquiror.

In Examples 8 and 9, after the steps, the investors own 60% and Foreign Parent owns 40% of Foreign Acquiror, which owns DE. Under the Temporary Regulations, in Example 9 the shares of Foreign Acquiror issued to the investors would be excluded under the Nonqualified Property Exclusion Rule, because they were issued for cash with the result that the Ownership Fraction would be 100% (as the De Minimis Exception does not apply). Under the Temporary Regulations, in Example 8, under the Frozen Numerator Rule, the Ownership Fraction might also be 100% because the sale of shares to the investors would be disregarded.[56] Neither Example 8 nor 9 should be covered by Section 7874, though, because DE started off owned by Foreign Parent and winds up owned by Foreign Acquiror.

We believe that Examples 5 through 9 should not be covered by Section 7874. A special exception to Section 7874 should be provided in cases where DE is owned before the transaction by a Foreign Parent.

There is one concern that could be raised, however, relating to treaty eligibility and earnings stripping. Suppose that Foreign Parent is not eligible for the benefits of a tax treaty with the United States, while Foreign Acquiror is eligible for a tax treaty that, say, provides for a zero percent withholding rate on dividends.[57] Under the treaty, in any of the examples,[58] after the transaction, DE could distribute a dividend in the form of a debt instrument to Foreign Acquiror subject to zero percent withholding. The interest deductions on the debt instrument would erode the United States corporate tax base.[59] Erosion of the corporate tax base is a policy concern of Section 7874. Arguably, however, Section 7874 is not an appropriate tool to police treaty shopping. Nothing in Section 7874 turns on application of a treaty nor does Section 7874 distinguish among foreign jurisdictions (except in relation to the "substantial business activities"

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[56] The result in Example 8 is not entirely clear. *See* discussion of Example 14, below.

[57] Variations of this example would include scenarios where Foreign Parent is eligible for a treaty and Foreign Acquiror is eligible for a different treaty that provides a lower rate of withholding on dividends.

[58] Example 7, involving a sale of all the stock of Foreign Acquiror for cash, should in any event be outside the ambit of Section 7874 for the reasons discussed above in Part IV.D.

[59] We also considered scenarios where Foreign Parent is a CFC and Foreign Acquiror is not a CFC or where Foreign Parent is a PFIC and Foreign Acquiror is not a PFIC. We do not believe that it is appropriate for Section 7874 to monitor these scenarios. The CFC and PFIC rules relate to taxation of the holders of a foreign corporation, whereas Section 7874, we believe, pertains to taxation of the foreign corporation itself, DE and its subsidiaries (or, in the case of a DE that is a partnership, taxation of the operations of DE and its subsidiaries).

test). If the IRS were to conclude, however, that Section 7874 should police treaty shopping, then our Recommendation to exempt transactions in which DE is owned before the transaction by Foreign Parent would not apply.

Treasury Regulations § 1.7874-2(c)(2) supports the view that Section 7874 should not apply to an acquisition of DE from Foreign Parent. That Regulation provides that an acquisition of stock of a foreign corporation that directly or indirectly owns DE is not considered to be an indirect acquisition of the properties of DE. Hence, Section 7874 would not apply to such an acquisition. The rationale for this Regulation would appear to be that no inversion occurs by reason of the acquisition because DE is already owned by a foreign corporation. Indeed, that Regulation would permit an already-inverted DE to gain access to a preferable treaty. Suppose Foreign Parent, in an unfavorable treaty jurisdiction, owns DE and that Foreign Acquiror, in a favorable treaty jurisdiction, acquires Foreign Parent. Suppose that after a period of time, in a separate transaction, Foreign Parent transfers the stock of DE to Foreign Acquiror. Under the Regulation, the acquisition of Foreign Parent is not an acquisition of the properties of DE, so Section 7874 does not apply despite the fact that DE was able to gain access to a better treaty. Treasury Regulations § 1.7874-2(c)(2) would imply that an acquisition of DE from Foreign Parent should not cause Section 7874 to apply as it appears that, with that Regulation, the IRS has determined not to pursue foreign-to-foreign transfers, despite potential treaty shopping that may occur through foreign-to-foreign transfers.

B. Domestic Parent: Spin-Offs

Scenarios where the temporary owner of Foreign Acquiror stock is a domestic corporation do raise potential Section 7874 policy concerns. In the case of a pro rata spin-off by Domestic Parent of DE into Foreign Controlled, the Ownership Fraction should be 100%. The rules should be modified to reach that result:

> **Example 10 (Domestic Parent—Section 355).** Suppose Domestic Parent contributes DE to Foreign Controlled and then spins off Foreign Controlled in a transaction covered by Section 355.

Example 10 raises an inversion concern because DE is initially owned by Domestic Parent and ends up owned by Foreign Controlled.

To a degree, a distribution by Domestic Parent of Foreign Controlled is already policed by Section 367 in that Section 367 mandates gain recognition to Domestic Parent except to the extent that the distributee is a domestic corporation.[60] But, the policies of Section 7874 differ in some respects from those of Section 367.

At the core of Section 7874 is a concern with scenarios where DE is acquired by Foreign Acquiror *and* there is continuity of ownership. Example 10 seems to merit an Ownership Fraction of 100%, because the indirect shareholders of DE continue to own 100% of DE. Before the transaction, they owned DE through Domestic Parent and after the transaction they own DE through Foreign Controlled.[61] As a technical matter, though, the shareholders of Domestic Parent are not historic owners of DE and therefore arguably their post-transaction ownership of Foreign Controlled is not taken into account in the numerator of the Ownership Fraction under the language of Section 7874(a)(2)(B)(ii).

The best way to address the transaction may therefore be by reference to Domestic Parent's ownership of Foreign Acquiror before the spin-off. Thus, in order to produce an ownership fraction of 100% in Example 10, the Frozen Numerator Rule could be made applicable so that the Ownership Fraction is measured after the contribution of DE to Foreign

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[60] Treas. Reg. § 1.367(e)-1(b)(1) (gain recognition except on distributions to citizens or residents of the United States or domestic corporations); Treas. Reg. § 1.367(b)-5(b) (gain recognition on distributions to individuals).

[61] The Exclusion Rule is not the best mechanism for capturing Example 10, as nonqualified property need not be involved in the transaction in order for it to raise Section 7874 concerns. Nonqualified property would be involved if Domestic Parent extracted value by, for example, leveraging up Foreign Controlled and having Foreign Controlled distribute the proceeds, having Foreign Controlled assume debt of Domestic Parent or engaging in a debt-for-equity exchange.

Controlled but before the spin-off. It would follow that, under the EAG Exclusion Rule, all the shares in Foreign Controlled would be disregarded resulting in a fraction of 0/0.[62] The EAG Exclusion Rule would therefore have to be modified to provide that, in these circumstances, shares held by Domestic Parent are included in both the numerator and the denominator, resulting in a fraction of 100%. The regulations would also have to provide, as implied by the 2009 Preamble, that the IGR exception does not apply when Foreign Acquiror (including Foreign Controlled) is meant to be transferred out of the EAG as part of the plan.

C. Domestic Parent: Disposition of 100%

The analysis is different if, instead of distributing the stock of Foreign Acquiror, the temporary owner, Domestic Parent, sells the stock of Foreign Acquiror, because, on the one hand, nonqualified property is involved and, on the other hand, unlike a spin-off, there is a lack of (or at least less) continuity of indirect ownership:

> **Example 11 (Domestic Parent; Drop and Sell).** Suppose Domestic Parent contributes DE to Foreign Acquiror and then sells Foreign Acquiror for cash to a group of investors.

