New York State Bar Association Tax Section

REPORT ON

SUBSTANTIAL BUSINESS ACTIVITIES TEST UNDER TEMPORARY SECTION 7874 REGULATIONS

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I. INTRODUCTION

This report[1] of the Tax Section of the New York State Bar Association sets forth comments on Temporary Treasury Regulations Section 1.7874-3T[2] (the "2012 Temporary Regulations"). The 2012 Temporary Regulations represent the latest attempt by the Treasury Department ("Treasury") at defining when a foreign corporation that would otherwise be a "surrogate foreign corporation" within the meaning of Section 7874[3] is not so treated because the expanded affiliated group ("EAG")[4] within which such foreign corporation is included is engaged in substantial business activities in the foreign corporation's country of organization (referred to in the 2012 Temporary Regulations and this report as the "relevant foreign country") relative to the EAG's total worldwide business activities (the "Substantial Business Activities Test").

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[2] T.D. 9592, I.R.B. 2012-28. The text of the 2012 Temporary Regulations also serves as the text of proposed regulations. Prop. Treas. Reg. § 1.7874-3.

[3] Except as otherwise specified, all "Section" references herein are to sections of the Internal Revenue Code of 1986, as amended (the "Code").

[4] The EAG is defined by reference to the affiliated group definition of Section 1504 but includes foreign corporations and applies a "more than 50 percent" ownership threshold rather than an "at least 80 percent" ownership threshold.

The report is divided into four parts. Part I is this Introduction. Part II describes the background of the 2012 Temporary Regulations and summarizes the provisions thereof, as well as prior reports of the Tax Section that addressed the Substantial Business Activities test. Part III is a summary of our recommendations. Part IV is a discussion of the issues and our recommendations.

II. BACKGROUND

Congress enacted Section 7874 in 2004 in order to combat perceived abuses associated with "inversion" transactions in which a domestic corporation is effectively expatriated by reincorporating in a foreign jurisdiction or by becoming a subsidiary of a foreign corporation, in each case without a substantial change in ownership. Section 7874(a) provides in relevant part that if, pursuant to a plan or a series of related transactions, (i) a foreign corporation ("FC") directly or indirectly acquires substantially all the properties held directly or indirectly by 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 of the stock (by vote or value) of FC is held by former shareholders or partners of the domestic entity ("DE") by reason of their former ownership of DE, and (iii) after the acquisition FC's EAG does not meet the Substantial Business Activities Test, the FC will be treated as a "surrogate foreign corporation" and any "inversion gain"[5] will be fully taxable from the date the acquisition begins until ten years after its completion, with only limited offset by losses or credits.[6] Section 7874(b) provides further that

[5] Section 7874(d)(2) defines "inversion gain" as income or gain recognized by DE during the "applicable period" from any property transfer (other than of inventory) or from a license of DE property, in each case either as part of DE's acquisition by FC, or afterwards if the transfer or license is to a "foreign related person."

[6] In addition, individuals who are "disqualified individuals" (in general, insiders) with respect to a corporation treated as an expatriated entity under Section 7874(a)(2) are subject to a surtax in respect of certain stock compensation. Section 4985.

if conditions (i) and (iii) above are met and at least 80 percent of the stock (by vote or value) of FC is held by former owners of DE by reason of such former ownership, the FC will be treated as a domestic corporation for federal tax purposes. The consequences described in Section 7874(a) and (b) do not apply, however, if the EAG satisfies the Substantial Business Activities Test.

The 2012 Temporary Regulations represent the third iteration in Treasury's efforts to delineate the requirements of the Substantial Business Activities Test. Temporary regulations issued in June 2006[7] (the "2006 Temporary Regulations") provided as a general rule that the determination of whether the Substantial Business Activities Test was satisfied was based on all relevant facts and circumstances.[8] The 2006 Temporary Regulations also provided a non-exclusive safe harbor, pursuant to which the Substantial Business Activities Test would be satisfied if at least 10 percent of the EAG's employees (by headcount and compensation) were based in the relevant foreign country, 10 percent of the EAG's tangible assets were located in such country, and 10 percent of the group's sales were made in such country.[9]

In June 2009, Treasury replaced the 2006 Temporary Regulations with a new set of temporary regulations[10] (the "2009 Temporary Regulations"). The 2009 Temporary Regulations eliminated the safe harbor provision of the 2006 Temporary Regulations, leaving the facts and circumstances test as the exclusive means of satisfying the Substantial Business Activities Test. The preamble to the 2009 Temporary Regulations stated by way of explanation

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[7] T.D. 9265, 2006-2 C.B. 1.

