

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

REPORT ON THE NON-ORDINARY COURSE DISTRIBUTION RULES IN NOTICE 2014-52

JULY 6, 2015

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I. Introduction

Notice 2014-52² (the “Notice”) announced (among other things) that Treasury and the Service are concerned “that certain recent inversion transactions are inconsistent with the purposes of Sections 7874 and 367,”³ and Treasury Regulations would be issued that, *inter alia*, would address transactions that are structured to avoid the purposes of Sections 7874 and 367.⁴ Section 2.02 of the Notice describes a proposal to curb the avoidance of Sections 7874 and 367 by disregarding certain “non-ordinary course distributions” made by domestic entities that are acquired by foreign corporations. This report (the “Report”) identifies certain ambiguities arising under Section 2.02 of the Notice and describes ways in which Treasury and the Service might implement through regulations⁵ the framework described in the Notice. Part I of this Report provides (1) an overview of the relevant rules under Sections 7874 and 367, (2) a summary of the portion of the Notice addressed in this Report, and (3) a summary of the

¹ The principal author of this Report was Joshua M. Holmes; the invaluable assistance of Rachel Reisberg is gratefully acknowledged. Substantial contributions were made by David H. Schnabel and David R. Sicular. Helpful comments were provided by Neil Barr, Kimberly Blanchard, Peter Blessing, Andy Braiterman, Peter Connors, Michael Farber, Kathleen Ferrell, Edward Gonzales, Stephen B. Land, Deborah L. Paul, Richard Reinhold, Michael Schler, Ansgar A. Simon, Eric Sloan, Eric Solomon, Linda Swartz and Gordon Warnke. This Report reflects solely the views of the Tax Section of the New York State Bar Association (“NYSBA”) and not those of the NYSBA Executive Committee or the House of Delegates.

² 2014-42 I.R.B. 712 (Sept. 22, 2014).

³ *Id.*

⁴ Unless otherwise indicated, all references in this Report to “Section” and “Sections” are to the Internal Revenue Code of 1986, as amended (the “Code”), and all references to “Treas. Reg. §” (or “Prop. Treas. Reg. §”) are to regulations (or proposed regulations) issued thereunder. References to the “Service” are to the Internal Revenue Service, and references to “Treasury” are to the United States Department of the Treasury.

⁵ The focus of this Report is the promulgation of regulations under Section 7874, though this Report raises certain questions regarding the relevance of any such regulations to Section 367 and the regulations thereunder. *See* note 64.

recommendations of this Report. Part II discusses ambiguities and uncertainties in the Notice, including those related to (1) the determination of whether a distribution is a “non-ordinary course distribution” and (2) the computational mechanics pursuant to which such distributions are disregarded for purposes of Section 7874. Part III discusses specific fact patterns giving rise to questions unanswered by the Notice, including particular types of distributions that may warrant special treatment and ambiguities regarding the treatment of multiple classes of stock and spin-offs.

A. Background

Under Section 7874, a foreign corporation (“Foreign Acquiror”) is generally treated as a “surrogate foreign corporation” if, pursuant to a plan (or series of related transactions), (1) after March 4, 2003, Foreign Acquiror acquires, directly or indirectly, substantially all of the properties held, directly or indirectly, by a domestic corporation⁶ (“Domestic Target” and such acquisition, the “Inversion Transaction”),⁷ (2) after the Inversion Transaction, the percentage of Foreign Acquiror stock (by vote or value) held by former Domestic Target shareholders by reason of such shareholders holding stock in Domestic Target⁸ (the “Ownership Fraction”) is at least sixty percent, and (3) after the Inversion Transaction, the expanded affiliated group (the “EAG”)⁹ that includes Foreign Acquiror does not have “substantial business activities” in the

⁶ Section 7874 also applies to the acquisition by Foreign Acquiror of substantially all of the properties constituting a trade or business of a domestic partnership.

⁷ This Report defines “Inversion Transaction” to generally refer to the acquisition by Foreign Acquiror, directly or indirectly, of substantially all of the properties of Domestic Target. As defined in this Report, an Inversion Transaction is not necessarily subject to either the rules applicable to 60% or 80% inversions under Section 7874 or shareholder-level gain under Section 367(a).

⁸ In the case of the acquisition of a domestic partnership, this test is measured by reference to Foreign Acquiror stock held by former Domestic Target partners by reason of such partners holding a capital or profits interest in the domestic partnership. See Section 7874(a)(2)(B)(ii)(II).

⁹ Foreign Acquiror’s EAG is defined as an affiliated group, within the meaning of Section 1504, except that (1) foreign corporations are included, and (2) the relevant ownership threshold is fifty percent instead of eighty

foreign country in which, or under the law of which, Foreign Acquiror is created or organized, when compared to the total business activities of the EAG (the “Substantial Business Activities Test”).¹⁰ Under the anti-abuse rule contained in Section 7874(c)(4), a transfer of properties or liabilities (including by contribution or distribution) is disregarded if such transfer is part of a plan a principal purpose of which is to avoid the purposes of Section 7874.¹¹

Under Section 7874(a)(1), the taxable income of an expatriated entity (*i.e.*, Domestic Target, if Foreign Acquiror is a surrogate foreign corporation with respect to Domestic Target) for any year that includes any portion of the applicable period (*i.e.*, the period beginning on the first date properties are acquired as part of the Inversion Transaction and ending on the date that is ten years after the last date properties are acquired as part of such Inversion Transaction)¹² cannot be less than the “inversion gain” of the expatriated entity for the taxable year. Section 7874(d)(2) defines inversion gain as the income or gain recognized as a result of the transfer during the applicable period of stock or other properties by an expatriated entity, and any income received or accrued during the applicable period as a result of certain licenses of properties by an expatriated entity. Further, under Section 7874(b), if the Ownership Fraction is at least eighty percent, the surrogate foreign corporation is treated as a domestic corporation for all purposes of the Code. Under Section 7874(g), Treasury may issue regulations “necessary to carry out [Section 7874], including regulations providing for such adjustments to the application of

percent. *See* Section 7874(c)(1). Under Treas. Reg. § 1.7874-4T(i)(3), whether or not an entity is considered part of Foreign Acquiror’s EAG is determined as of the end of the day on which the Inversion Transaction is completed.

¹⁰ Section 7874(a)(2)(B).

¹¹ For purposes of the Substantial Business Activities Test, any assets the transfer of which is disregarded under Section 7874(c)(4) are treated as though they are held by the EAG immediately after the Inversion Transaction but are not attributable to the foreign country in which, or under the laws of which, Foreign Acquiror is organized. *See* Treas. Reg. § 1.7874-3T(c)(1).

¹² Section 7874(d)(1).

[Section 7874] as are necessary to prevent the avoidance of the purposes of [Section 7874]” Generally, Section 367(a) and the Treasury Regulations promulgated thereunder require shareholder-level gain to be recognized in Inversion Transactions in which a U.S. person transfers property, directly or indirectly, to Foreign Acquiror in an exchange otherwise described in Section 332, 351, 354, 356, or 361, unless, among other requirements, the fair market value of Foreign Acquiror is at least equal to the fair market value of Domestic Target (the “Substantiality Test”).¹³

B. Section 2.02 of the Notice

In Section 2.02 of the Notice, Treasury and the Service announced their intention to issue regulations under Sections 7874 and 367 targeting transactions in which Domestic Target distributes property to its shareholders in order to (1) reduce the Ownership Fraction under Section 7874 and/or (2) satisfy the Substantiality Test under Section 367(a). Under such forthcoming regulations, for purposes of applying the anti-avoidance rule of Section 7874(c)(4),¹⁴ “non-ordinary course distributions” made by Domestic Target (including its predecessors) during the 36-month period ending on the date of the Inversion Transaction (the “Look-Back Period”) will be treated as part of a plan a principal purpose of which is to avoid the purposes of Section 7874 (and, thus, will be disregarded under Section 7874(c)(4)). “Non-ordinary course distributions” (“NOCDs”) are defined as the excess of all distributions made by Domestic Target during a taxable year with respect to the equity of Domestic Target over 110% of the average of such distributions during the 36-month period immediately preceding such taxable year (the “110% Threshold”). Distributions may be treated as NOCDs regardless of their

¹³ Treas. Reg. § 1.367(a)-3(c).

¹⁴ The Notice also notes that Treas. Reg. § 1.367(a)-3(c) will be modified to include a rule that incorporates these principles for purposes of the Substantiality Test.

form. The Notice specifically indicates that dividends, spin-offs otherwise qualifying under Section 355, stock redemptions under Section 302(a), and distributions of boot (to the extent directly or indirectly provided by Domestic Target for purposes of Section 356) in connection with the Inversion Transaction may be considered NOCDs. The Notice does not provide any examples or further detail describing the application of the rules for determining whether a distribution is considered an NOCD or for disregarding a distribution for purposes of Sections 7874 and 367.

C. Summary of Recommendations

1. *In General*

We note that Section 7874(c)(4), the statutory provision on which Section 2.02 of the Notice¹⁵ relies, requires an inquiry into the principal purposes underlying a particular transfer of properties or liabilities. If the transfer was part of a plan a principal purpose of which was to avoid the purposes of Section 7874, then that transfer will be disregarded. Presumably due to practical concerns about applying a principal purpose test, the Notice, in contrast to the statutory provision, adopts a mechanical *per se* rule under which any distribution during the Look-Back Period above the 110% Threshold is treated as falling within Section 7874(c)(4) and is automatically disregarded without any inquiry into its purpose. While we understand why Treasury and the Service might wish to promulgate a rule that avoids a factual inquiry into purpose, we think that goal needs to be balanced with other considerations: (1) corporations with no plans to invert routinely make distributions that would be covered by the Notice, (2) corporations regularly engage in cross-border transactions that are not within the intended scope of Section 7874, and (3) the penalties under Section 7874 can be severe. We are concerned that,

¹⁵ For the remainder of this Report, references to the “Notice” refer specifically to Section 2.02 thereof.

in the absence of a more balanced rule, a significant number of distributions that are *not* motivated by a principal purpose of avoiding the purposes of Section 7874 will nonetheless be swept into the ambit of the “strict liability” rule of the Notice. This could cause corporations to limit unnecessarily distributions that they would otherwise make even where they have no plans to engage in transactions that would be within the intended scope of Section 7874.

To avoid over-inclusiveness, we believe that the breadth of the rule implemented by future guidance (*i.e.*, which distributions are potentially covered) should reflect the type of rule that is adopted (*i.e.*, a *per se* rule versus one that looks to purpose). The more the mechanic of the rule tilts the burden of proof in favor of the Service (with a *per se* rule in favor of the government being at one end of spectrum), the narrower the scope of the rule should be. Thus, if future guidance under the Notice continues the broad scope of the Notice itself (*i.e.*, retains the 36-month Look-Back Period and the 110% Threshold), then we believe it would be important that taxpayers be permitted to rebut the presumption that a distribution made within the Look-Back Period was part of a plan a principal purpose of which was to avoid the purposes of Section 7874. On the other hand, we are sympathetic to the difficulties, uncertainties, and administrative burdens associated with the application of a purposive facts and circumstances test and can understand the desire for a *per se* rule. If final guidance under the Notice adopts a *per se* approach, we think it would be especially important to narrow the scope of distributions subject to such guidance by, for example, shortening the Look-Back Period¹⁶ and/or increasing the 110% Threshold.¹⁷ We note that this approach would not exempt any transactions from Section 7874(c)(4), but would simply require the Service to make an actual showing as to a taxpayer’s purpose where the distribution falls outside of the scope of the *per se* rule.

¹⁶ See Part II.B.1.

¹⁷ See Part II.B.2.

Regardless of how this question is ultimately resolved, we believe that it is important that any future guidance under the Notice provide taxpayers with clear mechanical rules describing how the principles articulated by the Notice will be implemented. Because the application of the NOCD rules has a significant and fundamental impact on the tax treatment of the Inversion Transaction—indeed, it will determine whether a cross-border transaction (including, potentially, a transaction in which the consideration consists of all cash, or only a small amount of Foreign Acquiror stock)¹⁸ is subject to Section 7874 and/or Section 367—clarity in the application of these rules is critical.