Example 11 should have the same consequences as if the investors who purchased Foreign Acquiror had instead formed Foreign Acquiror for cash and Foreign Acquiror had then used the cash to buy DE from Domestic Parent. Under these alternative steps, the Exclusion Rule would at first glance apply to exclude the shares of Foreign Acquiror issued to the investors. But because Domestic Parent owns no Foreign Acquiror shares after the transaction, the Ownership Fraction would be 0% pursuant to the De Minimis Exception. If, as recommended above in Part IV.D., the Frozen Numerator Rule is modified to permit the De Minimis Exception to apply to drop and sell scenarios, it does not seem that any further special rule is required to address the

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[62] Code § 7874(c)(2)(A); Treas. Reg. § 1.7874-1(b).

scenario in Example 11 in which the historic holder of DE is Domestic Parent, as distinguished from a group of shareholders.

D. Domestic Parent: Partial Dispositions

If Domestic Parent makes a partial disposition of DE, the analysis is more complex. The interplay of the EAG Exclusion Rule, the IGR exception and the Nonqualified Property Exclusion Rule could result in anomalies, as the regulations are currently drafted. In order to bring these to light, we compare scenarios where Domestic Parent initially owns 100% of DE and disposes of either 15%, 30% or 51%. (We refer to the amount disposed of by Domestic Parent, or the amount owned by the investors at the end of the day, as "x".) We believe that the rules generally work appropriately in the 15% and 51% cases, but not in the 30% case. That is, the rules generally work appropriately where Domestic Parent engages in an IGR (the 15% case) or where Domestic Parent and Foreign Acquiror are not members of the same EAG after the transaction (the 51% case). The rules do not work properly where Domestic Parent and Foreign Acquiror are in the same EAG after the transaction but Domestic Parent owns less than 80% of Foreign Acquiror. In this latter case, we believe the Foreign Acquiror shares owned by Domestic Parent and received for DE shares or partnership interests should be included in the numerator and the denominator of the Ownership Fraction. In other words, the EAG Exclusion Rule should not apply in such cases.

First, consider a case involving an IGR:

> **Example 12 (Domestic Parent; Drop and Sell; x=15).** Domestic Parent owns DE. Domestic Parent contributes DE to Foreign Acquiror in exchange for 100% of the stock of Foreign Acquiror, and then sells 15% of Foreign Acquiror to a group of investors for cash.

Example 12 should reach the same result as the following economically equivalent example in which investors form Foreign Acquiror:

> **Example 13 (Domestic Parent; Investors Form Foreign Acquiror; x=15).** Domestic Parent owns DE. Investors form Foreign Acquiror for cash. Then, Foreign Acquiror acquires DE from Domestic Parent for cash and 85% of the stock of Foreign Acquiror.

In both examples, Domestic Parent winds up owning 85% of Foreign Acquiror, and the investors 15%. In Example 12, the EAG Exclusion Rule would at first blush exclude the shares owned by Domestic Parent from the numerator and the denominator. But, the IGR exception would apply to reinstate the Foreign Acquiror stock held by Domestic Parent in the denominator of the Ownership Fraction, resulting in an Ownership Fraction of zero. In Example 13, the IGR exception would also apply. Thus, the 85% owned by Domestic Parent would be excluded from the numerator but not the denominator. The 15% of Foreign Acquiror issued to the group of investors for cash would be excluded pursuant to the Nonqualified Property Exclusion Rule. The result is an Ownership Fraction of 0/85, or zero. In both cases, zero is the right result because the transaction is an IGR.

Next consider the other end of the spectrum, a scenario where Domestic Parent is not a member of the EAG that includes Foreign Acquiror after the transaction but Domestic Parent does own more than a *de minimis* amount of Foreign Acquiror stock. Here the rules should result in an Ownership Fraction of 100%. Subject to a clarification in the case of Example 14, the rules appear to reach that result:

> **Example 14 (Domestic Parent; Drop and Sell; x=51).** Same as Example 12, except that Domestic Parent sells 51% of Foreign Acquiror to a group of investors for cash rather than 15%.

As above, Example 14 should have the same result as a scenario in which the investors form Foreign Acquiror:

> **Example 15 (Domestic Parent; Investors Form Foreign Acquiror; x=51).** Same as Example 13, except that Foreign Acquiror acquires DE from Domestic Parent for cash and 49% of the stock of Foreign Acquiror, rather than 85%.

In Examples 14 and 15, Domestic Parent winds up owning 49% of Foreign Acquiror, and the investors 51%. Taking Example 15 first, the 51% of Foreign Acquiror's stock issued to the investors for cash would be excluded from the denominator of the Ownership Fraction pursuant to the Nonqualified Property Exclusion Rule, resulting in an Ownership Fraction of 49/49, or 100%. The EAG Exclusion Rule would be inapplicable because Domestic Parent does not own more than 50% of Foreign Acquiror.[63]

It should be made clear that the Ownership Fraction for Example 14 is also 100%. As the rules are written, the result is not entirely clear. Testing after the first step in Example 14 (Domestic Parent's contribution of DE to Foreign Acquiror), Domestic Parent owns 100% of Foreign Acquiror. Those shares would arguably be excluded from the numerator and the denominator under the EAG Exclusion Rule. Although that step, taken alone, would be an IGR, the IGR exception should not apply because more than 20% of Foreign Acquiror is sold in the second step. Arguably, under that logic, the EAG Exclusion Rule also should not apply. Thus, after the first step, arguably the fraction is 100/100, and, if so, the Frozen Numerator Rule would apply to lock in an Ownership Fraction of 100%.

Finally, consider the intermediate case, where Domestic Parent does not wind up owning enough shares in Foreign Acquiror to qualify the transaction as an IGR but does wind up owning enough shares so that Domestic Parent and Foreign Acquiror remain in the same EAG:

> **Example 16 (Domestic Parent; Drop and Sell; x=30).** Same as Example 12, except that Domestic Parent sells 30% of Foreign Acquiror to a group of investors for cash rather than 15%.

Example 16 should have the same result as an economically equivalent scenario in which the investors form Foreign Acquiror:

[63] Code §§ 1504(a), 7874(c)(1).

> **Example 17 (Domestic Parent; Investors Form Foreign Acquiror; x=30).** Same as Example 13, except that Foreign Acquiror acquires DE from Domestic Parent for cash and 70% of the stock of Foreign Acquiror, rather than 85%.

Domestic Parent winds up owning 70% of Foreign Acquiror, and the investors 30%, in Examples 16 and 17.

The rules arrive at an incorrect result. In Example 16, Domestic Parent's 70% interest in Foreign Acquiror would be excluded from both the numerator and denominator of the Ownership Fraction pursuant to the EAG Exclusion Rule, resulting in an Ownership Fraction of 0/30, or zero.[64] The IGR exception would be inapplicable because Domestic Parent, after the transaction, would not hold 80% or more of the stock of Foreign Acquiror. In Example 17, Domestic Parent's 70% interest in Foreign Acquiror would again be excluded from both the numerator and denominator of the Ownership Fraction pursuant to the EAG Exclusion Rule. But, in Example 17, unlike in Example 16, the remaining 30% of Foreign Acquiror stock — held by the group of investors — would be excluded from the denominator pursuant to the Nonqualified Property Exclusion Rule. The result is an indeterminate Ownership Fraction of 0/0.[65]

We submit that, absent reconsidering whether the appropriate threshold for an IGR is 80% (an issue that is beyond the scope of this Report), the correct Ownership Fraction in both Examples 16 and 17 should be 100%. Domestic Parent should not be able to invert DE and avoid Section 7874 in these circumstances. In both examples, Domestic Parent reduces

[64] The Frozen Numerator Rule should not change this result, because all that rule does is preserve any Foreign Acquiror shares included in the numerator of the Ownership Fraction. In this Example, no shares were included in the numerator upon Domestic Parent's contribution of DE to Foreign Acquiror, because of the EAG Exclusion Rule.