[8] Temp. Treas. Reg. § 1.7874-2T(d)(1) (2006).

[9] Temp. Treas. Reg. § 1.7874-2T(d)(2) (2006).

[10] T.D. 9453, I.R.B. 2009-28.

that "[t]he IRS and the Treasury Department have concluded that the safe harbor provided by the 2006 temporary regulations may apply to certain transactions that are inconsistent with the purposes of Section 7874, which is meant to prevent certain transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership)."[11] The 2009 Temporary Regulations also removed the examples in the 2006 Temporary Regulations that illustrated the general facts and circumstances test.

The 2012 Temporary Regulations take an approach diametrically opposed to that of the 2009 Temporary Regulations. This latest incarnation of the Substantial Business Activities Test eliminates the facts and circumstances test and replaces it with an exclusive bright-line test. The preamble to the 2012 Temporary Regulations explains that Treasury and the Internal Revenue Service (the "IRS") believe that a bright-line test provides greater certainty and is easer to administer than a facts and circumstances test.[12] As described in more detail in Part IV below, the new test requires that at least 25 percent of the EAG's employees, assets, and gross income be located in or derived from the relevant foreign country; gross income is treated for this purpose as derived from the country in which the customer is located.

The 2012 Temporary Regulations also change the rules governing income earned through partnerships. Under the 2009 Temporary Regulations, a member of an EAG that held a 10 percent or greater capital and profits interest in a partnership was required to take into account its proportionate share of the partnership's items for purposes of the Substantial Business Activities Test. The 2012 Temporary Regulations, in an attempt to achieve consistency with the treatment of corporations, provide that partnership items are taken into account only if one or

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[11] Id.

[12] T. D. 9592, I.R.B. 2012-28.

more members of the EAG own more than 50 percent by value of the interests in the partnership, in which case all the items of the partnership are taken into account.

This report also represents our third effort at addressing the Substantial Business Activities Test. Prior to the release of the 2006 Temporary Regulations, we submitted a report (the "2006 NYSBA Report") on Section 7874 that addressed, among other issues, the Substantial Business Activities Test.[13] We recommended a facts and circumstances test with a safe harbor that would apply a modified form of the 7.5 percent substantial trade or business test applied in the limitation on benefits clauses in many U.S. income tax treaties.

Following the issuance of the 2009 Temporary Regulations, we submitted a second report on Section 7874 (the "2010 NYSBA Report"). The 2010 NYSBA Report, while acknowledging that the safe harbor in the 2006 Temporary Regulations might have been too lenient, urged the restoration of a safe harbor alternative to the facts and circumstances test. We proposed that in the case of EAGs conducting less than 50 percent of their business activities in the United States (measured by assets and employee compensation), the safe harbor be restored with a threshold equal to the greater of 15 percent of the EAG's worldwide activities and 20 percent of the EAG's activities outside the United States. In the case of EAGs conducting 50 percent or more of their activities in the United States, we recommended a 25 percent threshold. We also recommended eliminating the gross sales component of the safe harbor test. Our rationale for proposing elimination of the sales component was that the place of sale does not necessarily reflect where an asset was produced or where it will be used, that a sales factor is

[13] New York State Bar Association Tax Section Report No. 1107, *Report on Temporary Treasury Regulations Section 1.7874-1T*, March 22, 2006.

generally inappropriate given the global nature of markets, and that the sales component is more prone to taxpayer manipulation than the employee and asset components.