2. *Specific Recommendations*

Beyond basic issues relating to the type and scope of the NOCD rules, we believe it is important for guidance to address a variety of critical details that were not addressed in the Notice. First, the interaction between the Notice’s mechanical NOCD rule and the purpose-based anti-avoidance rule in Section 7874(c)(4) is unclear. Second, the Notice leaves unanswered several questions regarding how to determine, mechanically, if a distribution is considered an NOCD and whether a distribution by an entity other than Domestic Target will be deemed an NOCD by Domestic Target by virtue of the predecessor rule. Third, the Notice gives no indication of how taxpayers should “disregard” a distribution, including for purposes of calculating the Ownership Fraction under Section 7874. As discussed in more detail below, we recommend that the forthcoming regulations address these topics.

As discussed in this Report, in addition to our recommendation that Treasury and the Service resolve an array of ambiguities and complexities raised by the Notice, we recommend the following:

¹⁸ See the discussion at Part II.D.2.

- The *per se* NOCD rule should be revised to create a rebuttable presumption in favor of the Service, giving taxpayers the opportunity to establish that a distribution was not motivated by a tax-avoidance purpose.¹⁹
- If a *per se* rule is retained, Treasury and the Service should consider narrowing the scope of the NOCD rule, including by:
 - ◆ Shortening the Look-Back Period from 36 months to 24 months; and²⁰
 - ◆ Increasing the 110% Threshold.²¹
- For purposes of determining whether the portion of a distribution not in excess of the 110% Threshold is subject to the general anti-avoidance rule of Section 7874(c)(4), the fact that a portion of such distribution is treated as an NOCD (and thus deemed to have a bad “principal purpose”) should not be relevant.²²
- Historic targets of Domestic Target generally should not be considered predecessors of Domestic Target, *unless* Domestic Target acquired a historic target that was larger (by value) than Domestic Target.²³
- Distributing corporations and controlled corporations in tax-free spin-offs should not be treated as predecessors of one another for purposes of the NOCD rules.²⁴
- The determination of whether a distribution is an NOCD should be made based on an aggregate approach that considers all distributions made by Domestic Target during the relevant periods, in lieu of a year-by-year approach.²⁵

¹⁹ See Part II.A.

²⁰ See Part II.B.1.

²¹ See Part II.B.2.

²² See Part II.B.3.

²³ See Part II.C.1.

²⁴ See *id.*

- Promulgated guidance should clarify how the NOCD rules are applied in the context of Inversion Transactions that do not occur on the last day of a taxable year.²⁶
- Distributions made by Domestic Target should be valued on the date of the distribution and, for purposes of deeming an additional amount of Domestic Target shares to be outstanding at the time of the Inversion Transaction, by reference to the value of Domestic Target stock on the date of the Inversion Transaction.²⁷
- Foreign Acquiror stock should be attributed to a disregarded distribution based on the percentage of Foreign Acquiror stock that Domestic Target shareholders would have received had additional Domestic Target shares been outstanding in respect of the disregarded distribution using the exchange ratio of the actual Inversion Transaction.²⁸
- Mandatory redemptions of preferred stock pursuant to the terms of the preferred stock, and redemptions, whether mandatory or optional, of preferred stock that was issued for cash during the Look-Back Period should be excluded from the definition of “distribution” for purposes of the NOCD rules (or should satisfy the taxpayer’s burden under the Rebuttable Presumption, as defined below).²⁹
- Periodic distributions made by a Domestic Target treated as a partnership for federal income tax purposes to its partners in respect of such partners’ tax

²⁵ See Part II.C.2.

²⁶ See Part II.C.3.

²⁷ See Part II.D.1.

²⁸ See Part II.D.2.

²⁹ See Part III.A.1.

liabilities with respect to items of partnership income and gain allocated to such partners should be excluded from the definition of “distribution” for purposes of the Notice (or should satisfy the taxpayer’s burden under the Rebuttable Presumption).³⁰

- Promulgated guidance should address the application of the NOCD rules to spin-offs of controlled corporations by Domestic Target and spin-offs in which Domestic Targets are the controlled corporations.³¹
- Promulgated guidance should address the application of the NOCD rules to situations involving multiple classes of stock.³²
- Promulgated guidance should clarify whether the NOCD rules are intended to result in a distribution being subject to Treas. Reg. § 1.7874-3T(c)(1) (relating to the Substantial Business Activities Test) .³³

II. Type and Scope of NOCD Rules

A. Type of NOCD Rule: *Per Se* Rule vs. Rebuttable Presumption

As described above, there is a tension between the NOCD rules of the Notice and the statutory language of the general anti-avoidance rule of Section 7874. Both Section 7874(c)(4) and the Notice are intended to curb tax-motivated transactions. However, the NOCD rule has a broad scope and results in a *per se* determination that a particular distribution was made pursuant to a tax-motivated plan, even where the facts and circumstances may not support this conclusion. We recognize the desire to avoid a fact-intensive inquiry into a taxpayer’s motives and other

³⁰ See Part III.A.2.

³¹ See Part III.B.

³² See Part III.C.

³³ See Part III.D.

pertinent facts. However, we believe it is important that the NOCD rule be carefully crafted to apply to distributions that are (or are likely to be) intended to avoid the purposes of Section 7874, while providing relief (via a rebuttable presumption and/or specific exceptions, as discussed below) for distributions that are clearly not tax-motivated. While the approach described in the Notice would avoid the difficulties, uncertainties, and administrative burdens associated with the application of a purpose-based facts and circumstances test, the “strict liability” nature of the NOCD rule, combined with its breadth, risks sweeping distributions that were not part of a plan with a bad purpose into the regime of Section 7874. We believe that the revisions and exceptions as described below would appropriately reduce the risk that the NOCD rules arbitrarily apply in the case of distributions that are not likely to be motivated by a tax-avoidance purpose.³⁴ In considering how to tailor the NOCD rule more narrowly to apply to an appropriate range of distributions, we suggest that Treasury and the Service consider the consequences of imposing a *per se* NOCD rule and applying a 36-month Look-Back Period and a 110% Threshold.

Principally, we recommend that future guidance revise the NOCD rule so that it creates a presumption in favor of the Service but is not a *per se* rule (the “Rebuttable Presumption”). This would allow taxpayers some opportunity to establish that a distribution that falls within the reach of the rule will not be disregarded if the taxpayer can show that avoiding the purposes of Section 7874 was not a principal purpose of the distribution.³⁵ At the same time, the presumption would

³⁴ We note that the adoption of many or all of our proposals could, at the margins, exempt certain tax-motivated distributions from the mechanical NOCD rules. However, because the Service would retain the authority to disregard such distributions pursuant to the general anti-avoidance rule of Section 7874(c)(4), we believe that, on balance, an approach that avoids subjecting non-abusive transactions to the NOCD rules should be favored.

³⁵ Given the retroactive effect of the NOCD rule (by virtue of both the effective date of the Notice and the fact that the Look-Back Period and 110% Threshold together look back over a period of six years), the Rebuttable Presumption would provide an opportunity for relief to taxpayers that have made distributions unrelated to an Inversion Transaction at a time prior to the publication of the Notice but within the Look-Back Period.

address concerns regarding ease of administration by tilting the scales in favor of the Service. We note, moreover, that the factual burden of the taxpayer would remain significant, as the taxpayer effectively would be required to prove a negative—that is, to prove the absence of a principal purpose.³⁶ If, however, Treasury and the Service choose not to adopt a Rebuttable Presumption, for the reasons discussed above, we believe it would be especially important to narrow the scope of the *per se* rule, for example, by shortening the Look-Back Period,³⁷ increasing the 110% Threshold,³⁸ and providing targeted exceptions for distributions that are clearly non-abusive.³⁹

If a Rebuttable Presumption approach is adopted, Treasury and the Service should also consider the appropriate standard of proof applicable to the Rebuttable Presumption. One approach, as under Section 355(e)(2)(B) (which similarly allows taxpayers to rebut a presumption that a distribution and acquisition are part of a single plan), would require simply that the taxpayer establish that the relevant distribution is not part of a plan a principal purpose of which is the avoidance of the purposes of Section 7874. Another approach might require a heightened standard of proof, such as establishing that no plan exists by clear and convincing evidence. We do not believe that the Rebuttable Presumption would diminish the Service’s ability to require an abusive distribution to be disregarded pursuant to Section 7874(c)(4), which would remain in effect and operate independently from the NOCD rules.

³⁶ See Section 355(e)(2)(B) for a similar rebuttable presumption established by the Service in connection with the determination of whether a spin-off and an acquisition are part of a plan for purposes of Section 355(e) (presumption of a plan exists “unless it is established that the distribution and the acquisition are not pursuant to a plan or series of related transactions”).

³⁷ See Part II.B.1.

³⁸ See Part II.B.2.

³⁹ See Part III.A.

B. Scope of the NOCD Rules

1. *36-Month Look-Back Period*

We believe, for a number of reasons, that a 36-month Look-Back Period is too long, especially in the context of a *per se* rule. It seems especially unlikely that taxpayers could determine, 36 months prior to an Inversion Transaction, the requisite size of the distribution for purposes of sufficiently reducing the value of Domestic Target relative to the value of Foreign Acquiror on the date the Inversion Transaction is completed.⁴⁰ Indeed, 36 months seems like a longer than necessary period over which to deem distributions to be part of the same plan (and motivated by the same purposes) as an acquisition. For example, Treasury Regulations under Section 355(e) provide guidance regarding when an acquisition will be treated as “part of a plan (or series of related transactions)” with a spin-off (*i.e.*, a distribution).⁴¹ Under the “super safe harbor,” regulations provide that a distribution and a subsequent acquisition can be part of the same plan only if there was an agreement, understanding, arrangement, or substantial negotiations regarding the acquisition or a similar acquisition during the two-year period ending on the date of the distribution.⁴² The adoption of a two-year period for purposes of Section 355(e) is particularly pertinent in the context of the Notice, as both regimes seek to identify distributions that should be treated as related to acquisitions. Further, under step-transaction principles, especially those relevant in the context of corporate transactions, it is generally agreed that, absent clear evidence of a plan, two transactions should be integrated only where the steps

⁴⁰ For purposes of avoiding Section 7874, taxpayers would further need to determine, 36 months prior to an Inversion Transaction, the consideration to be paid to Domestic Target shareholders in the ultimate transaction. This exercise also seems especially difficult.

⁴¹ Section 355(e); Treas. Reg. § 1.355-7.

⁴² Treas. Reg. § 1.355-7(b)(2). This example is offered merely to demonstrate that in other similar contexts, two years is considered a sufficiently long period for integrating a distribution and an acquisition.

occur within a relatively short period of time, such as 12 months.⁴³ Moreover, we note that the longer the Look-Back Period, the more likely it is to apply to distributions where the facts and circumstances would indicate that the distribution was unrelated to the Inversion Transaction.

We assume that Treasury and the Service chose 36 months for one (or both) of two reasons. First, the Look-Back Period reflects a determination by Treasury and the Service that a 36-month period is short enough to warrant assuming that larger-than-usual distributions occurring during this period are related to the Inversion Transaction (and motivated by a desire to avoid tax with respect thereto). In our experience, many distributions made during the 36 months preceding an acquisition in fact have nothing to do with the acquisition. Second, the Look-Back Period may have been selected based on the 36-month period during which certain assets acquired by Foreign Acquiror are disregarded under the Substantiality Test of Section 367(a).⁴⁴ We understand the desire to maintain some level of consistency between the “anti-stuffing” rules of Section 367(a) and the “anti-slimming” NOCD Rule given the similar context in which both rules apply. However, while both address Inversion Transactions, the rules of Section 367(a) and Section 7874 address somewhat different concerns—Section 367(a) compares the *value* of Domestic Target and Foreign Acquiror, whereas Section 7874, among other things, tests the *continuity* of Domestic Target’s shareholders’ ownership in the combined company after the Inversion Transaction. We therefore do not believe that the 36-month period applicable in the Section 367(a) context should necessarily determine the question of the appropriate duration of the Look-Back Period.⁴⁵

⁴³ See, e.g., Treas. Reg. § 1.368-2(c) (the step transaction doctrine may apply in the case of a corporate reorganization if the relevant steps take place “over a relatively short period of time such as twelve months”).