[65] In a recent Private Letter Ruling, the IRS concluded that an Ownership Fraction of 0/0 is equal to an amount less than 60% — presumably, zero. *See* PLR 201432002 (August 8, 2014). In the Ruling, shares of the Foreign Acquiror issued in a Section 368(a)(1)(F) reorganization were excluded from the numerator and the denominator under the EAG Exclusion Rule, while shares of the Foreign Acquiror issued in a private placement and an initial public offering were excluded from the denominator under the Nonqualified Property Exclusion Rule.

Domestic Parent's ownership of Foreign Acquiror by receiving cash either directly (Example 16) or through a cash-stuffed Foreign Acquiror (Example 17). If Domestic Parent had wound up owning 80% or more of Foreign Acquiror, as in Examples 12 and 13 where x = 15, the transaction would constitute an IGR outside the scope of Section 7874. Instead, Domestic Parent winds up with more than 50% (activating the EAG Exclusion Rule) but less than 80% (switching off the IGR exception) of Foreign Acquiror. We see no reason that the EAG Exclusion Rule should apply in such cases to exclude shares from the numerator and denominator of the Ownership Fraction (other than perhaps that the transaction is close to being an IGR, but, as mentioned, we do not address the appropriate threshold for an IGR). The result in Examples 16 and 17 where x = 30 should not be a lower Ownership Fraction than in Examples 14 and 15 where x = 51. Examples 14 and 15 are arguably more sympathetic cases in favor of the taxpayer as Domestic Parent no longer controls DE.[66] Thus, the result in Examples 16 and 17 should be an Ownership Fraction of 100%. Where Domestic Parent is the transferor, the EAG Exclusion Rule between the 50% and 80% thresholds is distortive.

Accordingly, we recommend that if Domestic Parent partially disposes of DE in a transaction resembling Examples 16 or 17 where the IGR exception is not applicable, the EAG Exclusion Rule should be switched off altogether with respect to the Foreign Acquiror shares received by Domestic Parent in the transaction. Domestic Parent's shares in Foreign Acquiror should be included in both the numerator and denominator of the Ownership Fraction. Applying that recommendation to Examples 16 and 17, Example 16 would result in a 100/100 Ownership Fraction because, upon Domestic Parent's contribution of DE to Foreign Acquiror, the Frozen Numerator Rule would hold the Ownership Fraction constant notwithstanding Domestic Parent's

[66] *See* Part IV.A. above. On the other hand, in Examples 14 and 15, Foreign Acquiror is not a controlled foreign corporation, whereas in Examples 16 and 17, it is.

subsequent transfer of 30% to the investors. In Example 17, the Ownership Fraction would equal 70/70 because the 30% of Foreign Acquiror stock issued to the investors for cash would be excluded from the denominator pursuant to the Nonqualified Property Exclusion Rule. In either case, the Ownership Fraction would be 100%.

Our recommendation to switch off the EAG Exclusion Rule in these circumstances, and thus to include in the Ownership Fraction stock held by members of the EAG, seems at first blush to contradict the EAG Exclusion Rule set forth in Code Section 7874(c)(2)(A). However, Code Sections 7874(c)(6) and 7874(g) provide the IRS with broad regulatory authority . The IRS has previously relied on these provisions to promulgate the IGR and loss of control exceptions to the EAG Exclusion Rule.[67] We believe the IRS has authority to adopt our recommendation.

E. Domestic Parent: Partial Dispositions; Third Party Contributions of Qualified Property

Another anomaly arises if, in a modified version of Examples 13, 15 and 17 (where a group of investors forms Foreign Acquiror, which then acquires DE), the group of investors contributes not cash but qualified property to Foreign Acquiror:

> **Example 18 (Domestic Parent; Investors Form Foreign Acquiror; x=30; Qualified Property).** Foreign Acquiror issues stock representing 30% of its equity to a group of investors in exchange for qualified property. Domestic Parent contributes DE to Foreign Acquiror in exchange for 70% of Foreign Acquiror (and possibly cash).

Absent our recommendation, the EAG Exclusion Rule would apply to exclude from both the numerator and the denominator of the Ownership Fraction Domestic Parent's shares of Foreign Acquiror. The 30% of Foreign Acquiror stock issued to the group of investors in exchange for qualified property would be included in the denominator. Accordingly, the Ownership Fraction

[67] *See* T.D. 9238, 70 Fed. Reg. 76685 (Dec. 28, 2005), Preamble; T.D. 9399, 73 Fed. Reg. 29054 (May 20, 2008), Preamble.

would be 0/30, or zero. In this Example, the EAG Exclusion Rule seems unintentionally to permit Domestic Parent to avoid the anti-inversion rules. If, however, our recommendation in Part V.D. above is implemented, then because Domestic Parent has partially disposed of DE in a transaction not constituting an IGR, the EAG Exclusion Rule would be switched off and Domestic Parent's 70% shareholding in Foreign Acquiror would be included in both the numerator and denominator of the Ownership Fraction. The end result would be an Ownership Fraction of 70%, which reflects the economic reality of the transaction.

In a further twist, it appears that only a small amount of qualified property would be needed under the existing rules to result in an Ownership Fraction of 0%, an anomalous result:

> **Example 19 (Domestic Parent; Drop and Sell; x=30; Qualified Property and Nonqualified Property).** Domestic Parent contributes DE to Foreign Acquiror in exchange for 99 shares of Foreign Acquiror; Domestic Parent then sells 29 of those shares to investors for cash, and Foreign Acquiror issues one share to the investors in exchange for qualified property.

> **Example 20 (Domestic Parent; Investors Form Foreign Acquiror; x=30; Qualified Property and Nonqualified Property).** Foreign Acquiror issues stock representing 1% of its equity to a group of investors in exchange for qualified property and 29% of its equity to the investors in exchange for cash. Domestic Parent contributes DE to Foreign Acquiror in exchange for 70% of Foreign Acquiror and cash.

Here, the current rules seem to arrive at an Ownership Fraction of 0/1, or 0%, another inappropriate result. In Example 19, the EAG Exclusion Rule would exclude all Domestic Parent's Foreign Acquiror shares from the numerator and denominator of the Ownership Fraction. The IGR exception should be inapplicable because Domestic Parent winds up with less than 80% of Foreign Acquiror. The one share of Foreign Acquiror stock issued to the group of investors for qualified property would be included in the denominator, and the Ownership Fraction would therefore seem to be 0/1, or 0%. In Example 20, the 70 shares of Foreign Acquiror held by Domestic Parent would be excluded from the numerator and denominator of the Ownership Fraction under the EAG Exclusion Rule. And the 29 shares of Foreign Acquiror issued to the group of investors for cash would be excluded from the denominator under the Nonqualified Property Exclusion Rule. The result is an Ownership Fraction of 0/1, or zero.

Once again, our recommendation in Part V.D. above should fix this anomaly. If the EAG Exclusion Rule were switched off altogether, then in Example 19, upon Domestic Parent's contribution of DE to Foreign Acquiror, the 99 Foreign Acquiror shares included in the numerator of the Ownership Fraction would be locked in pursuant to the Frozen Numerator Rule, and the subsequent transfer of 29 of those shares to the investors for cash would be disregarded. The Ownership Fraction would be 99/100, or 99%. In Example 20, the 29 Foreign Acquiror shares issued to the investors for cash would be excluded from the denominator pursuant to the Nonqualified Property Exclusion Rule. The 70 Foreign Acquiror shares held by Domestic Parent would be included in both the numerator and denominator, because the EAG Exclusion Rule has been switched off. The Ownership Fraction would be 70/71, or 98.6%.

