New York State Bar Association
Tax Section

Report on Temporary Treasury Regulations Section 1.7874-1T

March 22, 2006

New York State Bar Association Tax Section Report on Temporary Treasury Regulations Section 1.7874-1T*

This report sets forth the comments of the New York State Bar Association Tax Section (the "NYSBA") to Temporary Treasury Regulations Section 1.7874-1T. Part I comments on the text of the Temporary Treasury Regulations. While we believe that those Regulations provide appropriate relief from the unintended potential overbreadth of the statute, we believe that they could be improved by adding a rule that generally disregards preferred stock described in Section 1504(a)(4).[1] Part II discusses certain issues raised by the preamble to the Temporary Treasury Regulations, as well as other issues, on which additional guidance may be appropriate.

I. TEMPORARY TREASURY REGULATIONS

A. Background

Section 7874 was enacted to address certain perceived abuses associated with so-called "inversion transactions" pursuant to which a domestic business could reincorporate in a foreign jurisdiction and replace the domestic parent of a multinational corporate group with a foreign parent corporation without significant change in the ultimate ownership or operations of the group.[2] Congress was concerned, in particular, that such transactions could be used to remove current and future foreign operations from the U.S. taxing jurisdiction and to reduce U.S. tax on domestic-source income through earnings stripping or other transactions.[3]

---

* This report was prepared by an ad hoc committee of the New York State Bar Association Tax Section chaired by David R. Sicular whose members are Kimberly S. Blanchard, Peter J. Connors, David P. Hariton, Douglas R. McFadyen, David S. Miller, Yaron Z. Reich, Willard B. Taylor and Alyssa F. Wolpin. Helpful comments were received from Peter H. Blessing, Andrew H. Braiterman, Andrew L. Oringer and Michael L. Schler.

[1] All section references are to the Internal Revenue Code of 1986, as amended (the "Code"), unless otherwise stated herein.

[2] *See generally* H.R. CONF. REP. NO. 108-755, 108th Cong., 2d Sess., at 568 (Oct. 7, 2004).

[3] *See id.; see also* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS (May 2005) [hereinafter 2005 BLUE BOOK], at 342 ("An inversion transaction may be accompanied or followed by further restructuring of the corporate group. . . . In addition to removing foreign operations from the U.S. taxing jurisdiction, the corporate group may derive further advantage

Section 7874(a) provides, in relevant part, that if (i) a foreign corporation ("FC") acquires substantially all the properties of a domestic corporation, or substantially all the properties constituting a trade or business of a domestic partnership, (ii) after the acquisition, at least 60 percent (by vote or value) of the FC stock is owned by former shareholders or partners of the domestic entity ("DE") by reason of their former ownership and (iii) the expanded affiliated group that includes FC (the "EAG") does not have substantial business activities in the country of FC's incorporation relative to the total business activities of the EAG, then any inversion gain is fully taxable without offset by losses or credits.[4] Section 7874(b) provides further that if conditions (i) and (iii) above apply and at least 80 percent of the FC stock is owned by former shareholders or partners of DE by reason of their former ownership, FC will be treated as a domestic corporation for all purposes under the Code. For these purposes, stock held by members of the EAG (the "affiliate-owned stock rule") and stock of FC that is sold in a public offering related to the acquisition are disregarded.[5] EAG is defined by reference to Section 1504(a), but includes foreign corporations and reduces the 80 percent ownership threshold to more than 50 percent.[6]

The affiliate-owned stock rule was intended both to curtail avoidance of Section 7874 when it should apply, as in the case of so-called hook stock (generally stock of FC that is owned by DE), and to prevent the application of Section 7874 to transactions that do not implicate its concerns, as in the case of internal group restructurings involving transfers of stock or assets of wholly owned DEs to wholly owned FCs without a change in the EAG parent.[7] However, the Internal Revenue Service (the "Service") and the Treasury Department ("Treasury") believed that further guidance was needed to accomplish those objectives. Accordingly, on December 27, 2005, Temporary Treasury Regulations were issued that address when and in what manner

---

from the inverted structure by reducing U.S. tax on U.S.-source income through various earnings stripping or other transactions.").

[4] Inversion gain is generally defined as the income or gain recognized by reason of the transfer, during the 10 year period following the acquisition, of stock or other property by an expatriated entity (*i.e.*, a DE described in the accompanying text and any U.S. person related (within the meaning of §§ 267(b) or 707(b)(1) to such DE), and any income received or accrued during that period from a license of any property by an expatriated entity, in each case as part of the acquisition or thereafter if such transfer or license is to a foreign related person (within the meaning of §§ 267(b), 707(b)(1) or 482 (under common control)). I.R.C. § 7874(a)(2), (d)(1)-(3).

[5] I.R.C. § 7874(c)(2).

[6] I.R.C. § 7874(c)(1).

[7] *See* 2005 BLUE BOOK, at 344.

affiliate-owned stock will be disregarded for purposes of determining whether a foreign corporation is a surrogate foreign corporation under Section 7874(a)(2)(B).[8]

In general, affiliate-owned stock is excluded from both the numerator and the denominator of the fraction that determines the ownership percentage in FC. The Temporary Treasury Regulations provide two carveouts to this general rule, under which affiliate-owned stock will be excluded from the numerator only. The first carveout applies if (1) before the acquisition at least 80 percent of the stock (by vote or value) or interests in DE is owned directly or indirectly by the common parent of the EAG and (2) after the acquisition less than 20 percent of the stock (by vote and value) of FC is owned by non-members of the EAG by reason of their former ownership in DE. The second carveout generally applies if former shareholders or partners of DE own no more than 50 percent (by vote and value) of the stock of any member of the EAG. However, the carveouts do not apply to stock or partnership interests owned by an entity in which at least 50 percent of the stock (by vote or value) or interests (capital or profits) is owned directly or indirectly by the issuer of such stock or interests (hook stock).

B. Temporary Treasury Regulations bring welcome relief from overbreadth of statute

We commend the Service and Treasury for issuing Temporary Treasury Regulations that provide appropriate relief from the potential overbreadth of Section 7874. We believe those Regulations go a long way toward excluding from the application of the statute certain non-abusive transactions of a type that Congress did not intend to cover. The lines drawn in those Regulations, while arguably somewhat arbitrary, seem, on balance, to be sensible and consistent with other provisions in the Code.[9] However, as discussed below, we believe that the Temporary Treasury Regulations could be improved by adding provisions that generally exclude Section 1504(a)(4) stock in applying their tests.

---

[8] T.D. 9238 (Dec. 27, 2005). A surrogate foreign corporation is an FC described *supra* in the text accompanying footnote 4.