⁴⁴ See Treas. Reg. § 1.367-3(c)(3)(iii)(B)(1).

⁴⁵ It might also be argued that the 36-month period in the Section 367 regulations should be shortened, but this goes beyond the scope of this Report

For these reasons, and especially if Treasury and the Service do not adopt our recommendation for a Rebuttable Presumption, we recommend that the Look-Back Period apply over a period of 24, instead of 36, months immediately preceding the Inversion Transaction.⁴⁶ While this change would result in distributions during the third year prior to the Inversion Transaction being excluded from the NOCD rules, any such distributions would continue to be subject to the general anti-avoidance rule of Section 7874(c)(4). Thus, the shortening of the Look-Back Period would not diminish the ability of Treasury and the Service to require abusive distributions to be disregarded, regardless of when such distributions were made, but it would give taxpayers engaged in non-tax motivated transactions greater comfort that those transactions would not arbitrarily be swept into the regime of Section 7874.

2. *110% Threshold*

While the Notice does not explain how Treasury or the Service selected the 110% Threshold, given the purposes of the Notice, this must reflect a determination by Treasury and the Service that distributions that exceed average historical distributions by a margin of 10% or less tend to be ordinary course, while distributions in excess of such amount are not. In addition to the line-drawing problems associated with implementing any bright-line test, we believe that a 10% cushion may often be insufficient to protect ordinary course distributions. Consider the following example:

Example 1 (Ordinary Course Distributions): Domestic Target, which has an initial value of \$10,000, has a 10% after-tax return on equity and a fixed 30% dividend payout rate, such that it makes dividend payments to its shareholders of 3% each year, reinvesting the

⁴⁶ Under this approach, the 110% Threshold would be calculated by reference to average distributions made during the 24-month period immediately preceding the relevant taxable year. We note that an alternative approach would be for the Look-Back Period to immediately precede the date on which Domestic Target and Foreign Acquiror entered into a binding commitment to undertake the Inversion Transaction.

remaining 7% of its return. In each of Years 1 through 6, Domestic Target made a dividend payment of \$300, \$321, \$343.47, \$367.50, \$393.24, and \$420.78, respectively.⁴⁷ Foreign Acquiror acquires Domestic Target on December 31, Year 6.⁴⁸

Under the Notice, the Year 4 distribution of \$367.50 must be tested to determine if it is an NOCD by comparing it to the 110% Threshold, which, on these facts, equals \$353.64.⁴⁹ Thus, the excess of the \$367.50 Year 4 distribution over the 110% Threshold, or \$13.86, would be treated as an NOCD, *i.e.*, as part of a plan a principal purpose of which is to avoid the purposes of Section 7874. It is difficult to justify, however, the application of the Notice to a distribution that is so clearly the product of a long-standing, non-tax-motivated dividend policy. Further, we note that Example 1 describes a set of facts not dissimilar to facts that frequently arise in the real world and, we believe, accurately illustrates the effect of the Notice on Domestic Targets that implement dividend policies with fixed payout rates based on return of equity.

Inasmuch as such distributions are clearly not part of a plan a principal purpose of which is to avoid the purposes of Section 7874, the Notice should attempt to exclude them. Accordingly, we recommend that Treasury and the Service consider the anomalous results potentially produced under the 110% Threshold and whether it would be appropriate to provide taxpayers with a larger margin.⁵⁰

⁴⁷ In each of the examples discussed in this Report, we assume that no other distributions have been made other than those specifically described in the example.

⁴⁸ For purposes of this Report, we assume all entities use the calendar year as their taxable year.

⁴⁹ $(\$300 + \$321 + \$343.47)/3 \times 110\% = \353.64 .

⁵⁰ For example, Treasury and the Service might consider a 125% threshold, which would comport with the PFIC rules relating to “excess distributions” under Section 1291(b) as well as the asset consistency rules under Section 338 (*see* Treas. Reg. § 1.338-8(g)(1)(iii)). Note, however, that the PFIC rules and asset consistency rules may be less relevant examples to the extent Treasury and the Service adopt a 24-month Look-Back Period, as these rules apply a 125% threshold in the context of a 36-month test.

3. *Continued Application of the Principal Purpose Test*

The Notice indicates that NOCDs “will be treated as part of a plan a principal purpose of which is to avoid the purposes of [S]ection 7874,” but does not indicate whether or how distributions that are not NOCDs will be tested independently under the “principal purpose” language of Section 7874(c)(4). We believe, and recommend that regulations make it clear, that even if a distribution (or a portion thereof) is not considered an NOCD under the Notice, the Service retains the authority to challenge such distribution under Section 7874(c)(4) to the extent it is part of a plan a principal purpose of which is to avoid the purposes of Section 7874. At the same time, the regulations should make it clear that if a portion of a distribution is an NOCD, this should have no adverse implication for the balance of such distribution. Consider the following example:

Example 2 (Base Case): In Year 3, Domestic Target distributed \$100 to its shareholders. In Year 5, Domestic Target distributed \$50 to its shareholders. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Under the Notice, any distributions made in Years 4, 5, and 6 must be tested to determine if they are NOCDs. The \$50 Year 5 distribution must be tested to see if it exceeds the 110% Threshold, which, on these facts, equals \$36.67.⁵¹ Thus, the excess of the \$50 Year 5 distribution over the 110% Threshold, or \$13.33, would be treated as an NOCD under the Notice, *i.e.*, \$13.33 of the Year 5 distribution would be treated as part of a plan a principal purpose of which is to avoid the purposes of Section 7874.

The question remains: how is the other \$36.67, *i.e.*, the non-NOCD portion of the Year 5 distribution, treated under Section 7874(c)(4)? We do not think the 110% Threshold was

⁵¹ $\$100/3 \times 110\% = \36.67 .

intended to create a safe harbor, and accordingly we believe that the non-NOCD portion must be tested under the general anti-avoidance rule of Section 7874(c)(4) to determine if it was part of a plan a principal purpose of which is to avoid the purposes of Section 7874. However, even if it is clear, under all the facts and circumstances, that the Year 5 distribution (and, specifically the non-NOCD portion of that distribution) was not tax-motivated, in order to take such a position, a taxpayer arguably must conclude that two arbitrarily-determined portions (in Example 2, \$13.33 and \$36.67) of a single distribution were part of two distinct plans with different purposes. Without specific guidance from the Service, taxpayers may be uncomfortable taking such a position, given that Domestic Target's decision to make the relevant distribution will likely have been unitary—the tax fiction under the Notice of splitting the distribution into an NOCD and non-NOCD portion is unlikely to square with the actual facts and circumstances relevant to the determination under Section 7874(c)(4).⁵²

If the language in the Notice defining an NOCD as the portion of a distribution “in excess of” the 110% Threshold is to retain its meaning, we recommend that Treasury and the Service make clear in forthcoming guidance that, for purposes of determining whether the portion of a distribution not in excess of the 110% Threshold is subject to the general anti-avoidance rule of Section 7874(c)(4), the fact that a portion of that same distribution is an NOCD is not relevant. A similar rule should apply with respect to other distributions made during the Look-Back Period that are not NOCDs and were made pursuant to the same plan as the NOCD.

⁵² In Example 2, if, instead of a single \$50 Year 5 distribution, Domestic Target made multiple distributions in Year 5 that equaled \$50 in the aggregate, the same \$13.33 would be treated as an NOCD. However, the Notice does not specify which of the Year 5 distributions is treated as giving rise to the NOCD. Thus, it is plausible that a pro rata portion of each of the distributions would be treated as an NOCD, resulting in a portion of each of the distributions being deemed to be part of a plan a principal purpose of which is tax avoidance. Without specific guidance, it seems uncertain that taxpayers could confidently treat any of the Year 5 distributions as not being part of such a plan. See Part II.C.2 below for a similar allocation issue that arises in the context of Inversion Transactions that occur on a date other than on the last day of the taxable year.

C. When is a Distribution an NOCD?

To apply the Notice, a taxpayer must first determine whether distributions made by Domestic Target (or its predecessors) during a taxable year within the Look-Back Period are treated as NOCDs. The Notice is clear that, for purposes of the forthcoming regulations, a distribution means “any distribution,” regardless of its form.⁵³ In making this determination, a threshold question is which entities are considered predecessors of Domestic Targets such that their distributions fall within the ambit of the NOCD definition.

Next, taxpayers must compare the aggregate distributions made during each taxable year in the Look-Back Period to the 110% Threshold to determine whether any NOCDs exist. It is unclear, however, how to allocate distributions that occur in a taxable year only a portion of which is included in the Look-Back Period between the Look-Back Period and the prior period. The Notice does not address this point and thus appears primarily to have contemplated situations where the relevant Inversion Transaction will have occurred on the last day of a taxable year, with the Look-Back Period comprised of three full taxable years.

1. Which Entities Are Considered Predecessors of Domestic Target?

The Notice provides that distributions by predecessors of Domestic Target factor into the determination of whether an NOCD exists, but does not elaborate on the meaning of “predecessor.” It is unclear whether the concept of a predecessor is based on the rules under Section 368(a)(1)(F), Section 368(a)(1)(D), Section 381, or considerations unique to Sections 7874 and 367. We recommend that future guidance explain how to determine whether an entity is a predecessor for this purpose, as understanding which distributions must be considered is a crucial threshold question in applying the rules of the Notice. In each of Examples 3A through

⁵³ See Part III.A for a discussion of certain types of distributions that we believe should be excluded from the definition of an NOCD.

3F, one might wonder whether Domestic Corporation could be considered a predecessor of Domestic Target, but the Notice does not provide a clear answer.

Example 3A (Asset Reorganization): In Year 4, Domestic Corporation distributed \$100 to its shareholders. In Year 5, Domestic Corporation merged into Domestic Target in an asset reorganization (*i.e.*, in a reorganization under Section 368(a)(1)(A) or 368(a)(1)(C)). Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Example 3B (Stock Reorganization): Same facts as Example 3A, except that Domestic Target acquired Domestic Corporation in a stock reorganization (*i.e.*, in a reorganization under Section 368(a)(2)(D), 368(a)(2)(E), or 368(a)(1)(B)).

Example 3C⁵⁴ (Spin-Off of Domestic Corporation; Pre-Spin-Off Distribution by Domestic Corporation): In Year 4, Domestic Corporation distributed \$100 to its shareholder, Domestic Target. In Year 5, Domestic Target (Distributing) distributed the stock of Domestic Corporation (Controlled) in a tax-free spin-off under Section 355. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Example 3D (Spin-Off of Domestic Corporation; Post-Spin-Off Distribution by Domestic Corporation): In Year 4, Domestic Target (Distributing) distributed the stock of Domestic Corporation (Controlled) in a tax-free spin-off under Section 355. In Year 5, Domestic Corporation distributed \$100 to its shareholders. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Example 3E (Spin-Off of Domestic Target; Pre-Spin-Off Distribution by Domestic Corporation): In Year 4, Domestic Corporation distributed \$100 to its shareholders. In Year 5, Domestic Corporation (Distributing) distributed the stock of Domestic Target (Controlled) in a

⁵⁴ In each of Examples 3C through 3F, we assume that the distributing corporation has not contributed assets to the controlled corporation. See Part III.B for a discussion of the contributions made in connection with spin-offs.

tax-free spin-off under Section 355. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Example 3F (Spin-Off of Domestic Target; Post-Spin-Off Distribution by Domestic Corporation): In Year 4, Domestic Corporation (Distributing) distributed the stock of Domestic Target (Controlled) in a tax-free spin-off under Section 355. In Year 5, Domestic Corporation distributed \$100 to its shareholders. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

In establishing a sensible, administrable predecessor rule, we believe that Treasury and the Service should bear in mind the purpose of the rule in light of the overall goals of the Notice and Section 7874(c)(4). If the guiding principle is that future regulations should curb transactions with a tax-avoidance purpose by targeting distributions that might well be part of a plan whose purpose is the avoidance of Section 7874, the predecessor rule should only reach putative predecessors whose distributions might well be part of such a plan, it should not treat as a predecessor of Domestic Target an entity whose distributions seem unlikely to be part of a plan a principal purpose of which is the avoidance of taxes in the Inversion Transaction in which Foreign Acquiror acquires Domestic Target.

