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Report No. 1477
June 2, 2023

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Re: Report No. 1477 - Report on Select Issues with Respect to Section 7874 and Partnerships

Dear Ms. Batchelder and Messrs. Werfel and Paul:

I am pleased to submit Report No. 1477 of the Tax Section of the New York State Bar Association, discussing select issues with respect to Section 7874 of the Internal Revenue Code and partnerships.

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

Respectfully submitted,

Philip Wagman
Chair


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**Report No. 1477**

**New York State Bar Association Tax Section**

# REPORT ON SELECT ISSUES WITH RESPECT TO SECTION 7874 AND PARTNERSHIPS

**June 2, 2023**

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# Report on Select Issues with respect to Section 7874 and Partnerships[1]

## I. Introduction

This report (the "**Report**") analyzes recent legislative and administrative proposals and select issues under current law with respect to Section[2] 7874 and partnerships.[3] Part II summarizes our recommendations for a legislative change Congress should make regarding the application of Section 7874 to partnership inversions[4] and amendments Treasury and the IRS should make to the Section 7874 regulations with respect to the treatment of partnerships. Part III provides background on Section 7874 and explores the potential reasons that motivated Congress to apply Section 7874 to partnership inversions. Part IV discusses recent legislative proposals to expand the scope of partnership inversions and a recommended alternative to those proposals. Part V describes current issues with respect to the treatment of partnerships for purposes of Section 7874 and sets forth recommendations for guidance on those issues.

## II. Summary of Recommendations

1. Instead of incorporating the partnership-related revisions to Section 7874 proposed in the Senate Draft of the Build Back Better Act and the FY24 Green Book, Congress should amend the statute to exclude domestic partnerships from the purview of Section 7874 and use targeted anti-base erosion measures to the extent existing measures are viewed as insufficient to address concerns regarding the foreign incorporation of partnership property.

2. Treasury and the IRS should clarify that (A) the Partnership Indirect Acquisition Rule does not apply for purposes of determining whether a domestic partnership is engaged in a trade or business, and (B) a trade or business of a lower-tier partnership is not otherwise attributed to an upper-tier partnership for purposes of determining whether the upper-tier partnership is engaged in a trade or business.

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[1] The principal authors of this Report are Stephen Massed, Gary Scanlon, Ian Simmons, and Wade Sutton, with substantial contributions by Adam Coulson. This Report reflects comments and contributions from Kimberly Blanchard, Robert Cassanos, Peter Connors, Jiyeon Lee-Lim, William McRae, Richard Nugent, Michael Schler and Philip Wagman. This Report reflects solely the views of the Tax Section of the New York State Bar Association ("**NYSBA**") and not those of NYSBA's Executive Committee or its House of Delegates.

[2] Any reference to "**Section**" in this Report is a reference to a section of the Internal Revenue Code of 1986, as amended (the "**Code**"), and any reference to "**Treas. Reg. §**" is a reference to a section of the regulations promulgated thereunder (the "**regulations**") by the U.S. Department of the Treasury ("**Treasury**") and the Internal Revenue Service ("**IRS**").

[3] Any reference to a "**partnership**" in this Report is a reference to an entity classified as a partnership for U.S. federal ("**Federal**") income tax purposes.

[4] "**Partnership inversion**," as well as terms used in Parts and I and II of this Report are defined below in Parts III through V.

3. Treasury and the IRS should amend the Section 7874 regulations to provide that:

    (i) the determination of whether an item of property constitutes a trade or business is based on all the facts and circumstances;

    (ii) an item of property generally constitutes a trade or business if it is: (A) held for the principal purpose of promoting the present conduct of the trade or business, (B) acquired and held in the ordinary course of the trade or business, or (C) otherwise held in a direct relationship to the trade or business; and

    (iii) property is held in a direct relationship to a trade or business if it is held to meet the present needs of the business, not its anticipated future needs (*i.e.*, property is not held in a direct relationship to a trade or business if it is held for future diversification into a new trade or business, a future expansion of a trade or business, or future business contingencies).

4. Treasury and the IRS should clarify that the Partnership Look-Through Rule applies to determine the EAG for purposes of the EAG Rules.

5. Treasury and the IRS should amend the EAG Rules to include the Deemed Corporation Rule.

6. Treasury and the IRS should amend the Partnership Incorporation Rule such that, in the case of a partnership incorporation, the amount of "by reason of" stock is limited to the foreign acquiring corporation stock received in exchange for the trade or business assets transferred by the domestic partnership to the foreign corporation.

7. Treasury and the IRS should clarify that the Distribution Rights Condition of the Substantially Similar Interest Rule is not satisfied unless each of the following two requirements is satisfied:

    (i) the holders of interests in an entity exchange their original interests either for interests in another entity or new interests in the same entity that have distribution rights that differ from the distribution rights with respect to the original interests, or the distribution rights with respect to the original interests are otherwise modified, including by reason of a legal or contractual arrangement between the holders of the original interests and the foreign corporation; and

    (ii) after any such exchange or modification, the terms of the interest itself, or any other legal or contractual arrangement that affects the distribution rights with respect to the interest, provide the holder distribution rights that are tied to or derivative of, and are substantially similar in all material respects to, the distribution rights provided by stock in the foreign corporation.

8. Treasury and the IRS should clarify that the Distribution Rights Condition of the Substantially Similar Interest Rule is not satisfied merely because the terms of the stock in a foreign corporation provide distribution rights that are similar in all material respects to those provided by interests in another entity.

9. Treasury and the IRS should clarify that the Substantially Similar Interest Rule does not apply for purposes of the Acquisition Requirement unless:

    (i) the holder is entitled to exchange the interest for stock in the foreign corporation or a related person;

    (ii) the holder is otherwise entitled to compel the foreign corporation or a related person to acquire or redeem the interest;

    (iii) the foreign corporation or a related person has the right to acquire or redeem the interest; or

    (iv) the interest is part of a plan or series of related transactions that provides the foreign corporation or a related person with the benefits and burdens of substantially all of a domestic corporation's properties or substantially all the properties constituting a domestic partnership's trade or business.

10. Treasury and the IRS should revise the Five Percent Owner Condition of the De Minimis Exception to provide that either: (i) ownership is determined based on direct or indirect ownership, like the Loss of Control Exception; or (ii) the proscribed level of ownership is presumed not to exist unless a member of the EAG knows, or has reason to know, such ownership exists. If, however, Treasury and the IRS determine that the Five Percent Owner Condition must include constructive ownership rules, the condition should be revised to provide that either: (y) Section 318(a) applies without regard to downward attribution; or (z) Section 318(a)(2)(A) applies only with respect to a partner that has a meaningful interest in the partnership (*e.g.*, 20 percent).

11. Treasury and the IRS should clarify that a distribution by a domestic entity of "by reason of" stock is not a "distribution" for purposes of the NOCD Rules.

12. Treasury and the IRS should exclude from the definition of a "distribution" for purposes of the NOCD Rules a distribution by a domestic entity of any consideration other than "by reason of" stock received in a domestic entity acquisition, unless the domestic entity directly or indirectly provides such property within the meaning of Treas. Reg. § 1.7874-10(k)(1)(iii).

## III. Background

### A. In General

Section 7874 applies with respect to the acquisition of the properties of a domestic corporation or a domestic partnership by a foreign corporation (a "**foreign acquiring corporation**") if, by reason of the acquisition, the foreign acquiring corporation is a surrogate foreign corporation with respect to the domestic corporation or the domestic partnership.[5] A foreign acquiring corporation is a surrogate foreign corporation with respect to a domestic

[5] *See* Section 7874(a).

corporation (a "**corporate inversion**") or a domestic partnership (a "**partnership inversion**") if, pursuant to a plan or a series of related transactions:

(i) the foreign acquiring corporation directly or indirectly acquires substantially all of either (a) the properties directly or indirectly held by the domestic corporation, or (b) the properties constituting a trade or business of the domestic partnership (such corporation or such partnership, each a "**domestic entity**," such acquisition, a "**domestic entity acquisition**," and such requirement the "**Acquisition Requirement**");[6]

(ii) after the domestic entity acquisition, at least 60 percent of the stock in the foreign acquiring corporation, as measured by vote or value, is held by the former shareholders of the domestic corporation (each, a "**former domestic entity shareholder**")[7] or the former partners of the domestic partnership (each, a "**former domestic entity partner**")[8] by reason of holding their stock in the domestic corporation or interests in the domestic partnership (such foreign acquiring corporation stock, "**'by reason of' stock**," such percentage, the "**ownership percentage**," or, if expressed as a fraction, the "**ownership fraction**," and such requirement, the "**Ownership Requirement**");[9] and

(iii) as of the date the domestic entity acquisition and all transactions related to the domestic entity acquisition are complete (the "**completion date**"),[10] the expanded affiliated group ("**EAG**")[11] does not have substantial business activities in the foreign country in which, or under the laws of which, the foreign acquiring corporation is organized when compared to the EAG's total business activities (the "**Lack of Substantial Business Activities Requirement**").[12]

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[6] Section 7874(a)(2)(B)(i).

[7] *See* Treas. Reg. § 1.7874-12(a)(13) (defining a "former domestic entity shareholder" as any person that holds stock in a domestic entity that is a corporation before the domestic entity acquisition, including any person that holds stock in the domestic entity both before and after the acquisition).

[8] *See* Treas. Reg. § 1.7874-12(a)(12) (defining a "former domestic entity partner" as any person that holds interests in a domestic entity that is a partnership before the domestic entity acquisition, including any person that holds interests in the domestic entity both before and after the acquisition).

[9] Section 7874(a)(2)(B)(ii).

[10] *See* Treas. Reg. § 1.7874-12(a)(3) (defining the "completion date," with respect to a domestic entity acquisition, as the date that the acquisition and all transactions related to the acquisition are complete).

[11] An EAG is, with respect to a domestic entity acquisition, an affiliated group as defined in Section 1504(a), determined without regard to Section 1504(b)(3) and applying Section 1504(a) by substituting "more than 50 percent" for "at least 80 percent" each place it appears, that includes the foreign acquiring corporation. Section 7874(c)(1); Treas. Reg. § 1.7874-12(a)(7). An EAG is generally determined as of the completion date. Treas. Reg. § 1.7874-12(a)(7); *but see* Treas. Reg. § 1.7874-1(c)(2)(iii) (discussed *infra* footnote 105 and accompanying text).

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

Except as provided in regulations, the Ownership Requirement is applied to the acquisition of a trade or business of a domestic partnership by treating all commonly controlled partnerships (within the meaning of Section 482) as one partnership.[13]

If the Acquisition Requirement, the Ownership Requirement, and the Lack of Substantial Business Activities Requirement are all satisfied with respect to a domestic entity acquisition, Section 7874 applies by reason of the acquisition. However, the Federal income tax consequences of the application of Section 7874 depend on whether the ownership percentage after the domestic entity acquisition is less than 80 percent or at least 80 percent.

If the ownership percentage is less than 80 percent (a "**60-percent inversion**"), the foreign acquiring corporation is a surrogate foreign corporation with respect to the domestic entity, and the domestic entity and any U.S. person related (within the meaning of Section 267(b) or 707(b)) to the domestic entity is an "**expatriated entity**."[14] The taxable income of an expatriated entity for any taxable year that includes a portion of the applicable period[15] cannot be less than its inversion gain for such year.[16] In general, the "**inversion gain**" of an expatriated entity is the income or gain recognized by reason of any transfer during the applicable period of stock or other properties by the entity (directly or indirectly), and any income received or accrued during the applicable period by reason of a license of any property by the entity (directly or indirectly), either as part of the domestic entity acquisition, or after the domestic entity acquisition if the transfer or license is to a foreign related person.[17] A 60-percent inversion may also result in other adverse Federal income tax consequences to an expatriated entity or the shareholders of a surrogate foreign corporation.[18]

If an expatriated entity is a domestic partnership, the inversion gain regime applies at the partner level, not the partnership level.[19] A partner's inversion gain for a taxable year is equal to

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[13] Section 7874(c)(5). No regulations have been issued under Section 7874(c)(5).

[14] Section 7874(a)(2); *see also* Treas. Reg. § 1.7874-12(a)(8) (providing that an entity is an expatriated entity if it is related to the domestic entity "on any date on or after the completion date").

[15] The "**applicable period**" is the period that begins on the first date on which the properties of a domestic entity are acquired in a domestic entity acquisition and ends on the date that is ten years after the last date on which the properties of the domestic entity are acquired as part of the acquisition. Section 7874(d)(1); Treas. Reg. § 1.7874-12(a)(2).

[16] Section 7874(a)(1).

[17] Section 7874(d)(2) and Treas. Reg. § 1.7874-11(b)(1). However, the transfer or license of inventory, within the meaning of Section 1221(a)(1), of an expatriated entity to a foreign related person after the domestic entity acquisition does not give rise to inversion gain. Section 7874(d)(2) (flush language) and Treas. Reg. § 1.7874-11(b)(2). An expatriated entity is not allowed to use credits, other than the foreign tax credit under Section 901, against its Federal income tax liability for any taxable year that includes a portion of the applicable period, unless the amount of such liability exceeds the product of the inversion gain of the entity for such taxable year *multiplied by* the highest Federal corporate income tax rate. Section 7874(e)(1). For purposes of determining the foreign tax credit allowed under Section 901, inversion gain is treated as from sources within the United States. *Id.* (flush language). Also, the inversion gain of an expatriated entity cannot be offset by net operating losses under Section 172. Section 7874(e)(3) (cross-referencing the rules of Section 860E(a)(3) and (4)).