[9] *See, e.g.*, I.R.C. §§ 368(c) (80% of combined voting power and total number of shares of all other classes of stock constitutes control of applicable corporation), 1504 (80% vote and value test for affiliated groups and consolidation; 80% threshold justifying something akin to single-entity treatment), 318(a)(2)(C), (a) (3)(C) (attribution to and from corporations based on ownership of 50% of corporation's value), 267(b), (f) (generally 50% value test for related persons where one is a corporation), 707(b) (partnerships related to other persons (including other partnerships) based on 50% capital or profits interest ownership); *see also* §§ 355(e) (corporate level tax may apply where a 50% or greater interest in distributing or controlled is acquired in connection with a spinoff), 382 (ownership change occurs if stock held by 5% shareholders increases by more than 50% for relevant period).

C. Section 1504(a)(4) stock

Section 7874(c)(1) defines the EAG by reference to Section 1504(a).[10] Therefore, so-called "plain vanilla" preferred stock (*i.e.*, non-voting, non-convertible stock that is limited and preferred as to dividends, does not participate in corporate growth to a significant extent and does not have more than a reasonable redemption or liquidation premium) ("Section 1504(a)(4) stock") is ignored for purposes of determining whether a corporation is a member of the EAG.[11] Absent any applicable Treasury Regulations, however, Section 1504(a)(4) stock is treated no differently from other stock, and is not per se ignored, for purposes of determining whether FC is a surrogate foreign corporation. We believe that this inconsistency could inappropriately undermine the relief intended to be provided by the Temporary Treasury Regulations.

Consider, for example, a DE in which a foreign parent owns 80 percent of the common stock, and minority shareholders own the remaining 20 percent. The foreign parent and the minority shareholders engage in a transaction pursuant to which the foreign parent exchanges its interests in DE for all the FC common stock, representing all the vote and less than 80 percent of the value in FC, and cash, and the minority shareholders exchange their interests in DE for all the FC Section 1504(a)(4) stock, representing more than 20 percent of the value in FC. Pursuant to Section 7874(c)(1), the foreign parent and DE are considered to be part of the EAG with FC. Accordingly, pursuant to Section 7874(c)(2), the common stock in FC owned by the foreign parent is ignored for purposes of determining whether FC is a surrogate foreign corporation. However, the transaction would not qualify for the carveout for internal group restructurings since, after the acquisition, the Section 1504(a)(4) stock owned by minority shareholders would exceed 20 percent of the value of FC. FC would thus be deemed a surrogate foreign corporation (assuming it did not meet the substantial business activities test).

It is difficult to imagine why the receipt by these former DE minority shareholders of Section 1504(a)(4) stock (by reason of their having owned shares in DE) would implicate the concerns addressed by Section 7874.[12] We believe that only non-

---

[10] However, foreign corporations are included, and the 80% ownership threshold is reduced to a more-than-50% threshold.

[11] *See* I.R.C. § 1504(a)(4).

[12] Note, too, that any Section 1504(a)(4) stock received by a U.S. taxpaying shareholder of DE in a transaction intended otherwise to be tax-free for U.S. purposes would frequently constitute non-qualified preferred stock within the meaning of § 351(g) and, therefore, be taxable to such shareholder irrespective of the application of § 7874 (unless such Section 1504(a)(4) stock was not puttable, nor mandatorily redeemable, nor more likely than not to be redeemed, in each case within 20 years of issuance, and its dividend rate did not vary with certain indices). Treas. Reg. § 1.356-6(a) (nonqualified preferred stock received in a reorganization, spinoff or splitoff or § 1036 exchange generally treated as not stock or securities and therefore as boot); I.R.C. § 351(b), (g) (same for a § 351 exchange).

Section 1504(a)(4) stock should be taken into account for all purposes of the new carveouts of Temporary Treasury Regulations Section 1.7874-1T. The same is true of a case in which the minority receive part Section 1504(a)(4) stock and part non-Section 1504(a)(4) stock. In that case, too, only the non-Section 1504(a)(4) stock should be taken into account in applying the carveouts.

The same result also seems appropriate in the converse case. We believe that if minority DE shareholders own Section 1504(a)(4) stock representing more than 20 percent of the value of all DE stock and exchange that stock for more than 20 percent of the FC common stock, the Section 1504(a)(4) stock should not be treated as DE stock and thus the carveout would be satisfied (the first clause because all of the relevant stock is owned by the EAG; the second because the minority shareholders acquired their FC stock by reason of holding DE securities not treated as stock). The reason Congress excluded Section 1504(a)(4) stock from the determination of an affiliated group was due to its similarity to a debt instrument.[13] For similar reasons, we believe that Section 1504(a)(4) stock should be disregarded for all purposes of Temporary Treasury Regulations Section 1.7874-1T. We also believe consideration should be given as to whether this exclusion should be extended to all of Section 7874, including for purposes of determining whether FC is a surrogate foreign corporation.[14] In any case, we believe that Section 7874(c)(6)(B), authorizing the promulgation of Treasury Regulations as appropriate to determine whether an FC is a surrogate foreign corporation, including to treat stock as not stock, grants the Service and Treasury the authority to address this inconsistency.

---

[13] P.L. 98-369, § 60(a)(4). STAFF OF THE JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF THE REVENUE PROVISIONS OF THE DEFICIT REDUCTION ACT OF 1984, 98th Cong., 2d Sess., at 171 (1984).

[14] *Cf., e.g.*, I.R.C. § 382(k)(6)(A); Treas. Reg. § 1.382-2(a)(3)(i) (Section 1504(a)(4) stock disregarded for purposes of determining whether there has been an ownership change).

II. FUTURE GUIDANCE

In addition to comments on the provisions of Temporary Treasury Regulations Section 1.7874-1T, the Service and Treasury requested comments with respect to specifically enumerated and other issues arising under Section 7874. Of the enumerated issues on which comments were requested, this Part comments on the following: (1) the requirement that the EAG's activities in the relevant foreign country not be substantial when compared to the EAG's total business activities; (2) whether and to what extent options on stock and other similar interests are treated as stock for the purpose of determining whether a corporation is a surrogate foreign corporation; (3) the treatment of stock sold in a public offering that is related to the acquisition; (4) possible changes to Treasury Regulations Section 1.367(a)-3(c), which governs the tax consequences at the shareholder level of certain transactions similar to those addressed by Section 7874, in light of the enactment of Section 7874; and (5) acquisitions of DE by foreign pass-through entities. In addition we address an additional issue arising under Section 7874: the application of Section 7874 to stock and asset acquisitions.

A. Enumerated issues

1. Definition of substantial business activities

FC will not be a surrogate foreign corporation if the EAG has (i) substantial business activities (ii) in the country of FC's incorporation (iii) relative to the total business activities of the EAG. We believe that whether the business activities conducted in FC's country of incorporation are substantial should be based on all the facts and circumstances. However, Treasury Regulations should also provide for a safe harbor, pursuant to which those business activities will be deemed substantial if they represent more than 7.5 percent of the EAG's total business activities measured by the following tests: (i) asset value (fair market or book depending on the method used by the EAG in keeping its books for purposes of financial reporting), (ii) gross income or (iii) payroll expense. As discussed below, we are evenly divided as to whether the safe harbor under Section 7874 should require two of these factors or all three.

