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New York State Bar Association

Tax Section

Report on Notice 2015-79

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Contents

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I. INTRODUCTION

This report[1] of the Tax Section of the New York State Bar Association comments on Notice 2015-79 (the "**Notice**").[2] The Notice expands on Notice 2014-52, (the "**2014 Notice**"),[3] which announced the intention of the Treasury Department and the Internal Revenue Service (the "**IRS**") to issue regulations to address transactions structured to avoid the purposes of sections 7874 and 367 of the Internal Revenue Code (the "**Code**").[4]

The 2014 Notice also announced that the Treasury Department and the IRS expected to issue additional guidance to further limit transactions that are "contrary to the purposes of section 7874" and the benefits of post-inversion tax avoidance transactions. The Notice provides some of this additional guidance. This report will address the guidance on transactions contrary to the purposes of section 7874, specifically

(1) an additional condition to be satisfied under the "Substantial Business Activities Test,"

(2) the treatment of "Third-Country Transactions," and

(3) the guidance on so-called "avoidance property,"

all as further described below.

The remainder of this Introduction will describe the general statutory background of section 7874 (Part I.A) and the provisions of the Notice discussed in this report (Part I.B). Part II

[1] The principal author of this report is Ansgar A. Simon. Helpful comments were received from Kimberley S. Blanchard, Andrew H. Braiterman, Robert Cassanos, Peter A. Glicklich, Stephen B. Land, Deborah L. Paul, Michael L. Schler and Davis J. Wang. The assistance of Matthew Kaden is gratefully acknowledged. This report reflects solely the views of the Tax Section of the New York State Bar Association and not those of the NYSBA Executive Committee or the House of Delegates.

[2] 2015-49 I.R.B. 775.

[3] 2014-42 I.R.B. 712.

[4] References to "sections" are to the sections of the Code, unless otherwise indicated.

will summarize our recommendations and proposals. Part III will discuss and explain in more detail these recommendations and proposals relating to the additional limitation on the Substantial Business Activities Test (Part III.A), the new rule regarding Third-Country Transactions (Part III.B) and the guidance on so-called avoidance property (Part III.C)

A. Background

Section 7874 was enacted in 2004 in response to concern that domestic businesses, whether conducted in corporate or partnership form for United States federal income tax ("**U.S. tax**") purposes, were "inverting," *i.e.*, reorganizing to place their assets and business activities outside of the U.S. taxing jurisdiction, often in tax havens, where the business conducted minimal business activity.[5]

Section 7874 provides two U.S. tax regimes for a domestic corporation or a domestic partnership (the "**expatriated entity**") that inverts after March 4, 2003.[6] If, after the inversion, at least 80 percent of the stock of the foreign acquiring corporation is owned by former shareholders (or former partners) of the expatriated entity by reason of holding stock (or capital or profits interests) in the expatriated entity (the "**80% Ownership Test**"), the foreign acquiring corporation is treated as a domestic corporation. If at least 60 percent, but less than 80 percent, of the stock of the foreign acquiring corporation is held by former shareholders (or former partners) of the expatriated entity by reason of holding stock (or capital or profits interests) in the expatriated entity (the "**60% Ownership Test**"),[7] the gain or loss of the expatriated entity and any of its related U.S. persons will not be less than the "inversion gain" and stock-based compensation of insiders may be subject to an excise tax.

Inversion gain is (1) income or gain that the expatriated entity recognizes by reason of the transfer of stock or other properties and (2) income that the expatriated entity receives or accrues by reason of a license of property, if the transfer or license is made as part of the inversion or,

[5] H.R. Rep. No. 108-548, pt. 1, at 243; Joint Committee on Taxation, General Explanation of Tax Legislation in the 108th Congress (JCS-5-05) 343 (May 2005). For a discussion of early inversion transactions, *see* Willard B. Taylor, *Corporate Expatriations – Why Not?*, 78 TAXES 146 (Mar. 2001).

[6] An inversion transaction includes all of a series of related transactions. Transactions are treated as pursuant to a plan if a foreign corporation acquires directly or indirectly "substantially all of the properties of a domestic corporation or partnership" during the four-year period beginning on the date which is two years before the ownership requirements above are met. Section 7874(c)(3).

[7] The 60% Ownership Test and the 80% Ownership Test will be collectively referred to as the "**Ownership Tests**," and the actual percentage of ownership as determined under section 7874, the related Treasury Regulations and further administrative rulings (such as the 2014 Notice and the Notice) as the "**ownership fraction**."

post-inversion, to a foreign related person, in each case during the 10-year period from the completion of the inversion transaction (the "**acquisition date**").[8]

An inversion for this purpose is defined as the direct or indirect acquisition by a foreign corporation of substantially all of the properties held directly or indirectly by a domestic corporation or substantially all of the properties constituting a trade or business of a domestic partnership.[9] The "**foreign acquiring corporation**" is the foreign corporation whose stock the exchanging shareholders receive in connection with the inversion by reason of having held the stock or partnership interests of the expatriated entity.[10] Accordingly, in situations where a subsidiary acquires the equity interests of the expatriated entity, the foreign acquiring corporation is the foreign parent that issues the stock, and not the subsidiary itself.

Neither of the two section 7874 regimes applies if, after the acquisition, the foreign acquiring corporation satisfies the "**Substantial Business Activities Test**" or if the shareholders or partners of the expatriated entity end up owning less than 60 percent of the stock of the foreign acquiring corporation by reason of holding equity interests in the expatriated entity.

The Substantial Business Activities Test is met if the expanded affiliated group ("**EAG**")[11] that includes the foreign acquiring corporation has "substantial business activities" in the foreign country in which or under the laws of which the foreign acquiring corporation is created or organized (the "**Organization Condition**"), as compared to the total business activities of the EAG.[12] Under Treasury regulations finalized in June 2015, business activities of an EAG in a particular foreign country are substantial if, and only if, the following four "**25-percent conditions**" are satisfied:

(1) the EAG's employees in that foreign country constitute at least 25 percent of the total employees by number;

(2) the compensation of the employees in that foreign country amounts to at least 25 percent of the total compensation incurred by the EAG with respect to all group employees;

(3) the EAG's assets in that foreign country constitute at least 25 percent, by value, of the total assets of the EAG; and

8 Sections 7874(d)(1) and (2).

9 Section 7874(a)(2)(B)(i).

10 *See* Section 7874(a)(2)(B); Temp. Treas. Reg. § 1.7874-4T(i)(4).

11 An EAG is an affiliated group as defined in section 1504(a), but treating foreign entities as members and testing for "more than 50%" rather than "at least 80%" as the threshold for affiliation. Section 7874(c)(1).

12 Section 7874(a)(2)(B)(iii).

(4) the EAG's income derived in that foreign country is at least 25 percent of the total income of the EAG.

Conditions (1) and (3) are tested on the "applicable date" (the acquisition date or the last day of the month preceding the acquisition date), and conditions (2) and (4) are tested for the one-year period ending on the applicable date.

Section 7874 contains two grants of regulatory authority to the Treasury Department and the IRS. Section 7874(c)(6) specifically authorizes the Treasury Department and the IRS to "treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and to treat stock as not stock" for purposes of determining whether the 60% or 80% Ownership Test is met. Section 7874(g) provides general authority to issue regulations "necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through (1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or (2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons."

B. Transactions Contrary to the Purposes of Section 7874 Addressed in the Notice

The Notice expands the anti-avoidance rules of section 7874 with three additional rules by (a) adding a "**Tax Residence Requirement**" to the Substantial Business Activities Test; (b) disregarding, for purposes of determining the ownership fraction, stock of the foreign acquiring corporation issued to a foreign target corporation's historical shareholders if the foreign acquiring corporation acquired the stock of the foreign target corporation in a "**Third-Country Transaction**"; and (c) modifying or clarifying the anti-stuffing rule, as explained more fully below.

(a) Under the Tax Residence Requirement, an EAG will not meet the Substantial Business Activities Test unless the foreign acquiring corporation is "subject to income taxation as a resident" of the "relevant foreign country"; *i.e.*, the country with respect to which the EAG satisfies the 25-percent conditions of the Substantial Business Activities Test.[13]

(b) If a foreign acquiring corporation engages in a Third-Country Transaction related to an inversion transaction, stock issued by the foreign acquiring corporation to the shareholders of the foreign target corporation involved in the Third-Country Transaction is disregarded in calculating the ownership fraction, *i.e.*, not included in the denominator. A foreign acquiring corporation engages in a Third-Country Transaction if (i) the foreign acquiring corporation acquires substantially all of the properties of another foreign target corporation (the "**foreign inversion**"), (ii) the tax residence of the foreign acquiring corporation is different from the tax

[13] Notice, Section 2.02(a).

residence of the foreign target corporation (determined before the foreign target acquisition and any related transaction) and (iii) the gross value of the properties directly or indirectly acquired by the foreign acquiring corporation in the foreign inversion exceeds 60 percent of the gross value of all foreign group property.