[18] *See, e.g.*, Sections 1(h)(11)(C)(iii)(II), 59A(d)(4), 965(l), 4501(d)(2).

[19] Section 7874(e)(2)(A).

the sum of (i) the partner's distributive share of the domestic partnership's inversion gain for the year, plus (ii) gain recognized by the partner for the year by reason of the transfer during the applicable period of an interest in the domestic partnership to the surrogate foreign corporation.[20] A partner's inversion gain is subject to Federal income tax at the highest marginal rate of tax that applies to the partner.[21]

If the ownership percentage is at least 80 percent (an "**80-percent inversion**"), the foreign acquiring corporation is a surrogate foreign corporation that is treated as a domestic corporation for all purposes of the Code and neither the domestic entity nor any related U.S. person is an expatriated entity.[22] Thus, the foreign acquiring corporation is subject to Federal income tax as if it were organized under the laws of the United States.[23]

U.S. income tax treaties, even treaties entered into after the enactment of Section 7874, cannot override, or otherwise provide any exemption to, any of the provisions of Section 7874.[24]

### B. Historical Perspective

The legislative history acknowledges the application of Section 7874 to partnership inversions, but does not explain the rationale for such application.[25] However, as discussed below, some potential rationales could be gleaned from the political environment of the early 2000s, a preliminary report on inversions issued by Treasury in 2002, and congressional hearings on inversions.

On February 28, 2002, Treasury announced its intention to study "the issues arising in connection with the reincorporation of U.S.-based multinational corporations in foreign countries, sometimes referred to as corporate inversion transactions, and the implications of these transactions for U.S. tax rules."[26] The announcement came in response to the "marked increase

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[20] Section 7874(e)(2)(B).

[21] Section 7874(e)(2)(C).

[22] Section 7874(a)(3), (b).

[23] The foreign acquiring corporation will continue to be treated as a domestic corporation even if the conditions resulting in its characterization as such are not satisfied at a later date. *See* Treas. Reg. § 1.7874-2(b)(6).

[24] Section 7874(f).

[25] *See* H.R. Rep. No. 108-755, at 1631 (2004) (hereinafter, the "**2004 Conference Report**") ("Under the proposal, inversion transactions include certain partnership transactions. Specifically, the proposal applies to transactions in which a foreign-incorporated entity acquires substantially all of the properties constituting a trade or business of a domestic partnership, if after the acquisition at least 60 percent of the stock of the entity is held by former partners of the partnership (by reason of holding their partnership interests), provided that the other terms of the basic definition are met. For purposes of applying this test, all partnerships that are under common control within the meaning of section 482 are treated as one partnership, except as provided otherwise in regulations. In addition, the modified 'toll charge' proposals apply at the partner level."); H.R. Rep. No. 108-548(I), at 245 (2004) (materially the same); S. Rep. No. 108-192, at 144 (2003) (materially the same); Joint Comm. Tax'n, General Explanation of Tax Legislation Enacted in the 108th Congress (Part I), at 233 (2005) (materially the same).

[26] Press Release, U.S. Department of Treasury, Treasury Announces Study on U.S. Based Multinational Corporations Reincorporating in Foreign Countries (Feb. 28, 2002), *available at* https://home.treasury.gov/news/press-releases/po1060.

in the frequency of [inversion] transaction announcements and an increase in the size of the transactions."[27] Inversions were not a new phenomenon.[28] However, the depressed economic environment of the late 1990s and early 2000s, resulting in lower equity prices, and the increase in the investment activities of tax-exempt and foreign investors, resulting in relatively fewer investors subject to U.S. tax on stock gain, reduced the cost of the then-existing shareholder and/or corporate toll charges imposed on inversions.[29] Thus, the economic environment and public market dynamics made inversions less costly than they had been historically.

Within a month of Treasury's announcement, four anti-inversion bills were introduced, and two more anti-inversion bills were introduced in the months that followed.[30] The McInnis Bill, the first anti-inversion bill introduced, proposed to amend Section 7701(a)(4) to treat a foreign corporation as a domestic corporation if such corporation was an "inverted domestic corporation." For this purpose, a corporation was an inverted domestic corporation "if, immediately after a transaction in which property is directly or indirectly transferred *by a domestic corporation* to such foreign corporation, more than 80 percent of the stock (by vote or value) of such foreign corporation [was] held by former shareholders of the domestic corporation by reason of holding stock in such domestic corporation."[31] The McInnis Bill did not apply to a foreign corporation that acquired properties of a domestic partnership.

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[27] *Id.*

[28] The first notable inversion transaction was the inversion of McDermott International in 1983. Other notable inversion transactions during the mid-to-late 1990s included the inversions of the Helen of Troy Corporation, Triton Energy Corporation, and Tyco International. The inversion of the Helen of Troy Corporation in particular inspired Treasury and the IRS to issue the anti-inversion rules in Treas. Reg. § 1.367(a)-3(c), which are referred to colloquially as the "**Helen of Troy regulations**."

[29] Prior to the enactment of Section 7874, inversions generally resulted in only corporate- and/or shareholder-level gain recognition under Section 367 and the Helen of Troy Regulations. *See* Section 367(a); Treas. Reg. § 1.367(a)-3(c). As noted in NYSBA Tax Section, Report No. 1014, Report on Outbound Inversion Transactions, at 12 (2002) (the "**2002 NYSBA Report**"), the troubled economic climate of the late 1990s and early 2000s "weakened the effectiveness of Notice 94-46 and the [Helen of Troy regulations] that implemented it in combating inversions without necessarily reducing the importance of the tax issues that inversions raise. The shareholder level tax imposed by Section 367(a) may not be very costly today given the depressed level of stock prices." In addition, as the 2002 NYSBA Report noted, the impact of Section 367(a) "is also lessened to the extent that the corporation's shares are held by tax-exempt institutions and foreign taxpayers on which Section 367 has no effect, or by other institutional investors that may be relatively indifferent to shareholder level taxes." 2002 NYSBA Report, at 13

[30] H.R. 3857, 107th Cong. (2002) (the "**McInnis Bill**"); Corporate Patriot Enforcement Act of 2002, H.R. 3884, 107th Cong. (2002) (the "**Neal Bill**"); Save America's Jobs Act of 2002, H.R. 3922, 107th Cong. (2002) (the "**Maloney Bill**"); S. 2050, 107th Cong. (2002) (the "**Wellstone-Dayton Bill**"); Uncle Sam Wants You Act of 2002, H.R. 4756, 107th Cong. (2002) (the "**Johnson Bill**"); Reversing the Expatriation of Profits Offshore (REPO) Act, S. 2119, 107th Cong. (2002) (the "**Grassley-Baucus Bill**"). The Grassley-Baucus Bill was the first bill to propose Section 7874 and is the predecessor of the current statute.

[31] McInnis Bill, at § 1(a) (emphasis added). The McInnis Bill would have also treated a corporation as an inverted domestic corporation if the ownership percentage was more than 50 percent, but only if three additional requirements were satisfied: (i) stock in the foreign corporation was publicly traded on a U.S. exchange; (ii) less than 10 percent of the foreign corporation's gross income was derived from activities in the foreign corporation's country of creation or organization; and (iii) less than 10 percent of the foreign corporation's employees were permanently located in the foreign corporation's country of creation or organization. *Id.*

The Neal Bill, which was introduced on the same day as the McInnis Bill, included, in addition to provisions similar to those the McInnis Bill, rules treating as a "corporate expatriation transaction" the foreign corporate acquisition of a trade or business of a domestic partnership.[32] The press release to the Neal Bill did not explain the reason for extending the anti-inversion rule to partnership inversions.[33] The Neal Bill was proposed to apply retroactively to inversions completed after September 11, 2001.[34] The effective date of the Neal Bill, known as the "Corporate Patriot Enforcement Act," was not a coincidence; inversions were seen by many members of Congress as unpatriotic, particularly in the wake of the World Trade Center attacks and the start of the Global War on Terrorism.[35]

On May 17, 2002, Treasury issued a preliminary report on inversions (the "**Preliminary Report**").[36] The Preliminary Report defined an "inversion" as "a transaction through which the *corporate structure* of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low- or no-tax country, replaces *the existing U.S. parent corporation* as the parent of the corporate group."[37] The Preliminary Report does not include the word "partnership."

The Preliminary Report provided that the primary Federal tax benefits of inversions were two-fold: (i) escaping U.S. taxation on foreign earnings through out-from-under transactions and structuring future growth outside the U.S. tax net; and (ii) eroding the U.S. tax base through deductible payments to related parties in low- or no-tax jurisdictions and moving intellectual property offshore.[38] The Preliminary Report also noted that "an inversion is not the only route to accomplishing this type of reduction in taxes."[39] In particular, the Preliminary Report highlights that such U.S. tax benefits were also available to a "U.S.-based start-up" that establishes a foreign corporate parent from the outset.[40] Although the Preliminary Report does not expressly discuss partnership inversions, the concern regarding "U.S. based start-ups" implicates partnership incorporations as many start-up ventures are formed as partnerships. However, Treasury expressly did not view the initial foreign incorporation of a start-up as an "inversion,"

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[32] Neal Bill, at § 2(a).

[33] Press Release, U.S. Congress, Democratic Leader Gephardt Joins Congressmen Neal and Maloney in Support of Bill to Stop Corporate Traitors from Relocating Overseas (Apr. 24, 2002), *available at* Tax Notes, 2002 TNT 80-55.

[34] The Neal Bill also applied to corporate inversions and partnership inversions completed on or before September 11, 2001, but only for taxable years of the foreign acquiring corporation beginning after December 31, 2003. The Maloney Bill included the same effective date provisions, but the Johnson Bill would have only applied to inversions completed after September 11, 2001. The Wellstone-Dayton Bill, which was introduced in the Senate after the Neal Bill, did not address partnership transactions, and applied to taxable years of inverted domestic corporations beginning after December 31, 2002, without regard to when the corporation became an inverted domestic corporation.

[35] *See infra* note 44.

[36] Office of Tax Policy Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications* (May 2002).

[37] Preliminary Report, at 1 (emphasis added).

[38] Preliminary Report, at 12-14.

[39] Preliminary Report, at 2.

[40] Preliminary Report, at 2, 18-20, 29.

but rather merely as another symptom of a U.S. international tax system that disadvantaged domestic companies relative to their foreign competitors.[41]

Congress held hearings in June and October 2002 in response to the Preliminary Report (collectively, the "**2002 Hearings**"). The 2002 Hearings focused exclusively on the Federal tax consequences of corporate inversions and frequently highlighted the recent spate of inverters by name. Of the companies named in the 2002 Hearings, Accenture was the only example furnished of a domestic partnership that had "inverted."[42] Even with respect to the Accenture transaction, the 2002 Hearings included no testimony or analysis regarding the implications of that transaction, other than a statement provided by a representative of the company itself defending its foreign incorporation on the grounds that the company "has never been a U.S.-based or operated organization and has never operated under a U.S. parent corporation."[43] Thus, the 2002 Hearings did not include a technical discussion of the Federal tax reasons for subjecting the foreign incorporation of domestic partnership properties to the same rules as corporate inversions. Rather, congressional participants in the 2002 Hearings painted all the named companies with the same broad brush as unpatriotic for relinquishing their status as "American companies."[44]

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[41] *See* Preliminary Report, at 29-30 ("Both the recent inversion activity and the increase in foreign acquisitions of U.S. multinationals are evidence that the competitive disadvantage caused by our international tax rules is a serious issue with significant consequences for U.S. businesses and the U.S. economy. A comprehensive reexamination of the U.S. international tax rules is needed. It is appropriate to question the fundamental assumptions underlying the current system. We should look to the experiences of other countries and the choices that they have been made in designing their international tax systems. Consideration should be given to fundamental reform of the U.S. international tax rules, including the merits of the exemption-based tax systems of some of our major trading partners. Consideration also should be given to significant reforms within the context of our current system. The reach of the various anti-deferral regimes, which can operate to impose current U.S. tax on active business income earned abroad, should be reevaluated. The restrictions on the use of the foreign tax credit, which can operate to defeat the underlying purpose of the credit and can result in double taxation of business income earned abroad, also should be reevaluated. The many layers of rules in our current system arise in large measure because of the difficulties inherent in satisfactorily defining and capturing income for tax purposes, particularly in the case of activities and investments that cross jurisdictional boundaries. However, the complexity of our tax law itself imposes a significant burden on U.S. companies. Therefore, we also must work to simplify our international tax rules.").

[42] See H. HRG 107-75, at 61.

[43] *See* Prepared Statement of Accenture Ltd., S. HRG 107-811, at 64 (Oct. 16, 2002) ("The majority of Accenture's partners, employees and revenues are outside the U.S. and were never a part of Accenture's U.S. operations. Further, the majority of Accenture's partners and employees are not U.S. citizens. Accenture newly incorporated in Bermuda in 2001; Accenture did not reincorporate in Bermuda. Before incorporation, Accenture operated as a group of more than 40 locally-owned partnerships and other entities in 47 countries coordinated by contract through a Swiss-based entity. In 2001, Accenture's 2,500 partners, more than half of whom were non-U.S. citizens, chose to move to corporate form and seek a public listing in order to build the capital structure necessary to fuel the company's continued growth. With thousands of partners and employees of many nationalities, it was particularly important, as a cultural matter, for the organization to select a neutral place of incorporation for its parent company. Accenture's partners voted to incorporate the parent company, Accenture Ltd, in Bermuda.") (footnotes omitted).