III. SUMMARY OF RECOMMENDATIONS

As discussed in more detail below, our principal recommendations are as follows:

1. Consistent with our earlier reports, we continue to believe that a general facts and circumstances test, combined with a safe harbor, is preferable to an exclusive bright-line test. An alternative would be to have a bright-line test that, if failed, would create a presumption that the Substantial Business Activities Test is not satisfied, with an opportunity for the taxpayer to rebut the presumption based upon all the facts and circumstances. If the exclusive bright-line test approach of the 2012 Temporary Regulations is preserved, it should be modified so that the tests are clearly defined and companies that are clearly engaged in substantial business activities in the relevant foreign country can satisfy the test. Situations in which the EAG's activities are substantially concentrated in the relevant foreign country but more than 75 percent of the customers are located in other jurisdictions are particularly problematic. We recommend addressing this issue by revising the bright-line test so that it can be satisfied if the average of the three relevant factors is at least 25 percent and at least two (but not necessarily all three) of the factors individually meet the 25 percent threshold. A substantial minority of our Executive Committee, as an alternative to or in addition to this change, would revise the gross income test so that it focuses on the location of income-producing activities rather than on the location of customers.

2. Only active business income and assets and employees that produce active income should be taken into account for purposes of the tests. Under the 2012 Temporary

Regulations, it is unclear whether the same universe of activity is taken into account for the three tests.

3. In the case of an acquisition involving an unrelated third party, the applicable date for determining compliance with the tests should be the date on which there is a binding commitment to make the acquisition, rather than the acquisition date. The regulations should be clarified to provide that the constituent members of the EAG are determined as of the acquisition date and that items of group members that are disposed of prior to the acquisition date are excluded.

4. We approve of the general approach of the group employees test which looks to the country in which each employee spends more time than any other country, rather than basing the test on the percentage of working time of all employees that is spent in the relevant foreign country. The compensation component of the group employees test should provide more specific guidance as to when compensation expense is deemed to be incurred, especially in the case of deferred compensation.

5. At least in the case of highly mobile assets such as ships and aircraft, the group assets test should look solely to where assets are predominantly located during the one year testing period, rather than requiring presence in the relevant foreign country on the acquisition date. In addition, the eight-times annual rent valuation for leased assets should be modified to take into account the fact that different assets have different useful lives. Consideration should also be given to excluding certain assets such as servers that are owned and maintained by third parties.

6. We recommend that the test treating income as derived in the place where the customer is located generally be clarified to refer to the place of consumption, use or

disposition of the goods, services or products that are sold. In the case of a banking, financing, or similar business, income should instead be sourced under the principles applicable to determining whether income is effectively connected with a U.S. trade or business. In addition, the test should be based on gross receipts rather than gross income.

7. An argument can be made that the anti-abuse rules are inconsistent with the intent of the bright-line test to provide certainty. However, we believe that some sort of anti-abuse rule is appropriate in light of the fact that the statutory mandate is that substantial business activities take place in the relevant foreign country after the acquisition, while the bright-line tests are backward-looking. Accordingly, we recommend that the anti-abuse rule be limited to situations in which activities are moved outside the relevant foreign country after the acquisition pursuant to a plan in effect on the acquisition date with a principal purpose of avoiding the purposes of Section 7874, as opposed to situations in which they are moved into the relevant foreign country with such a purpose.

8. We agree with the 2012 Temporary Regulations' approach to inclusion of partnership items for purposes of the tests.

IV. DISCUSSION

A. General Approach of 2012 Temporary Regulations

We continue to believe that it is appropriate to have a general facts and circumstances test along with a safe harbor. A facts and circumstances test recognizes the difficulty of formulating rigid numerical tests that produce appropriate results in all (or even in substantially all) cases, while a safe harbor provides qualifying taxpayers with a high degree of certainty. A possible middle ground would be to provide bright-line tests that, if not met, would create a presumption that the Substantial Business Activities Test is not satisfied, but to give

taxpayers the right to rebut that presumption based upon all the facts and circumstances. We recognize, however, that a facts and circumstances test is difficult to apply in practice and that in any event taxpayers who do not qualify under a safe harbor will be reluctant to rely upon a facts and circumstances test except in obvious cases, especially where the former shareholders of the inverted domestic corporation end up owning 80 percent or more of the stock of the foreign corporation, which would be taxed as a domestic corporation if treated as a surrogate foreign corporation.

If, however, a bright-line test is to be the exclusive means of satisfying the Substantial Business Activities Test, we think that it is essential that the criteria be clearly defined and that inversion transactions involving companies that clearly engage in substantial business activities in the relevant foreign country under any reasonable interpretation of the term are able to satisfy the test. We believe that the 2012 Temporary Regulations have significant failings in this regard.