The Third-Country Transaction rule applies only if, without its application, the inversion transaction would satisfy the 60% Ownership Test.[14] In other words, the Third-Country Transaction rule may pull a foreign acquiring corporation from the 60% Ownership Test regime, which creates a lower bound for the amount of inversion gain to be recognized after the inversion, into the 80% Ownership Test regime, which treats the foreign acquiring corporation as a domestic corporation for U.S. tax purposes. This limitation to the Third-Country Transaction rule, however, does not threaten to pull any inversion into the 80% Ownership regime if the expatriated entity is relatively small as compared to the foreign acquiring corporation and its EAG.

(c) Section 7874(c)(2)(B) as modified by temporary Treasury regulations excludes stock of the foreign acquiring corporation from the ownership fraction, if the stock is "**disqualified stock**" (subject to a *de minimis* exception).[15] Stock is so disqualified if transferred in exchange for disqualified property, which comprises "specified nonqualified property," such as cash or cash equivalents, marketable securities and certain obligations, and "**avoidance property**," *i.e.*, any other property acquired in a transaction (or series of transactions) related to the acquisition with a principal purpose of avoiding he purposes of section 7874.[16] The Notice clarifies that "avoidance property" is to be interpreted broadly, and may in fact include active trade or business assets.[17]

II. SUMMARY OF RECOMMENDATIONS

A. Recommendations in Relation to the "Tax Residence Requirement"

(1) On the basis of the rationale offered for the new Tax Residence Requirement, the Treasury Department and the IRS should consider replacing the Organization Condition with the Tax Residence Requirement, not adding the Tax Residence Requirement to the Organization Condition.

(2) A foreign acquiring corporation that is resident in a no-income-tax jurisdiction should be treated as satisfying the Tax Residence Requirement.

[14] Notice, Section 2.02(b).

[15] Temp. Treas. Reg. § 1.7874-4T(b) and (d).

[16] Temp. Treas. Reg. § 1.7874-4T(c) and (i)(7).

[17] Notice, Section 2.03(c)

(3) A foreign acquiring corporation that is treated as a partnership or a disregarded entity in the relevant foreign country should not satisfy the Tax Residence Requirement. However, a foreign corporation that is an investment or similar vehicle that is permitted to deduct dividend distributions to its equity holders should be able to satisfy the Tax Residence Requirement.

(4) The standard for determining tax residence should be the standard of determining tax residence under the U.S. model income tax treaty, except for the case of foreign acquiring corporations located in no-income-tax jurisdictions.

B. Recommendations in Relation to the Third-Country Transaction rule

(1) We agree that the Third-Country Transaction rule in general can play a useful role in limiting potential avoidance of section 7874, and that its usefulness is not outweighed by the fact that it might in some rare situations provide a "first mover advantage" to already expatriated entities or to inverted foreign acquiring corporations.

(2) We agree with applying the Third-Country Transaction rule only in situations where the domestic inversion otherwise would fall under the 60% Ownership Test.

(3) We do not believe that the existence of non-tax business purposes for a Third-Country Transaction should by itself be sufficient to avoid the Third-Country Transaction rule.

(4) It should be clarified whether the more-than-60 percent gross asset test of the Third-Country Transaction rule does or does not include any assets acquired from the foreign target group.

(5) In addition to not meeting the more-than-60 percent gross asset test, it should be considered whether a foreign inversion should not give rise to a Third-Country Transaction if the foreign acquiring corporation would meet the Substantial Business Activities Test in the third country after the foreign inversion and before the domestic inversion.

(6) In addition, it should be considered whether a foreign inversion should not give rise to a Third-Country Transaction if the foreign acquiring corporation is eligible for the benefits of an income tax treaty that is substantially equivalent to the benefits of the income tax treaty for which the foreign target corporation is eligible.

(7) It should further be considered whether, to the extent that the income tax treaty for which the foreign acquiring corporation is eligible is not substantially equiva-

lent to the income tax treaty for which the foreign target corporation is eligible, the foreign acquiring corporation should alternatively be able to elect reduced benefits equal to those afforded by the income tax treat of the foreign target corporation in respect of the relevant item.

(8) A mere change in tax residence of a foreign acquiring corporation should be tested as a Third-Country Transaction as if it were a foreign inversion.

C. Recommendations in Relation to the Scope of the Definition of Avoidance Property

(1) We agree that the plain language of the temporary Treasury regulations has the broad meaning that any property could be classified as avoidance property.

(2) Additional guidance is needed outlining factors to consider in determining whether property is avoidance property under the broad interpretation of the Treasury regulations. Specifically, regulations should clarify that there is no avoidance property if the (directly or indirectly) transferred assets constitute a trade or business within the meaning of section 1.367(a)-2(b)(2) or otherwise are related to the existing business of the foreign acquiring corporation and are, in each case, transferred without a plan to dispose of them at a later time.

III. DISCUSSION

A. Substantial Business Activities Test

The Notice provides that an EAG will satisfy the Substantial Business Activities Test only if the foreign acquiring corporation is "subject to income taxation as a resident" of the "relevant foreign country"—*i.e.*, the country with respect to which the EAG satisfies the four 25-percent conditions of the Substantial Business Activities Test.[18] The fact sheet published by the Treasury Department on the issuance of the Notice paraphrases this requirement as demanding that "the new foreign parent is a tax resident in the foreign country in which it is created or organized."[19]

U.S. income tax treaties generally define "resident" of the respective treaty partner country as a person that is "liable to tax therein by reason of his domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature" ("**Simple Residence**"), but exclude any person that "is liable to tax in [the foreign country] in respect only of

[18] Notice, Section 2.02(a).

[19] U.S. Department of the Treasury, Fact Sheet: Additional Treasury Actions to Rein in Corporate Tax Inversions (Nov. 19, 2015) at https://www.treasury.gov/press-center/press-releases/Pages/jl0281.aspx.

income from sources in [the foreign country] or of profits attributable to a permanent establishment in" the foreign country (with this exclusion, "**Treaty Residence**").[20] Thus, a person with only a permanent establishment in a country could be a Simple Resident of that country, but would not be a Treaty Resident.

Because the United States does not enter into tax treaties with no-tax jurisdictions, it is unclear what being subject to income taxation as a resident means for a foreign acquiring corporation in such a jurisdiction. This part will further discuss which entities should be treated as, or as akin to, "fiscally transparent" entities, which the Notice concludes are not subject to income taxation as a resident in the jurisdiction where they are so treated. It then addresses whether the concept of tax residence should replace, rather than complement, the concept of place of organization in determining the relevant country for the Substantial Business Activities Test. Last, this part will discuss whether Treaty Residence or Simple Residence is appropriate for the Tax Residence Requirement.

1. Subject to Income Taxation

(a) Jurisdictions that do not impose any income tax

A foreign acquiring corporation may be organized, and managed and controlled, in a jurisdiction that imposes no income tax. If "tax residence" or "being subject to income taxation as a resident" were to be taken literally in this situation, no inversion involving a foreign acquiring corporation organized in a no-tax jurisdiction could ever qualify for an exception from section 7874 on account of satisfying the Substantial Business Activities Test.

We do not believe that this would be the correct result. Regulations should accordingly clarify that a foreign acquiring corporation organized in a no-income tax jurisdiction would be considered "tax resident" in that jurisdiction for purposes of the Substantial Business Activities Test and the Tax Residence Requirement.[21]

If, for example, an insurance company organized as a limited company under Bermuda law acquired a U.S. insurer and satisfied the four 25-percent conditions of the Substantial Business Activities Test, it should in our view be outside the scope of the Ownership Tests of section 7874. This approach would be consistent with the definition of "resident" under the convention with Bermuda relating to the taxation of insurance businesses (there is not comprehensive in-

[20] U.S. Model Income Tax Treaty (2006), Art. 4(1).

[21] For the reasons discussed in subpart 2. below, this would apply only if the foreign acquiring corporation is not subject to income tax as a resident in another country that is not a no-tax jurisdiction.

come tax treaty with Bermuda), which defines as a resident, in the case of Bermuda, “a company, partnership, trust, or association created under the laws of Bermuda.”[22]

(b) Fiscally transparent entities

One of the two examples in the Notice illustrating the Tax Residence Requirement describes a foreign acquiring corporation that is not “subject to income taxation as a resident” because of a difference in entity classification rules between the United States, which treats the foreign acquiring corporation as a corporation, and the relevant foreign country, which treats the foreign acquiring corporation as a partnership. In this case, even if otherwise the four 25-percent conditions were satisfied in the jurisdiction of the reverse hybrid foreign acquiring entity, the manner in which the partners of the foreign partnership would be taxed is unclear. This generally might make it difficult to assess to what extent a hybrid entity can be used to treaty shop or to engage in improper base erosion. In any event, the application of section 7874 could be avoided by electing to treat the foreign acquiror as a partnership for US tax purposes. We therefore do not disagree with excluding a reverse hybrid foreign acquiring entity from being treated as a subject to income taxation as a resident for purposes of the Substantial Business Activities Test (as amended by the Notice).