[44] *See, e.g.*, Rep. Maloney, H. HRG 107-73, at 43, 44 (Jun. 6, 2002) ("These companies continue to reside in the United States, take advantage of our infrastructure, our education system, our water systems, federal, state, and local services such as police, fire, and public schools, and, of course, they still rely on the protection of our courageous Armed Services, here at home, and around the world. The only difference is they now get it all for free, while US

### C. Observations

Congress's reasons for extending Section 7874 to partnership inversions are unclear. The congressional materials related to the enactment of Section 7874 focus solely on corporate inversions and do not discuss the technical differences between corporate and partnership inversions, indicating that Congress may have chosen to apply Section 7874 to domestic partnership inversions for other reasons. The 2002 Hearings are replete with references to inversions being unpatriotic acts by "American companies" to dodge taxes. Also, there was only a single domestic partnership inversion that had been completed by the time of the 2002 Hearings, which was a company that benefitted significantly from government contracts.[45] Based on this history, it would be reasonable to conclude that Congress chose to extend Section 7874 to foreign incorporations of domestic partnerships simply because a majority of members (and their constituents) considered such entities "American companies." From a U.S. tax perspective, a domestic partnership is no more an American company than a foreign partnership, because neither are taxpayers. But Congress may have deemed it sufficient that a domestic partnership is formed under U.S. laws and may have reasonably assumed that a domestic partnership is more likely than a foreign partnership to have U.S. operations and/or U.S. partners that benefit from U.S. legal and physical infrastructure (*e.g.*, legal protections, roads, and schools).

It could also be argued that Congress included partnership inversions within the scope of Section 7874 to address the Preliminary Report's observation that inversion benefits could have

citizens and loyal US companies are paying the bill . . . . Ironically, some of these same companies have large contracts to provide goods and services to the Federal Government. Now they are saying they don't want to pay their fair share of US taxes. This is outrageous, and must be permanently stopped. These Bermuda tax avoidance schemes are especially unpatriotic in light of our current economic and national security situation . . . . In addition, as our country continues its war on terrorism, and makes efforts to improve homeland security, all or our citizens, elected officials, and corporations should remain united and committed to defending our homeland and eliminating terrorism. Corporate expatriates are saying that profit gained from tax avoidance is more important than the security and wellbeing of our country . . . . We certainly should not allow expatriated companies to maintain indefinitely a tax advantage over American companies that are loyal to our country."); Rep. McNulty, H. HRG 107-75, at 13 (Jun. 25, 2002) ("I have no sympathy for the argument that these Benedict Arnold companies are justified in their actions, literally turning their back on this country because of problems they claim with our tax laws. No one should justify tax avoidance at a time of war by complaining about the laws . . . . Corporate executives may decide that patriotism needs to take a back seat to profits. I believe that Congress will take a different view. At a time when we are asking our Armed Forces to risk their lives in the war against terrorism, I find it contemptible that corporations would renounce their allegiance to this country in order to evade taxes. It is especially troubling that some of these expatriating corporations have profitable contracts with the Federal Government."); Rep. Johnson, H. HRG 107-75, at 15 (stating that legislation introduced "will stop the destructive practice of American companies renouncing their American identity to avoid the taxes that provide the very services they benefit from. American companies should act like American companies and pay their fair share to keep our country strong."); Rep. Neal, H. HRG 107-75, at 18 (Jun. 25, 2002) ("The practice of reincorporating in a foreign country to avoid paying U.S. income tax is inconsistent with American corporate citizenship and blatantly unfair to those individuals and businesses who pay their fair share in taxes . . . . Despite patriotic sentiments expressed around this great Nation in the wake of the attacks of September 11, even public rebukes in newspapers have had little impact.").

[45] *See, e.g.,* GAO-03-194 (Oct. 1, 2002). Interestingly, the U.S. General Accounting Office did not consider the foreign incorporation of Accenture to be an inversion transaction. *See id.*; *see also* Cong. Rec. H4523-24 (Jun. 18, 2004) (discussing the government contract benefits of inverters during the congressional debates on the Department of Homeland Security Appropriations Act of 2005, six months before the passage of the AJCA).

been obtained by a U.S. start-up through an initial foreign incorporation. However, this justification would not explain why a partnership's place of formation is relevant to the analysis; if the start-up were initially formed as a foreign partnership, Section 7874 would not apply to the subsequent incorporation. Also, this approach would not explain why the foreign incorporation of sole proprietorships are not subject to Section 7874.

The motivation for including partnership inversions in Section 7874 is made more unclear by the fact that it is difficult to identify technical reasons for applying Section 7874 to partnership inversions. Partnerships, whether foreign or domestic, are not subject to entity-level taxation in the United States.[46] Rather, income of a partnership is only included in the U.S. tax base to the extent its partners are subject to U.S. tax on the income, either because such partners are taxable U.S. persons (each, a "**U.S. partner**") or because the income of the partnership is effectively connected with a U.S. trade or business ("**effectively connected income**" or "**ECI**").[47] Thus, the Federal tax benefit of any partnership inversion depends entirely on either the residence of the partnership's partners or the source and character of its income. Accordingly, if Congress wanted to discourage the Federal tax benefits of partnership inversions, then the Acquisition Requirement should apply without regard to partnership residence, and would most logically apply only with respect to an acquisition of properties constituting a trade or business within the United States, within the meaning of Section 864(b) (a "**U.S. trade or business**").

A review of the relevant law in force when Section 7874 was enacted is useful to discern what the possible tax policy concerns could have been that motivated the application of the provision to partnership inversions, and whether those concerns still exist today. Assume the following ownership structure (the "**Pre-Inversion Structure**"):

(i) U.S. Individual and Foreign Individual are partners in USPS, a domestic partnership;

(ii) U.S. Individual is a U.S. partner and Foreign Individual is not a U.S. partner;

(iii) USPS directly owns all the issued and outstanding interests in USDE and FDE;

(iv) USDE is a domestic limited liability that is disregarded for Federal tax purposes (a "**disregarded entity**") and conducts a U.S. trade or business, and FDE is a foreign disregarded entity that conducts a trade or business outside of the United States (*i.e.*, not a U.S. trade or business); and

(v) FP is a foreign corporation.

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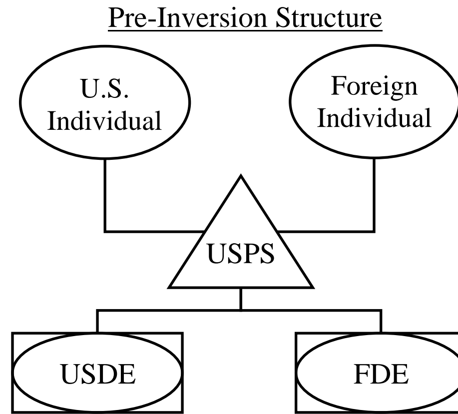
[46] *See* Section 701.

[47] *See* Sections 875(1), 871(b), 882(a)(1).

Pre-Inversion Structure



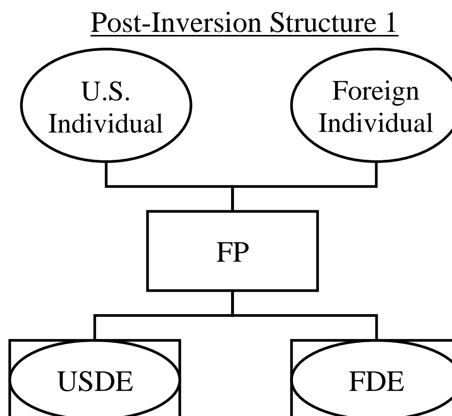

In the Pre-Inversion Structure, the following Federal income tax consequences resulted from the operations of USDE and FDE:

(i) U.S. Individual was subject to Federal income tax on its distributive share of the income of USDE and FDE and gain from the sale of the assets of USDE and FDE; and

(ii) Foreign Individual was subject to Federal income tax on its distributive share of the income of USDE (currently as ECI) and gain from the sale of USDE's assets under Sections 864(c) and 897(a).

In the Pre-Inversion Structure, the U.S. tax base of Foreign Individual could be eroded through deductible payments. For example, interest payments made by USPS to Foreign Individual, to the extent allocated and apportioned to income produced by USDE's assets, could reduce ECI while the associated interest income could be subject to reduced withholding tax rate under a U.S. income tax treaty. However, any such deductible payments would fundamentally alter the economic relationship between U.S. Individual and Foreign Individual, and thus it would be unlikely the parties would agree to such arrangement solely for U.S. tax purposes. All of the Federal income tax consequences discussed above would have been the same if USPS was a foreign partnership.

Assume that USPS transferred all its assets to FP and then liquidated, so that the structure was as follows ("**Post-Inversion Structure 1**"):




The following Federal income tax consequences would have resulted in Post-Inversion Structure 1:

(i) U.S. Individual was subject to Federal income tax on: (A) dividends paid by FP, (B) either its pro rata share of FP's subpart F income and earnings invested in U.S. property under the Code's subpart F rules if FP was a controlled foreign corporation (a "**CFC**"), or its investment in FP under the Code's passive foreign investment company ("**PFIC**") rules if FP was a PFIC, (C) its distributive share of gain recognized on the transfer of USDE's tangible property to FP under Section 367(a),[48] and (D) its share of income recognized on the transfer of USDE's and FDE's intangible property under Section 367(d);[49]

(ii) Foreign Individual was not subject to Federal income tax on its investment in FP; and

(iii) FP was subject to Federal income tax on the income of USDE (currently as ECI or under the Section 884 branch profits tax to the extent earnings were not reinvested in USDE's U.S. trade or business) and gain from the sale of USDE's assets under Sections 864(c) and 897(a).

[48] Prior to being repealed by the Tax Cuts and Jobs Act of 2017, Pub. L. No. 115-97 (2017), Section 367(a)(3) provided an exception to Section 367(a) gain recognition for outbound transfers of tangible property used in or held for use in an active trade or business conducted outside the United States. Thus, the transfer of FDE's tangible assets to FP would have generally not resulted in gain recognition under Section 367(a).

[49] Prior to the TCJA, outbound transfers of foreign goodwill and foreign going concern value were not subject to Section 367(d). *See* Treas. Reg. § 1.367(d)-1T(b) (2016). It also appeared that an outbound transfer of foreign goodwill and foreign going concern value did not give rise to gain under Section 367(a) by reason of the active trade or business exception of Section 367(a)(3). *Cf.* Treas. Reg. § 1.367(a)-2T (2016) (generally treating as eligible all outbounded assets, except for certain narrow exclusions, none of which excluded foreign goodwill and foreign going concern value).

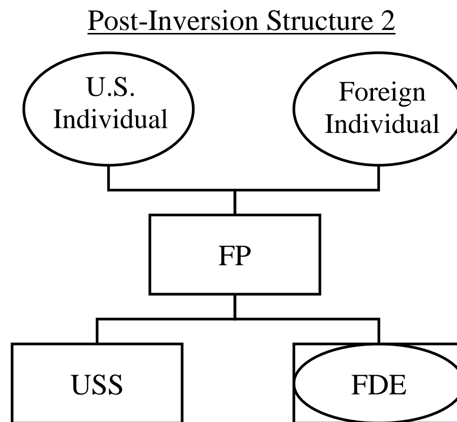
As a result of the inversion, U.S. Individual could have obtained deferral of its share of FDE's income (subject to the application of the subpart F and PFIC rules), and deferral on its share of USDE's earnings to the extent the Federal corporate income tax imposed on FP, including the branch profits tax, with respect to those earnings was less than the Federal individual income tax imposed on U.S. Individual.[50] But any such deferral benefits from a partnership inversion could be obtained only at the cost of current taxation of U.S. Individual on the transfer of USDE's tangible property under Section 367(a), and future taxation with respect to USDE's and FDE's intangible property (other than FDE's foreign goodwill and foreign going concern value) under Section 367(d). Since the inversion would have generally produced current and future tax liabilities to U.S. Individual under Section 367 in exchange for deferral with respect to FDE's operations, it is unlikely that deferral benefits alone would have motivated the inversion in most situations.

In contrast, a permanent benefit could have been obtained relative to the Pre-Inversion Structure through the reduction in Federal income tax related to Foreign Individual's share of USDE's earnings. Specifically, a benefit could be obtained to the extent that the Federal corporate income tax rate imposed on FP with respect to Foreign Individual's share of USDE's earnings was less than the Federal individual tax rate with respect to Foreign Individual's share of USDE's earnings pre-inversion. Moreover, this benefit could have been increased to the extent deductible payments made by FP were allocated to the income earned by USDE and the associated income was subject to little or no Federal income tax. For example, interest paid by FP to Foreign Individual could reduce U.S. corporate tax at a 21 percent rate, whereas the interest income might be eligible for a zero or reduced rate of withholding tax under an applicable tax treaty. However, as discussed in relation to the Pre-Inversion Structure, any such deductible payments would have a significant impact on the economic relationship between U.S. Individual and Foreign Individual, and thus would not be frictionless. Further, all the benefits discussed above may have also been obtained through a domestic incorporation, assuming an applicable tax treaty that could reduce or eliminate U.S. tax withholding.

Assume that, after the inversion described above, FP incorporates USDE as a domestic corporation (USS), so that the structure was as follows ("**Post-Inversion Structure 2**"):

[50] At the time Section 7874 was enacted, the top marginal Federal income tax rate for individuals and corporations were 39.6 percent and 35 percent, respectively. Sections 1(a)-(d), 11(b)(1) (2004).

Post-Inversion Structure 2




By reason of the incorporation of USDE, U.S. Individual may have not been subject to tax under Section 367 with respect to the transfer of USDE to FP.[51] Further, FP would have no longer been subject to Federal income tax on its ECI under Section 882, but USS would have been subject to full Federal corporate income tax on the former operations of USDE.