VI. Stock Acquisitions versus Asset Acquisitions

If Foreign Acquiror, as part of a plan to acquire DE, also acquires all the stock of a foreign corporation ("Foreign Target"), all the Foreign Acquiror stock issued in exchange for the stock of Foreign Target would generally be included in the denominator of the Ownership Fraction, regardless of the constituent assets of Foreign Target.[68] In contrast, if Foreign Acquiror were to acquire all the *assets* of Foreign Target, Foreign Acquiror stock issued in exchange for such assets would be excluded from the denominator of the Ownership Fraction to

[68] If Foreign Acquiror acquired a domestic target for Foreign Acquiror stock, as well as acquiring DE, the Foreign Acquiror stock exchanged for that domestic target would generally be included in the numerator of the Ownership Fraction under Treas. Reg. § 1.7874-2(e). As discussed in Part VIII.A. below, any shares included in the numerator should also be included in the denominator regardless of what the Exclusion Rule would otherwise provide.

the extent attributable to Foreign Target assets that constitute nonqualified property.[69] This disparity should be eliminated in cases where Foreign Target is publicly traded:

> **Example 21 (Forward Merger of Publicly Traded Foreign Target—Cash in Foreign Target).** DE, a domestic publicly traded corporation, and Foreign Target, a foreign publicly traded corporation, want to combine. They establish a new foreign corporation, Foreign Acquiror. Foreign Acquiror acquires all the stock of DE in a reverse triangular merger in exchange for 55 shares of Foreign Acquiror. Foreign Target's jurisdiction of incorporation does not permit reverse triangular mergers. Furthermore, an acquisition of Foreign Target's widely held stock would be costly and time-consuming under local law, because of minority holdouts. As is customary in Foreign Target's jurisdiction, the parties agree on a forward merger of Foreign Target into Foreign Acquiror (with Foreign Acquiror surviving). The forward merger eliminates minority shareholders in Foreign Target who might wish to hold out and can be accomplished with an affirmative vote of a majority of the shareholders and a relatively speedy court approval process. The consideration for the Foreign Target shares is 45 shares of Foreign Acquiror. Foreign Target owns cash which arose in the ordinary course of its business. The cash represents 30% of the value of Foreign Target's assets.

At first glance, the Ownership Fraction is 55%.[70] Indeed, the Ownership Fraction would be 55% if Foreign Acquiror had acquired the stock, rather than the assets, of Foreign Target. Publicly traded shares do not generally constitute marketable securities, a form of nonqualified property, if the shares are of a corporation that becomes a member of Foreign Acquiror's EAG.[71]

The Temporary Regulations provide a different regime, however, for Example 21, because in the forward merger of Foreign Target into Foreign Acquiror, Foreign Acquiror is treated as acquiring the assets of Foreign Target. As such, the Nonqualified Property Exclusion

[69] Temp. Treas. Reg. §§ 1.7874-4T(b), -4T(c)(1)(i). By the same token, it appears that no look-through principle applies in the case of an acquisition by Foreign Acquiror of partnership interests, whereas an acquisition of business assets would be analyzed on an asset by asset basis. If Foreign Acquiror acquires partnership interests, the Nonqualified Property Exclusion Rule would generally not apply. The partnership interests would not be marketable securities if there was no market for them prior to the transaction (*see* Code § 453(f)(2)) or if the foreign target partnership is a member of Foreign Acquiror's EAG after the transaction. Temp. Treas. Reg. §§ 1.7874-4T(g), -4T(i)(6).

[70] Code § 7874(a)(2)(B)(ii).

[71] Temp. Treas. Reg. §§ 1.7874-4T(i)(6), -4T(7)(ii). Membership in the Foreign Acquiror's EAG is tested as of the end of the day on which the acquisition of DE is completed. Temp. Treas. Reg. § 1.7874-4T(i)(3). Thus, if Foreign Acquiror acquires DE and the stock of the Foreign Target on the same day, the Foreign Target is a member of Foreign Acquiror's EAG and, accordingly, the shares of Foreign Target are qualified property.

Rule applies to test the extent to which the Foreign Acquiror stock was issued for nonqualified property held by Foreign Target. On the facts of Example 21, 30% of the 45 shares of Foreign Acquiror stock issued in the forward merger would be attributable to Foreign Target's cash, even though the amount of such cash arose in the ordinary course of business. Accordingly, 13.5 shares of Foreign Acquiror stock would be excluded from the denominator. The Ownership Fraction would be 55/(100 - 13.5) = 64.6%.

Indeed, in a further formalism, in the case of an asset acquisition, the Temporary Regulations provide different results depending on where in the Foreign Target group the cash is held:

> **Example 22 (Forward Merger of Publicly Traded Foreign Target—Cash in Subsidiary of Foreign Target).** The facts are the same as Example 21, except that instead of Foreign Target owning cash that arose in the ordinary course of its business, a corporate subsidiary of Foreign Target owns cash that arose in the ordinary course of its business.

In Example 22, the Ownership Fraction would be 55%, the same as if Foreign Acquiror had acquired the stock of Foreign Target. The Temporary Regulations would not exclude Foreign Acquiror shares, because the cash in the Foreign Target group is held by a subsidiary of Foreign Target. As a result, the shares of Foreign Acquiror are deemed to be exchanged for the stock of the subsidiary (qualified property) and not for cash (nonqualified property).

The Preamble justifies the disparate treatment of stock and asset acquisitions on the grounds that:

> the complexity of adopting rules to harmonize the treatment of stock and asset acquisitions, such as by applying a look-through approach to stock acquisitions, would outweigh the benefits of consistent treatment.[72]

[72] T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ C).

We believe that acquisitions of assets and stock should be better coordinated in the case of acquisitions of publicly traded Foreign Targets. But, we do not believe that the appropriate solution is to adopt a look-through approach. The Temporary Regulations already police acquisitions of stock of a Foreign Target by providing that any property acquired with a principal purpose of avoiding Section 7874 constitutes nonqualified property.[73] Specifically, if Foreign Target issues stock in exchange for assets in a transaction intended to bolster the size of Foreign Target, such Foreign Target stock would be nonqualified property on the basis that it was acquired with a bad principal purpose. When that tainted Foreign Target stock is exchanged for Foreign Acquiror stock, the Foreign Acquiror shares would be excluded from the denominator under the Exclusion Rule. In a case where, before Foreign Target is acquired by Foreign Acquiror, Foreign Target issues shares for a bad principal purpose, there is no need to look through to the assets of Foreign Target, because the Foreign Target shares issued with a bad principal purpose would themselves be nonqualified property.

The rules for asset acquisitions should be conformed to the rules for acquisitions of stock in the case of a publicly traded Foreign Target. Specifically, if a publicly traded Foreign Target is merged into Foreign Acquiror (or if a publicly-traded Foreign Target transfers substantially all its assets to Foreign Acquiror and liquidates), none of the Foreign Target's property should be treated as nonqualified property unless such property was acquired with a principal purpose of avoiding Section 7874. This would address the disparities described with respect to Examples 21 and 22.

In the case of a publicly traded Foreign Target, no new cash or other nonqualified property is coming into the system by virtue of the acquisition of Foreign Target (whether

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[73] Temp. Treas. Reg. § 1.7874-4T(i)(7)(iv).

Foreign Target stock or assets are acquired), because the Foreign Acquiror is generally newly-formed and Foreign Target generally comes to the transaction with its historic assets.[74] Foreign Acquiror and Foreign Target should be thought of as a unit for purposes of considering whether "stuffing" has occurred.