The Notice does not further describe what qualifies as a “fiscally transparent” entity, apart from giving an example involving a partnership. Section 894(c) is the only place where the term is used in the Code apart from a cross-reference to section 894(c) in recently enacted section 897(k)(3)(B)(iii). The Regulations issued under section 894(c) provide:

> “an entity is fiscally transparent under the laws of the relevant jurisdiction … to the extent that the laws of that jurisdiction require the interest holder in the entity, wherever resident, to separately take into account on a current basis the interest holder’s respective share of the … income paid to the entity, whether or not distributed to the interest holder, and the character and source of [an] item [of income] in the hands of the interest holder are determined as if such item were realized directly from the source from which realized by the entity.”[23]

This definition generally treats a partnership and a disregarded entity in a foreign jurisdiction as fiscally transparent. U.S. tax treaties likewise refer to entities that are “fiscally

[22] Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (on behalf of the Government of Bermuda) relating to the Taxation of Insurance Enterprises and Mutual Assistance in Tax Matters, Art. 2(b).

[23] Treas. Reg. § 1.894-1(d)(3)(ii).

transparent."[24] The Treasury explanation to Article 1(6) of the 2006 U.S. Model Treaty states that this refers to

> "entities that are not subject to tax at the entity level, as distinct from entities that are subject to tax, but with respect to which tax may be relieved under an integrated system. … Entities falling under this description in the United States include partnerships, common investment trusts under section 584 and grantor trusts. This paragraph also applies to U.S. limited liability companies ('LLCs') that are treated as partnerships or as disregarded entities for U.S. tax purposes."

We believe that this rule properly limits which entities should be treated as not subject to income taxation as a resident in the relevant foreign country. In particular, the Tax Residence Requirement should not be failed by collective investment vehicles that, similar to real estate investment trusts or regulated investment companies under US tax law, are entitled to a deduction for distributions to persons holding equity interests in the collective investment vehicle.[25]

Investment or similar vehicles may appear similar enough to fiscally transparent entities (as construed under section 894(c) or the 2006 U.S. Model Treaty) in that they enjoy a deduction for equity distributions and thereby can and generally do achieve relief from full entity level taxation. However, unlike reverse hybrids, these vehicles must make distributions to their shareholders, including the historic shareholders of the expatriated entity. These vehicles are therefore more akin to entities that are fiscally transparent both in the relevant foreign country and for U.S. tax purposes. A foreign acquiring partnership, however, would not be subject to section 7874. The use of a vehicle allowing for a deduction for dividends paid to its shareholders should therefore not be disqualified from relying on the Substantial Business Activities Test to remain exempt from section 7874.

We do not believe that the Tax Residence Requirement should be extended to a so-called integrated tax system where, upon distribution, equity holders may in some manner credit their proportionate share of the foreign acquiring corporation's income taxes against their individual income tax liabilities. Nor do we believe that the Tax Residence Requirement should be extended to cover systems that, like the current US tax system, provides for preferential income tax rates for distributions in respect of equity. Both types of regime subject a foreign corporation to corporate income tax, and not treating entities in those systems as fiscally transparent is consistent with Treasury's interpretation of the U.S. Model Treaty. In any event, we are not aware of how foreign acquiring corporations in those jurisdictions could be used to avoid the purposes of section 7874.

[24] *See* U.S. Model Treaty (2006), Art. 1(6).

[25] For U.S. tax law, see section 561 and subchapter M of chapter 1 of the income tax provisions (subtitle A) of the Code.

2. It should be considered whether the Tax Residence Requirement should fully replace the Organization Condition for the Substantial Business Activities Test

The Tax Residence Requirement applies in addition to the Organization Condition, *i.e.*, the requirement that the substantial business activities are conducted in the country in which, or under the laws of which, the foreign acquiring corporation is created or organized. The statutory provision, however, include only the Organization Condition. According to the Notice, its expansive reading of the statutory language is justified by the policy underlying the exception from section 7874 afforded by the Substantial Business Activities Test. While the Notice does not develop the nature of this policy in more detail or point to the legislative history, it states that for purposes of the policy underlying section 7874

> … the statute's reference to country of creation or organization reflects the U.S. standard for determining tax residency. However, the U.S. standard for determining tax residency does not always align with foreign countries' standards. Allowing the exception to apply when the foreign acquiring corporation is not subject to tax as a resident of the relevant foreign country effectively permits an EAG to replace its U.S. tax residence with tax residence in any other country (or, in certain cases, in no other country), without regard to the location of any substantial business activities conducted by the EAG.[26]

Typical early inversion transactions, which provide the foil for this understanding of the statute, involved "naked" expatriations into jurisdictions where the new, foreign parent corporation was not subject to tax while there was no change in the place of management or headquarters away from the United States. This supports the view that an inversion should not be able to avail itself of the benefits of the Substantial Business Activities Test unless the activities are conducted in the relevant foreign country in a manner that typically would make the foreign acquiring corporation subject to corporate income tax in that foreign country. The position expressed by the Notice that "the statute's reference to country of creation or organization reflects the U.S. standard for determining tax residency" is therefore defensible.

This explanation does not justify, however, why the 25-percent conditions, if satisfied in the country of tax residence, simultaneously have to be satisfied also in the country of organization. Any foreign acquiring corporation whose tax residence diverges from its place of organization would be automatically barred from passing the Substantial Business Activities Test. If, however, the critical element of the Substantial Business Activities Test is that the substantial business activities are subject to tax where they are conducted, then there should be good reasons to jettison the Organization Condition.

[26] Notice, Section 2.02(a).

In other words, interpreting the statutory reference to "country of organization" as "country of tax residence" casts doubt over the continued relevance of the Organization Condition itself. If the statutory language is in fact shorthand for "tax residence," then the Substantial Business Activities Test should be modified to require only that its four 25-percent conditions must be satisfied by the EAG with respect to the foreign country (if any) in which the foreign acquiring corporation is "subject to income taxation as a resident." Once the standard has been made more precise, the imprecise standard should be replaced by it and not added to it.

It is therefore not clear to us why the Organization Condition is kept as a substantive factor for the Substantial Business Activities Test. The Treasury Department and the IRS should consider a purely Residence-Based Substantial Business Activities Test. This test would require that the EAG that includes the foreign acquiring corporation has substantial business activities in the foreign country in which the foreign acquiring corporation is tax resident, as compared to the total business activities of the EAG. The relevant country, in other words, is the country of tax residence, not the country of organization (or the country of tax residence *and* organization).[27]

In situations involving disregarded subsidiaries, the Residence-Based Substantial Business Activities Test yields the intuitively correct result.

> *Example 1:* In a section 368(a)(1)(B) reorganization, a subsidiary (FS_{DRE}) of *FA*, a foreign acquiring corporation, acquires all of the stock of a domestic target (*DT*) in exchange for stock of *FA*. *FA* is organized under the laws of country *P*, and FS_{DRE} is organized under the laws of country S. Both *FA* and FS_{DRE} are liable to tax in country *S* by reason of their domicile (in the case of FS_{DRE}) or place of management (in the case of *FA*). For U.S. tax purposes, FS_{DRE} is disregarded as a separate entity from FA. After the stock-for-stock acquisition of *DT* by FS_{DRE}, the *FA*-parented EAG fails to meet the Substantial Business Activities test (including the Tax Residence Requirement) solely because *FA* is organized under the laws of country *P*.

Under the Notice, *FA* could not satisfy the expanded Substantial Business Activities Test. If *FA* had, shortly before the acquisition of *DT*, migrated to *S*, however, it would.[28] The Notice offers no reason why that should be so. There appears to be no substantive distinction for U.S. tax purposes between *FA-organized-in-P* and *FA-organized-in-S*. Regardless of where it is organized, *FA* would for example be eligible (or fail to be eligible) for the U.S. tax treaty with

27 A foreign acquiring corporation that is organized in, or created under the laws of, a no-tax country, however, should be treated as tax resident in that country and be able to satisfy the Substantial Business Activities Test with respect to that country, provided it is not also tax resident in another country that imposes an income tax. In the latter case, the Residence-Based Substantial Business Activities Test should apply as described above.

28 The Third-Country Transaction rule discussed below should not apply because *FA's* tax residence remains unchanged.

country *S*, and FS_{DRE} would likewise qualify or fail to qualify for the country *S* tax treaty regardless of where *FA* is organized. Earnings stripping rules (most prominently section 163(j), but also, *e.g.*, the exception from the portfolio interest exemption for 10-percent shareholders in section 881(c)(3)(B)) depend on the relationship between payor and payee and would likewise not be affected by the country of *FA*'s organization.