In Post-Inversion Structure 2, related party base-erosion strategies were potentially more effective than in the Pre-Inversion Structure and in Post-Inversion Structure 1. First, if USS issued a note to FP, 100 percent of the interest expense could have reduced U.S. taxable income, subject to the taxable income limitation under Section 163(j),[52] rather than just the portion of the interest expense that could have been allocated and apportioned to USDE's income. Second, in contrast to the Pre-Inversion Structure and Post-Inversion Structure 1, base-eroding payments from USS to FP in Post-Inversion Structure 2 would have had no effect on the economic relationship of U.S. Individual and Foreign Individual; the payment would effectively have moved money from one pocket to another as far as the shareholders of FP were concerned. In addition, the Federal income tax imposed in respect of such base-eroding payments could have been minimal, if the payments qualified for reduced U.S. tax withholding under the relevant U.S. tax treaty and the corresponding income was not included in the gross income of U.S. Individual currently (*e.g.*, because FP was neither a CFC nor a PFIC). Therefore, such base-eroding payments could have been frictionless.

Assume the facts of the Pre-Inversion Structure, except that USPS owned all the issued and outstanding shares in FS, a foreign corporation. In that case, the pre-inversion structure (the

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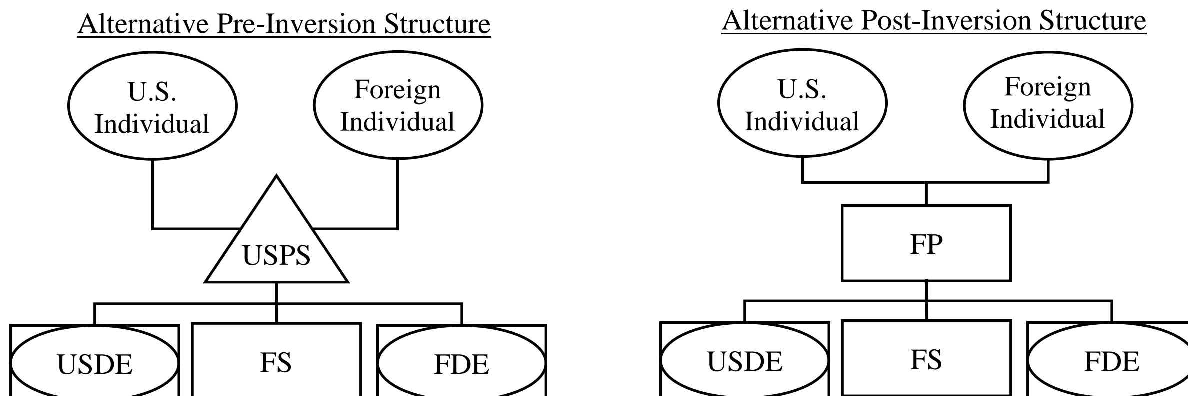
[51] The incorporation of USDE as USS would have resulted in the transaction being treated as an indirect stock transfer under Treas. Reg. § 1.367(a)-3(d)(1)(vi). Thus, U.S. Individual would be treated for purposes of Section 367(a) as transferring the shares in USS to FP. *See id.*; Treas. Reg. § 1.367(a)-3(d)(2)(vi)(B)(2). Depending on the relative values of USS and FDE, U.S. Individual may have not been subject to current U.S. taxation with respect to the deemed transfer of USS stock to FP. *See* Treas. Reg. § 1.367(a)-3(c).

[52] At the time Section 7874 was enacted in 2004, and until the passage of the TCJA in 2017, Section 163(j) generally disallowed interest deductions paid by a corporation to certain "related" persons to the extent that the corporation's "excess interest expense" (*i.e.*, its interest expense in excess of its interest income) exceeded 50 percent of its "adjusted taxable income." *See* Section 163(j) (2004).

"**Alternative Pre-Inversion Structure**") and the post-inversion structure (the "**Alternative Post-Inversion Structure**") would be as follows:




In this case, the inversion could have provided a further deferral benefit for U.S. Individual. Specifically, in the Alternative Pre-Inversion Structure, (i) FS would have been a CFC because USPS directly owned more than 50 percent of the voting power in FS, and (ii) USPS would have been a United States shareholder with respect to FS because it directly owned at least 10 percent of the voting power in FS. Thus, U.S. Individual would have been subject to current Federal income tax on its distributive share of FS's subpart F income and Section 956 investments, irrespective of U.S. Individual's indirect ownership interest in FS. In the Alternative Post-Inversion Structure, however, U.S. Individual would have only been subject to the subpart F rules with respect to FS to the extent its indirect ownership interest in FS implicated the rules. Depending on the facts and circumstances of FS's operations, the "de-CFCing" benefit provided by the inversion may have been meaningful.[53]

It would be surprising, however, if curtailing this benefit was the reason why Congress included partnership inversions within the scope of Section 7874. First, this deferral benefit could have been achieved by replacing USPS with a non-publicly traded foreign partnership. The foreign partnership's acquisition of all USPS's properties would not have satisfied the Acquisition Requirement because the foreign partnership was not a foreign acquiring corporation, and thus, the transaction would not have implicated Section 7874. Second, if USPS only owned FS stock, a foreign corporation's acquisition of all USPS's properties would have not satisfied the Acquisition Requirement, because the FS stock would have not constituted a trade or business of USPS. Accordingly, the acquisition would have not been subject to Section 7874.

[53] The "de-CFCing" benefit, however, may be subject to deemed dividend inclusions to prevent the circumvention of Section 1248. For example, if FS had material, untaxed earnings and profits at the time of the "de-CFCing" event, USPS may have recognized a deemed dividend equal to its Section 1248 amount with respect to FS, and U.S. Individual would have been subject to Federal income tax on its distributive share of such dividend. Treas. Reg. § 1.367(b)-4(b); Section 751(b).

## IV. Recent Proposals

### A. The Senate Draft and FY24 Green Book

Recent proposals, such as the Senate draft of the Build Back Better Act (the "**Senate Draft**")[54] and the Biden Administration's General Explanations of the Administration's Fiscal Year 2024 Revenue Proposals ("**FY24 Green Book**"),[55] would significantly expand the application of Section 7874 with respect to partnerships.[56] As with the original decision to include partnership inversions within the scope of Section 7874 in 2004, the rationale for applying Section 7874 to a broader range of partnership transactions is left unexplained. No report accompanied the Senate Draft and the relevant "Reasons for Change" discussion FY24 Green appears to be focused exclusively on corporate inversions.[57]

The Senate Draft and the FY24 Green Book would expand Section 7874 with respect to partnerships in two significant ways. First, the Senate Draft would treat as a domestic entity acquisition the acquisition of substantially all of the properties held directly or indirectly by a domestic partnership.[58] As discussed below, under current law, a partnership inversion is limited to the acquisition of substantially all of the properties *constituting a trade or business* held *directly* by (*i.e.*, "of") a domestic partnership. Second, the Senate Draft and the FY24 Green Book would include as a domestic entity acquisition the acquisition of substantially all of the U.S. trade or business assets of a foreign partnership.[59] Currently, Section 7874 does not apply to the acquisition of the assets of a foreign partnership, regardless of the composition of its assets.[60] In addition, the FY24 Green Book provides regulatory authority to exempt certain "internal restructurings" involving partnerships from the application of Section 7874 and to define a trade or business for purposes of Section 7874.

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[54] Finance Committee, Title XII of H.R. 5376 (Dec. 11, 2021).

[55] FY24 Green Book, *available at* https://home.treasury.gov/system/files/131/General-Explanations-FY2024.pdf.

[56] *See also* No Tax Breaks for Outsourcing Act, S. 357, 118th Cong. (2023).

[57] The relevant "Reasons for Change" discussion in the FY24 Green Book is entitled "Limitations on the ability of domestic *corporations* to expatriate." *See* FY24 Green Book, at 27 (emphasis added). While the discussion test itself refers generally to "domestic entities," the description of the benefits of inversions under current law describes the benefits from corporate inversions.

[58] Senate Draft, at Sec. 128153(a)(1). The FY24 Green Book does not include this proposal.

[59] *Id.*; FY24 Green Book, at 30. The FY24 Green Book proposal differs slightly from the Senate Draft in that the former would apply to acquisitions of "substantially all of the U.S. trade or business assets of a foreign partnership" whereas the latter proposal would apply to the acquisition of "substantially all the properties held directly or indirectly by a foreign partnership and constituting a United States trade or business."

[60] As regards a foreign partnership owned by a domestic corporation, Section 7874 could apply by reason of the acquisition of the foreign partnership's properties if such properties constituted substantially all the properties of the domestic corporation. Also, as regards a foreign partnership owned by a domestic partnership, we have assumed that, consistent with our recommendations in Part V.A. of this Report, the trade or business of a foreign partnership is not attributed to the domestic partnership for purposes of the Acquisition Requirement.

## B. Observations

### 1. Recommendation

Although the rationale for these proposed partnership changes is not explained in the FY24 Green Book or in legislative history to the Senate Draft, one could speculate that these changes were intended to create parity between domestic partnerships and domestic corporations, on the one hand, and domestic partnerships and foreign partnerships, on the other. We generally agree with the maxim that "like cases must be treated alike," but, for purposes of Section 7874, domestic partnerships and domestic corporations are not "like cases." And while we laud the desire to create parity between domestic partnerships and foreign partnerships, we would create this parity by excluding domestic partnerships from the purview of Section 7874, rather than by including foreign partnerships, and using targeted anti-base erosion measures to the extent existing measures are viewed as insufficient to address concerns regarding the foreign incorporation of partnership property.[61]

As discussed above in Part III of this Report, partnerships differ significantly from domestic corporations in that they do not pay tax. That is, partnerships do not have a tax base to erode; rather, U.S. partners pay tax with respect to the partnership's profits or, in the case of foreign partners, with respect to the ECI of the partnership. Under prior law, the transfer of a partnership's assets to a foreign corporation may have facilitated deferral with respect to these profits, as illustrated by the examples discussed in Part III.C above. However, such deferral has been significantly curtailed after the enactment of the Tax Cuts and Jobs Act of 2017 (the "**TCJA**"), which eliminated the active trade or business exception contained in prior Section 367(a)(3), expanded the definition of intangible property under Section 367(d)(4) to include goodwill and going concern value, amended Section 482 to permit the valuation of intangible property based on aggregate values or realistic alternatives, and added the Global Intangible Low Taxed Income ("**GILTI**") rules under Section 951A.[62] In other words, partners have little ability to avoid current taxation of partnership earnings by incorporating assets in a foreign corporation and will, in fact, accelerate taxation of such earnings in most circumstances under Section 367. These changes are in addition to other tax rules that may tax earnings in the hands of the foreign corporation, such as the ECI rules under Section 882 or the branch profits tax.[63]

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[61] In this case, if a domestic corporation was a partner in a domestic or foreign partnership and a foreign corporation directly or indirectly acquired interests in, or assets of, such partnership, Section 7874 would apply by reference to the domestic corporate partner and its interest in the partnership and partnership assets.

[62] Pub. L. No. 115-97 (2017).

[63] We also note that, by comparison to the results that were obtained under the subpart F regime under the law in place at the time Section 7874 was enacted, the subpart F rules have now significantly narrowed the differences in results that are obtained when U.S. investors own a foreign corporation through a domestic, rather than a foreign, partnership. Although a domestic partnership continues to be treated as a U.S. shareholder for purposes of determining whether the foreign corporation is a CFC, a domestic partnership no longer has a subpart F or GILTI inclusion; rather, only a U.S. partner that owns at least 10 percent of the CFC may have an inclusion under Section 951 or Section 951A. *See* Treas. Reg. § 1.958-1(d). Thus, in the Alternative Pre-Inversion Structure it may no longer be necessary to convert USPS to a foreign entity in order to limit the application of the provisions of subpart F, including GILTI.

Although deferral has been significantly curtailed after the enactment of the TCJA, a transfer by a partnership of its U.S. trade or business assets to a foreign corporation could, in theory, facilitate base erosion of domestic profits (*e.g.*, ECI). This could be accomplished in situations similar to Post-Inversion Structure 2, discussed in Part III.C above, where the foreign corporation subsequently transferred these ECI-producing assets to a domestic corporate subsidiary, which thereafter could then make base eroding payments to its foreign parent that are eligible for a reduced rate of tax under an applicable income tax treaty. Nevertheless, this base erosion has also been curtailed through other measures enacted as part of the TCJA, such as the base erosion and anti-abuse tax ("**BEAT**") under Section 59A,[64] the interest expense limitations under Section 163(j),[65] the anti-hybrid rules under Section 267A,[66] as well as regulations issued under Section 385 that were finalized in 2016.[67]

[64] Section 59A(a) imposes on each applicable taxpayer for any taxable year a tax equal to the base erosion minimum tax amount for such taxable year, in addition to any other tax. The "base erosion minimum tax amount" for a taxable year is generally computed as the excess, if any, of (i) the *product of* the applicable percentage (*i.e.*, the BEAT rate) and the taxpayer's modified taxable income for such year, *over* (ii) the taxpayer's regular tax liability (with certain adjustments for credits) for such year. Section 59A(b)(1). An applicable taxpayer's "modified taxable income" for a taxable year is its taxable income for such year, computed without regard to (y) any base erosion tax benefit with respect to any base erosion payment for such year, and (z) the base erosion percentage of any net operating loss deductions allowed under Section 172 for such year. Section 59A(c)(1). A "base erosion payment" includes any amount paid or accrued by the taxpayer to a foreign related person for which a deduction is allowable under the Code, and amounts paid or accrued to a related foreign person in connection with the acquisition of depreciable or amortizable property by the taxpayer from such person. Section 59A(d)(1), (2). A "base erosion tax benefit" includes the amount of a deduction allowed under the Code with respect to a base erosion payment. Section 59A(c)(2)(A)(i). In the case of a base erosion payment attributable to the acquisition of depreciable or amortizable property from a related foreign person, the "base erosion tax benefit" for a taxable year is the amount of the deduction allowed for such taxable year for depreciation or amortization with respect to the property. Section 59A(c)(2)(A)(ii).

