NEW YORK STATE BAR ASSOCIATION
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May 3, 2010

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Re: NYSBA Tax Section Report on Certain Issues Under Section 7874

Gentlemen:

We are pleased to submit the New York State Bar Association Tax Section's Report No. 1211 relating to certain issues arising under Section 7874, which addresses expatriated entities and their foreign parents. Our report makes a number of recommendations, which are summarized below.

One of the threshold issues under Section 7874 is whether the expanded affiliated group of which the relevant entities are a part conducts "substantial business activities" in the jurisdiction in which the foreign parent is organized. The 2009 temporary regulations under Section 7874 removed the "substantial business activities" safe harbor that was included in the 2006 temporary regulations under this Section. The preamble to the 2009 temporary regulations requested comments relating to this removal.

We believe that more specific guidance would benefit both taxpayers and tax administration and have attempted to address certain perceived shortcomings in the prior safe harbor. We recommend a safe harbor that would consider the location of the expanded affiliated group's assets and employees, but would not consider the group's sales. We also recommend splitting the safe harbor into two tests, one for expanded affiliated groups conducting less than 50% of their business activities in the United States (measured by employee compensation and assets) and one for expanded affiliated groups conducting 50% or more of their business activities in the United States (measured by either employee compensation or assets). For expanded affiliated groups conducting less than 50% of their business activities in the United States, we propose that the safe harbor require that each of the two elements in the relevant foreign jurisdiction must be at least equal to the greater of (i) 15% of the group's worldwide activities in respect of such element and (ii) 20% of the group's activities in respect of such element outside the United States. For expanded affiliated groups conducting 50% or more of their business activities in the United States, we propose that the safe harbor require that the group meet a 25% threshold in respect of each of the two elements.

The 2009 temporary regulations also addressed the treatment of options and similar instruments for purposes of calculating certain ownership thresholds under Section 7874. The preamble to the 2009 temporary regulations requested comments relating to rules concerning options. We recommend generally ignoring options for these purposes, subject to an anti-abuse rule that treats certain options as stock. If, however, it is determined to retain the approach of generally counting options as stock (subject to an anti-abuse rule), we would recommend specifying categories of options that would be carved out of the general rule (again subject to an anti-abuse rule). If the final regulations adopt (for purposes of the general rule and/or anti-abuse rules) the spread value approach proposed in the 2009 temporary regulations, which we believe generally would be the better approach but would require a rule addressing voting power, a more limited carve-out of certain categories of options would seem appropriate, but we believe it should at least carve out customary compensatory options.

The option rules in the 2009 temporary regulations also contain an anti-abuse rule that applies only with respect to options on stock of the foreign acquiror. We recommend extending this anti-abuse rule to cover options on stock of the domestic expatriating entity. Finally, we request certain clarifications, including (i) guidance on the application of the "spread value" approach to option valuation for purposes of testing voting power, (ii) guidance on the "substantially all of the properties" requirement of Section 7874(a)(2)(B)(i), and (iii) clarification that, in circumstances when options are counted for purposes of Section 7874, the existing shareholders' ownership percentages for these purposes are reduced by a corresponding amount.

Notice 2009-78 announced the intention to issue regulations providing that foreign parent stock would not be taken into account for purposes of the ownership thresholds under Section 7874 if it was issued in exchange for cash or certain other non-qualifying assets. This would be an expansion of the statutory provision ignoring foreign parent stock that was "sold in a public offering." We agree that disparate treatment of public and private offerings makes little sense as a policy matter in most cases, although the authority to issue the rule adopted by the Notice is not free from doubt. In any event, we believe that broad application of this rule, without any exception, may result in its inappropriate application to transactions the predominant effect of which is not that of an expatriation bur rather that of a sale or a joint venture. Therefore, we recommend exceptions for sufficiently large primary issuances (whether made in a public or private offering) and other situations where the historical shareholders of the domestic entity fail to retain some threshold percentage of their proprietary interest in the domestic entity, in each case subject to an anti-abuse rule. In the alternative, we recommend replacing the *per se* rule with a rebuttable presumption that transactions targeted by the Notice are abusive and therefore are subject to the anti-stuffing rule of Section 7874(c)(4). We also request certain clarifications regarding the circumstances when pre-transaction distributions from the domestic entity are treated as abusive under the anti-stripping rule of Section 7874.

With respect to the interaction between the rules disregarding stock issued for cash and the rules for determining whether the relevant entities are part of an expanded affiliated group, we believe that shares excluded because they were issued for cash should nevertheless be counted for other purposes. We also recommend an exception to the expanded affiliated group rules that would apply to foreign parent stock received by historic shareholders of the domestic entity other than "by reason of" their proprietary interests in the domestic entity.

Finally, we make technical recommendations relating to calculations of the relevant ownership thresholds in the context of multi-step transactions and the proposed treatment of creditor claims with respect to an insolvent domestic entity as stock in such entity.

We appreciate your consideration of our recommendations. If you have any questions or comments regarding this report, please feel free to contact us and we will be glad to discuss or assist in any way.

Sincerely,

Peter H. Blessing
Chair

Enclosure

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