This proposal is based on several recent U.S. tax treaties. Although many comparable standards used elsewhere in the Code are subject only to a facts and circumstances determination,[15] we believe that the Service and Treasury should also prescribe a safe harbor that is not open to administrative interpretation on a case by case basis. A specific standard would allow for greater certainty in the market, and safeguards could decrease any risk of manipulation.

The exact standard "substantial business activities" is not used elsewhere in the Code.[16] Analogous standards, which we examine below, suggest that the

---

[15] *See, e.g.*, Temp. Treas. Reg. § 1.367(a)-2T(b)(2).

[16] The standard was included in Prop. Treas. Reg. § 1.1502-47 under the 1953 Code (filing of life-nonlife consolidated returns) but replaced, without explanation, by an "active trade or business" standard in the final Treasury Regulations.

substantial business activities requirement should be satisfied by some threshold level that is between 5 and 33 1/3 percent relative to FC's total business activity. For the reasons described herein, we believe that a facts and circumstances test, with a modified form of the 7.5 percent safe harbor applied in the limitation on benefits clauses of many U.S. treaties, is the most appropriate.

We believe that the approach applied in the limitation on benefits clauses of many U.S. treaties (including the United States Model Income Tax Convention (the "U.S. Model Treaty")) provides a particularly apposite and easily administrable standard to be adapted to the Section 7874 context.[17] Those clauses generally provide that a resident of a contracting state (the "first contracting state") will be entitled to treaty benefits with respect to income derived in the other contracting state (the "other contracting state") if, *inter alia*, (i) such resident is engaged in the active conduct of a trade or business in the first contracting state, and (ii) that trade or business is "substantial" in relation to the activity in the other contracting state that generated the income. Whether a trade or business is substantial for these purposes is generally determined based on all the facts and circumstances. However, a safe harbor provides that a trade or business will be deemed substantial if, for the preceding taxable period, or for the average of the three preceding taxable periods, each of the following ratios exceeds 7.5 percent and the average of the ratios exceeds 10 percent: (i) the ratio of the value of assets used or held for use in the active conduct of the trade or business by the income recipient in the first contracting state to the value of such assets so used or held for use by the trade or business producing the income in the other contracting state;[18] (ii) the ratio of gross income derived from the active conduct of the trade or business by the income recipient in the first contracting state to the gross income so derived by the trade

---

[17] Sept. 20, 1996. *See also* Memorandum of Understanding re U.S.-Austria Income Tax Treaty, art. 16 (May 31, 1996); Income Tax Treaty, U.S.-Barbados, art. 22, § 2 (Dec. 31, 1984, as amended by 1991 and 2004 protocols) (July 14, 2004 protocol replaced prior limitation on benefits provision with current one designed to address Congressional concerns that U.S companies were inverting under tax-haven corporations); Income Tax Treaty, U.S.-Denmark, art. 22, § 3 (Aug. 19, 1999); Income Tax Convention, U.S.-Estonia art. 22, § 3 (Jan. 15, 1998); Income Tax Treaty, U.S.-France, art. 30, § 2 (Aug. 31, 1994); Income Tax Treaty, U.S.-Ireland, art. 23, § 3 (July 28, 1997); Income Tax Convention, U.S.-Latvia, art. 23, § 3 (Jan. 15, 1998); Income Tax Convention, U.S.-Lithuania. art. 23, § 3 (Jan. 15, 1998); Income Tax Treaty, U.S.-Luxembourg, art. 24, § 3 (Apr. 1996); Memorandum of Understanding re U.S.-Netherlands Income Tax Treaty (2004 Protocol), ¶ XXII re art. 26 (Mar. 8, 2004); Income Tax Treaty, South Africa, art. 22, § 3 (Oct. 31, 1997); Income Tax Treaty, U.S.-Sri Lanka, art. 23, § 3 (Mar. 14, 1985).

[18] Although "value," as used in the first prong, is generally not defined, the Technical Explanation to the U.S. Model Treaty states that this term will be defined, in accordance with U.S. law, using the method applied by the taxpayer in keeping its books for purposes of financial reporting in its country of residence. United States Model Income Tax Convention of September 20, 1996, Treasury Technical Explanation, art. 22, *citing* Treas. Reg. § 1.884-5(e)(3)(ii)(A).

or business producing the income in the other contracting state; and (iii) the ratio of the payroll expense of the trade or business for services performed within the first contracting state to the payroll expense of the trade or business for services performed in the other contracting state.[19]

The purpose of the limitation on benefits clause is to prevent inappropriate treaty shopping by residents of third countries.[20] In order to avoid a subjective determination of intent, the limitation on benefits clause sets forth a series of objective tests. The rationale behind those tests is that satisfaction of the applicable requirements evinces a real business purpose for the structure or a sufficiently strong nexus to the first contracting state, either of which outweighs any purpose to obtain the benefits of the treaty. With regard to the active trade or business test in particular, "[i]t is considered unlikely that the investor would incur the expense of establishing a substantial trade or business in the [first contracting state] simply to obtain the benefits of the Convention."[21]

We believe that a variation on the treaty substantiality test would both establish sufficient nexus in FC's country of incorporation to prevent avoidance of the intent of Section 7874 and provide parameters that are sufficiently objective to reduce any impediment to non-abusive transactions. The ratios must, in accordance with Section 7874(a)(2)(B)(iii), be relative to the EAG's *total* worldwide business activities as opposed merely to its *U.S.* business. As a result, the denominators will be much larger (and thus the percentages will appear smaller) in the context of Section 7874. Accordingly, we think it appropriate that the substantial business activities standard under Section 7874 be a more liberal one than that set forth in treaty limitation on benefits clauses.[22] At the same time, however, we think that the thresholds should not be de

---

[19] *See, e.g.*, Memorandum of Understanding re U.S.-Austria Income Tax Treaty, art. 16 (May 31, 1996); Income Tax Treaty, U.S.-Barbados, art. 22, § 2 (Dec. 31, 1984, as amended by 1991 and 2004 protocols); Income Tax Treaty, U.S.-Denmark, art. 22, § 3 (Aug. 19, 1999); Income Tax Convention, U.S.-Estonia, art. 22, § 3 (Jan. 15, 1998); Income Tax Treaty, U.S.-France, art. 30, § 2 (Aug. 31, 1994); Income Tax Treaty, U.S.-Ireland, art. 23, § 3 (July 28, 1997); Income Tax Convention, U.S.-Latvia, art. 23, § 3 (Jan. 15, 1998); Income Tax Convention, U.S.-Lithuania art. 23, § 3 (Jan. 15, 1998); Income Tax Treaty, U.S.-Luxembourg, art. 24, § 3 (Apr. 1996); Memorandum of Understanding re U.S.-Netherlands Income Tax Treaty (2004 Protocol), ¶ XXII re art. 26 (Mar. 8, 2004); Income Tax Treaty, South Africa, art. 22, § 3 (Oct. 31, 1997); Income Tax Treaty, U.S.-Sri Lanka, art. 23, § 3 (Mar. 14, 1985).