There are a number of fact patterns in which the Substantial Business Activities Test under the 2012 Temporary Regulations would not be satisfied despite what clearly appear to be substantial business activities in the relevant foreign country. The common thread of these situations is failure to satisfy the gross income test, which under the 2012 Temporary Regulations is based upon the location of customers as opposed to the location of the EAG's income-producing activities.[14]

Consider the following simple example:

> Example 1: Domestic corporation P reincorporates in foreign Country X. P and its EAG are engaged in a manufacturing business. All of the EAG's employees and

[14] The gross income test is discussed in more detail at IV.F. below.

> all of its property, as well as all of its manufacturing activity, are located in Country X, but more than 75 percent of its sales are to customers outside Country X.

P, a corporation subject to U.S. tax solely as a result of its U.S. domicile, would fail the Substantial Business Activities Test under the 2012 Temporary Regulations because it does not satisfy the 25 percent gross income test. Based on the statutory language, given that everything that P and its EAG do is done in Country X, it is hard to see how their business activities in that country are not substantial. It might be possible in some cases to argue that since substantially all of the EAG's customers are located outside of Country X, there is no particular reason for it to conduct its manufacturing activities in that jurisdiction. However, we think that the more straightforward reading of the statutory language is that the relevant inquiry should focus on what activities are conducted in the jurisdiction, rather than why they are conducted there. Otherwise, in situations where customers are dispersed throughout the world, it could be argued that there is no reason to locate business activities in any particular jurisdiction.[15]

Similar issues are raised by situations involving the exploitation of intangible property:

> Example 2: Domestic corporation Q reincorporates in foreign Country Y. Q and its EAG develop intangible property and license it to third party customers, more than 75 percent (in terms of revenue) of which are located outside Country Y, in exchange for royalties. All of the EAG's employees (including its marketing staff) and tangible assets are located in, and all the research and development activities are conducted in, Country Y.

[15] In the case of businesses such as mining and oil and gas exploration, it would be implausible to argue that there is no reason to locate the business activities in a location other than the customers' location.

As in Example 1, Q would fail the Substantial Business Activities Test under the 2012 Temporary Regulations. Example 2 arguably presents a somewhat less clear case for satisfying the Substantial Activities Test than does Example 1, because Q has a continuing interest in its intangible property which is being used outside Country Y. We nevertheless believe that the Substantial Business Activities Test should be viewed as satisfied based on the location of the EAG's employees and tangible assets and the fact that all its income results from activities conducted in Country Y.

Service businesses also have the potential for geographical separation of business activities and customers:

> Example 3: Domestic corporation R reincorporates in foreign Country Z. R and its EAG are engaged in a service business. All of the EAG's employees are located in and work in Country Z, but more than 75 percent of its customers are located outside Country Z.

Most countries, including the United States, source service income to where the services are performed and assert taxing jurisdiction on this basis even in the case of a nonresident.[16] Under the gross income test of the 2012 Temporary Regulations, however, income is considered to be derived in the relevant foreign country if and only if it is generated from customers of the EAG in that country.

Although a majority of our members agree that customer location is the appropriate factor for purposes of the Substantial Business Activities Test and should be the sole criterion for the gross income test, they do not believe that the failure to satisfy the 25 percent threshold of each of the three tests should disqualify all inversions, in particular those similar to the transactions described in the preceding examples (each of which involve highly concentrated

[16] If the nonresident is entitled to claim the benefit of a treaty, taxing jurisdiction would also depend upon whether the nonresident has a permanent establishment in the country.

activities of the EAG within the relevant foreign country). A substantial minority of our members would address this issue either by eliminating the gross income test entirely or by revising it to focus on the location of the income-producing activity (possibly by reference to the source of income rules of Sections 861 to 863) rather than the location of the customers. Accordingly, we recommend that rather than requiring the EAG to satisfy the 25 percent threshold of all three tests, final regulations should require that the EAG satisfy the 25 percent threshold of at least two of the three tests and that the average threshold of all three tests equals or exceeds 25 percent.

We also considered whether issues with the bright-line test of the 2012 Temporary Regulations could be addressed by lowering the 25 percent threshold. We believe that although any threshold percentage is inherently arbitrary to some extent, 25 percent is a reasonable measure of substantiality.