We are aware that other statutory provisions refer to the country of creation, organization or incorporation. Examples are the same-country exception of section 954(c)(3)(A), the active dealer exception in section 954(c)(2)(C), the branch income rule for foreign base company sales income in section 954(d)(2), the definition of "home country" for purposes of the active financing exception in section 954(h)(5)(B) or the exception under section 864(d)(7) from related-party factoring income for acquisitions of receivables from related persons with a substantial active business in the same country. Unlike the Substantial Business Activities Test, however, these provisions historically have never been interpreted to involve a Tax Residence Requirement. That these provisions adhere to the statutory language should therefore not constrain the interpretation of a provision where that is not the case. Importantly, we are not aware that these provisions play a role in limiting earnings stripping by U.S. (expatriated or non-expatriated) entities in a manner similar to that of section 7874.

A Residence-Based Substantial Business Activities Test would affect the treatment of fiscally transparent entities. The discussion in the preceding subsection, as well as the example in the Notice, implicitly assumed that the foreign acquiring corporation is treated as fiscally transparent in the country of its organization. It therefore failed the Substantial Business Activities Test for lack of meeting the Tax Residency Requirement in the country where is satisfied the Organization Condition.

This exclusion from the Substantial Business Activities Test should not be automatic if the fiscally transparent entity satisfies the Tax Residence Requirement with respect to some other jurisdiction. If the foreign acquiring corporation is tax resident in a foreign country other than the country of its organization (where it is treated as fiscally transparent), then it should be able to avail itself of the Residence-Based Substantial Business Activities Test in the country of its tax residence.

> *Example 2:* *FA* is organized under the laws of country *P*, where it is treated as fiscally transparent. *FA* is managed and controlled in country *S*, however, and treated as a tax resident of country *S*. *FA* is treated as an association taxable as a corporation for US tax purposes. The EAG with *FA* has 30 percent of its employees in country *S*, incurs 35 percent of is compensation cost in country *S*, employs 28 percent of its assets in country *S* and derives 40 percent of its income in country *S*.

There seems to be no reason for causing *FA* to fail the Substantial Business Activities Test: it is subject to income tax as a resident in *S* on equal footing with any comparable corporation organized under the laws of *S*; it conducts a large enough portion of its business activities in *S* so that they rise to the appropriate level of substantiality; and if there is a tax treaty in effect between the United States and country *S*, *FA* should qualify, or would fail to qualify, for its benefits based on the same criteria as any corporation organized in country *S* that is tax resident there. None of these criteria looks to *FA's* place of organization. Neither should the Substantial Business Activities Test.

That the place of the organization should not be a relevant criterion is further supported by the fact that *FA* could, as a technical matter, satisfy it by reincorporating in country *S.* As a matter of commercial law, that may not be easy or even legally possible. But as a matter of tax law, the migration would have no further effect. And it appears that it should not.

We therefore propose that the Treasury Department and the IRS consider whether replacing the Organization Condition with the Tax-Residence Requirement would be appropriate to implement the purposes of the Substantial Business Activities Test and section 7874 in general.

3. As a Resident

The Notice does not further elaborate what it means to be subject to income taxation *as a resident*. As mentioned above, the language suggests that the relevant concepts are borrowed from income tax treaties, although they deviate somewhat.

We believe that Treaty Residence is the appropriate concept to employ (as modified for foreign acquiring corporations that are organized in a no-tax jurisdiction and, if a Residence-Based Substantial Business Activities Test is accepted, are not otherwise subject to income taxation as a resident in another jurisdiction).

Treaty Residence yields the right result when applied to a foreign acquiring corporation that acquires and holds the stock of an expatriated entity through disregarded entities.

> *Example 3: FS* is a wholly owned subsidiary of *FA*, a foreign acquiring corporation treated as a corporation for U.S. tax purposes. *FS* is a corporation organized in no-tax jurisdiction *S*, where it is not subject to any income tax, and is not subject to tax as a Treaty Resident in any other jurisdiction. *FA* is organized in jurisdiction *P*, where it is subject to income tax as a Treaty Resident (and is not subject to tax as a resident in any other jurisdiction). *FA*'s tax base for country *P* tax purposes does not include any of the undistributed income of FS. *FS* acquires all of the stock of a domestic target (*DT*) from *DT*'s shareholders in exchange for stock of *FA*. The EAG with *FA* as its parent satisfies the four 25-percent conditions of the Substantial Business Activities Test in country *P*.

That *FS* is not subject to tax in country *P* should be irrelevant in this case. Treaty Residence (as well as Simple Residence) would agree with this and give the right result that *FA* is tax resident in *P*, regardless of whether *FS* is disregarded or treated as a corporation for U.S. tax purposes. If *FS* were disregarded, it should, for example, not be able to obtain income tax treaty benefits under an income tax treaty between the United States and country *P* under section 894(c) and the Treasury regulations issued thereunder. *FA* would not be considered subject to income tax in country *P* with respect to its branch in country *S*. This, however, should not affect the conclusion that *FA* itself is subject to income tax in country *P*. *FA* is, after all, subject to income tax in country *P* with respect to all items of income that are considered, in country *P*, to be items derived by *FA*. In other words, we do not believe that something more extensive than Treaty Residence is required to address the case of a hybrid acquisition vehicle.

If *FS* were treated as a corporation for U.S. tax purposes, its tax treatment in country *S* is likewise irrelevant for purposes of the Substantial Business Activities Test; only *FA* is relevant. Because *FA* is organized and subject to tax as a resident in country *P*, the Substantial Business Activities Test is met (both under the traditional test, the traditional test with the added Tax Residence Requirement under the Notice, and the Residence-Based Substantial Business Activities Test). There seems to be no reason why this conclusion should come out differently if *FS* were instead disregarded. Thus, regardless of how *FS* is treated for U.S. tax purposes, Treaty Residence correctly classifies *FA* as tax resident in country *P*.

> *Example 4:* *FA* is a foreign acquiring corporation that is organized and resident in no-tax jurisdiction *P* and is not subject to tax as a Treaty Resident in any other jurisdiction. *FA* is a corporation for U.S. and country *P* purposes. *FA* maintains branch *FB* in country *B*, where it is subject to income tax with respect to the profits properly attributable to *FB*. *FB* acquires all of the stock of a domestic target (*DT*) from *DT*'s shareholders in exchange for stock of *FA*.

Under the Treaty Residence concept, *FA* is not considered a tax resident of *B*, because it is liable to tax "in respect only of income from sources in [country *B*] or of profits attributable to a permanent establishment in" country *B*. *FA* would, however, be tax resident under Simple Residence. We believe that this is the wrong result, as it would in effect allow *FA* to satisfy the Substantial Business Activities Test with respect to country *B* through a branch, even though it would not be able to do so – under the old Substantial Business Activities Test and under the test as modified by the Tax Residence Requirement (under either Simple or Treaty Residence) – if it operated in *B* through a subsidiary. Electing to treat such a subsidiary as a disregarded entity, for example, should not affect the results of the Substantial Business Activities Test, but it would under Simple Residence.

Treaty Residence should therefore be the criterion for what is means to be "subject to income tax as a resident" regardless of whether the Tax Residence Requirement of the Substantial Business Activities Test is applied in addition to, or in lieu of, the Organization Condition.

B. The Third-Country Transaction Rule

Under the Third-Country Transaction rule, stock is disregarded for determining whether the 80% Ownership Test is met if:

> (1) there is a foreign target acquisition, *i.e.*, the foreign acquiring corporation (directly or indirectly) acquires substantially all of the properties held directly or indirectly by another foreign corporation (foreign target corporation) in a transaction related to the inversion of the domestic corporation;
>
> (2) the foreign acquiring corporation and the foreign target corporation have different "tax residences," as determined before the foreign target acquisition;
>
> (3) the gross value of all property (directly or indirectly) acquired by the foreign acquiring corporation exceeds 60 percent of the gross value of all foreign group property,[29] excluding for this purpose foreign group non-qualified property (the "**Gross Value Condition**"); and
>
> (4) without regard to the Third-Country Transaction rule, the 60% Ownership Test would be satisfied with respect to the inversion (the "**Ownership Threshold Condition**"). [30]

The archetypal transaction that the Treasury Department and the IRS consider to run counter to the purposes of section 7874 under this rule is exemplified by:

> *Example 5: DT*, a domestic target corporation, and *FS*, a foreign corporation tax resident and organized in country *S*, are contemplating a combination resulting in an inversion of *DT*. In order to achieve this combination, a new foreign acquiring corporation, *FA*, is organized in country *P* where it will be tax resident. *FA* then acquires (directly or indirectly, e.g., by acquiring the stock of *FS*) all of the assets of *FS* and (directly or indirectly) all of the assets of *DT*. Shareholders of *FS* receive stock of *FA* in exchange for their stock in *FS* that amounts to more than 20 percent but less than 40 percent of the stock of *FA*. The shareholders of *DT* end up holding less than 80 percent but more 60 percent (by vote and value) of the stock of *FA* by reason of having held stock of *DT*.