[20] *See* United States Model Income Tax Convention of September 20, 1996, Treasury Technical Explanation, art. 22.

[21] *Id.*

[22] For the same reason, we generally believe that the thresholds applied in the substantial presence test for purposes of determining the branch profits tax are inappropriately high in the context of § 7874. *See* Treas. Reg. § 1.884-5(e)(3) (applying a substantially similar three factor test but comparing the foreign corporation's (not the EAG's) business activities in its country of incorporation to that corporation's (not

minimis. This led us to conclude that the thresholds for each factor should be 7.5 percent, as in the treaties, but that a 10 percent average should not be required.

A second issue is how many factors should be required. In the treaty context, an "active trade or business" is required; that concept is generally thought to require all activities necessary to earn income and pay expenses, including employees. Thus, it is clearly appropriate for the treaty provisions to require all three factors. By contrast, Section 7874 requires "substantial business activities" but does not use the phrase trade or business. A substantial manufacturing facility in a jurisdiction where there are no third party sales should meet the substantive requirements of Section 7874; the question is whether it should fall within a safe harbor. Some of our members are concerned that a two-factor safe harbor could lead to abuses in less sympathetic cases. If the Service and Treasury choose to require all three tests to be met for purposes of the safe harbor, the Treasury Regulations should make it clear that the facts and circumstances test does not necessarily require all three factors.

In any case, for purposes of the asset test, "value" should be defined by the method used by the EAG in keeping its books for purposes of financial reporting. In addition, we believe that intangible assets should either not be taken into account at all (*i.e.*, excluded from both the numerator and denominator) or taken into account based on situs of use rather than situs of ownership. For purposes of the gross income test, "gross income" should be defined consistently with Section 61 so that, among other things, on the sale of goods gross income would equal revenue less cost of goods sold. We would also add a provision that would disregard any non-business assets (including cash), any gross income derived from any assets and any employees, in each case that were acquired with the principal purpose of satisfying the substantial business activities test.

We also considered, but rejected, a second safe harbor that would, in cases some felt appropriate, treat certain multinationals as meeting the requirements of the Section 7874(a)(2)(B)(iii) exception even though they do not have a critical mass of operations in any one country. For example, certain EAGs might meet several multiples of the proposed safe harbor factors by reference to the European Union (the "EU") as a whole, but not for any single EU member. Alternatively, a multinational business may, as a result of EU tax and non-tax considerations, incorporate the headquarters of its European operations (*i.e.*, FC) in a country in which it does not have substantial business activities, even though it may have substantial business activities in other EU countries.[23] The majority of the Executive Committee rejected the recommendation of a second safe harbor to address those special EU considerations. However, if the Service and Treasury deem a second safe harbor appropriate, the Executive Committee generally believes that such safe harbor should permit the ratios to apply with respect to the EU as a whole,

---

the EAG's) worldwide business activities and requiring, for the taxable year, that each ratio be at least equal to 20% and that the average thereof exceed 25%).

[23] The choice of one EU country over another may be motivated, at least in part, by specific EU policies such as the parent subsidiary directive and nondiscrimination.

provided that the EAG has some meaningful business activities in the country of FC's incorporation.[24]

We note that other analogies in the Code could easily justify a lower threshold than the one we suggest for the safe harbor. In the case of Section 355, the active trade or business requirement has been satisfied by the devotion of as little as 5 percent of the net book value of a corporation's assets,[25] or less[26] if the corporation performs active and substantial management and operational functions.[27] A low threshold standard also finds support in the legislative history to Section 7874: "Congress believed that inversion transactions resulting in a *minimal* presence in a foreign country of incorporation were a means of avoiding U.S. tax and should be curtailed."[28]

---

[24] *Cf.* United States Model Income Tax Convention of September 20, 1996 Treasury Technical Explanation, art. 22 ("[A] resident of one of the States that is not otherwise entitled to the benefits of the Convention may be granted benefits under the Convention if the competent authority of the State from which benefits are claimed so determines. This discretionary provision is included in recognition of the fact that, with the increasing scope and diversity of international economic relations, there may be cases where significant participation by third country residents in an enterprise of a Contracting State is warranted by sound business practice or long-standing business structures and does not necessarily indicate a motive of attempting to derive unintended Convention benefits.").

[25] *See, e.g.*, Gen. Couns. Mem. 34238 (Dec. 15, 1969) (requiring at least 5% of net book value of assets/not de minimis to constitute active trade or business); P.L.R. 8712019 (Dec. 18, 1986). In Rev. Proc. 96-43, 1996-2 C.B. 330 (*see also* Rev. Proc 2003-3 § 4.01 (30), 2003-1 C.B. 118), the Service announced that it would no longer issue advanced rulings where the fair value of the gross assets of the purported active trade or business were less than 5% of the fair value of the total assets of the corporation but abandoned this threshold, without explanation, in Rev. Proc. 2003-48, § 4.07, 2003-2 C.B. 86.

[26] As a matter of anecdotal experience, we understand that the Service regularly accepts smaller percentages in issuing private letter rulings.

[27] *See, e.g.*, Treas. Reg. § 1.355-3(b)(2)(iii); Rev. Rul. 89-27, 1989 C.B. 106; Rev. Rul. 88-19, 1988-1 C.B. 114; Rev. Rul. 73-234, 1973-1 C.B. 180. The active trade or business test of § 367 seems inapposite because it is not country-specific, includes the FC broader group (the substantiality requirement being relative to the domestic corporation rather than other businesses in the foreign acquiror group) and requires that the activities being relied on be able to constitute an independent economic enterprise carried on for profit. Treas. Reg. § 1.367(a)-3(c)(3)(i)(A), 3(c)(3)(iii)(A); Temp. Treas. Reg. § 1.367(a)-2T(b)(2), (3).

[28] 2005 BLUE BOOK, at 343 (emphasis added).