The remainder of our discussion assumes that final regulations will retain an exclusive bright-line test subject to the foregoing modification (or some other alternative that would allow inversions similar to those described in the preceding examples) and focuses on how to make them work more effectively and equitably.

B. Assets, Employees and Income Taken into Account

Under the 2012 Temporary Regulations, assets are taken into account only if they are used or held for use in the active conduct of a trade or business by members of the EAG.[17] By contrast, it appears that all employees, regardless of whether they are involved in an active business, are taken into account,[18] while gross income is taken into account if and only if it arises

[17] Temp. Treas. Reg. § 1.7874-3T(d)(5).

[18] Temp. Treas. Reg. § 1.7874-3T(d)(6).

from "transactions occurring in the ordinary course of business with customers that are not related persons."[19] The purpose of these distinctions is unclear.

We recommend a consistent approach in which only active (as opposed to passive) income, and employees and assets engaged or used in activities that produce active income, are taken into account.[20] It would also be appropriate to exclude gain from the sale of capital assets and Section 1231 property, since such gain is not "ordinary course" income. This would be consistent with the statutory language that refers to the substantiality of "business activities" of the EAG within the relevant foreign country relative to the worldwide business activities of the EAG.[21] The definition of "passive income" in the passive foreign investment company rules[22] would be appropriate in this context to distinguish between active and passive income with determinations being made taking into account the activities of the entire EAG rather than looking at activities on an entity-by-entity basis.[23]

We recognize that this could result in an EAG with primarily passive income but a small active business being able to satisfy the Substantial Business Activities Test if a

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[19] Temp. Treas. Reg. § 1.7874-3T(d)(7). It is not clear what types of transactions are considered to be with "customers" in this context and whether there is an intent to limit the type of income taken into account. Section 1221(a)(1) refers to "customers" in defining ordinary income property held for sale in the ordinary course of business, and Treas. Reg. § 1.864-2(c)(2)(iv) refers to sales to customers in the context of defining "dealers" in stocks or securities.

[20] Employees who are engaged in activities that produce both active and passive income could be taken into account based on their primary responsibilities or the portion of their compensation allocable to active business activities using the principles of Treas. Reg. § 1.861-8. If this recommendation is adopted, consideration should be given to providing guidance on the treatment of headquarters employees, including employees responsible for cash management and other treasury functions of EAGs that are primarily engaged in active businesses.

[21] Section 7874(a)(2)(B)(iii).

[22] Section 1297(b).

[23] We made a similar recommendation in the context of the passive foreign investment company rules. New York State Bar Association Tax Section Report No. 1207, *Report Commenting on Select Issues with Respect to the Passive Foreign Investment Company Rules*, March 8, 2010.

sufficient portion of the active business activity is conducted in the relevant foreign country. This anomaly appears to be a consequence of the statutory language, although there is a reasonable policy argument that corporations that, following inversion, are passive foreign investment companies should be disqualified *per se* from meeting the Substantial Business Activities Test on the basis that they do not engage in substantial active business activities anywhere.

C. Testing Dates

The tests required by the 2012 Temporary Regulations are applied as of the "applicable date" in the case of the number of employees and the location of tangible property, and based on the "testing period" in the case of employee compensation and group income. The applicable date is, at the company's option (which must be consistently applied) the date on which the acquisition giving rise to the inversion is completed or the last day of the month immediately preceding the acquisition date.[24] The testing period is the one year period ending on the acquisition date.[25]

In contrast to the statutory language, which looks to the EAG's activities after the acquisition, the applicable date and testing period under the 2012 Temporary Regulations look backward in time. We recognize that this retrospective approach is necessary to provide certainty to taxpayers at the time of the acquisition on whether the inversion transaction in question satisfies the bright-line test.[26] We believe that final regulations should be clarified, however, to provide that the constituent members of the EAG are determined as of the

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[24] Temp. Treas. Reg. § 1.7874-3T(d)(2).

[25] Temp. Treas. Reg. § 1.7874-3T(d)(1).

[26] In extreme cases involving diminished activity in the relevant foreign country following the acquisition, the anti-abuse rule of Treas. Reg. § 1.7874-3T(c), discussed at IV.G. below, can be applied.

acquisition date and therefore include both the inverted domestic corporation and the acquiring foreign corporation, while excluding group members that are disposed of (or substantially all the assets of which are disposed of) prior to the acquisition.