[65] Section 163(j) was amended by the TCJA to tighten the limitation on deductible interest expense. *See supra* note 52, for a brief description of Section 163(j) prior to the TCJA. In particular, the TCJA amended the Code to (i) apply Section 163(j) to all business interest expense (rather than just related-party interest expense); (ii) reduce the maximum interest expense deduction from 50 percent to 30 percent of a taxpayer's adjusted taxable income; and (iii) define "adjusted taxable income" for taxable years beginning after December 31, 2021, without regard to deductions allowable for depreciation, amortization, and depletion. *See* Section 163(j)(1), (8)(A)(v).

[66] Section 267A disallows deductions for any disqualified related party amount paid or accrued pursuant to a hybrid transaction or by, or to, a hybrid entity. Section 267A(a). A "disqualified related party amount" is interest or royalties paid or accrued to a related party to the extent that: (i) such amount is not included in the income of the related party under the tax law of its resident country; or (ii) the related party is allowed a deduction with respect to such amount under the tax law of its resident country. Section 267A(b)(1). A "hybrid transaction" is a transaction, series of transactions, agreement, or instrument one or more payments with respect to which are treated as interest or royalties for Federal tax purposes but not treated as such under the tax law of the recipient's resident country. Section 267A(c). A "hybrid entity" is an entity that is treated as fiscally transparent for Federal tax purposes but treated as opaque under the tax law of its resident country, or *vice versa*. Section 267A(c) and (d).

[67] The Section 385 regulations, in relevant part, characterize a related-party debt instrument as equity if: (i) the instrument is issued by a domestic corporation and held by a related corporation that is not a member of the same U.S. consolidated group as the issuer (*e.g.*, a related foreign corporation), and (ii) the instrument is not a new capital investment in the issuer (*i.e.*, the instrument is issued in a distribution or a transaction (or series of transactions) that is economically similar to a distribution). *See* Treas. Reg. § 1.385-3. If a debt instrument is characterized as equity under the Section 385 regulations, in-form interest payments are treated as distributions on stock for Federal income

More importantly, however, this base erosion strategy is not unique or necessarily related to an inversion transaction. Any foreign corporation or individual that has ECI-generating assets could engage in a similar transaction. This observation suggests that Section 7874 is a blunt and potentially misguided tool to police the taxation of partnership assets that were not owned by a U.S. corporation and subject to corporate-level Federal income tax in the first instance, as it is both under- and over-inclusive. Under current law, the provision is overinclusive because it treats a foreign corporation that acquires assets in a partnership inversion as a domestic corporation, even if income from those assets was never subject to U.S. tax (*e.g.*, in the case of a domestic partnership with solely a non-U.S. trade or business and foreign partners). The current statute is underinclusive in the sense that it does not curtail base erosion of ECI earned by foreign corporations or U.S. or foreign individuals who are sole proprietors.

In light of the facts that Section 7874 is an imprecise tool for policing base erosion concerns outside of the domestic corporate context and that the rationale for applying Section 7874 to partnerships has never been clearly articulated, we believe that Section 7874 should be fundamentally rethought in the partnership context, beyond the revisions proposed in the Senate Draft or the FY24 Green Book. Rather than expanding the provision to capture more partnership "inversions," partnerships should be removed from the inversion regime entirely and base erosion concerns, whether in the context of assets owned by a partnership, individual or a foreign corporation, should be policed more directly through targeted proposals aimed specifically at transfers of assets to a domestic corporation that makes base eroding payments (as well as base eroding payments by a U.S. branch of a foreign corporation). Such proposals might include, but not be limited to, the FY24 Green Book's Undertaxed Payment Rule proposal.

### 2. Alternative Approaches Considered

Under the presumption that the proposed partnership changes in the Senate Draft and the FY24 Green Book were principally motivated by a desire to promote consistency among similar cases, we also considered an alternative approach whereby, if Congress chooses to retain partnership inversions within the purview of Section 7874, then any partnership (whether domestic or foreign) should be subject to Section 7874 if substantially all of its properties constituting a U.S. trade or business are acquired by a foreign corporation. If the principal reason partnership inversions were made subject to Section 7874 in the first place is because an acquisition of a partnership's assets by a foreign corporation could facilitate erosion of the U.S. tax base, this concern is only implicated where the partnership has a U.S. tax base to preserve, *i.e.,* ECI-generating assets that are subject to U.S. tax regardless of the identity of the partners. As discussed in Parts III.B and III.C above, comments of members of Congress in reference to the potential enactment of Section 7874 suggest the core concern underlying the provision was that "American companies" with businesses in the United States were acting in an "unpatriotic" fashion by avoiding U.S. tax on the income generated by those businesses, while at the same time availing themselves of the protection and other valuable services provided by the U.S. government.[68] Though not specifically addressed in congressional commentary at the time, this

tax purposes, and thus, are not deductible and treated under Section 316 as dividends to the extent of the issuer's current or accumulated E&P.

[68] *See supra* note 44.

core concern is implicated where a partnership owns ECI-generating assets that might generate less income subject to U.S. tax if transferred to a foreign corporation. It is not implicated, however, when the assets transferred are not used in the conduct of a U.S. trade or business. Finally, the place of formation of a partnership should be wholly irrelevant for purposes of Section 7874.

While we would consider such an approach an improvement over the Senate Draft and the FY24 Green Book proposals, we did not adopt it as a recommendation because, as noted above, we do not view Section 7874 as the appropriate tool for policing base erosion concerns outside of the domestic corporate context. Also, if Section 7874 were expanded to apply to all partnerships that have a U.S. trade or business, there appears to be no compelling reason why the provision should not be also expanded to apply to the foreign incorporation of sole proprietorships with a U.S. trade or business.[69] The fact that consistent application of the principle at work here would require an expansion of "inversion" rules to a foreign incorporation of a sole proprietorship – a dramatic broadening of the statute, to transactions entirely unlike a corporate inversion – reinforces the inappropriateness of applying Section 7874 to non-corporate entities in the first place.

## V. Current Issues under the Existing Section 7874 Rules

The application of Section 7874 to partnerships can be uncertain because of ambiguities in the Code and regulations—some of which stem from the fact that the policy rationale for subjecting partnership inversions to Section 7874 is unclear. For example, neither the Code nor the regulations define "trade or business" for purposes of Section 7874. The lack of guidance for this issue is understandable because the resolution requires a fact-intensive analysis that does not lend itself to bright-line rules. Also, this issue has been well-litigated in other areas of Federal income tax law, and thus, taxpayers should be able to apply appropriate principles of analogous authorities in analyzing Section 7874.[70] In contrast, we believe that there are other issues as regards the interaction of Section 7874 and partnerships that should be addressed or clarified through administrative guidance. Below, we discuss these issues and recommend clarifications and amendments Treasury and the IRS should make to the regulations impacting the treatment of partnerships for purposes of Section 7874.

### A. Trade or Business Attribution

As noted above, the Acquisition Requirement is satisfied if a foreign corporation directly or indirectly acquires substantially all of either (i) the properties held directly or *indirectly* by a

[69] An argument could be made that sole proprietorships are more likely than partnerships to be "small businesses," and Congress has often justified preferences in the Code based on encouraging and protecting small businesses. *Cf.* Cong. Rec. S8089-138 (Dec. 19, 2017) (Senate Republicans advocating for the Section 199A deduction for passthrough income on the basis that it would provide needed tax relief for "small businesses"). However, it would be difficult, as a matter of tax policy, to justify such an exclusion solely on such grounds, and, in any case, we have obtained no empirical evidence supporting the premise of this argument.

[70] For example, it is well established for purposes of Section 162 that the mere ownership of stock is not a trade or business for noncorporate taxpayers. *Higgins v. United States*, 312 U.S. 212 (1941); *City Bank Farmers Trust Co. v. Helvering,* 313 U.S. 121 (1941)*; United States v. Pyne,* 313 U.S. 127 (1941); *Dalton v. Bowers*, 287 U.S. 404 (1932); *Whipple v. United States*, 373 U.S. 193 (1963).

domestic corporation, or (ii) the properties constituting a trade or business *of a* domestic partnership. Thus, the Acquisition Requirement applies by reference to properties indirectly held by a domestic corporation, whereas the requirement does not appear to apply to acquisitions of properties indirectly held by a domestic partnership because such properties do not constitute a trade or business of the partnership. This interpretation is consistent with authorities in other areas that hold a trade or business of a partnership is not attributed to its partners,[71] and a trade or business of a partner is not attributed to a partnership.[72] This interpretation is also consistent with Treas. Reg. § 1.7874-2(b)(2), which states that "references to properties held by a domestic corporation include properties held directly or indirectly by the domestic corporation" but does not provide a similar rule for properties constituting a trade or business of a domestic partnership.

Treas. Reg. § 1.7874-2(c)(1) provides that an "indirect acquisition of properties" for purposes of the Acquisition Requirement includes an acquisition of an interest in a partnership (the "**Partnership Indirect Acquisition Rule**").[73] The Partnership Indirect Acquisition Rule applies to determine whether a foreign corporation has *acquired* indirectly properties directly or

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[71] *See, e.g.*, *Podell v. Comm'r*, 55 T.C. 429, 433-34 (1971) (making the trade or business determination for purposes of Section 1221(1) at the partnership level); *Boone v. United States* 374 F.Supp 155 (D.N.D. 1973) (denying ordinary business expense deduction to partner for losses incurred as a result of a hedging transaction related to partnership's potato dealing business, because the partner, as an individual, was not engaged in the potato dealing business); *Snow v. Comm'r* 416 U.S. 500 (1974) (characterizing research and development expenses as Section 174 expenses, not ordinary and necessary Section 162(a) expenses, by reference to the activities of a partnership, not its partners); *United States v. Basye*, 410 U.S. 441, 448 (1973) ("Thus, while the partnership itself pays no taxes, [Section] 701, it must report the income it generates, and such income must be calculated in largely the same manner as an individual computes his personal income. For this purpose, then, the partnership is regarded as an independently recognizable entity apart from the aggregate of its partners. Once its income is ascertained and reported, its existence may be disregarded since each partner must pay tax on a portion of the total income as if the partnership were merely an agent or conduit through which the income passed."); TAM 9728002 (neither Section 875(1) nor Section 1402(a) (or any other provision of the Code or regulations) "lends significant support to the general premise that, as a matter of law, a partner is engaged in the trade or business of his partnership"); *Bielfeldt v. Comm'r*, 231 F.3d 1035 (7th Cir. 2000) (denying "dealer" status to taxpayer related to losses incurred trading in securities, even though taxpayer owned 95.5 percent of a partnership engaged in a securities dealer business); Rev. Rul. 2008-39 (management fee paid by upper-tier partnership only deductible under Section 212 (rather than Section 162) even though lower-tier partnership engaged in a trade or business); *but see* Section 875(1) (stating for purposes of subtitle A, not subtitle F where Section 7874 is located, "[a] nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership of which such individual or corporation is a member is so engaged"); *Ward v. Comm'r*, 20 T.C. 332 (1953) (treating partner as engaged in the trade or business of the partnership for the purpose of characterizing the partner's bad debt deduction as a business expense); *Butler v. Comm'r*, 36 T.C. 1097 (1961) (same); Rev. Rul. 98-15 (ruling that the activities of a partnership are attributed to a corporate partner for the purposes of the corporate partner satisfying the requirements of Section 501(c)(3)); *Dagres v. Comm'r*, 136 T.C. 263 (2011) (permitting a partner to take a bad debt deduction as a business expense due to the partnership's trade or business in the context of LLCs and multiple-tiered partnerships).

[72] *See, e.g.*, *Madison Gas & Elec. Co. v. Comm'r,* 72 T.C. 521 (1979) *aff'd* 633 F.2d 512 (7th Cir. 1980) (holding for Section 162 purposes that the trade or business test must be applied at the partnership level without regard to the businesses of the corporate partners: "[t]he business of the partners cannot be attributed to the partnership for purposes of determining whether expenditures of the partnership were startup costs of the partnership's initial activity."); *Goodwin v. Comm'r*, 75 T.C. 424 (1980), *aff'd* 691 F.2d 490 (3d Cir. 1982) (same); *Brannen v. Comm'r*, 78 T.C. 471 (1982), *aff'd* 722 F.2d 695 (11th Cir. 1984) (same).

[73] Treas. Reg. § 1.7874-2(c)(1)(ii).

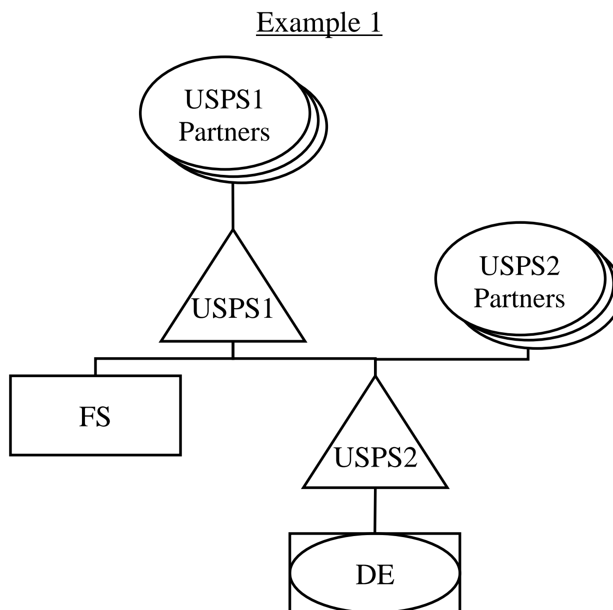
indirectly held by a domestic or a foreign partnership, not for purposes of determining whether a domestic partnership is engaged in a trade or business by reason of properties *held* indirectly by the partnership.[74] We believe that this interpretation of the Partnership Indirect Acquisition Rule should be clarified in regulations.