We also considered other analogies in the subchapter C and penalty areas, but based on this legislative history and the context in which the test is being applied, those thresholds seem too high. Based on those authorities, "substantial" would certainly denote a less than 50 percent standard by analogy to other relevant authorities including: (i) the continuity of interest requirement for tax-free reorganizations ("COI") (a "substantial part" of the value of proprietary interests in target[29] is generally accepted to be preserved by historic target shareholder continuity of 40 percent[30] or less[31]); (ii) penalty provisions ("substantial authority" can exist for more than two positions and therefore can be satisfied by less than 50 percent);[32] and (iii) Section 341 (one-third constituted a "substantial part of net income").[33] Like the "substantial" requirement of Section 341, the "significant" component of the continuity of business enterprise requirement ("COBE") can be satisfied by a one-third threshold. COBE is satisfied if acquiror continues at least one "significant" line of target's historic business.[34] The term significant does not mean predominant but is satisfied by the continuation of one out of three business lines that are equal in value.[35]

2. Treatment of options, exchangeable shares and other stock rights as stock

Section 7874(c)(6)(A) authorizes the promulgation of Treasury Regulations as appropriate to determine whether an FC is a surrogate foreign corporation,

---

[29] Treas. Reg. § 1.368-1(e)(1)(i).

[30] *Compare* Prop. Treas. Reg. § 1.368-1(e)(7), Ex. 10 (COI preserved by 40% historic target shareholder continuity), *with* Prop. Treas. Reg. § 1.368-1(e)(7), Ex. 12 (COI not preserved by 30% historic target shareholder continuity). Rev. Proc. 77-37, 1977-2 C.B. 568, § 2.03 provided a COI safe harbor where historic target shareholders exchanged at least 50% by value of the total target shares exchanged for acquiror shares in the reorganization but stated that the 50% safe harbor was not intended to define the lower limits of COI.

[31] *See John A. Nelson Co. v. Helvering*, 296 U.S. 374 (1935) (adequate continuity when target shareholders received 38% non-voting, callable preferred stock and 62% cash); *Miller v. Comm'r*, 84 F.2d 415 (6th Cir. 1936) (25% continuity deemed adequate for COI purposes). *But see Kass v. Comm'r*, 60 T.C. 218 (1073), *aff'd without opinion*, 491 F.2d 749 (3d Cir. 1974) (16% continuity insufficient).

[32] Treas. Reg. § 1.6662-4(d)(3)(i) (there may be substantial authority for more than one position with respect to the same item).

[33] *See, e.g.*, Rev. Rul. 72-48, 1972-1 C.B. 102; *Comm'r v. James B. Kelley*, 293 F.2d 904 (1961), *aff'g* 32 T.C. 135 (1959); *Comm'r v. E. J. Zongker*, 334 F.2d 44 (1964), *aff'g per curiam* 39 T.C. 1046 (1963); *George W. Day v. Comm'r*, 55 T.C. 257 (1970).

[34] Treas. Reg. § 1.368-1(d)(2).

[35] Treas. Reg. § 1.368-1(d)(5), Ex. 1.

including to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock. We believe that options, exchangeable shares and other stock rights generally should not be treated as stock for purposes of Section 7874 unless: (i) they would be deemed stock of DE or FC, as applicable, under common law principles or (ii) they were otherwise issued, transferred or structured with a "principal purpose" of avoiding the application of Section 7874.

In general, stock rights are not treated as stock for other purposes of the Code,[36] unless issued with an anti-avoidance purpose.[37] Similarly, we believe that, absent an anti-avoidance purpose, stock rights should not be treated as stock for purposes of Section 7874. In determining whether stock rights have been issued with an anti-avoidance purpose, we believe that safe harbors similar to those provided in the affiliated group context, setting forth circumstances in which a stock right will not be treated as an option for such purposes, and subchapter S, setting forth circumstances in which an option will not be treated as a second class of stock, would be appropriate. Those safe harbors include rights issued to employees or independent contractors in connection with the performance of services, rights issued in connection with a commercially reasonable loan from a person in the lending business, certain rights exercisable at a price that is at least 90 percent of the value of the underlying stock and other rights which should be deemed issued principally with a valid business purpose other than to avoid the application of Section 7874.[38]

However, the general presumption of treating stock rights as not stock should not apply if the instrument would be treated as stock under general principles of law. For example, so-called "deep in-the-money" options or other rights might be treated as stock under general principles[39] (whether or not they satisfied any of the safe harbors for stock rights).[40] In addition, certain exchangeable shares with respect to which

---

[36] *See, e.g.*, Treas. Reg. §§ 1.354-1(e) (rights to acquire stock are treated as debt securities with a zero principal amount, not stock), 1.356-3 (to the same effect); *see also* Treas. Reg. §§ 1.367(a)-3(c)(4)(ii), 1.382-4(d)(2)-(6).

[37] *See, e.g.*, Treas. Reg. §§ 1.367(a)-3(c)(4)(ii), 1.382-4(d)(2)-(6).

[38] *See* Treas. Reg. §§ 1.1504-4(d)(2), (e), (g); 1.1361-1(l)(4)(iii)(B), (C). The option rules of § 1504 seem particularly apposite given that the EAG definition relies on that Section.

[39] *See, e.g.*, Rev. Rul. 82-150, 1982-2 C.B. 110 (taxpayer treated as owning the underlying stock when the purchase price for the option equalled 70% of the fair market value of the underlying stock and the exercise price equalled 30% of the fair market value of the underlying stock); Rev. Rul. 83-98, 1983-2 C.B. 40 (convertible note treated as equity because of the high probability of conversion where note was worth $600 at maturity but convertible into stock currently worth $1,000).

[40] *Cf.* Treas. Reg. §§ 1.1504-4(a)(1) (the treatment of an instrument as a stock right under these Treasury Regulations does not preclude treatment of the instrument as stock under general principles of law), 1.1361-1(l)(4)(ii) (except as otherwise provided, any

arrangements are put in place to ensure that the shareholders have rights that are effectively equivalent to what they would have had if they held directly the shares into which the instruments are exchangeable may also be treated as the underlying stock under general principles.[41] Indeed, we believe that such exchangeable shares should, in appropriate cases, be treated as the underlying stock for purposes of determining whether FC is a surrogate foreign corporation even if under a common law analysis they might be treated as stock of the nominal issuer.[42]

3. Public offerings

We have two comments relating to public offerings.

Definition of public offering. Our first set of comments relates to the question of how "public offering" should be defined. We think the answer is relatively simple if the offering takes place in the United States – the starting point should be whether the offering is required to be registered with the Securities Exchange Commission under the Securities Act of 1933. The question becomes more complex if the offering is not required to be so registered because of special facts about the issuer (*e.g.*, banks) or the location of the offering (*e.g.*, entirely outside the United States). It seems to us that neither of those circumstances should provide a free pass. One approach might be to consider whether, absent the special circumstances, the offering would have

---

instrument, obligation or arrangement issued by a corporation is treated as a second class of stock if it constitutes equity or otherwise results in the holder being treated as the owner of stock under general principles and a principal purpose is to circumvent the one class of stock rule).