We believe that the result should be the same whether the historic publicly traded foreign corporation directly acquires DE or a new Foreign Acquiror acquires both DE and the historic foreign corporation (whether by acquiring assets or stock). In all these cases, regardless of the form of the transaction, the historic cash or nonqualified property in the publicly traded foreign corporation should not be viewed as having been "stuffed". If a historic foreign corporation acquires DE and has "old and cold" cash, such cash generally will have no effect on the Ownership Fraction. Only the infusion of new cash (or other nonqualified property) in exchange for stock of the foreign corporation would trigger the Nonqualified Property Exclusion Rule. The same result should prevail if, instead of an acquisition of DE by the historic foreign corporation, a newly-formed foreign corporation acquires both DE and the historic foreign corporation. In such a case, the cash and other nonqualified property in the historic foreign corporation are historic, not "stuffed" in a transaction that is related to the acquisition. The abuse targeted by the Nonqualified Property Exclusion Rule is not that a foreign corporation happens to hold cash but rather the stuffing of new cash in order to reduce the Ownership Fraction. A look-through approach disregards this distinction.

A counterargument could be that acquisitions by a historic publicly traded foreign corporation differ from acquisitions by a newly-formed foreign corporation in that the newly-formed foreign corporation is likely resident in a jurisdiction chosen because it has a favorable

[74] One could consider exceptions to our recommendation if either Foreign Acquiror is not newly formed or if Foreign Target spins off or disposes of substantial assets as part of the transaction.

income tax treaty with the United States. While it is true that U.S. tax considerations contribute to a decision to form a foreign acquiror in a particular jurisdiction, many other considerations, including business, corporate legal and foreign tax, also contribute to the decision. Moreover, the Exclusion Rule is too imprecise to monitor such choices, as it measures cash and other nonqualified property of the Foreign Target, an attribute that has nothing to do with concerns about taxpayers making U.S. tax-motivated choices among foreign jurisdictions.

In addition to the point that no new cash is generally coming into the system in an asset or stock acquisition of a publicly traded Foreign Target, anti-abuse rules in the Temporary Regulations provide protection. Both in the case of an acquisition of Foreign Target stock or assets, the rule in Temporary Treasury Regulations § 1.7874-4T(i)(7)(iv) — namely, that property acquired with a bad principal purpose is nonqualified property — protects against abuse. As well, the rule in Temporary Treasury Regulations § 1.7874-4T(i)(6) that treats an acquisition of publicly traded Foreign Target shares as nonqualified property if a principal purpose for acquiring them was to avoid the purposes of Section 7874 protects against abuse in the case of an acquisition of stock, and an analogue could be grafted onto the rule that we are recommending in the case of acquisitions of assets.

One concern might be that our recommendation to conform acquisitions of assets of publicly traded foreign targets to acquisitions of the stock of publicly traded foreign targets would permit Foreign Target to hold more cash than it needs to facilitate an inversion. But, if the cash was not acquired with a bad principal purpose and arose in circumstances other than a private or public offering related to the acquisition of DE, then, in the case of an acquisition of the stock of a Foreign Target, the application of the Nonqualified Property Exclusion Rule turns on whether the acquisition of the stock of the Foreign Target was acquired with a bad principal purpose. The result should be the same if the acquisition is instead structured, for nontax purposes, as a forward merger or other asset acquisition of the publicly traded Foreign Target.

Another concern might be that the Foreign Target could issue Foreign Target shares in a public or private offering related to the acquisition of DE and then merge into Foreign Acquiror in exchange for Foreign Acquiror stock. We believe that Foreign Acquiror shares in such a case should be excluded, just as Foreign Acquiror shares would generally be excluded if Foreign Acquiror itself issued shares in a public or private offering. The Temporary Regulations may already address this. Cash received by the Foreign Target in such a public or private offering would be nonqualified property because it would be an asset acquired with a principal purpose to circumvent Section 7874. Thus, the Foreign Acquiror shares issued for such cash in the forward merger would be excluded. Suppose, though, that the cash raised by the Foreign Target in the offering was used to repay debt of the Foreign Target such that no asset acquired by Foreign Target with a bad principal purpose was exchanged for Foreign Acquiror shares — notwithstanding that the raising of the cash coupled with the repayment of the liability had such a purpose. To address this situation, the Temporary Regulations could provide, as an elaboration on Temporary Treasury Regulations § 1.7874-4T(i)(7)(iv), that, in the case of a merger of the Foreign Target into Foreign Acquiror, the value of any property transferred to the Foreign Acquiror is nonqualified property to the extent of any liabilities of the transferor or any related party repaid in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding the purposes of Section 7874.

We acknowledge that the corporate law reasons for effecting an acquisition of a publicly-traded Foreign Target as a forward merger (rather than as an acquisition of stock) may not apply in the case of a privately-held Foreign Target. Accordingly, in the case of a privately held

Foreign Target, we do not feel as strongly that the rules relating to an acquisition of assets of the Foreign Target should be conformed to the rules relating to an acquisition of stock.

The main anomaly that we see is that an acquisition of the stock of a publicly traded Foreign Target is treated differently from a merger of the Foreign Target into Foreign Acquiror. The difference in structure would be driven by corporate and other legal considerations that should not have an impact on Section 7874. Our recommendations described above would harmonize the treatment of stock and asset acquisitions of a publicly traded Foreign Target in a combination with DE.

As a further note, insofar as the distinction between acquisitions of assets of Foreign Target and acquisitions of stock of Foreign Target is retained, we believe that additional examples would be helpful to clarify the application of the rules. For instance, we would recommend including an example involving (a) a forward triangular merger of Foreign Target into a subsidiary of Foreign Acquiror, (b) an acquisition of the stock of Foreign Target followed by a "check the box" election on Foreign Target causing Foreign Target to be treated as a disregarded entity owned by Foreign Acquiror and (c) an acquisition of the stock of Foreign Target with a Section 338 election.

VII. Obligations

A. Transferor Obligation Rule

We believe that the Transferor Obligation Rule appropriately treats issuances of shares of Foreign Acquiror in repayment of debt as if the Foreign Acquiror shares were issued for cash. The paradigmatic application of the Transferor Obligation Rule is as follows:[75]

> **Example 23 (Foreign Acquiror Debt).** Foreign Acquiror has 100 shares of common stock outstanding. Foreign Acquiror owns $600 in operating assets and owes $500 to a

[75] Temp. Treas. Reg. § 1.7874-4T(e).

> creditor. Thus, the common stock of Foreign Acquiror is worth $100 in the aggregate. Foreign Acquiror simultaneously (i) acquires all the stock of DE, worth $500, in exchange for 500 shares of Foreign Acquiror stock, and (ii) issues 500 shares of Foreign Acquiror stock to Foreign Acquiror's creditor in satisfaction of the $500 debt. As a result, Foreign Acquiror has a total of 1100 shares of stock outstanding and assets worth $1100 (namely, its preexisting operating assets worth $600 and the stock of DE worth $500).

In Example 23, if the Ownership Fraction is tested with regard to all the outstanding shares of Foreign Acquiror, the fraction would be 500/1100 = 45.5%. Pursuant to the Transferor Obligation Rule, however, the 500 shares of Foreign Acquiror stock issued to the creditor would be treated as having been transferred to the creditor in exchange for $500 of cash (nonqualified property), and would therefore be excluded from the denominator of the Ownership Fraction. Accordingly, the former DE shareholders would be treated as owning 500/600 = 83.3% of Foreign Acquiror.

One perceived abuse, presumably, is that the creditor may have lent $500 to Foreign Acquiror in anticipation of Foreign Acquiror's acquisition of DE in order to circumvent the Nonqualified Property Exclusion Rule. We agree that if the creditor lent in anticipation of the transaction, then the loan of cash followed by the repayment of the loan in Foreign Acquiror shares should be treated the same as a purchase of Foreign Acquiror shares for cash.