In the case of a typical acquisitive reorganization (Examples 3A and 3B) where Domestic Target acquires a historic target (*i.e.*, Domestic Corporation) whose value is less than that of Domestic Target, we believe it is generally unlikely that pre-acquisition distributions made by Domestic Corporation could be part of a plan a principal purpose of which is tax avoidance with respect to the Inversion Transaction ultimately undertaken by Domestic Target post-acquisition. However, we note that if the predecessor rule simply excluded acquisitive reorganizations, Domestic Target could, in view of a planned Inversion Transaction, make a tax-motivated

distribution to shareholders, structure an acquisition whereby Domestic Corporation was treated as the “acquiror” for purposes of the reorganization rules (despite it being the smaller of the two entities), and then have Foreign Acquiror acquire Domestic Corporation (the surviving, acquiring corporation). To limit this potential abuse, we recommend that Treasury and the Service consider implementing a rule that, for purposes of the NOCD rules, historic targets of Domestic Target are generally not considered predecessors of Domestic Target, *unless* Domestic Target acquired a historic target that was larger (by value) than Domestic Target.⁵⁵ In calculating the value of the putative predecessor (*i.e.*, historic target) for this purpose, the value of any distributions made by the historic target prior to the acquisition by Domestic Target and during the Look-Back Period would be added back to the value of the historic target on the date of the acquisition by Domestic Target. Such an approach would treat historic targets as predecessors of Domestic Target in situations raising the specter of tax-avoidance (*i.e.*, where there is an indication that the form of the historic acquisition was intended to avoid the application of the predecessor rule), while avoiding the need for complicated due diligence with respect to historic distributions made by historic targets of Domestic Target where the likelihood of such distributions having any relation to a future Inversion Transaction is highly unlikely.

With respect to tax-free spin-offs (Examples 3C through 3F), the notion that the distributing and controlled corporations are predecessors of one another seems inappropriate and out of synch with the principles underlying the Notice. In each of these fact patterns, the distributions by the putative predecessor (Domestic Corporation) do not reduce the value of

⁵⁵ We note that this proposal is limited to the calculation of NOCDs under the Notice and is not intended to limit the ability of the Service to treat an entity as a predecessor of Domestic Target under the general anti-avoidance rule of Section 7874(c)(4).

Domestic Target.⁵⁶ Thus, it is unclear why these distributions raise a concern about the avoidance of the purposes of Section 7874. Indeed, where Domestic Target (Distributing) distributes the stock of its subsidiary in a tax-free spin-off during the Look-Back Period, and that subsidiary has previously made intercompany distributions to Domestic Target (Example 3C), the intercompany distributions cannot possibly give rise to a tax avoidance concern with respect to the later Inversion Transaction, as the distributions can only *increase* the value of Domestic Target. Where, instead, the spun-off subsidiary makes post-spin-off distributions to its shareholders (Example 3D), the distributions are generally the result of decisions made by a separate, independent company and have no relevance to Domestic Target (Distributing).⁵⁷ In fact, with respect to both Examples 3D and 3F (discussed below), the value of the distribution made by the putative predecessor represents value that was never attributable to Domestic Target, and the distribution itself occurs at a time when the putative predecessor is (and remains) unrelated to Domestic Target. Similarly, where Domestic Target was itself the controlled subsidiary in a tax-free spin-off during the Look-Back Period, distributions its corporate parent makes pre-spin-off (Example 3E) and post-spin-off (Example 3F) have no bearing on the value of Domestic Target and are unrelated to Domestic Target. Indeed, it is hard to see how they could be part of the plan pursuant to which Domestic Target independently decided to pursue an Inversion Transaction. Because there is no situation in which treating either the distributing

⁵⁶ In Example 3C, Domestic Corporation (Controlled) makes a pre-spin-off distribution to its parent, Domestic Target, of \$100, increasing Domestic Target's value by \$100. In Example 3D, Domestic Corporation (Controlled) makes a post-spin-off distribution to its shareholders of \$100, having no effect on Domestic Target's value. In Example 3E, Domestic Corporation (Distributing) makes a pre-spin-off distribution to its shareholders of \$100, having no effect on Domestic Target's value. In Example 3F, Domestic Corporation (Distributing) makes a post-spin-off distribution to its shareholders of \$100, having no effect on Domestic Target's value.

⁵⁷ In addition, counting the post-spin-off distribution by the spun-off subsidiary would also seem to result in double counting: Domestic Target (1) would have made a distribution in the amount of the value of Domestic Corporation (Controlled) and (2) would be deemed to have made the post-spin-off distribution actually made by Domestic Corporation, the value of which was included in the distribution described in subclause (1).

corporation or the controlled corporation in a tax-free spin-off as a predecessor of the other would further purposes of the Notice, we recommend that Treasury and the Service make clear in forthcoming regulations that the fact patterns in Examples 3C through 3F do not give rise to predecessors of Domestic Target.⁵⁸

Regardless of how the term “predecessor” is defined for purposes of the NOCD rules, the Notice clearly requires that distributions made by a predecessor be tested for NOCD status (and, in appropriate circumstances, be added back to Domestic Target). It is less clear, however, that any such distributions made by a predecessor are included for purposes of calculating the 110% Threshold (or higher threshold, if our recommendation is adopted). We can see no principled reason for such an inconsistency and do not believe that it was intended. Accordingly, we would suggest that Treasury and the Service make clear in future guidance that, under the predecessor rule, distributions are attributed to Domestic Target for purposes of both counting distributions made during the Look-Back Period and measuring the 110% Threshold (or higher threshold, if our recommendation is adopted).

2. *Aggregate vs. Year-by-Year Approach*

In light of potential distortions arising under the year-by-year testing approach (including, for example, the anomalous results associated with mid-year Inversion Transactions described in Part II.C.3, below), we recommend that Treasury and the Service instead adopt an aggregate testing approach (the “Aggregate Test”) to determine whether a distribution is an NOCD. Under

⁵⁸ Note that, if this proposal is adopted, where Domestic Target (Controlled) is newly-formed by Domestic Corporation (Distributing) in connection with the spin-off, it may be difficult to apply the NOCD rules to Domestic Target for the first six years after its formation because of an inadequate distribution history. Treasury and the Service should consider limiting the application of the NOCD rules in the case of newly-formed entities (including newly-formed controlled corporations) and instead subjecting them only to the general anti-avoidance rules of Section 7874(c)(4) in light of the inability to apply the NOCD rules. We do not believe it would be appropriate to penalize Domestic Target in this circumstance (or in any other circumstance involving a newly-formed entity) by deeming all distributions to be NOCDs to the extent Domestic Target’s history does not allow for full application of the NOCD rules.

the Aggregate Test, NOCDs would be defined as (1) the excess of the aggregate of all distributions made by Domestic Target with respect to the equity of Domestic Target during the Look-Back Period over (2) 110% (or such greater percentage as may be adopted) of the aggregate of such distributions made during the 36-month (or shorter, if our other recommendations are adopted) period immediately preceding the Look-Back Period.

Example 4 (Pattern of Declining Distributions): In Years 3 through 6, Domestic Target distributed \$600, \$300, \$200, and \$100, respectively, to its shareholders. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Under the Notice, in Example 4, the Year 4 distribution of \$300 would be compared to the 110% Threshold of \$220,⁵⁹ and \$80 of the Year 4 distribution would be treated as an NOCD. However, the circumstances indicate that, in the four years preceding the Inversion Transaction, Domestic Target consistently decreased its distributions, behavior that, if anything, seems inconsistent with a plan to decrease its size relative to a Foreign Acquiror. Under the Aggregate Test, the taxpayer would compare the aggregate distributions in Years 4 through 6 (\$600) to 110% of the aggregate distributions in Years 1 through 3 (\$660) and resulting in none of the distributions in the 36-month period preceding the Inversion Transaction being treated as NOCDs.

We acknowledge that under the Aggregate Test, Domestic Target gets the benefit of having made its largest distribution immediately preceding the Look-Back Period, but we do not think this raises potential for abuse. The Look-Back Period (whether 36 months, as under the Notice, or a shorter period, as recommended by this Report) theoretically represents the period of time during which it is reasonable to presume that Domestic Target's actions are part of the same

⁵⁹ $\$600/3 \times 110\% = \220 . We note that in Example 4, the 110% Threshold would remain the same even if the Year 3 distribution had not represented an increase over the distributions made in Year 1 and Year 2, as long as the cumulative distributions for Years 1 through 3 equaled \$600.

plan as the Inversion Transaction. Distributions made outside of this period (*e.g.*, in Example 4, the \$600 distribution in Year 3) should not be treated as related to the Inversion Transaction.

While we believe it is especially important to adopt the Aggregate Test in the context of a *per se* rule, because the Aggregate Test more clearly reflects the taxpayer's pattern of distributions over the relevant periods and avoids the potentially anomalous results of the year-by-year approach, we recommend that Treasury and the Service adopt the Aggregate Test irrespective of whether the Rebuttable Presumption is adopted.

We also would recommend that Treasury and the Service consider an Aggregate Test that adds back contributions made to the capital of Domestic Target during the relevant period. For example, issuances of Domestic Target equity for cash that result in an increase in the value of Domestic Target for purposes of Section 7874 would be subtracted from any aggregate distributions made during the same period. An approach that takes into account only those transactions that effect a reduction in the value of Domestic Target while ignoring transactions that result in an offsetting increase in value seems imbalanced.

3. *Mid-Year Inversion Transactions*

We recommend that regulations implementing the NOCD rules clarify how to apply those rules to Inversion Transactions that do not occur on the last day of the taxable year. The uncertainties arise because only NOCDs made during the Look-Back Period, which may comprise portions of taxable years, are treated as tax-motivated under the Notice—but NOCDs are tested on the basis of distributions made during whole taxable years. Consider the following example:

Example 5A (Mid-Year Inversion; Distributions Prior to Look-Back Period): In Year 3, Domestic Target distributed \$100 to its shareholders. On January 1, Year 4, Domestic

Target distributed \$30 to its shareholders. On December 31, Year 4, Domestic Target distributed \$20 to its shareholders. Foreign Acquiror acquires Domestic Target on July 1, Year 7.

Under the Notice, all distributions made during a taxable year must be compared to the 110% Threshold with respect to such taxable year to determine if distributions made during such taxable year are NOCDs. Thus, the \$50 of aggregate distributions made during Year 4 must be tested to see if they exceed the 110% Threshold for Year 4, which equals \$36.67.⁶⁰ Under the rules of the Notice, the excess (\$13.33) is an NOCD. However, only those NOCDs made during the Look-Back Period, beginning on July 1, Year 4 and ending on June 30, Year 7, are treated as part of a plan a principal purpose of which is to avoid the purposes of Section 7874. In Example 5A, forty percent of the Year 4 distributions were made during the Look-Back Period, while sixty percent of the Year 4 distributions occurred prior this period. However, the Notice provides no guidance on whether or how to allocate the \$13.33 NOCD between the portion of Year 4 ending on June 30 and the portion of Year 4 beginning on July 1. There are several approaches one might take to making such allocation,⁶¹ and specific guidance on this point to avoid taxpayer uncertainty would be welcome.

Questions may also arise where an Inversion Transaction occurs mid-year and Domestic Target makes distributions during the stub period ending with the date of the Inversion Transaction, such as in the following example:

Example 5B (Mid-Year Inversion; Distributions at End of Look-Back Period): In

Year 6, Domestic Target distributed \$100 to its shareholders. On January 1, Year 7, Domestic

⁶⁰ $\$100/3 \times 110\% = \36.67 .