[41] We are thinking specifically of exchangeable shares that are in the nature of those issued in certain mergers and acquisitions involving a Canadian target. The objective in those transactions is to give Canadian target shareholders shares of a Canadian company (which are generally eligible for tax-deferred treatment) that are economically equivalent to shares of the non-Canadian acquiror. The terms of the exchangeable shares, together with the terms of certain ancillary agreements, generally provide for dividends equivalent to the dividends paid on acquiror shares, a retraction right, which (subject to a nuance that is not relevant to this discussion) allows the holder to require target to redeem the exchangeable shares at any time for acquiror shares, rights to get acquiror shares on liquidation and rights to vote shares of acquiror. Arrangements are also put in place that give target contractual rights against acquiror to ensure fulfillment of the companies' obligations. As noted in NYSBA TAX SECTION, REPORT NO. 1014, at 13 n.29 (May 24, 2002), some inversion transactions effected in the late 1990s offered some shareholders the ability to defer their § 367(a) tax through the use of exchangeable shares.

[42] For example, exchangeable shares (particularly ones that do not have the right to vote any acquiror shares) might be treated as stock of the issuer under tracking stock principles even though they are economically equivalent to the underlying shares.

been considered a public offering under U.S. law principles, or, alternatively, under local law principles in the jurisdiction in which the offering occurs.

We also believe that the Service and Treasury should confirm that shares of FC that are issued to shareholders of a historic foreign corporation ("Old FC") in exchange for their stock of Old FC in connection with the acquisition of both Old FC and DE will not be considered "sold in a public offering" for purposes of Section 7874(c)(2)(B). Consider the case where, in connection with an acquisition of DE, Old FC creates a newly-formed FC which acquires (i) all the outstanding DE shares from former DE shareholders in exchange for 49 percent of the shares in FC and (ii) all the outstanding Old FC shares from former Old FC shareholders in exchange for 51 percent of the shares in FC. Assume, further, that each of DE, Old FC and FC is a publicly traded corporation. We believe that the FC stock that was issued to the former shareholders of Old FC should not be considered sold in a public offering. Otherwise, former DE shareholders would be deemed to own 100 percent of FC by reason of their former ownership of DE, and FC would be treated as a U.S. corporation. By contrast, if Old FC had simply acquired DE, Section 7874 would not have applied at all. As a policy matter, the parties should not be worse off in such case than in the basic transaction where the Old FC acquires DE directly. Moreover, it is hard to see why the FC shares issued to Old FC shareholders should be treated differently, for these purposes, from the FC shares issued to DE shareholders. Yet to consider all the FC shares as having been issued in a public offering would lead to the absurd result that none of those shares would be included for purposes of Section 7874, even if former DE shareholders received 80 percent of the stock of FC.

Related to the acquisition. Second, Section 7874(c)(2)(B) provides that stock issued in a public offering that is "related to" the acquisition shall not be taken into account for purposes of determining ownership of FC. We believe that the purposes of Section 7874 are best served if not all public offerings that are contemporaneous with an acquisition are treated as related to that acquisition. In particular, if the public offering is sufficiently large, it should be treated as a stand-alone transaction for this purpose. To that end, we encourage the Service and Treasury to create a public offering exception parallel to that in the Temporary Treasury Regulations for internal group restructurings. Under this exception, public offerings would not be considered "related to" an acquisition, and stock issued in such an offering would be included in the denominator but not the numerator of the ownership fraction if, after the acquisition, at least 80 percent of FC is owned directly or indirectly by holders who received their FC stock in a public offering. The second requirement of the first carveout in Temporary Treasury Regulations Section 1.7874-1T (*i.e.*, that less than 20 percent of FC be owned by former shareholders or partners of DE by reason of their ownership in DE) could be added to this test, but in this context seems superfluous.

The classic inversion transaction targeted by Section 7874 is the replacement of the domestic parent of a multinational group with a foreign parent corporation without significant change in the ultimate group ownership.[43] The substantial

[43] *See* T.D. 9238 (Dec. 27, 2005).

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

Analogies exist under exceptions to the application of the step transaction doctrine. The step transaction doctrine focuses on the intent of the parties[44] and the temporal proximity of the transactions in question.[45] However, the Service and courts have curtailed the application of step transaction doctrine in cases where two or more transactions carried out pursuant to an overall plan had economic significance independent of each other or were functionally unrelated.[46] A sizeable public offering, particularly if it includes a sizeable capital infusion into the corporation, should be deemed to have independent economic significance.[47]

---

[44] *See, e.g., Penrod v. Comm'r*, 88 T.C. 1415 (1987); *Estate of Christian v. Comm'r*, 57 T.C.M. 1231, T.C. Mem. 1989-413 (1989); *Cal-Maine Foods, Inc. v. Comm'r*, 93 T.C. 181, 203-204 (1989); *see also* T.A.M. 8646002 (July 18, 1986) (two transactions separated by 10 months are not stepped together when the second transaction was not contemplated at the time of the first).

[45] Absent a binding commitment at the time of the first transaction to effect the second transaction, the shorter the period between the two the likelier that step-transaction doctrine will be applied. *See, e.g.*, P.L.R. 8742033 (July 20, 1987) (two transactions separated by 4 months were not independent); Rev. Rul. 66-23, 1966-1 C.B. 67, *declared obsolete on other grounds by* T.D. 8760 (Jan. 28, 1998); Rev. Rul. 2003-99, 2003-2 C.B. 388 (notwithstanding requirement, at time of acquisition, to dispose of target within 7 years, acquisition and subsequent disposition not stepped together); Rev. Rul. 69-48, 1969-1 C.B. 106 (two transactions separated by 22.5 months stepped together).

[46] *See, e.g.,* Rev. Rul. 79-250, 1979-2 C.B. 156 (a forward subsidiary merger and a reincorporation effected pursuant to the same plan were not stepped together, because each reorganization was real and substantial and the economic motivation supporting each was sufficiently meaningful to warrant independence); *but see* Rev. Rul. 96-29, 1996-1 C.B. 50 (Rev. Rul. 79-250 unique to "F" reorganizations). *See also Reef Corp. v. Comm'r*, 368 F.2d 125 (1966), *cert. denied*, 386 U.S. 1018 (1967); Temp. Treas. Reg. § 1.338(h)(10)-1T(c) (buyer and seller may validly make § 338(h)(10) election with respect to a first step, which viewed independently constitutes a qualified stock purchase, of a multi-step transaction that would constitute a reorganization if integrated).