We also recommend that final regulations change the applicable date determination to reference the date of a binding agreement to make the acquisition in the case of a transaction involving an unrelated third party.[27] Absent a binding commitment rule, the applicable date definition is potentially especially problematic in cases involving two-step acquisitions, where a tender offer by a foreign corporation for stock of a domestic corporation is followed by a second step merger. Although closing of acquisitions in some cases can be conditioned on the Substantial Business Activities Test being satisfied if avoiding surrogate foreign corporate status is important to the parties, in a two-step acquisition where the applicable date follows the first stage acquisition and the facts have changed it may be too late as a practical matter for the parties to unwind the transaction.

D. Group Employees Test

Under the 2012 Temporary Regulations, the group employees test is satisfied if at least 25 percent of the EAG's employees are based in the foreign country of organization on the applicable date and at least 25 percent of total employee compensation incurred during the one year testing period is incurred with respect to employees based in the foreign country.[28]

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[27] The recommended approach for transactions involving unrelated parties is analogous to the approach of the "signing date rule" under the continuity-of-interest regulations in the context of corporate reorganizations. *See* Treas. Reg. § 1.368-1(e)(2). A binding commitment approach would not be appropriate in the case of a transaction such as a reincorporation effected through a reverse subsidiary merger that does not involve unrelated parties.

[28] Temp. Treas. Reg. § 1.7874-3T(b)(1).

An employee is treated as based in the relevant foreign country if he or she spent more time providing services in that country than in any other country during the testing period. In some cases, this can subvert the purpose of the group employee test:

> Example 4: Each of 25% of the EAG's employees spends less than half of his or her working time (but more time than is spent in any other country) in the relevant foreign country. None of the other employees spend any time working in the relevant foreign country. The two groups of employees have the same average compensation.

The EAG in Example 4 would satisfy the group employees test even though substantially less than 25 percent of total employee time is spent working in the relevant foreign country.

An alternative approach would be to base the test on the percentage of each employee's time spent working in the relevant foreign country, so that an employee a third of whose time during the testing period was spent working in such country would be treated as a third of a "good" employee, regardless of the amount of time worked in any other particular country. Although this alternative approach arguably is more clearly reflective of where activities are actually taking place, on balance we prefer the approach taken in the 2012 Temporary Regulations because of its relative simplicity. Even the anomalous result in Example 4 is mitigated somewhat by the fact that the 25 percent threshold is fairly high to begin with, so that there generally will still be a reasonably significant amount of time spent working in the relevant foreign country. We do suggest, however, that the final regulations clarify that time spent working in international waters, international airspace, or outer space should be ignored entirely.

The application of the compensation element of the employees test poses additional issues. The rules should be clarified to specify that compensation is deemed to be

incurred in the period in which it is deductible by the employer under U.S. tax accounting principles. It is not clear when nonqualified deferred compensation is considered to be "incurred" for purposes of the test.[29] The simplest approach would be to treat such compensation as incurred when it would be deductible for U.S. federal income tax purposes, thus avoiding more complicated inquiries into the time of economic accrual.

There is also potential for distortion in applying the compensation element when the testing period straddles two taxable years. One possible solution would be to provide that year-end bonuses and similar periodic compensation are prorated over the taxable year, although this could result in compliance with the test not being determinable until after the inversion has taken place.[30] Another approach would be to redefine the "applicable date" (or possibly just the testing period) so that the testing period is always a full taxable year.

Finally, it may be appropriate to include independent contractors in the test at least in some circumstances, especially in businesses such as oil and gas exploration and drilling and trucking, where most of the workforce consists of independent contractors. It seems counterintuitive that a business engaged in drilling in the ground or delivering goods by road in the relevant foreign country would not be permitted to take the personnel performing such activities into account in determining whether it has substantial business activities in such country. A possible approach would be to include only those independent contractors who perform core functions of the business. In any event, the term "employee" should be defined to

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[29] Temp. Treas. Reg. § 1.7874-3T(d)(3) expressly provides that all forms of compensation, including deferred compensation, employee benefits, and employer payroll taxes, are taken into account, but the 2012 Temporary Regulations do not provide specific timing rules.