To illustrate the scope of the Partnership Indirect Acquisition Rule, consider the following example:

(i) USPS1, a domestic partnership, owns an interest in USPS2, a domestic partnership, and all the issued and outstanding shares in FS, a foreign corporation, and does not conduct a trade or business; and

(ii) USPS2 directly owns all the issued and outstanding interest in DE, a disregarded entity that conducts a trade or business.

Example 1




Assume FA, a foreign corporation, acquires all the issued and outstanding interests in USPS2 from USPS1 and the other USPS2 partners. In that case, it is clear that, under the Partnership Indirect Acquisition Rule, the acquisition by FA of all of the USPS2 interests constitutes an "indirect acquisition" of all the properties of USPS2 constituting a trade or business (*i.e.,* the disregarded interests in DE), and thus a domestic entity acquisition of USPS2.

[74] This interpretation is also consistent with Example 2 in Treas. Reg. § 1.7874-2(k). This example provides that a foreign corporation's acquisition of a 40 percent interest in a domestic partnership that owns 100 percent of the issued and outstanding shares in a domestic corporation is treated as an indirect acquisition by the foreign corporation of 40 percent of the domestic corporation's properties. This example, however, does not provide that the foreign corporation is treated as acquiring a trade or business of the domestic partnership on account of acquiring the domestic corporation's properties—*i.e.*, the example does not apply the Partnership Indirect Acquisition Rule to attribute the domestic corporation's properties to the domestic partnership for purposes of applying the Acquisition Requirement to the foreign corporation's acquisition of the domestic partnership.

In contrast, the acquisition of the USPS2 interests should not constitute a domestic entity acquisition of USPS1, regardless of the quantum of USPS1's interest in USPS2, because there is nothing in the Code or regulations that would attribute USPS2's trade or business properties to USPS1 for purposes of Section 7874. Accordingly, the Ownership Requirement would be applied by reference to FA stock received by the former domestic entity partners of USPS2 (*i.e.*, USPS1 and the other USPS2 partners), subject to the application of Section 7874(c)(5) applying to treat the USPS1 partners as former domestic entity partners of USPS2.

The trade or business analysis discussed above should be the same if FA instead acquires all the issued and outstanding interests in USPS1. Specifically, the Partnership Indirect Acquisition Rule should apply first to treat FA as indirectly acquiring all the issued and outstanding shares in FS and USPS1's interests in USPS2, and then should also apply to treat FA as indirectly acquiring a percentage of USPS2's trade or business properties equal to USPS1's percentage ownership in USPS2. If FA indirectly acquires substantially all the properties of USPS2's trade or business in this scenario (*e.g.*, if USPS1 owned 90 percent of USPS2), then the acquisition would be a domestic entity acquisition of USPS2, but not USPS1. In this case, for purposes of the Ownership Requirement, the numerator of the ownership fraction should include only the FA shares received by USPS1 partners attributable to the value of the USPS2 interests.[75] In contrast, the FA shares received by USPS1 partners attributable to the value of the FS shares should not be included in the numerator, but should be included in the denominator of the ownership fraction unless otherwise excluded under the Section 7874 regulations.[76]

Applying the Acquisition Requirement without attributing trades or businesses of lower-tier partnerships to upper-tier partnerships is not only more consistent with the plain language of

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[75] *Cf.* PLR 202237005 (Jun. 21, 2022) (treating as "by reason of" stock the foreign acquiring corporation stock received in exchange for the portion of the interests in a foreign partnership attributable to the foreign partnership's indirect interests in a lower-tier domestic partnership that was engaged in a trade or business). As noted above, Section 7874(c)(5) provides that, unless regulations provide otherwise, for purposes of applying the Ownership Requirement to the acquisition of a trade or business of a domestic partnership, all partnerships that are under common control, within the meaning of Section 482, are treated as one partnership. Treas. Reg. § 1.482-1(i)(4) defines "controlled" to include "any kind of control, direct or indirect, whether legally enforceable or not, and however exercisable or exercised, including control resulting from the actions of two or more taxpayers acting in concert or with a common goal or purpose." We would expect Section 7874(c)(5) to apply to most situations in which an acquisition of interests in USPS1 would result in a domestic entity acquisition of USPS2. For example, if USPS1 was the majority partner in USPS2, we would expect USPS1 and USPS2 to be commonly controlled partnerships. Conversely, if USPS1 was a minority partner in USPS2, USPS1 and USPS2 may not be commonly controlled partnerships, but an acquisition of all the USPS1 interests would not be expected to result in a domestic entity acquisition with respect to USPS2. For example, if USPS1 owns 49 percent of USPS2, an acquisition of 100 percent of USPS1 would be an indirect acquisition of less than half the properties constituting a trade or business of USPS2, and thus, would not be a domestic entity acquisition of USPS2. One situation where further guidance may be necessary is where USPS1 is a minority partner in USPS2 and, pursuant to the same plan or series of related transactions, a foreign corporation completes a domestic entity acquisition of USPS2 by acquiring interests in USPS1 from the USPS1 partners and interests in USPS2 from the other USPS2 partners. In this situation, USPS1 and USPS2 may not be commonly controlled partnerships, and thus section 7874(c)(5) would not apply. We would support Treasury and the IRS issuing guidance treating the USPS1 partners as former domestic entity partners of USPS2 to the extent of their indirect ownership in USPS2. *See* PLR 202237005.

[76] *Cf.* PLR 202237005 (treating as stock other than "by reason of" stock the foreign acquiring corporation stock received in exchange for the portion of the interests in a foreign partnership attributable to assets other than the foreign partnership's indirect interests in a lower-tier domestic partnership that was engaged in a trade or business).

the Code, but it is also a more administrable approach to applying Section 7874. Specifically, by not attributing trades or businesses through tiered partnership structures, neither taxpayers nor the government will be forced to determine the extent to which an upper-tier partnership's undivided interest in each asset of a lower-tier partnership's trade or business is sufficient to "constitute" a trade or business of the upper-tier partnership. For example, if USPS1 owned a minority interest in USPS2 (*e.g.,* USPS1 owns one percent of USPS2), if USPS2's trade or business properties could be attributed to USPS1, it would have to be determined at what threshold USPS2's trade or business would be attributed to USPS1 for purposes of the Acquisition Requirement. If it were determined that USPS1's minority interest in USPS2's trade or business constituted a trade or business *of* USPS1, then an acquisition of USPS1 by a foreign acquiring corporation would be a domestic entity acquisition notwithstanding that only a minority interest in the underlying trade or business was actually transferred to a foreign corporation. We believe this result is incorrect and not supported by the Code because it would effectively read the "trade or business" aspect of the Acquisition Requirement out of the Code with respect to tiered partnership structures.[77] Further, the trade or business analysis would be more difficult in tiered partnership structures that include complex economic allocations to achieve desired investment rights.

The trade or business analysis discussed above in Example 1 should also be the same irrespective of whether USPS1 or USPS2 is a foreign partnership. For example, if USPS2 were instead a foreign partnership (FPS in the diagram below) with a trade or business, such trade or business should not be attributed to USPS1 for Section 7874 purposes. For reasons that are unclear, Congress decided to apply Section 7874 to partnership inversions by reference to the residence of the partnership that directly conducts the trade or business in question. Thus, in this scenario, Section 7874 should not apply to an indirect acquisition of FPS's trade or business, regardless of the form of the acquisition (*e.g.*, an acquisition of USPS1 interests or FPS interests).[78]

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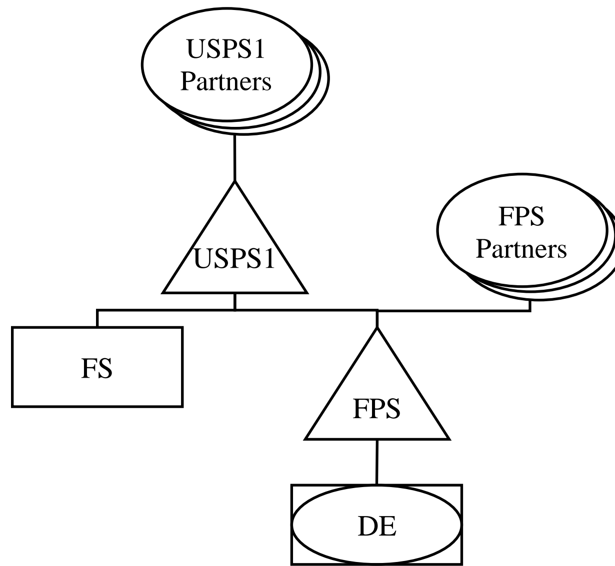
[77] For similar reasons, we believe that, in Example 1, USPS1 should not be attributed a trade or business conducted by FS (or, if FS was instead a domestic corporation, a trade or business conducted by that domestic corporation). In addition to not being supported by the statutory language, which refers to a trade or business "of" a domestic partnership, such an approach would not achieve any meaningful policy objective. Since FS's assets already are in foreign corporate solution, it is hard to see why a direct or indirect transfer of those assets should implicate the inversion rules. In addition, if FS was a domestic corporation, the rules dealing with corporate inversions should apply to the transfer of the stock in such domestic corporation. *See* Treas. Reg. § 1.7874-2(e) (providing that if, pursuant to a plan (or series of related transactions), a foreign corporation completes more than one domestic entity acquisition, then such acquisitions are treated as a single domestic entity acquisition and such domestic entities are treated as a single domestic entity). Particularly given the unclarity of the congressional goals behind including partnership inversions in the statute, it would seem that a straightforward reading and application of the relevant statutory wording is the preferable approach.

[78] It could be argued that not attributing the trade or business of a lower-tier foreign partnership to an upper-tier domestic partnership facilitates Section 7874 avoidance because the upper-tier domestic partnership could transfer a trade or business to a lower-tier foreign partnership in anticipation of such trade or business being subsequently acquired by a foreign corporation. We believe the Code provides sufficient safeguards against this type of transaction. First, Section 7874 would integrate all steps that occur "pursuant to a plan (or a series of related transactions)." *See* Section 7874(a)(2)(B). In addition, Section 7874(c)(4) would disregard any transfers of properties or liabilities if such transfers are part of a plan with a principal purpose of avoiding the purposes of Section 7874. Thus, we believe Treasury and the IRS have adequate authority to address transitory transfers of

Example 2




**B. Identifying Property that Constitutes a Trade or Business**

As discussed above, the Acquisition Requirement is satisfied when a foreign acquiring corporation acquires substantially all of the properties that constitute a trade or business of a domestic partnership. Neither the Code nor the regulations provide guidance as to when items of property "constitute" a trade or business.

The dictionary definition of "constitute" is "to be the elements or parts of; compose."[79] Therefore, we believe that an item of property constitutes a trade or business if it is part of—*i.e.*, is used in or held for use in—the trade or business. As such, we recommend Treasury and the IRS amend the Section 7874 regulations to provide, consistent with other areas of Federal income tax law, that:

(i) the determination of whether property constitutes a trade or business is based on all of the facts and circumstances;

(ii) property generally constitutes a trade or business if it is: (A) held for the principal purpose of promoting the present conduct of the trade or business, (B) acquired and held in the ordinary course of the trade or business, or (C) otherwise held in a direct relationship to the trade or business; and

trades or businesses that are intended to prevent the Acquisition Requirement from being satisfied. We also note that, under current law, this issue is not fundamentally one related to tiered partnership structures, since a domestic partnership can redomicile to a foreign partnership without triggering the application of Section 7874.

[79] The American Heritage Dictionary of the English Language (5th ed. 2022).

(iii) property is held in a direct relationship to a trade or business if it is held to meet the present needs of the business, not its anticipated future needs (*i.e.*, property is not held in a direct relationship to a trade or business if it is held for future diversification into a new trade or business, a future expansion of a trade or business, or future business contingencies).[80]

We believe the above guidelines will assist taxpayers and the government in determining whether property constitutes a trade or business based on a domestic partnership's unique facts and circumstances.[81] For example, liquid assets may constitute a trade or business of a domestic partnership that is engaged in an investment trade or business, but may not constitute a trade or business of a domestic partnership that is engaged in a manufacturing trade or business. In different cases, treating assets as part of a trade or business of a domestic partnership may increase, or decrease, the likelihood of a partnership inversion, with the result that neutral and commercially reasonable rules as to whether property constitutes a trade or business of a domestic partnership – as we believe the above suggested rules to be – appear to be the most sensible way to implement the statute.