[29] "Foreign group property" is discussed below.

[30] Notice, Section 2.02(b).

The Notice states that "in certain circumstances, the use of a third-country parent is contrary to the policy underlying the 80-percent threshold of section 7874(b) and is an appropriate circumstance for the exercise or regulatory authority under section 7874(c)(6) and (g)." For the reasons explained below, we propose to draw the "circumstances" narrower than conditions (1) through (3) of the Third-Country Transaction rule above.

We briefly note that in our view the Third-Country Transaction rule does not create a "first mover" advantage that is somehow unfair to taxpayers. The Third-Country Transaction rule applies to acquisitions completed on or after November 19, 2015. A foreign acquiring corporation that resulted from or engaged in a Third-Country Transaction in connection with an inversion (including a foreign inversion) completed before this effective date would generally not be retroactively subject to the Third-Country Transaction rule in future acquisitions.[31]

A foreign acquiring corporation that came into existence in a prior inversion involving a Third-Country Transaction seemingly would get an advantage over a foreign acquiring corporation that did not do so. This appears sound as a technical matter, but in any real world scenario it is a complex set of business reasons that primarily drives any planned cross-border combination, unlike the naked inversions that originally prompted enactment of section 7874 in 2004. We therefore do not believe that this rule as such provides an advantage to already expatriated entities that previously engaged in a Third-Country Transaction over potential foreign acquirors that have not done so. (If U.S. tax minimization by itself gave rise to inversions involving cross-border combination, the volume of those inversions should arguably have been much larger than the actual volume.) A "first mover advantage" should therefore be more academic than real.[32]

1. The Ownership Threshold Condition

There is no Third-Country Transaction unless, without regard to the Third-Country Transaction rule, the 60% Ownership Test would be satisfied with respect to the inversion of the domestic target. Accordingly, if, without testing for the presence of a Third-Country Transaction, the shareholders of the expatriated entity hold less than 60 percent of the shares of the foreign acquiring corporation by reason of having held shares in the expatriated entity prior to the inversion, there cannot be a Third-Country Transaction. In such a case, the foreign acquiring corporation is free to migrate (before or after the inversion of its domestic target) to any jurisdiction it likes. If, however, independently of the Third-Country Transaction rule, the shareholders

[31] This would not apply if the later acquisition of the expatriated entity was "related" to the original foreign inversion transaction. *See* section 7874(a)(2)(B). The inversions contemplated here are assumed not be so related to the prior Third-Country Transaction.

[32] The Third-Country Transaction rule does not prohibit a future foreign-to-foreign inversion of the foreign acquiring corporation after the inversion of the domestic, expatriated entity is completed so long as that the foreign-to-foreign inversion is not related to the inversion of the domestic entity.

of the expatriated entity end up with 60 percent or more of the foreign acquiring corporation's shares, the foreign acquiring corporation is limited in its former and future mobility or risks being treated as a domestic corporation.

On the face of it, the underlying policy concerns of section 7874 – impermissible tax treaty shopping and erosion of the U.S. tax base – should be same regardless of whether more or less than 60 percent of the shares acquiror are held by the shareholders of the expatriated entity.[33] This would have the implausible consequence, however, that an acquisition of a comparably much smaller domestic corporation by a much bigger foreign acquiror could be swept under the 80% Ownership Test on account of the foreign acquiror migrating to a third country.

Section 2.02(b) of the Notice refers to the Senate Report and the Joint Committee of Taxation explanation on section 7874[34] for the statement that

> "the 80% threshold under section 7874(b) for treating a foreign acquiring corporation as a domestic corporation reflects an assumption that, when the existing foreign corporation's shareholder will own more than 20 percent of the interest in the combined group, there is a sufficient likelihood of a non-tax business purpose for replacing the U.S. parent with a foreign parent."

The Notice then continues:

> "However, the Treasury Department and the IRS have concluded that, when a domestic entity combines with an existing foreign corporation by establishing a new parent for the combined group that is tax resident in a third country, the likelihood that there is a sufficient non-tax business purposes for replacing the U.S. parent with a foreign partner is significantly lower than Congress assumed in establishing the 80-percent threshold."

In other words, the Treasury Department and the IRS are concerned about the relative weight of tax and non-tax business purposes underlying the Third-Country Transaction. If the historic shareholders of an expatriated entity hold less than 60 percent of the stock of the foreign acquiring company by reason of holding stock of the expatriated entity,[35] the inversion is conclu-

33 The legislative history indicates that section 7874 was meant to prevent domestic companies from undergoing a mere change of form in order to "avoid U.S. tax on foreign operations and engage in earnings stripping techniques to avoid U.S. tax on domestic operations." S. Rep. No. 108-192, at 142 (2003).

34 *Id*.; Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05) (May 31, 2005).

35 Subject to the other anti-stuffing rules under section 7874. *See* Section 7874(c)(2)(B) and (c)(4); Treas. Regs. §1.7874-4T; and Section 2 of the 2014 Notice.

sively treated as not in avoidance of the purposes of the 80% Ownership Test, *i.e.*, continuing to conduct the business of the domestic corporation in generally unaltered form.

In light of this rationale, we agree that the Third-Country Transaction rule should have a threshold for its application. A lower percentage of continued ownership of foreign acquiring corporation by shareholder of the expatriated entity makes it less likely that the transaction is principally driven by tax avoidance reasons relating to the domestic expatriating entity. The further the continued stock ownership falls below the threshold of the 80% Ownership Test, the less likely this should be the case.

A threshold of 60 percent, however, sweeps every transaction that is in the scope of section 7874 under what in effect is a non-rebuttable presumption of section 7874(b) avoidance encapsulated in the Third-Country Transaction rule. Potential exceptions to the Third-Country Transaction Rule (in addition to the Gross Value Condition) should therefore be considered inappropriate. In the next part, we discuss two proposals for consideration by the Treasury Department and the IRS.

2. The Treasury Department and the IRS should consider exceptions to the Third-Country Transaction rule in addition to the Gross Value Condition

The Notice in effect has created a non-rebuttable presumption that a Third-Country Transaction is contrary to the purposes of section 7874. More specifically, the Notice expresses concern that:

> "A decision to locate the tax residence of a new foreign parent corporation outside of both the United States and the jurisdiction in which the existing foreign corporation is tax resident generally is driven by tax planning, including the facilitation of U.S. tax avoidance following the acquisition. For example, the third country may have a more favorable income tax treaty with the United States than the country in which the existing foreign corporation is tax resident, with the result that U.S. withholding taxes on dividends, interest, and royalties paid by the domestic entity may be reduced or eliminated. The third country may also have a more favorable tax system than the country in which the existing foreign parent corporation is tax resident, including a less restrictive regime for controlled foreign corporations, than the country in which the existing foreign corporation is tax resident. Thus, a third-country parent typically is chosen to facilitate the use of low- or no-taxed entities to erode the U.S. tax base following the acquisition."[36]

In our experience, the choice to relocate to a third country is often driven by business reasons, for example regulatory reasons or the need to find a neutral jurisdiction between the

[36] Notice, Section 2.02(b).

domestic target and the foreign target. It is in our experience also not generally driven by treaty shopping. We do not believe, however, that the presumption created by the Third-Country Transaction rule should (or could) be rebutted by substantial business reasons for such a transaction. Many business reasons could be satisfied by incorporating in a third jurisdiction, but the new foreign acquiring corporation could in that case avoid the Third-Country Transaction rule merely by becoming a tax resident in the country of the foreign target by, *e.g.*, continuing to be managed and controlled in the jurisdiction of the foreign target.

There may be some cases where this is not desirable because the continued management and control in foreign target's jurisdiction does not provide for a neutral third jurisdiction for the governance of the combined businesses or, *e.g.*, because the tax system of the foreign target's jurisdiction is problematic for various reasons. There should, therefore, be additional ways to rebut the presumption of tax avoidance.

One such rebuttal is in effect the Gross Value Condition. We agree with the Gross Value Condition, but it should be clarified for the reasons described in the following subpart. The Gross Value Condition in any event provides only a narrow exception from Third-Country Transaction status. There are other situations in which a foreign inversion should not be subject to a non-rebuttable presumption of section 7874 avoidance. Accordingly, we propose below for consideration by the Treasury Department and the IRS additional conditions that should suffice to rebut the tax avoidance presumption of the Third-Country Transaction rule.

(a) Clarification of "foreign group property"

The Gross Value Condition functions like a conclusive rebuttal of the presumption that an inversion avoids the purposes of the 80% Ownership Test if, in a related (direct or indirect) transaction, the foreign acquiring corporation directly or indirectly acquires substantially all of the properties of a foreign target with a different tax residence from the foreign acquiring corporation.