⁶¹ For example, one might allocate a pro rata portion of the \$13.33 to the Look-Back Period based on the percentage of Year 4 distributions that were made during such period, resulting in forty percent (or \$5.33) being treated as an NOCD. On the other hand, one might take a cumulative approach, allocating the \$13.33 based on when the last \$13.33 of distributions were made in Year 4, resulting in one hundred percent (or \$13.33) being treated as an NOCD. We believe the former approach (proration) would be more balanced and straightforward.

Target distributed \$36.67 to its shareholders. Foreign Acquiror acquires Domestic Target on January 31, Year 7.

Under the Notice, the \$36.67 Year 7 distribution must be tested to see if it exceeds the 110% Threshold for Year 7, which equals \$36.67.⁶² There is no excess, resulting in no NOCD. Domestic Target has essentially benefitted from the arbitrary stub period occurring as a result of the mid-year inversion—it is able to use its entire capacity under the 110% Threshold during the first month of Year 7. While this result seems odd, especially in cases where Domestic Target has not historically front-loaded its distributions in the ordinary course, we would not recommend modifying (and thus adding complexity to) the mechanical NOCD rule to change the result, as we believe that the general anti-avoidance rule of Section 7874(c)(4) is well-suited to apply in this and similar situations where the facts and circumstances raise the possibility of abuse.⁶³

D. What does it Mean to “Disregard” a Distribution for Purposes of Section 7874?

Once the amount of the NOCD allocable to the Look-Back Period has been determined, the Notice simply states that “such distributions will be disregarded for purposes of [S]ection 7874.” But the Notice does not explain how the Service will “disregard” such distributions. With no elaboration provided in the Notice, several questions arise. First, if a distribution must be disregarded, it seems that the distributed property should be “added back” to Domestic Target (or its predecessor) as though Domestic Target continued to own the property on the date of the Inversion Transaction, raising the question of how to value the relevant distribution. Second, to disregard the distribution for purposes of determining the Ownership Fraction, one must

⁶² $\$100/3 \times 110\% = \36.67 .

⁶³ Because the Service retains the ability to police situations such as those in Example 5B under Section 7874(c)(4), we do not believe it is necessary to prorate Domestic Target’s distribution capacity to account for a stub period in the year of the Inversion Transaction.

determine if and to what extent Domestic Target shareholders should be deemed to have received Foreign Acquiror stock in respect of the shares of Domestic Target deemed outstanding by virtue of the disregarded distribution.⁶⁴ This raises several unanswered questions, including those related to the value of each of Domestic Target and Foreign Acquiror and determining how to apply this construct in the context of various acquisition structures. We understand, from various unofficial comments by Treasury and the Service staff, that the government’s view may involve the construct of first adding the value of the disregarded distribution back to Domestic Target and then attributing Foreign Acquiror stock to the increased Domestic Target value, but we note that this construct is not set forth in the Notice.⁶⁵ As a threshold recommendation, we suggest that Treasury and the Service propose a detailed set of rules providing taxpayers with a clear understanding of how distributions will be disregarded.

1. Measuring the Value of the Distribution

In order to increase the value of Domestic Target in respect of the disregarded distribution, one must understand when and how the distribution is to be valued. We believe it is simplest and most appropriate to value the distribution on the date of such distribution, without

⁶⁴ We note that this second step is only relevant to the application of the Notice in the context of Section 7874 and not Section 367(a), which merely requires that the distribution be added back to the value of Domestic Target for purposes of applying the Substantiality Test. This Report, like the Notice, focuses on the more complex question of the application of the rules described in the Notice for purposes of Section 7874. The Notice simply states that the Substantiality Test “will be modified to include a rule that incorporates the principles” described in the Notice. We recommend that Treasury and the Service give consideration to the differences in the relevant inquiries under Section 367(a) (*i.e.*, value of Domestic Target) and Section 7874 (*i.e.*, calculation of the Ownership Fraction and, perhaps, application of the Substantial Business Activities Test (*see* Part III.D, below)) before applying the same set of rules to both regimes.

⁶⁵ As an alternative approach, in the case of redemptions of Domestic Target stock, the Notice could require a number of Domestic Target shares equal to the number of Domestic Target shares redeemed (or, in the case of distributions other than redemptions, the number of shares with a value equal to the distribution at that time) to be added back to Domestic Target. Under this construct, the distribution would be disregarded by adding back to Domestic Target the value of the shares on the date of the Inversion Transaction, even though at the time Domestic Target made the relevant decision to undertake the redemption or other distribution, its value was decreased by a smaller (or conceivably greater) amount. We believe, however that such an approach is inconsistent with the underlying theory of the Notice, in that a taxpayer can only have a bad purpose with respect to the actual amount of the distribution at the time of the distribution.

adding interest, a growth factor, or any other amount. Because the reason for disregarding a particular distribution is that the distribution was (or is presumed to have been) intended to facilitate tax avoidance by reducing the value of Domestic Target in advance of an Inversion Transaction, that intent logically relates to the value distributed on the date the taxpayer undertook the tax-motivated action, *i.e.*, the date of the distribution.⁶⁶ Consider the following examples:

Example 6A (Base Case): In Year 3, Domestic Target distributed \$100 to its shareholders. On January 1, Year 5, when Domestic Target shares were each worth \$1, Domestic Target distributed \$50 cash to its shareholders. Foreign Acquiror acquires Domestic Target on December 31, Year 6, when Domestic Target shares are each worth \$2.

Example 6B (Redemption of Domestic Target Stock): In Year 3, Domestic Target distributed \$100 to its shareholders. On January 1, Year 5, when Domestic Target shares were each worth \$1, Domestic Target redeemed 50 shares for a total of \$50. Foreign Acquiror acquires Domestic Target on December 31, Year 6, when Domestic Target shares are each worth \$2.

In Example 6A, where it is clear that the value of the distribution to be disregarded, both at the time of the distribution and on the date of the Inversion Transaction, is \$13.33, we believe the value to be added back to Domestic Target is \$13.33. Thus, for purposes of determining the shares of Domestic Target outstanding immediately prior to the Inversion Transaction, additional Domestic Target shares worth \$13.33 (or 6.665 shares) should be deemed outstanding. In Example 6B, the value of the distribution to be disregarded, as measured at the time of the

⁶⁶ We note that taxpayers could, arguably, anticipate a certain interest or growth rate during the period between the distribution and the Inversion Transaction and factor this rate into the net present value of the distribution on the date of distribution. However, the administrative complexity associated with attributing an appropriate rate of interest or growth to a distribution seems to weigh in favor of taking a simpler approach.

distribution, is \$13.33, but on the date of the Inversion Transaction, the value of the number of shares redeemed has increased to \$26.66. Consistent with the approach described above, we believe the value to be added back to Domestic Target is \$13.33 (and an additional 6.665 shares of Domestic Target stock should be deemed outstanding). Rules and examples to this effect in promulgated regulations and guidance would be helpful.

2. *Attributing Foreign Acquiror Stock to the Distribution*

After adding back sufficient value to Domestic Target to effectively disregard the distribution for valuation purposes (and converting such value into additional Domestic Target shares deemed outstanding), one must determine whether and how to attribute Foreign Acquiror shares to such additional Domestic Target shares. In other words, to determine the effect of disregarding the distribution under Section 7874, one must determine whether, had the distribution not occurred, a greater percentage of former Domestic Target shareholders would have held Foreign Acquiror shares by reason of holding such additional Domestic Target shares, as compared to the Ownership Fraction as calculated giving effect to the relevant (but disregarded) distribution. The Notice offers no guidance on how to implement this rule. Essentially, the construct requires the additional Domestic Target shares deemed outstanding to have hypothetically received consideration in the Inversion Transaction (as if the disregarded distribution had not occurred). We believe the outcome of this approach should depend on the consideration Foreign Acquiror actually pays in the Inversion Transaction.

Example 7A (100% Stock Consideration; Fixed Consideration): In Year 3, Domestic Target distributed \$100 to its shareholders. On January 1, Year 5, Domestic Target distributed \$50 cash to its shareholders. Foreign Acquiror acquires Domestic Target on December 31, Year 6 in a transaction in which the consideration is 100% Foreign Acquiror stock

and at a time when each Foreign Acquiror share is worth \$1. In the transaction, each Domestic Target shareholder receives \$1 of Foreign Acquiror stock for every \$1 of Domestic Target stock.

Example 7B (50% Stock/50% Cash Consideration; Fixed Consideration): In Year 3, Domestic Target distributed \$100 to its shareholders. On January 1, Year 5, Domestic Target distributed \$50 cash to its shareholders. Foreign Acquiror acquires Domestic Target on December 31, Year 6 in a transaction in which the consideration is 50% Foreign Acquiror stock and 50% cash⁶⁷ and at a time when each Foreign Acquiror share is worth \$1. In the transaction, each Domestic Target shareholder receives \$0.50 of Foreign Acquiror stock and \$0.50 of cash for every \$1 of Domestic Target stock.

Example 7C (100% Cash Consideration): In Year 3, Domestic Target distributed \$100 to its shareholders. On January 1, Year 5, Domestic Target distributed \$50 cash to its shareholders. Foreign Acquiror acquires Domestic Target on December 31, Year 6 in a transaction in which the consideration is 100% cash and at a time when each Foreign Acquiror share is worth \$1.

⁶⁷ We note that in Example 7B, if the cash paid in connection with the Inversion Transaction were paid, directly or indirectly, by Domestic Target, as opposed to being sourced at Foreign Acquiror, then, under the Notice, a portion of such cash payment would be considered an NOCD and would be disregarded. Regardless of where the cash is sourced, Domestic Target shareholders receive the same consideration. Thus, the relevant theory must be that if Domestic Target had not been the source of the cash consideration, Foreign Acquiror would have instead provided additional *stock* consideration. This theory is consistent with an approach that adds back to Domestic Target the value of distributions made by Domestic Target prior to the Inversion Transaction and deems Foreign Acquiror stock to have been paid in respect of such additional value. While we believe that a distinction between boot payments sourced at Domestic Target and those sourced at Foreign Acquiror may be sensible (because pre-acquisition distributions paid by Domestic Target should be on equal footing with boot sourced at Domestic Target), we note that, given the disparate treatment, taxpayers may prefer to structure transactions to ensure that boot payments are sourced at Foreign Acquiror.

Further, it is unclear whether taxpayers utilize cash distributions by Domestic Target to avoid the application of Section 7874 (as distinguished from the avoidance of Section 367(a)) when, as an alternative, Foreign Acquiror could instead increase the *cash* consideration paid in respect of Domestic Target stock. In light of this, if Treasury and the Service adopt the Rebuttable Presumption, we would suggest that consideration be given to providing guidance as to whether taxpayers could rebut such presumption by providing evidence of Foreign Acquiror's ability and willingness to have increased the cash consideration paid if the relevant distribution were not made.

In each of Examples 7A, 7B, and 7C, the value of the distribution to be disregarded is \$13.33. Under Section 7874, however, adding back this value is not enough—calculation of the Ownership Fraction embodies a “continuity” concept, in that it requires the taxpayer to determine the percentage of Foreign Acquiror stock held “by reason of” holding Domestic Target stock. The relevant question is what value of (and how many) additional shares of Foreign Acquiror stock should be deemed to have been paid to Domestic Target shareholders in the Inversion Transaction on account of the \$13.33 of additional value at Domestic Target. In the absence of a clear rule in the Notice, the possibility exists that the entire added back value (in Examples 7A through 7C, \$13.33) could be treated as receiving Foreign Acquiror stock in the Inversion Transaction. However, especially in the context of a transaction in which the consideration paid by Foreign Acquiror is 100% cash (*i.e.*, Example 7C), this is an improbable result. We believe that it is important for future guidance to adopt a rule that taxpayers can apply consistently to determine the tax treatment of cross-border transactions. While we note that any such mechanical rule which, by its nature, cannot consider all relevant facts and circumstances, will be arbitrary, we believe a sensible (albeit arbitrary) rule would look to the available extrinsic facts relevant to the determination of the consideration deemed paid for additional Domestic Target stock, namely, the actual mix of cash and stock consideration paid in the Inversion Transaction.