### C. EAG Rules

Foreign acquiring corporation stock held by EAG members is disregarded for purposes of determining the ownership percentage (the "**General EAG Rule**").[82] An EAG is an affiliated group that includes the foreign acquiring corporation.[83] For purposes of Section 7874, an "**affiliated group**" is defined by cross-reference to Section 1504(a), but determined (i) without regard to the limitation in Section 1504(b)(3) that prevents foreign corporations from being considered includible corporations, and (ii) using a "more than 50 percent" ownership threshold, instead of the usual "at least 80 percent threshold."[84] Thus, an EAG is one or more chains of domestic or foreign corporations that are includible corporations connected through stock ownership with a domestic or foreign common parent corporation that is an includible

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[80] *See* Treas. Reg. § 1.367(a)-2(d)(5); *see also* Treas. Reg. §§ 1.864-4(c)(2)(ii), (iv) (providing similar standards for determining whether an asset is used in, or held for use in, the conduct of a U.S. trade or business); 1.884-5(e)(3)(ii)(A) (cross-referencing Treas. Reg. § 1.367(a)-2(d)(5) for purposes of the branch profits tax substantial presence test); 1.936-10(c)(4)(ii) (cross-referencing Treas. Reg. § 1.367(a)-2(d)(5) for purposes of the Section 936 qualified business activity determination); 1.897-1(f)(2) (cross-referencing Treas. Reg. § 1.864-4(c)(2) for purposes of determining whether an asset is used in or held for use in an entity's trade or business for purposes of Section 897).

[81] The definition of a "trade or business" for purposes of Section 7874 is beyond the scope of this Report. However, Treasury and the IRS may consider defining the term "trade or business" for purposes of Section 7874 under the regulatory authority in Sections 7805(a) and 7874(g). This definition could limit the application of Section 7874 to acquisitions of substantially all of the properties constituting a U.S. trade or business, so Section 7874 would apply to circumstances that could facilitate U.S. base erosion and would not apply to circumstances that do not present U.S. base erosion concerns. A more modest refinement, however, may be to exempt trades or businesses from the application of Section 7874 where Congress has made an explicit choice to exempt income generated by such business activities from U.S. taxation, such as the exception for trading in securities or commodities under Section 864(b)(2) or shipping income subject to Section 883(a).

[82] Section 7874(c)(2)(A); Treas. Reg. § 1.7874-1(b).

[83] Section 7874(c)(1); Treas. Reg. § 1.7874-12(a)(7).

[84] Treas. Reg. § 1.7874-12(a)(1).

corporation, if: (i) the common parent owns directly at least 50 percent (by vote and value) of the stock in at least one of the other includible corporations; (ii) at least 50 percent (by vote and value) of the stock in each of the includible corporations (except the common parent) is owned directly by one or more of the other includible corporations; and (iii) the chain(s) include the foreign acquiring corporation. In general, the determination of whether an EAG exists and its composition is made as of the completion date (*i.e.*, the date that the domestic entity acquisition and all transactions related to the domestic entity acquisition are complete).[85]

The General EAG Rule was included in Section 7874 for two reasons. First, the rule was intended to prevent the avoidance of Section 7874 by disregarding affiliate-owned "hook" stock for purposes of determining the ownership percentage.[86] Second, the rule was intended to limit the scope of Section 7874 and prevent intragroup transactions from resulting in inversions.[87]

The General EAG Rule is subject to the Internal Group Restructuring Exception and the Loss of Control Exception (each as defined below, and collectively with the General EAG Rule, the "**EAG Rules**"). If either of these exceptions applies to a domestic entity acquisition, foreign acquiring corporation stock owned by EAG members is included in the denominator, but not the numerator, of the ownership fraction (unless otherwise excluded from the denominator of the ownership fraction under another Section 7874 regulation).[88] The "**Internal Group Restructuring Exception**" applies to a domestic entity acquisition if: (i) before the acquisition, at least 80 percent of the vote and value of the domestic entity was held directly or indirectly by the corporation that is the common parent of the EAG after the acquisition, and (ii) after the acquisition, at least 80 percent of the vote and value of the foreign acquiring corporation is held directly or indirectly by such common parent.[89] The "**Loss of Control Exception**" applies to a domestic entity acquisition if, after the acquisition, the former domestic entity shareholders do not hold, in the aggregate, directly or indirectly more than 50 percent of the stock (as measured by vote or value) of any member of the EAG.[90] Treasury promulgated the Internal Group Restructuring Exception to prevent Section 7874 from applying to certain transactions occurring as part of an internal group restructuring involving a domestic entity,[91] and promulgated the Loss of Control Exception to prevent the General EAG Rule from causing Section 7874 to apply to certain acquisitive business transactions between unrelated parties where the former domestic

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[85] Treas. Reg. § 1.7874-12(a)(3), (a)(7); *but see* Treas. Reg. § 1.7874-1(c)(2)(iii) (discussed *infra* note 105 and accompanying text).

[86] 2004 Conference Report, at 1626 ("In determining whether a transaction meets the definition of an inversion under the provision, stock held by members of the [EAG] is disregarded. For example, if the former top-tier U.S. corporation receives stock of the foreign incorporated entity (*e.g.*, so-called 'hook' stock), the stock would not be considered in determining whether the transaction meets the definition.").

[87] *Id.* ("Similarly, if a U.S. parent corporation converts an existing wholly owned U.S. subsidiary into a new wholly owned controlled foreign corporation, the stock of the new foreign corporation would be disregarded.").

[88] Treas. Reg. § 1.7874-1(c)(1).

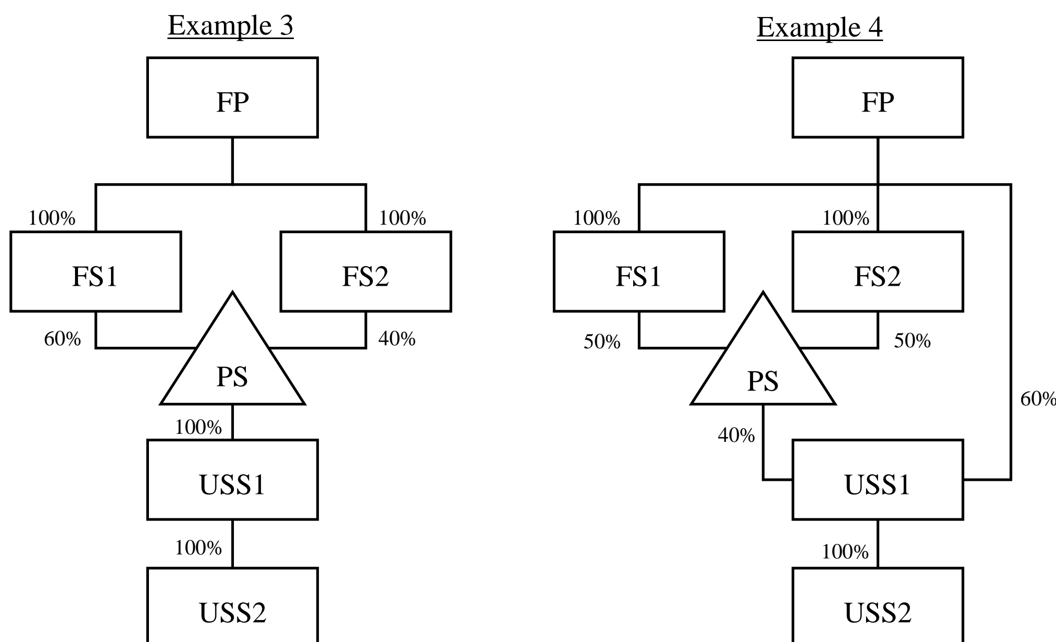
[89] Treas. Reg. § 1.7874-1(c)(2).

[90] Treas. Reg. § 1.7874-1(c)(3).

[91] T.D. 9238, 70 Fed. Reg. 76685 (Dec. 28, 2005).

entity shareholders or the former domestic entity partners have a minority interest in the acquired properties after the acquisition.[92]

A partnership is not an "includible corporation" and thus is not a member of an affiliated group under the rules of Section 1504 and also for purposes of Section 7874. Moreover, for purposes of determining an affiliated group, a partnership is generally treated as an entity, rather than an aggregate of its partners, and thus the interposition of a partnership within a group of corporations can "disaffiliate" members of the corporate group. For example, in Example 3 (depicted below), because of the interposition of PS in the structure, FP, FS1, and FS2 are members of one affiliated group for purposes of Section 7874, and USS1 and USS2 are members of another, separate affiliated group. In contrast, in Example 4, because FP owns a sufficient interest in USS1 directly (*i.e.*, without regard to PS), FP, FS1, FS2, USS1, and USS2 are all members of the same affiliated group.




Determining the composition of an affiliated group is the first step in identifying an EAG, and identifying an EAG is important for many purposes in Section 7874. Therefore, a partnership's ability to "break" affiliation presents unique challenges to the operation of Section 7874. To address these challenges, the Section 7874 regulations provide various rules prescribing the treatment of partnerships, depending on the context. For example, for purposes of the EAG Rules (*i.e.*, the rules for determining the stock to be excluded for purposes of the Ownership Requirement), each partner in a partnership is treated as holding its "proportionate share" of stock held by the partnership, as determined under the rules and principles of Sections

[92] *Id.*

701 through 777 (the **Partnership Look-Through Rule**").[93] The Partnership Look-Through Rule applies for many purposes in Section 7874,[94] including for purposes of the Lack of Substantial Business Activities Requirement.[95]

In addition to the Partnership Look-Through Rule, Treasury and the IRS have employed another rule for addressing the treatment of partnerships for purposes of the Ownership Requirement and the Lack of Substantial Business Activities Requirement. This alternative rule provides that if one or more EAG members, in the aggregate, owns more than 50 percent of the value of the interests in a partnership, then the partnership is treated as a corporation that is a member of the EAG for purposes of the regulation in question (the "**Deemed Corporation Rule**").[96] In some instances the Deemed Corporation Rule is the only rule that addresses the treatment of partnerships,[97] and in other instances the Deemed Corporation Rule applies only after the Partnership Look-Through Rule.[98] In the preamble to the regulations implementing the

[93] Treas. Reg. § 1.7874-1(f). Stock held by a partnership was considered held proportionately by its partners solely for purposes of the EAG Rules when the Internal Group Restructuring Exception and Loss of Control Exception were first promulgated as temporary regulations in 2005. Treas. Reg. § 1.7874-1T(b) (2005). Treasury expanded the scope of this look-through rule when it finalized the exceptions in 2008, applying the Partnership Look-Through Rule for all Section 7874 purposes. Treas. Reg. § 1.7874-1(e) (2008). A year later, however, Treasury opted to return to a formulation of the Partnership Look-Through Rule similar to its original formulation in the 2005 temporary regulations by limiting the application of the rule to the EAG Rules. This change was made to ensure that the rule applied only for purposes of determining whether the Ownership Requirement is satisfied, and not also for purposes of the Lack of Substantial Business Activities Requirement. T.D. 9453, 74 Fed. Reg. 27920 (Jun. 12, 2009). However, as discussed in text below, Treasury and the IRS eventually decided to apply both the Partnership Look-Through Rule and the Deemed Corporation Rule (defined and discussed below) to the Lack of Substantial Business Activities Requirement.

[94] *See, e.g.,* Treas. Reg. §§ 1.7874-2(b)(3) (applying the Partnership Look-Through Rule for purposes of determining "properties held by a partnership (such as stock)"); 1.7874-6(d)(1) (applying the Partnership Look-Through Rule for purposes of the Transferred Stock Rules (defined and discussed below)).

[95] *See* Treas. Reg. § 1.7874-3(e)(1).

[96] *See* Treas. Reg. §§ 1.7874-3(e)(2) (applying the Deemed Corporation Rule for purposes of the Lack of Substantial Business Activities Requirement); 1.7874-4(g) (applying the Deemed Corporation Rule for purposes of the rules disregarding certain stock issued in connection with a domestic entity acquisition (the "**Disqualified Stock Rules**")); 1.7874-6(d)(2) (applying the Deemed Corporation Rule for purposes of the Transferred Stock Rules); 1.7874-7(d) (applying the Deemed Corporation Rule for purposes of the rules disregarding stock attributable to passive assets ("**Excessive Passive Asset Rules**")). By treating a partnership as an EAG member, the Deemed Corporation Rule ensures that the partnership's assets are also taken into account for purposes of the relevant provision. For example, if the Deemed Corporation Rule applies to treat a partnership as a member of the EAG, the assets and operations of a partnership would be taken into account in determining whether the Lack of Substantial Business Activities Requirement is satisfied or whether more than 50 percent of foreign group property constitute foreign group nonqualified property for purposes of the Excessive Passive Asset Rules. In contrast, the Partnership Look-Through Rule can operate only to ensure that corporate partners of a partnership and subsidiaries of that partnership are included in the same EAG; that rule would not include the partnership itself, including its assets and operations, in any EAG.

[97] Treas. Reg. §§ 1.7874-4(g) (the Disqualified Stock Rules) and 1.7874-7(d) (Excess Passive Asset Rules).