The Gross Value Condition would not be satisfied in a Third-Country Transaction if the gross value of all properties (directly or indirectly) acquired by the foreign acquiring corporation does not exceed 60 percent of the gross value of all "foreign group property," excluding for this purpose foreign group non-qualified property. Foreign group property is defined in the context of an inversion of a domestic entity as property held by the EAG after completion of the acquisition and related transactions other than (a) property that is directly or indirectly acquired in the acquisition and that, at the time of the acquisition, was held directly or indirectly by "the domestic entity"; (b) stock or partnership interest in a member of the EAG and obligations of members of the EAG (to avoid double counting of properties); and (c) foreign group nonqualified property. Foreign group nonqualified property comprises cash, cash equivalents, marketable securities, obligations or former shareholders or partners or certain related persons, and properties acquired with a principal purpose of avoiding the purposes of section 7874.[37]

Regulations should clarify how the first exclusion from foreign group property is to be interpreted in the context of a Third-Country Transaction.

It is clear from the definition of foreign group property that property is excluded from the Gross Value Condition if it is directly or indirectly acquired by the foreign acquiring corporation in the inversion of the domestic expatriated entity and, at the time of the inversion, is held directly or indirectly by the domestic entity.

In addition, a literal reading of the definition entails that property is *not* excluded if it is directly or indirectly acquired by the foreign acquiring corporation in the foreign inversion of the foreign target entity. In other words, while the definition excludes the properties of the inverted domestic target, it does not do so for the inverted foreign target. Regulations should make it explicit whether the definition of "foreign group property" should apply literally here (the "**Literal Application**") or whether it should apply, *mutatis mutandis*, in the same manner as it does for domestic inversion, *i.e.*, by treating the properties of the inverting foreign target for purposes of the Gross Value Condition in the same manner as the properties of the inverting domestic corporation for purposes of the anti-stuffing rule of section 1.7874-4T of the temporary Treasury regulations (the "**MM Application**"). The following example illustrates the difference.

> *Example 6:* The EAG of foreign acquiring corporation *FA* has properties with a fair market value of 90*x* prior to the acquisition of foreign target, *FT*, that is tested for its status as a Third-Country Transaction as well as prior to the domestic inversion. *FA's* EAG has properties with a gross asset value of $60*x*. None of the properties of *FA* and *FT* constitute foreign group non-qualified property. *FA*, which is organized and tax resident in country *P*, acquires the stock of *FT*, which is organized and tax resident in country *S*, in a foreign inversion and simultaneously acquires all of the stock of domestic corporation *DT*. The inversion satisfies the 60% Ownership Test, but not the 80% Ownership Test, prior to testing for a Third-Country Transaction. *FA*'s EAG after the inversions will not satisfy the Substantial Business Activities Test.

Under the MM Application, the foreign target properties would not be included in "foreign group property." The Gross Value Condition would then be satisfied in Example 6 because the foreign acquiring corporation acquires gross assets with a value ($60*x*) in excess of 60 percent of the gross value of *FA*'s foreign group property ($90*x*). As a result, there would be a Third-Country Transaction.

[37] 2014 Notice, Section 2.01(b); Notice, Section 2.02(b).

Under the Literal Application, by contrast, the properties of *FT* that *FA* acquires in the foreign inversion would be included as relevant foreign group property and as a result there would be no Third-Country Transaction. The Gross Value Condition would not be satisfied in Example 6, because *FA* acquires property with a gross value ($60*x*) equal to 40 percent, and not in excess of 60 percent, of the gross value of *FA's* and *FT's* combined foreign group property ($150*x*, *i.e.*, $90*x* plus $60*x*).

Regulations should clarify whether the Literal Application or the MM Application govern the Third-Country Transaction rule. If it is the MM Application, a relatively smaller acquisition by the foreign acquiring corporation similar to the one illustrated above would already satisfy the Gross Value Condition. By contrast, the Literal Application would permit a relatively small foreign acquiring corporation to invert a much larger domestic entity without running afoul of the 80% Ownership Test. To illustrate (assuming that no leverage is involved), a foreign acquiring corporation *FA* with slightly more than $90*x* of gross assets could acquire foreign target *FT* with $135*x* of gross assets and domestic target *DT* with gross assets of $900*x* under the Literal Application.[38] Without the foreign inversion, *FA* could under these facts acquire *DT* with gross assets of only up to $360*x* while staying below the 80% Ownership Test.[39] Under the MM Application, by contrast, *FA* with slightly over $90*x* of gross assets could acquire (absent any leverage) *FT* with gross assets of up to $54*x* and *DT* with gross assets of up to $576*x*.[40]

> (b) *If the foreign acquiring corporation satisfies the Substantial Business Activities Test without regard to the domestic inversion, there should be no Third-Country Transaction.*

The Treasury Department and the IRS should consider whether there should be no Third-Country Transaction if the foreign acquiring corporation satisfies the Substantial Business Activities Test with respect to the foreign country of its tax residence after the foreign target acquisition.[41] If the foreign acquiring corporation satisfies this test after a domestic inversion transaction, the inversion is in effect treated as having occurred for sufficiently substantial non-

38 The ratio of 1:10 between the foreign acquiring corporation's historic gross assets and domestic target's historic gross assets could be even smaller, of course, if the leverage of domestic target exceeded the leverage (if any) of the foreign acquiring corporation.

39 The assets valued at slightly over $90*x* would represent just over 20 percent of total gross assets of slightly over $450*x* (*i.e.*, $360*x* plus slightly more than $90*x*).

40 *FT*'s gross assets are just below 60% of *FA*'s assets in this case. Their combined gross assets of slightly over $144*x* would then represent slightly more than 20 percent of total gross assets of slightly over $720*x* (*i.e.*, $576*x* plus slightly more than $144*x*)

41 Naturally, the Third-Country Transaction rule would not apply if the foreign acquiring corporation satisfied the Substantial Business Activities Test after the foreign target acquisition and the domestic inversion transaction, because section 7874(a)(1) and (b) would not apply.

tax business purposes in order to suspend section 7874. This arguably should also be the case with respect to the foreign acquiring corporation in a foreign migration. The fact that the foreign acquiring corporation has substantial business activities in its country of tax residence would then be considered to establish that its choice of tax residence has a sufficient non-tax business purpose.

(c) If the foreign acquiring corporation is eligible for the benefits of an income tax treaty that is substantially equivalent to the income tax treaty for which the foreign target corporation is eligible, there should be no Third-Country Transaction.

The Treasury Department and the IRS should also consider whether there should be no Third-Country Transaction if (i) the foreign acquiring corporation is tax resident in a country with which the United States has a tax treaty (the "**Destination Treaty**"), (ii) the foreign target corporation is tax resident in a country with which the United States has a tax treaty (the "**Original Treaty**"), and (iii) the Destination Treaty is "substantially equivalent" to the Original Treaty. In this case, we believe there are good reasons to consider the presumption of treaty shopping underlying the Third-Country Transaction rule to have been rebutted.

While this substantial tax treaty equivalence would address treaty shopping, it would not respond to concerns about base erosion, which according to the Notice also motivate the Third-Country Transaction rule. Absent any treaty shopping concern (which should be the case when the Destination Treaty is substantially equivalent to the Original Treaty), however, base erosion concerns should in our view be largely inapposite.

The principal concerns, according to the Notice, would be that (1) the expatriating entity avails itself of excessive interest deductions not subject to withholding tax, (2) the expatriating entity is able to avoid withholding tax on dividend distributions, and (3) the expatriating entity makes deductible royalty payments to related foreign persons other than its subsidiaries that are not subject to withholding tax. How much (if any) U.S. gross withholding tax is imposed on these payments will depend on the available treaty. Any potential abuse in that respect is addressed by substantial tax treaty equivalence.

Concerns relating to interest deductions should be addressed by appropriate earnings stripping rules, transfer pricing rules with respect to setting interest rates appropriately and appropriate rules that prevent or limit the creation of new debt in connection with the inversion transaction itself.[42] There is no additional ability for earnings stripping created by a Third-Country Transaction, and it is therefore not limited by limiting Third-Country Transactions.

[42] Recent modifications of the so-called Killer-B regulations would limit increased leverage that could be effected in connection with an outbound reorganization that is a "reorganization" under Section 368. In general, taxpayers will seek to qualify the transaction as a reorganization where not more than 50 percent of the stock of the

Dividend payments, by contrast, do not give rise to U.S. earnings stripping in the first place. We therefore believe that substantial tax treaty equivalence should be sufficient grounds for avoiding the application of the Third-Country Transaction rule here.