[30] For example, if a calendar year taxpayer is "inverted" on June 30, year-end bonuses might not be known until as late as March 15 of the following year.

include any persons treated as employees under applicable local law, as well as any persons treated as employees under U.S. tax principles.

E. Group Assets Test

Under the 2012 Temporary Regulations, for purposes of the group assets test, an asset is treated as located in the relevant foreign country only if it was physically present in such country on the acquisition date and was physically present in such country for more time than in any other country during the testing period.[31] Assets can be valued at either their adjusted tax basis or fair market value. Property leased from unrelated parties is valued at eight times the annual rent.

The group assets test is problematic in the case of highly mobile assets, such as aircraft and vessels. We believe that the requirement that such assets be located in the foreign country on the acquisition date is unrealistic.[32] It would be more appropriate to base the location of such assets solely on the basis of the country in which it spends more time than any other country during the testing period. An alternative approach for assets used in international transportation activities would be to apply a proportionate approach based on the source of the income produced from use of the assets during the testing period using the principles of Section 863(c).[33] With respect to satellites and other assets used in outer space, it would be appropriate to either ignore the assets altogether or look to the place on earth from which they

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[31] Temp. Treas. Reg. § 1.7874-3T(d)(5).

[32] On a more detailed level, it is unclear why this rule refers to the "acquisition date" rather than the "applicable date."

[33] Section 863(c) looks to the places in which transportation begins and ends.

are controlled.[34] In the case of assets such as offshore drilling rigs which are located exclusively in international waters, on the other hand, there is a case to be made for treating the asset as located outside the relevant foreign country. Although those types of questions appear to be very narrowly focused, they are important in the context of an exclusive bright-line test that precludes applying "common sense" on a case-by-case basis.

The eight-times annual rent valuation rule for leased assets is presumably meant to be a simple rule of thumb. However, applying the same multiple to all tangible assets is potentially distortive, with the possibility of unfair treatment of or manipulation by taxpayers. For example, it would be appropriate to use a substantially higher multiple for a building than for a computer. One possibility would be to base multiples on MACRS depreciation lives.

Consideration should also be given to excluding from the test certain assets such as servers that are owned and maintained by third parties. This issue is particularly important in the case of start-up technology companies that are heavily reliant on third party cloud service providers. The ability of such a company to satisfy the Substantial Business Activities Test should not depend on where servers owned by third parties are located or whether the servers are viewed as leased by the company or merely being used by the third party to provide a service to the company.

F. Group Income Test

Under the 2012 Temporary Regulations, group income is defined as gross income of members of the EAG from transactions occurring in the ordinary course of business with

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[34] Looking to the place of launch would not be appropriate since launching is a one-time activity typically carried out through independent contractors. Reference to the sourcing rules of Section 863(d) for space and ocean activities would produce inappropriate results, since those rules are based on residence.

customers that are not related persons.[35] Group income is treated as derived in the relevant foreign country only if it is derived from a transaction with a customer located in such country.[36]

Basing the location of income on the location of the customer is in many cases difficult to apply in the absence of further elaboration on where a customer is deemed to be located. This is especially true in the case of services rendered and intangible property licensed to multinational enterprises, where it is unclear where the "customer" is located. A clearer formulation of the test would treat income as derived in the relevant foreign country if the services, goods, or other property are sold for use, consumption or disposition within such country. This would be consistent with the rules applicable to foreign base company sales income under subpart F,[37] as well as the safe harbor test under the 2006 Temporary Regulations.[38] Further guidance as to how to make this determination in certain circumstances would be helpful. For example, where services provided to a multinational corporation relate to its worldwide operations, taxpayers should be permitted to use a reasonable methodology, consistently applied, such as one based on the customer's revenues to determine the extent to which the services are used in the relevant foreign country.

In the case of a banking, financing or similar business, treating income as derived in the place of use, consumption or disposition appears to be impractical. For example, if an investment bank earns income from underwriting bonds, it is unclear whether the relevant customer is the issuer or the purchasers of the bonds, and, if the latter, it may be impossible to

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[35] Temp. Treas. Reg. § 1.7874-3T(d)(7).

[36] Id.

[37] Section 954(d)(1)(B).