In Example 7A, where all Domestic Target shareholders receive Foreign Acquiror shares in the Inversion Transaction, it seems reasonable to deem an additional \$13.33 of Foreign Acquiror shares to have been paid to Domestic Target shareholders (*i.e.*, Foreign Acquiror shares should be attributed to 100% of the disregarded distribution). However, in Examples 7B and 7C, where less than 100% of the consideration in the Inversion Transaction consists of Foreign

Acquiror stock, it is not clear that the same approach should apply. Instead, we would propose a pro rata approach (the “Pro Rata Attribution Rule”) under which Foreign Acquiror stock would be attributed to a disregarded distribution based on the percentage of Foreign Acquiror stock that Domestic Target shareholders would have received had additional shares been outstanding in respect of the disregarded distribution.⁶⁸ Under the Pro Rata Attribution Rule, in Example 7B, where 50% of the consideration in the Inversion Transaction consists of Foreign Acquiror stock, an additional \$6.67 of Foreign Acquiror shares should be deemed to have been paid to Domestic Target shareholders (*i.e.*, Foreign Acquiror shares should be attributed to 50% of the disregarded distribution).⁶⁹ Likewise, in Example 7C, where the Inversion Transaction is an all-cash deal, under the Pro Rata Attribution Rule, no Foreign Acquiror shares should be deemed to have been paid to Domestic Target shareholders.

We believe that an approach that arbitrarily deems Domestic Target shareholders to receive only Foreign Acquiror stock in respect of a disregarded distribution, especially when inconsistent with the consideration paid in the actual Inversion Transaction, would be inconsistent with the purposes of the Notice. The benefit the taxpayer enjoys as a result of undertaking a tax-motivated distribution, in terms of the avoidance of Section 7874, is theoretically capped at the amount of Foreign Acquiror stock that was not issued to Domestic Target shareholders in the Inversion Transaction by making the distribution. Therefore, if facts

⁶⁸ We assume that, when attributing Foreign Acquiror shares to the disregarded distribution, additional Foreign Acquiror stock is considered to be both (1) held by Domestic Target shareholders, and (2) outstanding (*i.e.*, the additional Foreign Acquiror stock is added to both the numerator and denominator of the Ownership Fraction) and would suggest future guidance make this clear.

⁶⁹ If, in Example 7B, facts and circumstances indicated that the cash consideration paid in the Inversion Transaction was sourced at Domestic Target, not Foreign Acquiror, it is unclear how the rules would apply. The cash payment would be treated as a distribution by Domestic Target and tested under the NOCD rules. The value of any resulting NOCD would be added back to the Domestic Target. Under the Pro Rata Attribution Rule, however, it is unclear whether the consideration paid by Foreign Acquiror would be considered to be 50% stock, 50% cash or, in light of the fact that the cash is treated as a distribution by Domestic Target, 100% stock. We suggest that forthcoming guidance address this fact pattern.

and circumstances (as evidenced by the consideration actually paid) indicate that, had the relevant distribution not been made, Domestic Target shareholders would have received additional Foreign Acquiror stock in respect of only a portion of the increased value (or would not have received any additional Foreign Acquiror shares), rules implementing the Notice should not arbitrarily attribute Foreign Acquiror stock to 100% of the disregarded distribution. Arbitrarily deeming Foreign Acquiror stock to have been paid in respect of the disregarded distribution in an otherwise all-cash acquisition seems particularly unreasonable. Cross-border transactions completed entirely for cash consideration should not raise concerns under the inversion rules. Therefore, we suggest that Treasury and the Service adopt the Pro Rata Attribution Rule described above.⁷⁰

III. Additional Scope Issues

In addition to the mechanical questions raised in Part II of this Report, we believe that there are certain specific fact patterns that highlight other scope issues that arise under the Notice, and we recommend that guidance, when issued, address these circumstances. First, the Notice indicates that a broad set of distributions are considered distributions for purposes of the NOCD rules, but does not consider or address certain types of distributions that may warrant special consideration, including distributions made with respect to certain classes of preferred stock, and partnership tax distributions. Second, the Notice leaves unanswered certain questions arising with respect to the treatment of distributions under Section 355 (*i.e.*, tax-free spin-offs).

⁷⁰ We note that in any Inversion Transaction, it is possible that Foreign Acquiror is cash constrained and absent the NOCD would have had to utilize its stock, and not cash, to pay Domestic Target shareholders in respect of the increased Domestic Target value. In this circumstance, the Pro Rata Attribution Rule (by assuming that Foreign Acquiror has the wherewithal to pay Domestic Target shareholders in respect of the increased Domestic Target value in the same stock/cash proportion as it paid the remainder of the consideration) may assume a result that would not have been possible in the real-world. As noted above, we believe any mechanical rule (*i.e.*, one that does not apply a facts and circumstances analysis) will necessarily be arbitrary in some respects, but the Pro Rata Attribution Rule has the advantage of taking into account the actual mix of consideration paid in the transaction. Therefore, despite this result, we believe the Pro Rata Attribution Rule reflects the most appropriate, workable approach.

Third, the Notice does not address the circumstance in which either Domestic Target or Foreign Acquiror has multiple classes of stock outstanding, including how to disregard distributions made with respect to certain classes of stock. Finally, the Notice does not address whether and how distributions should be disregarded for purposes of the Substantial Business Activities Test under Section 7874.

A. Potential Exceptions to the Definition of “Distribution”

As described above, the Notice defines “distribution,” for purposes of the NOCD rules, as “any distribution, regardless of whether it is treated as a dividend or whether, for example, it qualifies under [S]ection 355.” It goes on to explain that stock redemptions pursuant to Section 302(a) and payments of boot to Domestic Target shareholders in connection with the Inversion Transaction, to the extent such boot is provided, directly or indirectly, by Domestic Target for purposes of Section 356, are distributions for purposes of the Notice. The Notice does not exclude any type of distribution for these purposes. We believe that with respect to certain distributions, the likelihood that such distributions are part of a plan a principal purpose of which is to avoid the purposes of Section 7874 is so remote that exceptions are warranted. If the Rebuttable Presumption is adopted, in lieu of an exception, an alternative approach would be to address the distributions described in this Part III.A by clarifying through examples in the regulations that such distributions would, at least generally, satisfy the taxpayer’s burden under the Rebuttable Presumption.

1. Certain Redemptions of Preferred Stock

Example 8A (Mandatory Redemption): In Year 5, Domestic Target redeemed all of its preferred stock for \$50 pursuant to a mandatory redemption obligation that was contained

in the terms of the preferred stock when it was issued. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Example 8B (Issuance and Redemption During Look-Back Period): In Year 4, Domestic Target issued a new class of preferred stock in exchange for \$50. In Year 5, Domestic Target redeemed all of its preferred stock for \$50. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Under the Notice, it seems that, in each of Examples 8A and 8B, the \$50 Year 5 distribution, in the form of redemption of an entire class of preferred stock, would give rise to an NOCD that would be disregarded. In Example 8A, however, Domestic Target was required to undertake such redemption pursuant to the terms of the preferred stock. In these circumstances, it is difficult to imagine that the terms of the preferred stock mandating redemption in Year 5 were arranged as part of a plan a principal purpose of which is to avoid the purposes of Section 7874.⁷¹ Similarly, in Example 8B, because Domestic Target both issued the preferred shares in exchange for cash and redeemed the preferred shares for cash during the Look-Back Period, Domestic Target did not reduce its net value during such period.⁷² Thus, in either example, treating the distribution of cash to preferred holders in redemption of such preferred shares as an NOCD does not comport with the purposes of either the Notice or Section 7874(c)(4). We recommend that (1) mandatory redemptions of preferred stock pursuant to its terms⁷³ and (2)

⁷¹ If, to the contrary, facts and circumstances indicate that the mandatory redemption feature was included in the preferred stock instrument for tax-avoidance reasons, the Service retains the authority to require the redemption to be disregarded under the general anti-avoidance rule of Section 7874(c)(4).

⁷² We note that if our recommendation to add back contributions made to the capital of Domestic Target during the relevant period, *see* Part II.C.2, is adopted, the fact pattern in Example 8B would not give rise to an NOCD to the extent the cost of redemption was offset by the proceeds of issuance.

⁷³ A more nuanced approach might require that the mandatory redemption be for the issue price of the preferred stock or for the issue price plus a *de minimis* premium. We would further recommend that the Service consider excluding from the definition of an NOCD dividend payments made by Domestic Target with respect to its outstanding preferred stock (where such preferred stock was not issued as part of a part of a plan a principal

redemptions, whether mandatory or optional, of preferred stock where such stock was issued for cash during the Look-Back Period be excluded from the definition of “distribution” for purposes of the NOCD rules.⁷⁴

2. *Partnership Tax Distributions*

The governing documents of entities treated as partnerships for federal income tax purposes frequently allow or require the partnership to make periodic distributions to its partners in respect of its partners’ tax liabilities in respect of items of partnership income and gain allocated to such partners. Whereas a corporate entity merely pays its tax bill and does not need to make distributions of cash for this purpose, the mechanics of Subchapter K can result in partners being liable for cash tax payments in respect of partnership taxable income and gain without having received actual cash distributions from the partnership. Thus, tax distributions made by partnerships are merely a mechanism of convenience to allow partners to make payments to tax authorities.

The Notice, however, does not provide an exception for such conventional tax distributions, and thus it appears that these tax distributions could be deemed NOCDs. Because the clear purpose of such tax distributions is for the partnership to bear the tax costs of its partners, we recommend that such distributions be excluded from the definition of “distribution” under the Notice.⁷⁵

purpose of which is to avoid the purposes of Section 7874) bearing a market rate of return. As in Example 8A, in this circumstance, it is difficult to imagine that the coupon rate of the preferred stock was negotiated as part of a plan a principal purpose of which is to avoid the purposes of Section 7874.

⁷⁴ As noted above, if Treasury and the Service adopt this Report’s recommendation for a Rebuttable Presumption, an alternative approach would be to clarify, through examples or other guidance, that such redemptions satisfy the taxpayer’s obligation, pursuant to the Rebuttable Presumption, to establish that a distribution is not part of a tax-motivated plan. In addition, adoption of the Aggregate Test discussed above in Part II.C.2 would address Example 8B.

⁷⁵ As noted above, if Treasury and the Service adopt this Report’s recommendation for a Rebuttable Presumption, an alternative approach would be to clarify, through examples or other guidance, that such distributions satisfy

B. Spin-Offs

1. *Spin-Offs Under the Notice Generally*

As a general matter, it seems clear that, under the Notice, a distribution made by Domestic Target of the stock of a controlled corporation in a manner that is tax-free under Section 355 may give rise to an NOCD in the amount of the excess of the value of the stock of the controlled corporation on the date of the distribution (plus the value of any other distributions during the Look-Back Period) over the 110% Threshold. We believe it is clear that a spin-off with a principal purpose to reduce the size of Domestic Target relative to Foreign Acquiror in advance of an Inversion Transaction to avoid Foreign Acquiror being treated as a surrogate foreign corporation should be disregarded under the NOCD rules and the general anti-avoidance rule of Section 7874(c)(4). However, where there is no such purpose, we believe that the unique rules governing tax-free spin-offs under Section 355 warrant independent consideration of the application of the regulations implementing the Notice to distributions made in the context of such transactions.⁷⁶

Example 9A (Spin-Off by Domestic Target): In Year 5, Domestic Target (Distributing) distributed the stock of a controlled corporation in a transaction qualifying under Section 355. Facilitating the acquisition of Domestic Target was not a motivating purpose for the spin-off; rather the spin-off was motivated by one or more independent business purposes.

the taxpayer's obligation, pursuant to the Rebuttable Presumption, to establish that a distribution is not part of a tax-motivated plan.

⁷⁶ Some of us believe, as a general matter, that tax-free spin-offs under Section 355 are distinguishable from, for instance, taxable distributions of cash and should be treated differently under the NOCD rules. Not only are they already subject to an extensive statutory and regulatory regime designed to prevent nontaxable spinoffs if motivated by a purpose related to the avoidance of federal income tax, but they are also complex transactions that are difficult to complete and frequently transformative to the businesses involved. Therefore, we further suggest that, if our recommendation to adopt the Rebuttable Presumption is not adopted as a general matter, Treasury and the Service consider adopting a Rebuttable Presumption approach for spin-offs.