Potential earnings stripping abuses relating to royalty payments are addressed by the limitation under section 7874(a) that the taxable income of the expatriated entity may not be less than its inversion gain for a taxable year. This includes gain recognized by reason of a transfer, during the applicable period, of properties, including intellectual property, to a foreign related person after the inversion. Section 7874 is not a backstop to the transfer pricing rules with respect to royalty payments that the expatriated entity would make to the foreign acquiring corporation or its subsidiaries that are not part of the expatriated entity's EAG. If the concern is that the expatriated entity (or domestic members of its EAG) make royalty payments to their historic foreign affiliates and these affiliates are moved "out from under" the expatriated entity, this should be addressed by rules under section 367 and subpart F, as has been done in part by the 2014 Notice and further in the Notice. In any event, it is not clear why this concern should require a rule applying only to Third-Country Transactions and not to all inversions falling under the 60% Ownership Test.

Thus, treaty shopping, not earnings stripping, should pose the critical issue in a Third-Country Transactions.[43]

The substantial equivalence standard of tax treaties could be fashioned along the lines of the concept of "equivalent beneficiaries" that is incorporated in several U.S. income tax trea-

foreign acquiring corporation is received by the exchanging shareholders of the domestic target. In such a case, debt could be distributed as a dividend by the domestic target to the foreign acquiring corporation without the imposition of U.S. withholding tax generally after a one-year waiting period, if the foreign acquiring corporation is tax resident in a tax treaty jurisdiction with a zero-percent withholding tax for dividends from controlled subsidiaries. We note that the Third-Country Transaction rule applies only to inversions meeting the 60% Ownership Test and would therefore not stop any earnings stripping in a 50 percent or less transaction. *See* Treas. Reg. §§ 1.367(a)-3 and 1.367(b)-10; Notice 2014-32, 2014-20 I.R.B. 1006. Moreover, in a transaction that is not intended to qualify as a reorganization, taxpayers sometimes seek to create intercompany debt as part of the transaction by having a U.S. subsidiary of the foreign acquiring corporation pay the foreign acquiring corporation for the foreign acquiring corporation's shares that will be used to acquire the domestic target, such payment being made in the form of debt of the U.S. subsidiary. These transactions are not addressed by the Killer-B regulations, as they are not reorganizations, nor do they rely on a tax treaty for the creation of the intercompany debt. Thus, the Notice may not provide an impediment to earnings stripping in the context of these transactions either.

43 The Notice also mentions a "more favorable tax system", including a "less restrictive regime for controlled foreign corporations," as a factor making Third-Country Transactions suspect, this seems to be a question of foreign tax reduction (or avoidance). We do not believe that limiting foreign tax avoidance is a policy concern of section 7874.

ties.[44] With respect to U.S. source payments, an equivalent beneficiary generally must, in the case of dividends, interest and royalties, qualify under the U.S. income tax treaty with its country of residence for withholding tax at a rate that is at least as low as the applicable tax rate of the income tax treaty to which the benefits are compared.[45] As the Treasury Department and the IRS are concerned about these three categories of payments, substantial equivalence of tax treaties should be based on them. A Destination Treaty would then be treated as substantially equivalent to an Original Treaty if, with respect to each of these categories of payments, the withholding tax rate for the foreign acquiring corporation under the Destination Treaty is the same or lower than the rate of withholding applicable to the foreign target corporation under the Original Treaty. The foreign acquiring corporation and the foreign target corporations would have to be eligible for the benefits of their respective income tax treaties.

This may not always be the case. In particular, there may be cases in which the Destination Treaty, but not the Original Treaty, provides for a zero percent withholding rate on subsidiary dividends.[46] In this case, we believe that a foreign acquiring corporation should be able to put any presumption of improper treaty shopping to rest by entering into an agreement or election with the IRS to be subject to the higher withholding tax rate specified in the Original Treaty. The Code already has such an example: it provides for an election out of specific treaty provisions under section 897(i), which permits a foreign corporation that holds a United States real property interest to elect to be treated as a domestic corporation for purposes of sections 897, 1445 and 6039C. Permitting a similar election under the Third-Country Transaction rule with respect to a specific tax treaty provision is therefore not a novel concept.

Such an election should be limited in two ways. First, it should extend only over the ten-year period from the completion of the inversion, because this is set as the limit in time under the

[44] A number of U.S. income tax treaties, in particular with member countries of the European Union, contain a "derivative benefits" provision in the limitation on benefits article. This allows a foreign company to qualify for treaty benefits if, generally, 95% or more of its stock is owned, directly or indirectly, by a small number of "equivalent beneficiaries." *See, e.g.,* Convention for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital and to Certain Other Taxes between the United States and the Federal Republic of Germany, Art. 28(3).

[45] In addition, in the case of tax treaties with EU countries, the person must be a resident of a member state of the European Union or the European Economic Area or a party to the North American Free Trade Agreement and qualify for the benefits of a comprehensive income tax treaty between its home country and the United States. This aspect would be addressed by the fact that, for purposes of substantial treaty equivalence, the foreign acquiring corporation and the foreign target corporation must qualify for the benefits of an income tax treaty with the United States.

[46] *Compare* the U.S. income tax treaties with Australia, Germany, Japan or the United Kingdom (0% dividend withholding tax if certain conditions are met) *with* the U.S. income tax treaties with Canada, Ireland or Luxembourg (5% dividend withholding tax for direct investment is the lowest treaty-based dividend withholding tax rate).

regime of the 60% Ownership Test that would apply to inversions subject to the Third-Country Transaction rule. Second, the foreign acquiring corporation should be allowed to benefit from a change of the Original Treaty (by protocol or if it were replaced by a new income tax treaty with the United States), provided that the foreign acquiring corporation would qualify in relevant part if it were resident in the country of the Original Treaty.

A short comment on the provisions relating to expatriated entities in the recently released United States Model Income Tax Convention published on February 17, 2016 (the "2016 Model Treaty") may not be amiss.[47] Under the 2016 Model Treaty, dividends, interest, royalties and items of other income paid by an expatriated entity within the meaning of section 7874(a)(2)(A) to a beneficial owner that is (1) a company resident in the other contracting state and (2) a connected person with respect to the expatriated entity would not benefit from reduced withholding rates under the treaty.[48] As a consequence, payments by the domestic target (or a related domestic person) to a foreign acquiring corporation of dividends, interest, royalties or guarantee fees would generally be subject to U.S. gross withholding tax at a rate of 30 percent. The suspension of these tax treaty benefits would be limited to the ten-year period from the date when the inversion was completed. If these new provisions universally applied to expatriated entities, the principal policy concern underlying the Third-Country Transaction rule would appear to be addressed, *i.e.*, there could be no treaty abuse as a result of Third-Country Transactions and the effects of earnings stripping would be confined as a result of the imposition of U.S. gross withholding tax.

While the model treaty is beyond the scope of this report, we note that these new model treaty provisions will not make the Third-Country Transaction rule superfluous. First, none of these provisions is already reflected in any income tax treaty currently in effect, and it will generally take significant time before this will be the case. Second, even when the provisions start to enter new or updated U.S. income tax treaties, they will do so at different times as the relevant tax treaties are updated. If the Original Treaty applicable to a foreign target contains these provisions, the search for a third country with a Destination Treaty without the provisions would in fact make Third-Country Transactions even more attractive. In addition, as a model treaty is generally to be understood as "the baseline text the Treasury Department uses when it negotiates tax

47 United States Model Income tax Convention, February 17, 2016, https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-US Model-2016.pdf.

48 2016 Model Treaty, Arts. 10(5), 11(2)(d), 12(2)(b) and 21(2)(b). A foreign company is a connected person with respect to an expatriated entity if the foreign company owns, directly or indirectly, at least 50 percent of the stock (by vote and value) in the expatriated entity or both are under such 50-percent common ownership by another person.

treaties,"[49] even new or renegotiated tax treaties may not incorporate the provisions. The Third-Country Transaction rule therefore will have a role regardless of the new expatriation provisions in the 2016 Model Treaty.

3. Migrating Tax Residence

There is no Third-Country Transaction unless the foreign acquiring corporation and the foreign target corporation have different "tax residences." They apparently may have different countries of organization so long as they have the same country of tax residence, but this should be clarified. Tax residence of the foreign target corporation is tested before the foreign target acquisition and any transaction related to the foreign target acquisition.

The Notice further states that any change in the location of the management and control of a foreign target corporation is treated as a *transaction* for this purpose. This would be relevant in a situation where a foreign target corporation that is originally resident in country *A* first changed the location of its management and control to country *B* and, as a result of this change, its tax residence also changed from country *A* to country *B*. If after this change the stock of the foreign target corporation is acquired by a foreign acquiring corporation that is tax resident in country *B*, the foreign target corporation and the foreign acquiring corporation would be treated as having different tax residences for purposes of the Third-Country Transaction rule.

The converse, however, should also be the case: if a foreign acquiring corporation resident in country *A* acquires a foreign target that is tax resident in country *B*, and then changed its tax residence to country *B*, this should be treated as a related transaction, and the tax residence comparison should be made by taking this change into account. On the other hand, if the foreign acquiring corporation changed its residence to country *B* before the acquisition of a foreign target corporation that also is resident in country *B*, the change should not be treated as a transaction (or as a *related* transaction) for purposes of the tax residence comparison.