In the case of debt issued in anticipation of the transaction, the Foreign Acquiror shares used to repay the debt are potentially already excluded without recourse to the Transferor Obligation Rule. Under the step transaction doctrine, the loan might be disregarded and the transaction treated as an issuance of Foreign Acquiror shares for cash, triggering the Nonqualified Property Exclusion Rule. Further, Section 7874(c)(4) disregards transfers that "are part of a plan a principal purpose of which is to avoid the purposes" of Section 7874. The issuance and repayment of the debt using Foreign Acquiror shares may be viewed as having such a purpose. Finally, as noted above in Part II, Temporary Treasury Regulations § 1.7874-

4T(i)(7)(iv) treats as nonqualified property any property acquired "with a principal purpose of avoiding the purposes of section 7874." Thus, the loan itself may be viewed as nonqualified property. The Transferor Obligation Rule does not seem necessary to police debt incurred in anticipation of the acquisition. If this were all that the Transferor Obligation Rule were doing, then we would question whether it would even be needed in light of the step transaction doctrine and the anti-abuse rules.

The Transferor Obligation Rule goes a step farther in that it covers repayments of "old and cold" debt, as well as newly incurred debt. We believe this is appropriate. As illustrated in Example 23, DE is combining with a company whose equity is much smaller than that of DE ($500 equity value of DE versus $100 equity value of Foreign Acquiror). Moreover, if repayments of old and cold debt using Foreign Acquiror stock were not covered by the Transferor Obligation Rule, taxpayers could accomplish a transaction that is similar to a public offering — specifically, a public offering where the proceeds are used to repay debt. Compare a scenario where investors pay cash to the Foreign Acquiror for shares (clearly excluded under the Nonqualified Property Exclusion Rule) and the Foreign Acquiror uses the cash to repay old and cold debt with a scenario where the Foreign Acquiror issues shares to creditors holding old and cold debt in repayment of the debt and the creditors immediately sell the Foreign Acquiror shares to investors for cash. Absent the Transferor Obligation Rule, taxpayers might avoid the application of the Nonqualified Property Exclusion Rule using the latter scenario.

Another way of looking at the issuance of Foreign Acquiror stock for old and cold debt, however, is that it is akin to an issuance of Foreign Acquiror stock for qualified property on the view that the issuance of Foreign Acquiror stock for old and cold debt is an acquisition by Foreign Acquiror of an additional interest in its own assets. The recapitalization of the debt reduces creditors' claims against the assets of the Foreign Acquiror. Consequently, one could argue that to the extent the assets of the Foreign Acquiror are qualified property, the Exclusion Rule should not apply. It is as if the Foreign Acquiror acquired qualified property from the creditors. Nonetheless, on balance, we would not take that view as we view the owner of Foreign Acquiror's assets as Foreign Acquiror, not its shareholders and creditors. We respect the entity, Foreign Acquiror, for this purpose. The creditors never had the prospect of enjoying upside in the assets as an owner would. Even if the assets were pledged as security for the debt, the creditors' interest in them was contingent. While the issuance of stock in exchange for old and cold debt may alter the debt/equity ratio of Foreign Acquiror and the constituencies that ultimately would enjoy upside or suffer downside in Foreign Acquiror's assets, it does not affect Foreign Acquiror's actual ownership of its assets. Thus, we agree with the application of the Transferor Obligation Rule to old and cold debt.

B. Associated Obligation Exclusion Rule

1. Acquiring the Assets of DE

The Associated Obligation Exclusion Rule excludes shares from the denominator where Foreign Acquiror issues stock to DE, in lieu of assuming liabilities of DE, and the Foreign Acquiror stock so issued is then used to repay DE liabilities.[76] The Associated Obligation Exclusion Rule conforms scenarios where DE liabilities are assumed by Foreign Acquiror and scenarios where DE liabilities are not assumed and are instead repaid with Foreign Acquiror stock. Consider the following scenarios:

> **Example 24 (Liabilities of DE Assumed).** DE has $100 of assets and $30 of liabilities that arose in the ordinary course of its business. Foreign Acquiror acquires the assets and assumes the liabilities of DE's business in exchange for 70 shares, worth $70, of Foreign Acquiror stock. DE liquidates and distributes the 70 shares of Foreign Acquiror stock to

[76] Temp. Treas. Reg. § 1.7874-4T(c)(1)(ii); T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ B.2(b)).

DE's shareholders. The result is that Foreign Acquiror has 70 shares of stock outstanding in addition to whatever shares Foreign Acquiror had outstanding prior to the transaction. All 70 of those shares are held by former DE shareholders.

Example 25 (Liabilities of DE not Assumed). Same facts as in Example 24, except that Foreign Acquiror acquires DE's assets (but does not assume its liabilities) in exchange for 100 shares, worth $100, of Foreign Acquiror stock. DE distributes 30 shares of Foreign Acquiror stock to DE's creditors in satisfaction of DE's liabilities. DE liquidates and distributes the remaining 70 shares of Foreign Acquiror stock to DE's shareholders. The result is that Foreign Acquiror has 100 shares of stock outstanding in addition to whatever shares Foreign Acquiror had outstanding prior to the transaction. 70 of those 100 shares are held by former DE shareholders.

In Example 25, the Associated Obligation Exclusion Rule would exclude from the denominator the 30 Foreign Acquiror shares transferred by DE to its creditors, thus putting Example 25 on a par with Example 24. In both Examples, only 70 additional shares of Foreign Acquiror are treated as outstanding.

In both Examples, Foreign Acquiror acquired the business of DE, but the Examples are not economically equivalent. In Example 24, Foreign Acquiror assumes the liabilities, and the creditor becomes a creditor of Foreign Acquiror. The creditor's $30 claim against Foreign Acquiror is senior to that of the shareholders of Foreign Acquiror. The creditor does not share in the profitability of Foreign Acquiror, and the creditor's downside exposure is significantly less than that of the Foreign Acquiror shareholders. In contrast, the creditor in Example 25 is no longer a creditor of anyone, and has instead become an equity holder of Foreign Acquiror. The creditor's claim is the same as that of the holders of the other shares of Foreign Acquiror stock, and the creditor has exposed itself to the fortunes — good and bad — of Foreign Acquiror. Thus, on the surface, it appears counterintuitive to analogize Example 25 to Example 24 and exclude shares from the denominator in Example 25.

There could be arguments, however, for excluding the 30 Foreign Acquiror shares in Example 25. First, if the DE liabilities were incurred in anticipation of the transaction, that would seem to raise concerns similar to those discussed above in Part VII.A. in connection with the Transferor Obligation Rule. The transaction would be an indirect way of issuing Foreign Acquiror shares for cash. But, if so, step transaction principles and the anti-abuse rules of Code Section 7874(c)(4) and Temporary Treasury Regulations § 1.7874-4T(i)(7)(iv) may defeat such a transaction without the need for the Associated Obligation Exclusion Rule.

Second, the Associated Obligation Exclusion Rule may address similar concerns to those discussed above in Part VII.A. in connection with the Transferor Obligation Rule, namely, that the transaction is akin to Foreign Acquiror assuming the liabilities, issuing shares for cash, and then repaying the liabilities using such cash. Specifically, if Foreign Acquiror issues Foreign Acquiror shares in exchange for all or substantially all the assets (but not the liabilities) of DE, DE uses a portion of those shares to repay its liabilities, and the creditors then sell the Foreign Acquiror shares to investors, the parties are in the same place as if Foreign Acquiror had assumed DE's liabilities, issued shares to investors for cash, and used the proceeds to repay the assumed DE debt. We believe therefore that the Associated Obligation Exclusion Rule serves the purpose of backstopping the Nonqualified Property Exclusion Rule. From this perspective, we are not certain as to why the Associated Obligation Exclusion Rule requires that the obligation be "associated with" the property transferred. It would appear that repayment of any old and cold debt of DE would be a concern. The Transferor Obligation Rule contains no parallel requirement.