Under Section 355(e), the spin-off is not part of the same plan as the Inversion Transaction. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

In Example 9A, the application of the rules proposed in the Notice would, in effect, deem the spin-off of the controlled corporation by Domestic Target to have been part of a plan a principal purpose of which is the avoidance of the purposes of Section 7874. Where, as in Example 9A, a spin-off is not intended to facilitate an Inversion Transaction and, moreover, is deemed not to be part of the same plan as the Inversion Transaction under Section 355(e), it seems inappropriate to treat such a spin-off as a distribution that is part of a plan a principal purpose of which is the avoidance of Section 7874. Further, unlike distributions of cash, spin-offs by Domestic Target effect a major change in Domestic Target's business. Given the unique nature of spin-offs, we believe that, in certain circumstances where it is clear that a spin-off is unrelated to an Inversion Transaction, it is inappropriate to deem such a transaction to be motivated by a principal purpose to avoid the purposes of Section 7874. Thus, we would recommend that any guidance adopting a Rebuttable Presumption provide specific discussion, through examples or otherwise, of when and how taxpayers may demonstrate that a spin-off is not part of a plan a principal purpose of which is to avoid the purposes of Section 7874.

In crafting helpful guidance for taxpayers concerning the application of a Rebuttable Presumption to spin-offs, we believe it would be useful to look to Section 355(e) concepts to inform the facts and circumstances that indicate that a spin-off is or is not related to a subsequent Inversion Transaction.⁷⁷ We would also suggest that the regulations contain examples demonstrating whether and how a taxpayer could satisfy its burden under the Rebuttable

⁷⁷ See footnote 36, Part II.A, and text accompanying footnotes 41 and 42 for further discussion of Section 355(e), which similarly addresses the circumstances in which a distribution and acquisition are part of a single plan. As discussed in those sections, we believe that Section 355(e) is particularly pertinent in the context of the Notice, as both regimes seek to identify distributions that should be treated as related to acquisitions.

Presumption in the context of a spin-off transaction. First, guidance should address how a taxpayer could demonstrate that a spin-off is unrelated to the Inversion Transaction. Second, guidance should indicate whether a spin-off that has a purpose to facilitate a transaction, but not specifically the Inversion Transaction, could satisfy the taxpayer's burden under the Rebuttable Presumption.⁷⁸

2. *Valuation Concerns Related to Spin-Offs*

Further guidance would be helpful regarding the methodology for valuing the spin-off distribution (*i.e.*, valuing the stock of the controlled corporation) for purposes of the Notice. In the context of a spin-off, it is not clear how the value of controlled corporation stock should be measured. Frequently, a spun-off corporation is believed to have a greater value as an independent company than as a controlled subsidiary of the distributing parent corporation. Indeed, the Service has recognized the validity of a corporate business purpose related to an expected increase in the equity value of the controlled corporation as a result of the spin-off.⁷⁹ In a scenario in which the value of the stock of the controlled corporation in the hands of its independent shareholders (*i.e.*, the distribution date value) exceeds the value of such stock in the hands of Domestic Target, utilizing the distribution date value for purposes of the NOCD rules would seem to add back too much value. On the other hand, authority exists for the proposition that the spun-off corporation has greater value in the hands of the distributing corporation than in

⁷⁸ Two more nuanced versions of this example that might be addressed through guidance are fact patterns where (1) a spin-off has a purpose to facilitate a transaction, but not specifically the Inversion Transaction, and no Inversion Transaction was considered prior to the spin-off, and (2) a spin-off has a purpose to facilitate a transaction, but not specifically the Inversion Transaction, and a different Inversion Transaction was considered prior to the spin-off. Even if the distribution in the first example could satisfy the taxpayer's burden under the Rebuttable Presumption, the distribution in the second example may be more difficult to except from the application of the NOCD Rule.

⁷⁹ See Rev. Rul. 2004-23, 2004-10 I.R.B. 585 (Feb. 13, 2004).

the hands of the public, due to the controlling stake.⁸⁰ Because the purpose of the rules under the Notice is to disregard distributions by Domestic Target that are intended to decrease the value of Domestic Target, the value of controlled corporation stock for purposes of the Notice theoretically should be the value of such stock in the hands of Domestic Target (*i.e.*, the value foregone by Domestic Target by making the distribution). However, determining the value of a “captive” controlled is at best a challenging valuation exercise (whether or not a portion of the controlled corporation’s shares are publicly-traded prior to the spin-off). To facilitate taxpayers’ ability to understand the consequences of a spin-off under the NOCD rules and in light of the approach of the Notice to impose clear, mechanical rules, we suggest that Treasury and the Service specifically provide that the public market capitalization of the controlled corporation immediately following the spin-off—perhaps measured as the average of the high and the low market price of controlled corporation stock on the date of the spin-off—is the value of the company for purposes of the NOCD rules.⁸¹

3. *Domestic Target as a Newly-Formed Versus Historic Controlled Corporation*

Example 9B (Spin-Off of Historic Domestic Target; Pre-Spin-Off Distribution by Domestic Target): In Year 5, the stock of historic Domestic Target (Controlled) was distributed by the distributing corporation to its shareholders in a transaction qualifying under Section 355. In connection with the spin-off, Domestic Target made a distribution of \$50 to the distributing corporation. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Example 9C (Spin-Off of Newly-Formed Domestic Target; Pre-Spin-Off Distribution by Domestic Target): In Year 5, the stock of newly-formed Domestic Target

⁸⁰ See, e.g., *Pope & Talbot, Inc. v. Comm’r*, 104 T.C. 574 (1995).

⁸¹ See, e.g., Treas. Reg. § 20.2031-2(b)(1).

(Controlled) was distributed by the distributing corporation to its shareholders in a transaction qualifying under Section 355. In connection with the spin-off, Domestic Target made a distribution of \$50 to the distributing corporation. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

In Examples 9B and 9C, Domestic Target is the controlled corporation in the spin-off, and the relevant question is whether distributions made by Domestic Target prior to the spin-off, at a time when Domestic Target was a controlled subsidiary of the distributing corporation, should be tested to determine status as an NOCD. Under the Notice, in both Examples 9B and 9C, it appears that Domestic Target would be deemed to have made a \$50 NOCD that would be disregarded for purposes of determining the tax treatment of the Inversion Transaction. These examples are intended to raise two questions. First, should intercompany distributions made by Domestic Target (Controlled) at a time when it was part of the distributing corporation's consolidated group be treated as distributions under the NOCD rules? Second, should the rules make a distinction between a historic controlled versus a newly-formed controlled?

As discussed in Part II.C.1 above, where Domestic Target is the controlled subsidiary in a tax-free spin-off during the Look-Back Period, we believe it is inappropriate to treat distributions made by the distributing corporation as part of the plan pursuant to which Domestic Target independently decided to pursue an Inversion Transaction. We believe there is also at least a plausible argument that distributions made by Domestic Target at a time when it was controlled by the distributing corporation should have no bearing on the transactions Domestic Target decides to pursue after the spin-off as a separate corporation.

Another view would suggest a more complex approach that treats Examples 9B and 9C differently. Under such an approach, where Domestic Target is a historic entity (regardless of

whether the spin-off involves a divisive D reorganization with respect to Domestic Target), a distribution by Domestic Target to the distributing corporation should be subject to the NOCD rules because it is possible that the historic entity is utilizing the distribution to reduce its size in advance of an Inversion Transaction. Under such an approach, where Domestic Target is newly-formed in connection with the spin-off, and, in a divisive D reorganization, the distributing corporation contributes assets to Domestic Target in exchange for Domestic Target stock and cash, the cash should not be viewed apart from the contribution. As long as there is a “net contribution,” the distribution should be excepted from the NOCD rules.⁸²

We note that the latter approach (applying the Notice to pre-spin-off distributions by historic Domestic Target (Controlled) but not newly-formed entities) focuses on the valuation question under Section 7874 (and Section 367(a)). It would subject historic Domestic Target (Controlled) to the rules of the Notice because it is conceivable that distributions made by such entity could be intended to decrease Domestic Target’s value (whereas distributions by a newly-formed controlled corporation seem unlikely to be so motivated). On the other hand, the former approach (pursuant to which pre-spin-off distributions by Domestic Target (Controlled) would be disregarded regardless of whether the entity is historic or newly-formed) concentrates on the necessary link, under Section 7874(c)(4), between the distribution and the later Inversion Transaction. In other words, the former approach recognizes that the variables that guide the decision as to how the spun-off business is held and capitalized prior to the spin-off (*i.e.*, the variables that determine whether Domestic Target (Controlled) is historic or newly-formed) are, in all likelihood, unrelated to any subsequent Inversion Transaction and rather related to independent corporate motivations. Therefore, such approach would not distinguish between

⁸² We note that, in our experience, the majority of spin-offs involve a newly-formed controlled corporation, even where an existing entity conducts the business to be spun-off (*i.e.*, the existing entity, perhaps along with other assets, is contributed in a divisive D reorganization to a newly-formed entity that is subsequently spun-off).

historic and newly-formed entities on the theory that decisions made by a taxpayer that are disconnected from the purpose of the Notice should also be irrelevant in the context of the Notice. Independent of the question of focus as between the valuation question and the relatedness of the Inversion Transaction and the distribution, an approach that draws a distinction between historic and newly-formed Domestic Targets elevates form over substance, perhaps inappropriately.

Given the complexity of this issue, we would recommend that forthcoming guidance address whether “distributions” under the Notice include both distributions made by a historic Domestic Target to its corporate parent and distributions (including cash, assumptions of debt, and issuances of debt securities) made by a newly-formed Domestic Target to its corporate parent, *i.e.*, distributions under Section 361 in connection with a reorganization pursuant to Section 368(a)(1)(D).

4. *Direction of the Spin-Off*

Example 9D (Spin-Off of Domestic Corporation; Acquisition of Domestic Target):

Because Foreign Acquiror wanted to acquire large Business A and not small Business B, in Year 5, Domestic Target (Distributing) distributed Domestic Corporation (Controlled) to its shareholders in a transaction qualifying under Section 355. Immediately after the spin-off, Domestic Target, which conducts Business A, was valued at \$900, and Domestic Corporation, which conducts Business B, was valued at \$100. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Example 9E (Spin-Off of Domestic Target; Acquisition of Domestic Target):

Because Foreign Acquiror wanted to acquire large Business A and not small Business B, in Year 5, the stock of Domestic Target (Controlled) was distributed by Domestic Corporation

(Distributing) to its shareholders in a transaction qualifying under Section 355. Immediately after the spin-off, Domestic Target, which conducts Business A, was valued at \$900, and Domestic Corporation, which conducts Business B, was valued at \$100. Foreign Acquiror acquires Domestic Target on December 31, Year 6.

Examples 9D and 9E demonstrate the potential for abuse of the NOCD rules by reversing the direction of a spin-off. In Example 9D, Domestic Target's distribution of the controlled Domestic Corporation will be tested under the Notice and will likely give rise to an NOCD. In Example 9E, however, where Domestic Corporation instead distributes Domestic Target, despite the larger size of Domestic Target relative to Domestic Corporation, Domestic Target will not be treated as having made a distribution, and the NOCD rules will not apply. In this respect, the application of the NOCD rules to spin-offs is driven by the transaction's form.