[47] *Cf. J.E. Seagram Corp. v. Comm'r*, 104 T.C. 75 (1995), *appeal to 2d Cir. withdrawn* (Apr. 10, 1996) (tender offer and squeeze-out merger stepped together where

This conclusion is also consistent with the philosophy underlying the carveout to the general affiliate-owned stock rule set forth in Temporary Treasury Regulations Sections 1.7874-1T(c)(2), *i.e.*, the exception for unrelated party acquisitions with minority former shareholder interests. By way of an example, the preamble explains that the contribution of DE or its assets to a foreign joint venture corporation in exchange for a minority interest in that FC should not result in FC's being treated, for purposes of the ownership percentage test, as wholly owned by the former owners of DE by operation of the affiliate-owned stock rule. Similarly, we believe that the contribution of DE or its assets to FC, where at least 80 percent of FC will be owned by new public shareholders such that former owners of DE receive only a minority interest in FC, should not result in FC's being treated, for purposes of the ownership percentage test, as wholly owned by the former owners of DE by operation of the publicly offered stock rule.[48]

4. Coordination of Section 7874 and the Section 367 Treasury Regulations

The preamble to the Section 7874 Temporary Treasury Regulations states that the Service and Treasury are considering changes to Treasury Regulations Section 1.367(a)-3(c) in light of the enactment of Section 7874 and requests comments. Substantially the same request is made in the preamble to final Treasury Regulations relating to the qualification of mergers and consolidations involving foreign corporations as "statutory" mergers or consolidations.[49]

In April of last year we submitted a report which, in light of the enactment of Section 7874 and 10 years of experience with Treasury Regulations Section 1.367(a)-3(c), recommended that serious consideration be given to conforming Treasury Regulations Section 1.367(a)-3(c) in whole or in part to Section 7874 or to the elimination of Treasury Regulations Section 1.367(a)-3(c).[50] We continue to espouse the views set forth in that report and incorporate by reference the recommendations made therein.

---

taxpayer had a binding commitment to complete the merger once it had undertaken the tender offer).

We also reiterate that it seems odd to treat public offerings differently from private placements. NYSBA TAX SECTION, REPORT NO. 1014, at 52 (May 24, 2002). As proposed in the Senate bill, § 7874(e)(1)(A)(ii) would also have disregarded stock issued in private placements. However, the Conference bill followed the House bill, which was limited to public offerings. Accordingly, any application of § 7874 to privately placed stock would seem to require an amendment to the statute.

[48] We believe this should be the case even if cash raised in the public offering were used to finance the acquisition or otherwise to recompense the former shareholders of DE.

[49] T.D. 9243 (Jan. 26, 2006).

[50] NYSBA TAX SECTION, REPORT NO. 1086 (Apr. 26, 2005) (with respect to Treas. Reg. §1.367(a)-3(c)).

5. Acquisitions by foreign pass-through entities

In the preamble to the Temporary Treasury Regulations, the Service and Treasury took specific notice of transactions pursuant to which shareholders or partners of DE transferred their shares or interests to a newly formed, publicly traded foreign entity that had elected, pursuant to Treasury Regulations Section 301.7701-3, to be treated as a partnership for U.S. federal income tax purposes. The Service and Treasury further noted that taxpayers may take the position that such transactions are not subject to Section 7874 because the foreign entity is not a corporation for U.S. federal income tax purposes, and requested comments regarding appropriate rules with respect to such structures. As discussed below, we believe that it is appropriate for the Service and Treasury to promulgate Treasury Regulations in this area, but that such Regulations should be narrowly tailored to fulfill the purposes of Section 7874.

We do not believe that Treasury Regulations should provide for the blanket application of Section 7874, mutatis mutandis, to the acquisition of DE by a foreign pass-through entity ("FP"). It is clear to us that not every situation in which FP directly or indirectly acquires substantially all of the properties constituting a trade or business of DE should, as a policy matter, be covered by Section 7874. For example, in the case where neither DE nor FP owns any foreign subsidiaries (and FP does not create any foreign subsidiaries as part of the plan), we do not believe that the mere acquisition of stock, interests or assets of DE by FP would implicate the concerns underlying Section 7874. U.S. partners in FP would continue to be subject to U.S. taxation on a flow-through, and hence current, basis in respect of dividends paid by a corporate DE, income earned by a pass-through DE, or income earned in respect of the assets of DE now directly owned by FP, as the case may be. Therefore, while we recognize (as discussed below) that certain transactions involving an FP acquiror may implicate some of the same concerns as the core inversion structure that Section 7874 addresses, we believe that any Treasury Regulations promulgated to address acquisitions by FP should be more narrowly aimed at acquisitions in which FP acquires foreign corporate subsidiaries from DE or FP sets up a foreign corporate subsidiary as part of the same plan.

To the extent, however, that FP has or acquires a foreign subsidiary, the acquisition of DE by FP could generally facilitate the removal of the foreign operations from the U.S. taxing jurisdiction in a similar manner to a "classic" corporate inversion. Indeed, transactions to change the status of DE's existing CFCs would generally be easier to accomplish in connection with an acquisition by FP than FC, as hook partnership interests could be created more easily than hook stock on a tax-deferred basis contemporaneously with the initial acquisition.[51] In addition, an FP-parented EAG could

[51] In the case of a corporate acquiror, DE might generally have to participate in the larger outbound § 351 transaction, contributing its shares of any CFCs in exchange for hook stock unless the hook stock transaction could be structured as a "B" reorganization. Provided DE entered into a gain recognition agreement regarding such shares and provided they were not disposed of in a taxable transaction within the succeeding 5 years, DE could "de-control" (and sell) those foreign corporations at no U.S. tax cost. On the other hand, in the case of an acquiror that was a pass-through entity, the contribution of the CFCs to such FP in exchange for a "hook partnership interest"

achieve earnings-stripping through loans to, and other transactions with, DE using a foreign sister corporation rather than a foreign parent.

We note that even in the basic case discussed in the previous paragraph, an acquisition of DE by FP would not have the same consequences as an acquisition by FC. Even if FP did not extract distributions from its foreign operating subsidiaries to make current distributions to its owners, former shareholders of DE might nonetheless incur current taxable income. For example, in order to pay its expenses, FP would generally require distributions from its operating subsidiaries that were in excess of any distributions it might in turn distribute to its shareholders. However, in the case of an individual investor, any deductions related to such expenses might be allowable only to the extent that they (along with any other miscellaneous itemized deductions for such shareholder) exceeded two percent of such shareholder's adjusted gross income.[52] We note, too, that if an acquisition by FP resulted in FP's owning directly a foreign corporate subsidiary that was a passive foreign investment company ("PFIC"), U.S. partners in FP, unlike U.S. shareholders in FC, would be subject to the PFIC rules.[53]

Despite these differences, we agree with the Service and Treasury that it is appropriate to address the FP structure described above as a policy matter. We do not think, however, that the relevant Treasury Regulations should treat FP as a U.S. corporation. This would seem unduly harsh as it would create a second level of U.S. tax that had not existed prior to the expatriation where DE is a pass-through entity. Moreover, this approach would seem to conflict with the check-the-box Treasury Regulations, which generally provide that a taxpayer may elect to treat certain foreign corporations as pass-through entities for U.S. federal income tax purposes.[54] We believe that the far better alternative is to treat FP as a U.S. partnership. This approach would seem to satisfy the purposes of Section 7874, as it would address the core problem (most of which arise from the avoidance of CFC status) without undesirable ancillary consequences.