2. Acquiring Assets from Persons other than DE

In analyzing the extent to which the Associated Obligation Rule should apply to acquisitions of assets from persons other than DE, first consider a case where, in a transaction related to Foreign Acquiror's acquisition of DE, Foreign Target either merges into Foreign Acquiror for Foreign Acquiror shares or transfers substantially all its assets to Foreign Acquiror for Foreign Acquiror shares and liquidates. In either case, assume that Foreign Acquiror shares are paid to Foreign Target creditors in repayment of Foreign Target obligations. In these cases, we believe the Associated Obligation Exclusion Rule is properly applied. Otherwise, the Nonqualified Property Exclusion Rule could potentially be avoided as the economics are the same as Foreign Acquiror issuing shares for cash (clearly resulting in excluded Foreign Acquiror shares) with the cash being used to repay the Foreign Target obligations. Accordingly, we believe that, where Foreign Target merges into Foreign Acquiror[77] or Foreign Acquiror acquires substantially all the assets of a person other than DE, the Associated Obligation Exclusion Rule ought to apply.

It is less clear that the Associated Obligation Rule should apply if Foreign Acquiror acquires less than substantially all the assets of a transferor. For example, suppose an owner of multiple businesses transfers, in a transaction related to Foreign Acquiror's acquisition of DE, assets to Foreign Acquiror in exchange for Foreign Acquiror stock and uses Foreign Acquiror shares to repay certain liabilities of the owner:

> **Example 26 (Associated Obligation of Transferor other than DE).** Suppose that an owner (whether U.S. or non-U.S.) of several businesses (the "Transferor") transfers the assets (but not the liabilities) of one such business (all qualified property) to Foreign Acquiror in exchange for Foreign Acquiror stock in a transaction that is related to Foreign Acquiror's acquisition of DE. The Transferor then uses the Foreign Acquiror stock to repay certain liabilities that may or may not have been associated with the business transferred to Foreign Acquiror.

The Associated Obligation Exclusion Rule would apply to exclude from the denominator of the Ownership Fraction the Foreign Acquiror stock transferred by the Transferor to its creditors insofar as the liabilities that were repaid were associated with the contributed assets. Recall that, in applying the Associated Obligation Exclusion Rule, the Net Asset Requirement is tested not

[77] An exception could be considered for mergers not involving an acquisition of substantially all the assets of Foreign Target.

with respect to the transfer of Foreign Acquiror stock by the Transferor to its creditors (which transfer has no effect on the fair market value of Foreign Acquiror's net assets) but with respect to the transfer of assets by the Transferor to Foreign Acquiror in exchange for Foreign Acquiror stock (which transfer does increase Foreign Acquiror's net assets).[78]

We believe that the Associated Obligation Exclusion Rule should not apply in Example 26, because the transaction is economically similar to a scenario in which the Transferor instead disposes of the Foreign Acquiror stock for cash and transfers such cash to the creditors of the Transferor. No exclusion of Foreign Acquiror stock arises in such latter case. A disposition of Foreign Acquiror shares by the Transferor for cash would not satisfy the Net Asset Requirement, because it would not increase the fair market value of the net assets of the Foreign Acquiror.[79]

One could argue to the contrary that the denominator of the Ownership Fraction should only include Foreign Acquiror shares reflecting the value of the equity (i.e., assets less liabilities) of any business that is transferred to Foreign Acquiror by the Transferor. The transaction is economically the same as Foreign Acquiror issuing shares for cash, assuming the Transferor's liabilities and repaying those liabilities for cash. But, we believe that such a transaction differs meaningfully from Example 26 (where the liabilities are left behind at the Transferor) as the economic risk associated with the Foreign Acquiror stock in Example 26 lies with the Transferor. The Transferor may or may not be able to convince the creditors to take the Foreign Acquiror shares (or convince a buyer to buy the Foreign Acquiror shares for cash). If the liabilities are assumed, Foreign Acquiror bears the risk that it may or may not be able to issue

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[78] *See* T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ B(2)(b)). Recall that the Net Asset Requirement stipulates that Foreign Acquiror stock that is transferred in an exchange is excluded from the Ownership Fraction under the Exclusion Rule only to the extent that the transfer of the Foreign Acquiror stock increases the fair market value of the assets of Foreign Acquiror or decreases its liabilities.

[79] Temp. Treas. Reg. § 1.7874-4T(c)(2); T.D. 9654, 79 Fed. Reg. 3094, 3095 (Jan. 17, 2014), Preamble (Explanation of Provisions ¶ B(2)(b)).

Foreign Acquiror shares to raise the funds to pay off the liabilities. Thus, we think the stronger analogy to Example 26 is the case where Transferor sells the Foreign Acquiror shares for cash (not resulting in excluded shares) rather than the case where Foreign Acquiror assumes the liabilities. Moreover, in a case where less than substantially all the assets of the Transferor are acquired, it can be difficult or impossible to determine which of the numerous liabilities owed by the Transferor are "associated with" the particular assets transferred to Foreign Acquiror. Furthermore, the assets transferred to Foreign Acquiror may not even constitute a distinct "business", in which case the "associated with" determination becomes even vaguer.

C. Intercompany Obligations

As mentioned above, the definition of nonqualified property includes obligations of a member of the Foreign Acquiror's EAG. Intercompany receivables owned by a Foreign Target the assets of which are acquired by the Foreign Acquiror should not, however, be considered nonqualified property if they arose in the ordinary course of the group's cash management program. As discussed above, in the case of a publicly traded Foreign Target, we do not believe that asset acquisitions should generally be treated differently from acquisitions of stock of a Foreign Target. However, insofar as asset acquisitions are treated differently, then intercompany receivables should not be treated the same as cash:

> **Example 27 (Intercompany Debt).** Suppose Foreign Target owns FS1, a foreign subsidiary, and FS2, another foreign subsidiary. FS1 earns $100 in the ordinary course of its business, and pursuant to the Foreign Target group's cash management program, FS1 lends the $100 to Foreign Target, which, in turn, lends the $100 to FS2, which needs additional funds in the ordinary course of its business. Thus, Foreign Target is left with a payable to FS1 and a receivable from FS2. Each of Foreign Target, FS1 and FS2 has operating assets with a value of $200. Assume that the stock of FS1 is worth $300, and the stock of FS2 is worth $100. Pursuant to a plan in which Foreign Acquiror acquires DE, Foreign Acquiror also acquires all the assets of Foreign Target in exchange for shares of Foreign Acquiror stock. Since Foreign Target's net assets are worth $600, Foreign Acquiror issues 600 shares, worth $600, to Foreign Target. Foreign Target liquidates and distributes the 600 Foreign Acquiror shares to the Foreign Target shareholders. Foreign Target's gross assets are ostensibly worth $700 (equal to the sum

> of the $200 of Foreign Target operating assets, the FS1 stock worth $300, the FS2 stock worth $100 and the receivable from FS2 of $100). Under the Temporary Regulations, $600 of those assets are considered to be qualified property and the $100 receivable from FS2 is considered to be nonqualified property. Therefore, one-seventh of the 600 shares would appear to be excluded from the denominator.