We believe there are two alternative approaches to this fact pattern. First, the form-driven approach of the NOCD rules could be retained—if Domestic Target is the controlled corporation, a distribution of its stock will not be recharacterized as a distribution by Domestic Target of the distributing corporation's stock. This is consistent with general tax rules regarding spin-offs—the form, including the direction, of the transaction matters. Spin-offs generally are not recharacterized as having occurred in the opposite direction, even if the proverbial “minnow” distributes the “whale.”⁸³ However, as demonstrated in Examples 9D and 9E, a literal approach

⁸³ See, e.g., Rev. Rul. 2003-79, 2003-29 I.R.B. 80 (when a controlled corporation is spun-off and then acquired in a reorganization subject to the “substantially all” requirement, such requirement is measured by reference to the assets of only the controlled corporation and not by reference to the assets of the combined company pre-spin-off).

to the directionality of spin-offs would allow taxpayers to accomplish substantively the same transaction with vastly different results.⁸⁴

Alternatively, the Notice could adopt an approach that deems Domestic Target to have been the distributing corporation in the spin-off, regardless of whether it was, in form, the controlled corporation. A more nuanced version of this approach would deem Domestic Target to have been the distributing corporation only where it is larger, by value, than the actual distributing corporation. We recommend that Treasury and the Service address this question in forthcoming guidance.

C. Multiple Classes of Stock

Where Domestic Target has multiple classes of stock outstanding and, under the rules of the Notice, is deemed to have made an NOCD with respect to one class of such stock, it is not clear how such distributions are disregarded, particularly where Foreign Acquiror does not have a similar capital structure or where Domestic Target has a different capital structure at the time of the Inversion Transaction as compared to the time of the NOCD.

1. *Domestic Target Preferred Stock*

Example 10A (Redemption of a Portion of a Class of Domestic Target Preferred Stock): In Year 5, pursuant to the terms of its historic class of outstanding preferred stock, Domestic Target redeemed fifty percent of its preferred stock at maturity for \$100.⁸⁵ Foreign Acquiror acquires Domestic Target on December 31, Year 7. In the Inversion Transaction, Foreign Acquiror acquires Domestic Target common stock in exchange for Foreign Acquiror

⁸⁴ However, if the spin-off were clearly part of a plan a principal purpose of which is to avoid the purposes of Section 7874, even without a rule requiring the recharacterization of the transaction, the Service could require the spin-off to be disregarded under Section 7874(c)(4).

⁸⁵ We note that, if Treasury and the Service accept the proposal in Part III.A.1 of this Report to establish an exception for mandatory redemptions of preferred stock, the redemption in Examples 10A and 10B would not be subject to the rules of the Notice.

common stock and Domestic Target preferred stock in exchange for 50% Foreign Acquiror common stock and 50% cash.

Example 10B (Redemption of an Entire Class of Domestic Target Preferred Stock): In Year 5, pursuant to the terms of its historic class of outstanding preferred stock, Domestic Target redeemed all of its preferred stock at maturity for \$100. Foreign Acquiror acquires Domestic Target on December 31, Year 7. In the Inversion Transaction, Foreign Acquiror acquires Domestic Target common stock in exchange for Foreign Acquiror common stock.

In Example 10A, the Notice would require the \$100 distribution to be disregarded. Assuming the \$100 is added back to the value of Domestic Target such that there is a hypothetical additional \$100 of Domestic Target preferred stock outstanding at the time of the Inversion Transaction, the Pro Rata Attribution Rule would suggest attributing \$50 of Foreign Acquiror common stock to the distribution. We believe this is a sensible approach that should be confirmed in specific guidance.

In Example 10B, however, the class of Domestic Target preferred stock with respect to which the relevant distribution was made is no longer outstanding at the time of the Inversion Transaction. Thus, the Pro Rata Attribution Rule is not instructive as we cannot attribute to the Domestic Target preferred stock a pro rata amount of Foreign Acquiror stock based on the consideration paid to Domestic Target preferred stockholders in the Inversion Transaction. The question remains as to how to attribute Foreign Acquiror stock to the disregarded distribution. The parties to the Inversion Transaction did not negotiate the consideration to be received by Domestic Target preferred stockholders, providing no guidance as to how the hypothetical attribution should occur. A potential approach would be to apply the Pro Rata Attribution Rule,

assuming that, had the class of stock been outstanding at the time of the Inversion Transaction, it would have been entitled to receive the same consideration as was paid to the holders of Domestic Target common stock (*i.e.*, 100% Foreign Acquiror stock). We note, however, this approach may impose an unduly harsh result on taxpayers who might have negotiated consideration consisting of a lower percentage of Foreign Acquiror stock had the class of shares been outstanding (*e.g.*, the consideration payable to Domestic Target preferred stockholders in Example 10A). Assuming that our proposed Pro Rata Attribution Rule is adopted, we do not see a clear, logical approach to this question and suggest that Treasury and the Service provide specific guidance in this area.

2. *High-Vote/Low-Vote Stock*

Under the rules of the Notice, when a distribution is disregarded, it is disregarded for purposes of determining the Ownership Fraction with respect to both the vote and value of Foreign Acquiror held by former Domestic Target shareholders. The application of the Notice in situations involving classes of Domestic Target and/or Foreign Acquiror stock with disparate voting power is unclear.

Example 11A (Redemption of a Portion of High-Vote Domestic Target Stock): In Year 5, Domestic Target redeemed fifty percent of its Class B (high-vote) shares for \$100. Foreign Acquiror acquires Domestic Target on December 31, Year 7. In the Inversion Transaction, Foreign Acquiror acquires Domestic Target Class A (low-vote) shares in exchange for Foreign Acquiror common stock and Domestic Target Class B (high-vote) shares in exchange for 50% Foreign Acquiror common stock and 50% cash.

Example 11B (Redemption of an Entire Class of High-Vote Domestic Target Stock): In Year 5, Domestic Target redeemed all of its Class B (high-vote) shares for \$100.

Foreign Acquiror acquires Domestic Target on December 31, Year 7. In the Inversion Transaction, Foreign Acquiror acquires Domestic Target Class A shares in exchange for Foreign Acquiror common stock.

In Examples 11A and 11B, the Notice would require each of the \$100 distributions to Class B shareholders to be disregarded. Like in Example 10A, in Example 11A, the Pro Rata Attribution Rule would suggest attributing \$50 of Foreign Acquiror common stock to the distribution, because, in the Inversion Transaction, Class B shareholders received 50% of the deal consideration in Foreign Acquiror common stock.

In Example 11B, however, the Class B shares are no longer outstanding at the time of the Inversion Transaction, such that it is impossible to apply the Pro Rata Attribution Rule to attribute to the Class B shares a pro rata amount of Foreign Acquiror stock based on the consideration paid to holders of Class B shares in the Inversion Transaction. Further, to the extent the Notice requires the Ownership Fraction in respect of the voting power of Foreign Acquiror held by former Domestic Target shareholders to be calculated by reference to the disregarded distribution, the voting power associated with the Foreign Acquiror stock attributed to the Class B shares is relevant. One approach might assume that, had the Class B shares been outstanding at the time of the Inversion Transaction, Foreign Acquiror would have issued its own high-vote shares in respect of such shares. However, such an assumption seems particularly inappropriate where Foreign Acquiror does not have a class of high-vote shares outstanding at the time of the Inversion Transaction. Even if such a class were outstanding, because we do not know what bargain the parties would have reached had the Class B shares of Domestic Target been outstanding at the time of the Inversion Transaction, the assumption that the Class B shares would have been acquired in exchange entirely for high-vote shares of Foreign Acquiror may

unnecessarily penalize Foreign Acquiror. As with the fact patterns concerning preferred stock in Examples 10A and 10B above, specific guidance from Treasury and the Service would be welcome in the area of high-vote/low-vote stock. We note that, were Treasury and the Service to take the view that the Notice does not require distributions to be disregarded for purposes of calculating the Ownership Fraction with respect to the voting power (as opposed to the value) of Foreign Acquiror, the analysis would be simplified, but transactions involving high-vote/low-vote stock would continue to raise the same issues that arise in the case of preferred stock.⁸⁶

D. Disregarding a Distribution for Purposes of the Substantial Business Activities Test

Under the Substantial Business Activities Test, any assets the transfer of which is disregarded under Section 7874(c)(4) are treated as though they are held by the EAG immediately after the Inversion Transaction but are not attributable to the foreign country in which, or under the laws of which, Foreign Acquiror is organized (the “-3T Add-Back Rule”).⁸⁷ Essentially, under the -3T Add-Back Rule, the disregarded assets count against Foreign Acquiror in determining whether Foreign Acquiror can satisfy the Substantial Business Activities Test. This result may be sensible because, if a particular transfer of assets is part of a plan the purpose of which is to avoid the purposes of Section 7874, the taxpayer should not get the benefit of having disposed of such assets (for example, to reduce the assets held by the EAG in a jurisdiction other than the country in which the EAG seeks to establish substantial business activities) for purposes of the Substantial Business Activities Test.

⁸⁶ If the rules of the Notice did not apply with respect to determining the Ownership Fraction for purposes of voting power, the voting power of Foreign Acquiror stock paid in exchange for various classes of Domestic Target stock would become irrelevant, but the type and value of the consideration paid would remain crucial to the calculation of the Ownership Fraction for purposes of determining the value of Foreign Acquiror stock held by former Domestic Target shareholders.

⁸⁷ See Treas. Reg. § 1.7874-3T(c)(1).

Because the Notice treats NOCDs as distributions described in Section 7874(c)(4), it could be interpreted to require that NOCDs that are deemed to be part of a tax-motivated plan for purposes of the Notice be subject to the -3T Add-Back Rule for purposes of the Substantial Business Activities Test. If this result were to obtain, assets transferred pursuant to distributions that are treated as NOCDs and disregarded under the Notice would be treated as though they were continued to be held by the EAG (but were not associated with the relevant foreign country). However, because the NOCD rules are not aimed at preventing distributions motivated by a purpose to qualify under the Substantial Business Activities Test, subjecting NOCDs that are required to be disregarded under Section 7874(c)(4) to the -3T Add-Back Rule could lead to anomalous results. Consider the following example:

Example 12 (Single Foreign Country): All employees, assets, and income of Domestic Target (Distributing) and its wholly owned subsidiary, Domestic Corporation (Controlled), are attributable to business activities conducted in Country A. In Year 5, Domestic Target distributed the stock of Domestic Corporation to its shareholders in a transaction qualifying under Section 355. Foreign Acquiror, an entity formed and organized in Country A, acquires Domestic Target on December 31, Year 7.⁸⁸

Under the Notice, the spin-off of Domestic Corporation would be an NOCD and would be disregarded pursuant to Section 7874(c)(4). If this, in turn, subjected the spun-off employees, assets, and income to the -3T Add-Back Rule, such employees, assets, and income of Domestic Corporation would be deemed to be held by the EAG in a jurisdiction other than Country A, potentially causing the transaction to fail to satisfy the Substantial Business Activities Test on these facts. This result, however, makes no sense—the facts clearly indicate that the spun-off

⁸⁸ The facts here are intended to be illustrative, throwing the point into high relief. That point remains relevant in more realistic fact patterns where, for example Domestic Target has more geographically diversified operations (e.g., inside and outside of Country A).

assets were held in Country A and therefore the distribution of such assets could not have been motivated by a desire to satisfy the Substantial Business Activities Test. While we believe it is clear that the rules of the Notice were not intended to apply to the Substantial Business Activities Test,⁸⁹ the Notice does not expressly state that distributions that are disregarded for purposes of the NOCD rules are not subject to the -3T Add-Back Rule. Therefore, we recommend that Treasury and the Service make their position on this point clear in future guidance.⁹⁰

⁸⁹ Indeed, the Notice specifies that the perceived abuse it addresses is the distribution of assets to (1) reduce the numerator of the Ownership Fraction and/or (2) reduce the value of Domestic Target for purposes of the Substantiality Test.

⁹⁰ We note that if the fact pattern in Example 12 did give rise to an NOCD subject to the -3T Add-Back Rule, this would raise further questions. For example, it would be uncertain how to add back the employees, assets, and income of the controlled corporation to the denominator for purposes of the Substantial Business Activities Test. It would seem that only the employees, assets, and income of the controlled corporation as of the date of the distribution should be added back, but an alternative approach might require these items to be added back as of the date of the Inversion Transaction. We believe the latter approach would inappropriately ignore the fact that, beginning immediately after the spin-off, the controlled corporation is separate and independent from Domestic Target, and any changes in its employees, assets, and income after such date are undoubtedly unrelated to Domestic Target and its decision to engage in an Inversion Transaction.