We note that while a substantial majority of the Executive Committee believes that Section 7874(g) authorizes the promulgation of Treasury Regulations to address acquisitions of DE by an FP, this is not a universally held view.[55] The ad hoc

---

could occur, tax-free, at any time (though any recognition of § 704(c) gain by DE would not be limited to a 5 year period).

[52] I.R.C. § 67; Temp. Treas. Reg. § 1.67-2T(b).

[53] I.R.C. 1298(a)(3). *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS (May 2005), at 341 (subpart F and PFIC regimes achieve anti-deferral where a domestic parent owns foreign corporation).

[54] Treas. Reg. § 301.7701-3. *But see infra* TAN 59 and the related discussion.

[55] Section 7874(g)(1) provides the Secretary with the authority to "provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the

subcommittee charged with the preliminary consideration of this issue reached the opposite conclusion.[56] As a result, the Service and Treasury may wish to consider the authority question and possibly also to consider potential alternative sources of authority such as the stapled entity rules of Section 269B,[57] Section 7701(a)(4) and (5) (defining domestic and foreign, respectively),[58] the check-the-box Treasury Regulations[59] or legislation.

---

avoidance of the purposes of this section, including the avoidance of such purposes through the use of related persons, pass-through or other noncorporate entities, or other intermediaries." The language would appear to grant relatively broad regulatory authority to prevent avoidance purposes, including to provide adjustments to the application of § 7874, and we note that courts are typically deferential to the rule-making authority of the Service and Treasury. *See e.g., Nat'l Muffler Ass'n v. United States*, 440 U.S. 472 (1978) (upholding a Treas. Reg. promulgated under § 501(c)(6) where the Reg. narrowed the statutory language).

[56] The subcommittee was concerned that because § 7874 addresses two specific types of corporate inversion transactions, each of which results in the transfer of the stock or interests in, or substantially all the assets of, DE to a *foreign corporation* , applying § 7874 to acquisitions by FP would broaden, rather than "carry out" the statute. *Cf., e.g., Rowan Cos. v. United States*, 452 U.S. 247, 253 (invalidating FICA / FUTA Treas. Regs. based on their failure to implement the intent of the statute in a consistent and reasonable manner); *Rite Aid Corp. v. United States*, 255 F.3d 1357 (Fed. Cir. 2001) (invalidating the duplicated loss rule of consolidated return Treas. Reg. § 1.1502-20 on the grounds that it exceeded the statute's broadly delegated scope of authority).

[57] *See* I.R.C. § 269B(c)(1) (for purposes of determining whether two entities are stapled entities, the term "entity" means any corporation, partnership, trust, association, estate or other form of carrying on a business or activity).

[58] *See* JOINT COMMITTEE ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN 1997 (Dec. 1997), at 317 ("Under the Act, regulatory authority is granted to provide rules treating a partnership as a domestic or foreign partnership, where such treatment is more appropriate, without regard to where the partnership is created or organized. . . . The Congress intended that the general rule for classifying a partnership as domestic or foreign will continue to be the place where the partnership is created or organized (or the laws under which it is created or organized), and that the regulations will provide a different classification result only in unusual cases.").

[59] Treas. Reg. §§ 301.7701-1 – 301.7701-3. This seems particularly appropriate since the preamble to the Temp. Treas. Regs. suggests that the Service's and Treasury's primary concern is the acquisition of DE by a publicly traded foreign holding entity that has elected to be treated as a partnership for U.S. federal income tax purposes and that is not treated as a corporation pursuant to § 7704. T.D. 9238 (Dec. 27, 2005).

B. Other Section 7874 issues — direct or indirect acquisitions of DE

We also believe that it would be helpful for future Treasury Regulations to address the "real world" confusion as to whether both stock and asset acquisitions are addressed by Section 7874. Section 7874(a)(2)(B) refers to "the direct or indirect acquisition 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." We think it clear from the legislative history that both stock and direct asset acquisitions (and combinations thereof) are potentially subject to Section 7874.[60] We also think it clear that it is this distinction to which the term "direct or indirect" refers (direct being an asset acquisition and indirect being a stock or partnership interest (*i.e.*, an indirect asset) acquisition). Accordingly, we believe that Treasury Regulations should end any confusion by making explicit the simple point that for purposes of Section 7874(a)(2)(B), the "direct or indirect" acquisition of substantially all the properties of a domestic corporation or substantially all the properties constituting a trade or business of a domestic partnership applies both to acquisitions of stock or partnership interests, as the case may be, in DE and to acquisitions of assets from DE.

III. CONCLUSION

We commend the Service and Treasury for promulgating Temporary Treasury Regulations that appropriately liberalize the application of Section 7874 in the context of an EAG. However, we believe Treasury Regulations should provide that Section 1504(a)(4) stock is ignored for all purposes of those Treasury Regulations, and not merely for purposes of defining the EAG. In addition, we believe that further guidance regarding the application of Section 7874 is necessary. That guidance should provide, in particular, for (1) a facts and circumstances test, with a specific and administrable safe harbor, for determining substantial business activities, (2) the treatment of stock rights as not stock, except as otherwise provided by common law principles or where there is an avoidance purpose, (3) (A) the definition of public offering, including that, for such purposes, FC stock issued to shareholders of Old FC will not be treated as issued in a public offering and (B) the treatment of certain sizeable public offerings as not ancillary, and therefore not related, to the applicable acquisition (4) the coordination of Section 7874 and the provisions of Treasury Regulations Section 1.367-3(c) and (5) in the case of an acquisition of DE by FP where DE owns CFCs or the group sets up foreign corporations as part of the same plan with the acquisition, the treatment of FP as a domestic partnership. We also believe guidance is necessary and

---

[60] *See* H.R. CONF. REP. NO. 108-755, 108th Cong., 2d Sess., at 573 (Oct. 7, 2004) ("The first type of inversion is a transaction in which, pursuant to a plan or series of related transactions: (1) a U.S. corporation becomes a subsidiary of a foreign-incorporated entity or otherwise transfers substantially all of its properties to such an entity . . . . "); H.R. REP. NO. 108-548, pt. 1, at 243 (June 16, 2004) ("Inversion transactions may take different forms, including stock inversions, asset inversions, and various combinations of and variations on the two.").

appropriate to clarify that Section 7874 applies both to transactions structured as stock acquisitions and to transactions structured as asset acquisitions.