A reincorporation of a foreign corporation in another jurisdiction would be treated as an acquisition of all of the properties of a foreign target corporation by a foreign acquiring corporation.[50] If a foreign acquiring corporation is a tax resident in a jurisdiction that determines tax residence by location of management and control, however, it could change its tax residence by relocating management and control to another country that also determines tax residence in this manner. Such a migration of tax residence, however, is not, as a technical matter a (direct or indirect) *acquisition* of any properties by the foreign acquiring corporation. Yet in a tax-residency

[49] Preamble to 2016 U.S. Model Income Tax Convention, February 17, 2016, https://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Preamble-US Model-2016.pdf.

[50] *See* Treas. Reg. § 1.7874-2(c) and section 7874(a)(2)(B)(i).

based system, a migration of tax residency is comparable to an F-reorganization (which would qualify as an acquisition for purposes of section 7874).

We therefore believe that condition (1) of the definition of Third-Country Transactions should specifically state that a migration of tax residence should be treated as an "acquisition of substantially all of the properties" of the migrating foreign corporation. And a change of management and control should be treated not only as a *transaction* but also as an *acquisition*.

C. Clarification of the Scope of Avoidance Property

Section 7874(c)(2)(B) as modified by temporary Treasury regulations excludes disqualified stock of the foreign acquiring corporation from the ownership fraction, subject to a *de minimis* exception.[51] Disqualified stock is stock issued for "nonqualified property," which includes avoidance property, *i.e.*, "any other property acquired in a transaction (or series of transactions) related to the acquisition with *a* principal purpose of avoiding the purposes of section 7874" (emphasis added).[52]

The Notice clarifies that, for purposes of the anti-stuffing rule, "avoidance property" is to be interpreted broadly and may in fact include active trade or business assets. The Notice indicates that this purported clarification is made in response to the position apparently taken by some taxpayers that there is no transfer of avoidance property (*e.g.*, stock) if there is no indirect transfer of other specified nonqualified property such as cash, cash equivalents and marketable securities (see part I.B(c), page 5 above) to the foreign acquiring corporation.

We agree that the plain language of the temporary Treasury regulations does not contain or suggest such a limitation. The Notice therefore clarifies very little about the concept of avoidance property. It claims to illustrate the clarification with the following example:

> *Example 7: DT* is a publicly traded domestic corporation. *PRS* is a foreign partnership that is unrelated to *DT*. *PRS* transfers certain business assets (*PRS* properties) to *FA*, a newly formed foreign corporation, in exchange solely for 25 shares of *FA* stock. The shareholders of *DT* transfer all of their *DT* stock to *FA* in exchange solely for the remaining 75 shares of *FA* stock. None of the *PRS* properties is specified nonqualified property, but *FA* acquires the *PRS* properties with a principal purpose of avoiding the purposes of section 7874.

The analysis then concludes, unsurprisingly, that the 25 shares of *FA* stock issued to *PRS* are no included in the denominator of the Ownership fraction and that the ownership fraction is, accordingly, 75/75.

[51] Temp. Treas. Reg. §§ 1.7874-4T(c) and (d).

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

The example makes the all-important assumption that the *PRS* properties constitute avoidance property, but does not provide reasons why that may be so for business assets. The example contrasts with two scenarios described in Example 3 of § 1.7874-4T(j) of the temporary Treasury regulations.

> *Example 8:* *FT*, a publicly traded corporation, forms *FA*, and then *FA* forms *DMS* and *FMS*. *FMS* merges with and into *FT*, with *FT* surviving the merger (*FMS-FT* merger). Pursuant to the *FMS-FT* merger, the *FT* shareholders exchange their *FT* stock solely for 1,000 shares of *FA* stock and *FT* becomes a wholly owned subsidiary of *FA*. Following the *FMS-FT* merger, *DMS* merges with and into *DT*, also a publicly traded corporation, with *DT* surviving the merger (*DMS-DT* merger). Pursuant to the *DMS-DT* merger, the *DT* shareholders exchange their *DT* stock solely for the remaining 1,000 shares of *FA* stock, and *DT* becomes a wholly owned subsidiary of *FA*. After the completion of the plan, *FA* wholly owns *FT* and *DT*, *DMS* and *FMS* cease to exist, and the stock of *FA* is publicly traded.[53]

The regulations conclude that the *FT* stock does not constitute marketable securities within the meaning of section 1.7874-4T(i)(6) of the temporary Treasury regulations (because *FT* becomes a member of the expanded affiliated group that includes *FA* in a transaction related to *FA's* acquisition of substantially all the properties of *DT*) and therefore does not constitute nonqualified property. Accordingly, the *FT* stock is not disqualified stock and not disregarded in determining the denominator of the ownership fraction. However, any determination that the FT stock qualifies as marketable securities under this section presupposes that it is not the case that "a principal purpose for acquiring such stock … is to avoid the purposes of section 7874."[54]

> *Example 9:* The facts are the same as in [Example 8], except that, instead of undertaking the *FMS-FT* merger, *FT* merges with and into *FA* with *FA* surviving the merger (*FT-FA* merger). Pursuant to the *FT-FA* merger, the *FT* shareholders exchange their *FT* stock solely for 1,000 shares of *FA* stock. At the time of the *FT-FA* merger, *FT* does not hold nonqualified property and has no obligations.[55]

Here, too, the regulations conclude that *FA* stock transferred by *FA* to *FT* in exchange for the property of *FT* and then by *FT* to its shareholders in exchange for *FT* stock is not disqualified stock and therefore not disregarded in determining the denominator of the ownership fraction. Unlike in Example 8, however, *FT* stock is nonqualified property because it constitutes marketable securities (the stock of *FT* is publicly traded and *FT* is not a member of the EAG that

[53] Temp. Treas. Reg. § 1.7874-4T(j), Ex. 3(i). *FA*, *FT* and *FMS* are foreign corporations with a single class of stock outstanding and *DT* and *DMS* are domestic corporations.

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

[55] Temp. Treas. Reg. § 1.7874-4T(j), Ex. 3(iii).

includes *FA* after the acquisition). The example concludes that the transfer of *FA* stock by *FT* to the shareholders of *FT* neither increases the fair market value of the assets of *FA* nor decreases the liabilities of *FA*, and it is therefore not disqualified stock as defined in the temporary regulations.

The definition of "marketable securities" suggests that *FA*'s stock would not be *ipso facto* disqualified stock if *FT* were instead a partnership. Rather, it would be disqualified stock only if, although *FT* becomes a member of the EAG that includes *FA*, a principal purpose for acquiring the partnership interests is to avoid the purposes of section 7874. The definition also suggests that not all such acquisitions are *per se* for section 7874 avoidance purposes.

What then sets an avoidance transaction apart from a non-avoidance transaction, such as Examples 8 and 9? We understand from comments made by the IRS that the example and the clarification were intended to reach the unusual situation where the foreign acquiring corporation acquires business assets for the principal purpose of acquiring assets to "bulk up" in order to facilitate an inversion of a domestic target. This would generally be the case if the foreign acquiring corporation acquires assets that are unrelated to the foreign acquiring corporation's business and intends to dispose of those assets as soon as practicable.

Further, the acquisitions described in examples 8 and 9 could have been structured as acquisitions of the domestic, expatriated entity directly by the foreign target.[56] One reason why there is no principal purpose of section 7874 avoidance in these acquisitions is presumably that the inversions could have been done, and would have resulted in the same treatment under section 7874, without the acquisition of *FT* by *FA* (even if there are business or other legal reasons for setting up *FA*). Here, too, however, the critical additional requirement would appear to be that *FA* retains, directly or indirectly, the *FT* assets that it acquires and does not intend to dispose of them as soon as practicable.

Asset transfers by a partnership to a foreign acquiring corporation should in that case also not be treated as transfers of avoidance property if the assets constitute a trade or business (as would generally be the case in examples 8 and 9 with respect to *FT*) or, where the foreign acquiring corporation already is in existence, if the assets are related to the business of the foreign acquiring corporation. In either case, neither the transferring partnership nor the transferee foreign acquiring corporation should have any intention at the time of transfer to dispose of those assets.

Regulations should clarify that there is no avoidance property if the (directly or indirectly) transferred assets (1) (a) constitute a trade or business within the meaning of section 1.367(a)-

[56] The examples do not yet address the Third-Country Transaction rule, which would have to be applied separately for inversions completed after November 18, 2015. This discussion assumes that the rule is not relevant to the examples, *i.e.*, that *FA* and *FT* have the same tax residence.)

2(b)(2) or (b) otherwise are related to the existing business of the foreign acquiring corporation and (2) are, in each case, transferred without an intention to dispose of them at a later time.