We believe that no shares should be excluded from the denominator in Example 27. All the actions that took place took place in the ordinary course of business and were entirely internal. None of these actions implicate the policies of Section 7874. (Indeed, even if the cash lent by FS1 had remained with Foreign Target, we believe no shares should be excluded in the case of a publicly traded Foreign Target, but that is the subject of the asset/stock consistency discussion in Part VI. above.) The anomaly is highlighted by the disparate treatment provided in the Temporary Regulations for stock of subsidiaries, as compared with debt of subsidiaries. If in Example 27, Foreign Target had contributed the $100 to FS2, rather than loaned the $100 to FS2, none of the shares issued by Foreign Acquiror would have been excluded. It should not make any difference whether cash management of Foreign Target occurs via loans to subsidiaries or capital contributions to subsidiaries.

D. Obligations of Owners

Arguably, the receivable side of any obligation is akin to cash, because the obligation will eventually mature into cash. On that basis, one could argue that all obligations should be considered nonqualified property. However, the Temporary Regulations do not adopt that approach. Instead, the Temporary Regulations treat obligations constituting marketable securities as nonqualified property[80] presumably on the basis that marketable securities are akin to cash in the sense that they are liquid.

[80] Temp. Treas. Reg. § 1.7874-4T(i)(7)(ii).

As noted in Part II, the Temporary Regulations also treat as nonqualified property obligations issued by certain obligors. Specifically, nonqualified property includes an obligation owed by a former shareholder of (or former partner in) DE.[81] Presumably, this rule is motivated by an anti-abuse concern based on the observation that obligations do eventually mature into cash. It appears that an obligation issued by a person who owned only one share of DE, representing a tiny percentage of DE, would be covered by this rule. We believe, however, that the rule should not be triggered if the obligor owns only a *de minimis* amount of stock (or partnership interests) in DE.

Along similar lines, nonqualified property includes an obligation owed by a person that, before or after the acquisition, owns stock or a partnership interest in a member of Foreign Acquiror's EAG or in a former shareholder of (or former partner in) DE.[82] Again, it appears that even a tiny ownership percentage would trigger the rule. We would recommend that obligations issued by persons that own less than a specified ownership threshold would not be considered nonqualified property.

As well, certain members of Foreign Acquiror's EAG may be insignificant. An obligation owed by a person that owns a more than *de minimis* stake in an insignificant member of Foreign Acquiror's EAG should arguably not be considered nonqualified property.

VIII. Mechanics of the Exclusion Rule

A. Shares in Numerator

The regulations should expressly provide that any Foreign Acquiror shares that are included in the numerator of the Ownership Fraction are included in the denominator as well, even if the Exclusion Rule would otherwise exclude such shares from the denominator. The

[81] Temp. Treas. Reg. § 1.7874-4T(i)(7)(iii)(B).

[82] Temp. Treas. Reg. § 1.7874-4T(i)(7)(iii)(C).

Temporary Regulations may already provide for this result. For example, the Nonqualified Property Exclusion Rule does not apply in the case of Foreign Acquiror shares transferred to DE.

We believe it would be helpful, however, to state clearly that if a share is counted in the numerator, it is counted in the denominator, as there could be cases of uncertainty. For example, suppose that Foreign Acquiror acquires 49% of the stock of publicly traded DE in exchange for Foreign Acquiror stock. Arguably, the acquisition is outside of Section 7874 because, in acquiring only 49%, Foreign Acquiror arguably did not acquire "substantially all" the properties of DE, as required by Section 7874(a)(2)(B)(i). However, "substantially all" is not defined. If one were concerned that the acquisition of 49% of DE's stock could be considered an acquisition of "substantially all" the DE assets, then it would appear that the Foreign Acquiror shares issued in exchange for the DE shares may be excluded from the denominator on the basis that they were issued for DE stock constituting a "marketable security" under Temporary Treasury Regulations § 1.7874-4T(i)(6). The DE stock would be a marketable security because it is publicly traded and DE does not become a member of the Foreign Acquiror's EAG.[83] But, the Foreign Acquiror shares are included in the numerator of the Ownership Fraction because they are issued to the DE shareholders in exchange for their DE shares. The Ownership Fraction should not be skewed by counting shares in the numerator that are excluded from the denominator.

B. Issuances versus All Transfers

In a change from Notice 2009-78, the Temporary Regulations apply in the first instance to all transfers, not solely to issuances. The Net Asset Requirement then applies with the result that, in cases other than those involving hook stock, the Exclusion Rule appears only to apply to issuances.

[83] Temp. Treas. Reg. § 1.7874-4T(i)(6).

First, the regulations should include examples demonstrating how the Exclusion Rule applies to cases other than issuances. We would suggest:

> **Example 28 (Wholly Owned Hook Stock).** Foreign Acquiror has 110 shares outstanding, including 10 shares owned by Foreign Acquiror's wholly owned subsidiary S. S sells the 10 shares to investors for $10 cash in a transaction that is related to the acquisition by Foreign Acquiror of DE.

In Example 28, we believe that the ten shares are excluded from the denominator of the Ownership Fraction, because, under the framework of the Temporary Regulations, they were transferred for cash and the transfer increases the fair market value of the assets of the Foreign Acquiror. An example involving a non-wholly owned subsidiary would also be helpful:

> **Example 29 (Partially Owned Hook Stock—80%).** Same as Example 28, except that Foreign Acquiror owns only 80 percent of S.

The ten shares sold by S are transferred for cash satisfying the basic requirement of the Nonqualified Property Exclusion Rule. The value of the assets of Foreign Acquiror increased by $8, it would appear, as Foreign Acquiror indirectly owns 80% of the $10 of cash received by S. Thus, it would appear that eight shares should be excluded from the denominator. This result seems reasonable to us.

As well, an example should cover a case where S is not wholly-owned and S transfers Foreign Acquiror shares in part for qualified property and in part for nonqualified property.

Second, consideration should be given to refraining from excluding shares from the denominator of the Ownership Fraction if Foreign Acquiror's ownership of the seller is below a certain threshold:

> **Example 30 (Partially Owned Hook Stock—49%)**. Same as Example 28, except that Foreign Acquiror owns only 49 percent of S.

In Example 30, neither Foreign Acquiror nor DE controls the decisions of S. As a result, arguably, S's sale should not result in any shares sold by S being excluded from the denominator.

The case is even more persuasive if Foreign Acquiror owns only, say, five percent of S. In that case, Foreign Acquiror may not even know that S is selling Foreign Acquiror shares.

Third, we believe it would be more straightforward to apply the Exclusion Rule to issuances by Foreign Acquiror and to cases involving hook stock, rather than applying the Exclusion Rule to all transfers and then applying the Net Asset Requirement. The approach of the Temporary Regulations seems unnecessarily confusing and abstract. Thus, we would recommend that the only transfers, other than issuances by Foreign Acquiror, that must be tested are transfers by an entity owned directly or indirectly by Foreign Acquiror (i.e., hook stock). As drafted, the Temporary Regulations create unnecessary confusion, because each transfer must be tested under the Net Asset Requirement and in certain cases the application is complicated. For example, in the case of a transaction potentially subject to the Associated Obligation Exclusion Rule, the Net Asset Requirement applies only to the initial transfer, not to the use of the Foreign Acquiror stock to repay the associated obligation. We think it would be simpler to provide that only issuances and transfers of certain hook stock must be tested under the Exclusion Rule. In the latter case, the amount of excluded shares would depend on the economic percentage ownership of Foreign Acquiror in the transferor. If the Regulations are intended to cover something other than issuances by Foreign Acquiror and hook stock, they should say so explicitly.

C. Net Asset Requirement: Exchange by Exchange

An example demonstrating the rule that the Net Asset Requirement applies exchange by exchange would be desirable.