[38] Temp. Treas. Reg. § 1.7874-2T(d)(3)(iii) (2006).

determine the location of the purchasers. In order to provide a clearer test, we recommend that the determination of whether income of a banking, financing or similar business is attributed to the relevant foreign country should be based on the rules governing the determination of whether income from such business is effectively connected with the conduct of a U.S. trade or business,[39] substituting the relevant foreign country for the United States. We believe this will provide a more appropriate benchmark for determining the location of the income-producing activity of these businesses.

We also recommend that the group income test be revised so that it is based on gross receipts rather than gross income. The primary difference between gross income and gross receipts or sales is that gross income from sales of tangible property is reduced by the cost of goods sold.[40] Use of a gross receipts rather than a gross income test would avoid anomalies posed by sales that produce no or negative gross income because revenues do not exceed costs of goods sold, as well as the potential impact of different inventory accounting methods on the test. A gross receipts test also avoids the difficulties inherent in the need to ignore intra-group transactions. Under a gross income test that looks solely to income derived from transactions with parties outside the group, the group's gross income will be reduced if there are intermediate transactions within the group,[41] absent a complicated rule requiring redetermination of gross income as if the group were a single entity. This recommendation is consistent with the

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[39] Treas. Reg. § 1.864-4(c)(5).

[40] Treas. Reg. § 1.61-3(a).

[41] For example, if EAG member A sells goods with a cost of $100 to EAG member B for $150, and B sells the goods outside the group for $200, the EAG would only have gross income from unrelated party sales of $50; if A sold the goods directly outside the group for $200, there would be gross income of $100. In both cases, the gross receipts from unrelated sales would be $200.

provision in the 2006 Temporary Regulations which based the analogous safe harbor test on sales rather than gross income.[42]

G. Anti-Abuse Rules

The 2012 Temporary Regulations contain a three-part anti-abuse rule that excludes certain items from the numerator, but not from the denominator, for purposes of the group employees, group assets, and group income tests.[43]

The first component of this anti-abuse rule, which disregards assets, employees and income attributable to business activities that are associated with properties or employees the transfer of which is disregarded under Section 7874(c)(4),[44] seems appropriate since the underlying business is generally disregarded in applying the inversion rules.[45] However, consistency requires that these items be excluded from the denominator as well as the numerator.

The second and third components of the anti-abuse rule disregard (i) group assets, employees and income located or derived in the relevant foreign country as part of a plan with a principal purpose of avoiding the purposes of Section 7874, and (ii) items located or derived in the relevant foreign country if there is a subsequent transfer of the assets, employees or business activities outside such country in connection with a plan in effect on the acquisition date.[46]

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[42] Temp. Treas. Reg. § 1.7874-2T(d)(3)(iii)(2006).

[43] Temp. Treas. Reg. § 1.7874-3T(c).

[44] Temp. Treas. Reg. § 1.7874-3T(c)(1).

[45] Section 7874 provides that the transfer of properties or liabilities is to be disregarded if the transfer is part of a plan a principal purpose of which is to avoid Section 7874. The primary purpose of Section 7874(c)(4) appears to be preventing avoidance of the 60 percent and 80 percent ownership tests.

[46] Temp. Treas. Reg. § 1.7874-3T(c)(2), (3).

It can be argued that the second and third components of the anti-abuse rule should be eliminated. These provisions rely on inherently subjective determinations and have the potential to detract from the relative certainty provided by a bright-line test.

Rather than eliminating both the second and third components, however, we believe that it would be preferable to retain only the third component. This is appropriate in light of the statutory mandate that there be substantial business activities in the relevant foreign country following the inversion, whereas the bright-line tests are backward looking.

H. Treatment of Partnerships

The 2012 Temporary Regulations require taking into account all items of partnerships in which one or more EAG members own a greater than 50 percent interest, and otherwise ignore items of partnerships in which EAG group members own interests. We endorse the 2012 Temporary Regulations' treatment of partnerships in which EAG members own interests in a manner similar to corporations for purposes of determining whether to take partnership items into account in applying the bright-line tests.[47] Given the ability under the check-the-box regulations to freely choose between corporate and partnership classification, which in many cases will have no effect independent of Section 7874, we believe that inconsistent treatment would lead to an undesirable potential for abuse.

[47] Temp. Treas. Reg. § 1.7874-3T(e).