[98] Treas. Reg. §§ 1.7874-3(e)(2) (the rules relating to the Lack of Substantial Business Activities Requirement) and 1.7874-6(d)(2) (the Transferred Stock Rules); *see* T.D. 9720, 80 Fed. Reg. 31837 (Jun. 4, 2015) (explaining the interaction of the Partnership Look-Through Rule and the Deemed Corporation Rule as follows: "The final regulations coordinate the application of the deemed corporation rule with the look-through rule by providing that

Lack of Substantial Business Activities Requirement, Treasury and the IRS explained that the Partnership Look-Through Rule was necessary to ensure the proper functioning of the Deemed Corporation Rule in cases where the foreign acquiring corporation was owned by a partnership:

> A comment [to the temporary Section 7874 regulations issued in 2012 (T.D. 9592)] stated that the deemed corporation rule would not treat a partnership owning more than 50 percent of the stock of the foreign acquiring corporation or its corporate partners as members of the EAG because the partnership is not otherwise owned by a member of the EAG. For example, assume that P, a corporation, owns (by value) 75 percent of the interests of PS, a domestic partnership. PS forms FA, a foreign corporation, and transfers substantially all of its assets constituting a trade or business to FA in exchange for all the stock of FA. According to the comment, neither PS nor P is treated as a member of the EAG that includes FA under the 2012 temporary regulations.
>
> The Treasury Department and the IRS have determined that this result is inappropriate. Accordingly, the final regulations provide that, in determining the corporations that are members of the EAG, each partner in a partnership is treated as holding its proportionate share of the stock held by the partnership (look-through rule). *This rule is consistent with the rules provided in § 1.7874-1(e)* (disregarding certain affiliate-owned stock) and section 2.03 (b) (i) of Notice 2014-52 (addressing subsequent transfers of stock of the foreign acquiring corporation)."[99]

### 1. The Partnership Look-Through Rule and EAG Determination

The Partnership Look-Through Rule applies for the purposes of the EAG Rules, but the manner in which it applies is a critical issue for which clear guidance is needed. On one hand, the Partnership Look-Through Rule could be read to only apply for purposes of determining whether stock is owned by members of an EAG, as determined under the Code (*i.e.*, the Partnership Look-Through Rule applies *after* the EAG determination is made). This interpretation is supported by the fact that the Partnership Look-Through Rule applies "[f]or purposes of [Treas. Reg. § 1.7874-1]," but the definition of EAG is not included in that section.[100] On the other hand, the Partnership Look-Through Rule could be read to apply for purposes of determining whether a corporation is a member of an EAG in the first place (*i.e.*, the Partnership Look-Through Rule applies *to determine* the EAG). The discussion of the

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the look-through rule applies first and without regard to the deemed corporation rule. The result is that the look-through rule applies only for purposes of determining whether an entity that is actually a corporation for U.S. income tax purposes is a member of the EAG. Then, once those corporate entities are identified, the deemed corporation rule applies to treat certain partnerships in which those corporate entities are partners as corporations that are members of the EAG.").

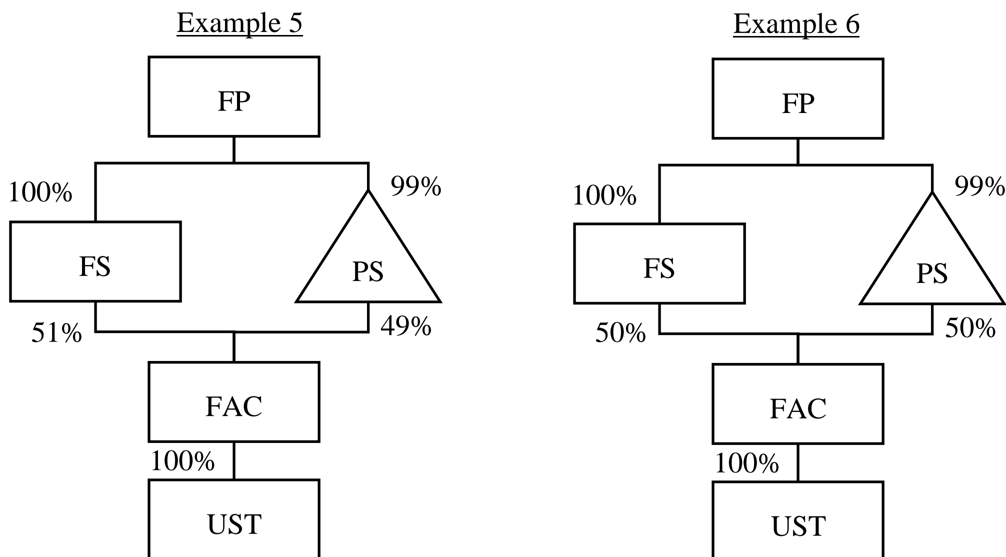
[99] T.D. 9720, 80 Fed. Reg. 31837 (Jun. 4, 2015) (emphasis added). The citation in the discussion to Treas. Reg. § 1.7874-1(e) is based on the 2008 version of Treas. Reg. 1.7874-1, before the Partnership Look-Through Rule was redesignated as Treas. Reg. § 1.7874-1(f).

[100] Treas. Reg. § 1.7874-1(a) cross-references Treas. Reg. § 1.7874-12 "[f]or definitions that apply for purposes of this section." Treas. Reg. § 1.7874-12(a)(1) and (7) define affiliated group and expanded affiliated group, respectively, and neither of these paragraphs explicitly incorporate the Partnership Look-Through Rule.

Partnership Look-Through Rule in the preamble to Treas. Reg. § 1.7874-3 strongly suggests the latter interpretation is correct.

To highlight the importance of this issue, we next consider several examples where, but for the existence of an intervening partnership, each corporation would be a member of the EAG that includes the foreign acquiring corporation.

Examples 5 and 6 depict the ownership of the FP group after FAC, a foreign corporation, has acquired 100 percent of the issued and outstanding shares in UST, a domestic corporation.



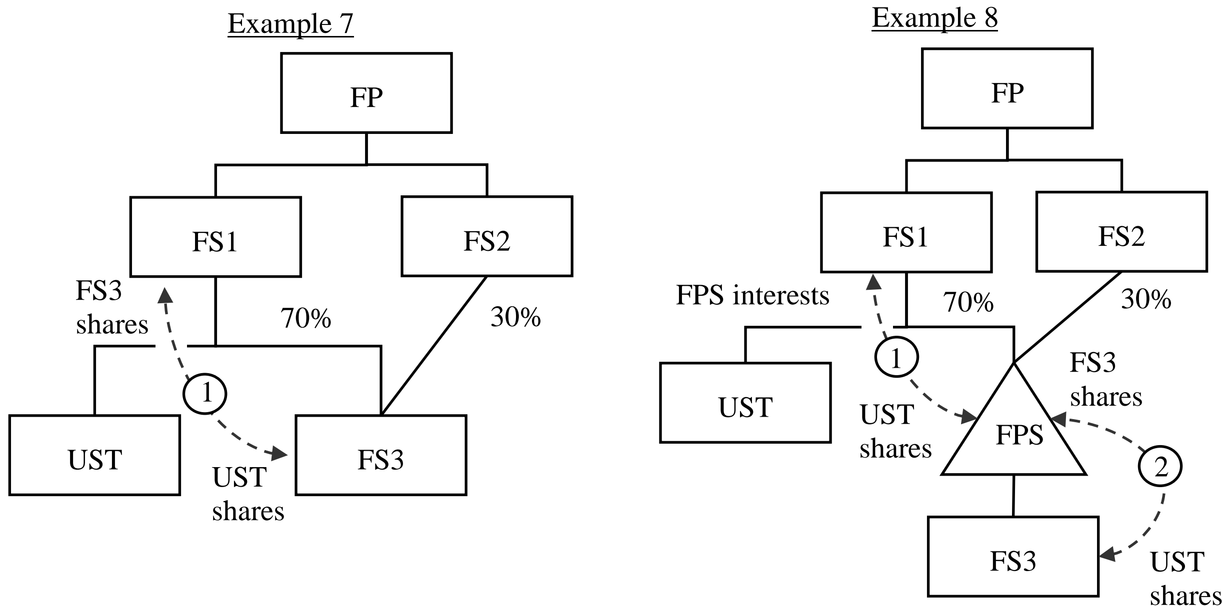

In Example 5, FS owns a sufficient interest in FAC such that FS and FP are members of the EAG under the Code. The Partnership Look-Through Rule applies to treat 99.51 percent of the issued and outstanding shares in FAC as held by EAG members.

In Example 6, however, FS does not own more than 50 percent of the vote and value of FAC, and thus, FS and FP are not members of FAC's EAG under the Code. Thus, if the Partnership Look-Through Rule does not apply to determine the EAG, neither FS nor FP is a member of the EAG and none of the shares in FAC may be subject to the EAG Rules, despite the fact that FP indirectly owns 99.50 percent of FAC.

The potentially divergent results in Examples 5 and 6 are in stark contrast to the nearly identical ownership structure and raise questions over whether the presence of PRS should cause such disparity. If, however, the Partnership Look-Through Rule applies for purposes of determining the EAG, the results are far more consistent: (i) Example 5 has an EAG parented by FP that includes FS, FAC, and UST, and EAG members own 99.51 percent of the issued and outstanding shares in FAC; and (ii) Example 6 has an EAG parented by FP that includes FS, FAC, and UST, and EAG members own 99.50 percent of the issued and outstanding shares in FAC. Thus, applying the Partnership Look-Through Rule to determine the EAG eliminates the

divergent results that would otherwise be caused by the interposition of PRS, bringing consistency to the nearly identical cases.

Examples 7 and 8 consider the impact of an intervening internal partnership on the application of the Internal Group Restructuring Exception. In each example, FS1 has held 100 percent of the issue and outstanding shares in UST before the plan or series of related transactions depicted in the example.




In Example 7, FS1 contributes 100 percent of the issued and outstanding shares in UST to FS3 solely in exchange for FS3 shares. After the transaction, FP is the common parent of the EAG, and FP, FS1, FS2, FS3, and UST are EAG members. The transfer of UST shares in Example 7 qualifies for the Internal Group Restructuring Exception, because (i) before the acquisition, FP, the common parent of FS3's EAG, indirectly owned more than 80 percent of the voting power and value of UST, and (ii) after the acquisition FP indirectly owns more than 80 percent of the voting power and value of FS3. Therefore, the numerator of the ownership fraction should be zero, and the denominator of the ownership fraction should be all the issued and outstanding shares in FS3, in each case subject to adjustment by other rules in the Section 7874 regulations.

In Example 8, (i) FS1 contributes 100 percent of the issued and outstanding shares in UST to FPS, a foreign partnership, in exchange for interests in FPS, and then (ii) FPS contributes the UST shares to FS3 in exchange for FS3 shares. If the Partnership Look-Through Rule does not apply to determine the EAG, then FP, FS1, and FS2 are not members of the EAG that includes FS3, the foreign acquiring corporation, and the EAG Rules do not apply, notwithstanding that FP indirectly owns 100 percent of both UST before and FS3 after the transaction. Therefore, the numerator of the ownership fraction would be the FS3 shares issued in exchange for the UST shares, and the denominator of the ownership fraction would be all the issued and outstanding shares in FS3, in each case subject to adjustment by other rules in the Section 7874 regulations. Accordingly, if the value of FS3 is small relative to the value of UST, UST had material nonordinary course distributions ("**NOCDs**") to FS1, or a material number

FS3 shares are disregarded under other rules in the Section 7874 regulations (*e.g.*, under the Disqualified Stock Rules), Example 8 could result in FS3 being a surrogate foreign corporation or a domestic corporation, notwithstanding that it has the same economics and indirect ownership as Example 7.

In light of the above, we recommend that Treasury and the IRS clarify that the Partnership Look-Through Rule applies to determine the EAG for purposes of the EAG Rules.

### 2. The Deemed Corporation Rule and the EAG Rules

While applying the Partnership Look-Through Rule for the purposes of determining the composition of the EAG should resolve many of the inconsistencies caused by intervening partnerships in organizational structures, we have also considered whether the Deemed Corporation Rule should also apply for purposes of the EAG Rules. The principal rationale for this approach is to conform the EAG definition used in the EAG Rules and in Treas. Reg. § 1.7874-6 (the "**Transferred Stock Rules**"). As discussed below, the Transferred Stock Rules apply to determine whether certain "by reason of" stock is treated as owned by EAG members for purposes of the EAG Rules. Thus, the Transferred Stock Rules alter the application of the EAG Rules in certain circumstances. Accordingly, it may be advisable for the Transferred Stock Rules and the EAG Rules to use the same rules to determine an EAG and its members.

The Transferred Stock Rules are largely intended to prevent taxpayers from taking the position that the EAG Rules apply to "by reason of" stock that is owned temporarily by one or more members of the EAG but then transferred outside the group to non-EAG members pursuant to the same plan or series of related transactions as the domestic entity acquisition (*e.g.*, the Transferred Stock Rules prevent the EAG Rules from applying to "spinversions").[101] Treas. Reg. § 1.7874-6(b) provides the general rule that transferred stock is not treated as held by EAG members for purposes of the EAG Rules (the "**Transferred Stock General Rule**"). "**Transferred stock**" is generally defined as "by reason of" stock that is received by a corporation that is either a former domestic entity shareholder or former domestic entity partner (a "**transferring corporation**") and is subsequently transferred in a transaction (or series of transactions) related to the domestic entity acquisition.[102] Thus, transferred stock is generally included in the numerator and denominator of the ownership fraction.

There are two exceptions to the Transferred Stock General Rule. If the requirements of either of these exceptions are satisfied, transferred stock is treated as held by EAG members for purposes of the EAG Rules. The "**U.S.-Parented Group Exception**" applies if the following requirements are satisfied: (i) before the domestic entity acquisition, the transferring corporation is the member of an affiliated group that has a domestic corporation as its common parent (a "**U.S.-parented group**"); and (ii) after the domestic entity acquisition, the transferring corporation (or its successor), any person that holds transferred stock, and the foreign acquiring corporation are members of a U.S.-parented group the common parent of which either (A) was a

[101] "By reason of" stock retains its character as such even if it is subsequently transferred by a former domestic entity shareholder or former domestic entity partner in a transaction related to the domestic entity acquisition. Treas. Reg. § 1.7874-5(a).

[102] Treas. Reg. § 1.7874-6(f)(2).

member of the pre-acquisition U.S.-parented group, or (B) was formed in a transaction related to the domestic entity acquisition and immediately after its formation was a member of the pre-acquisition U.S.-parented group.[103] The "**Foreign-Parented Group Exception**" applies if the following requirements are satisfied: (i) before the domestic entity acquisition, the transferring corporation and the domestic entity are members of the affiliated group that has a foreign corporation as its common parent (a "**foreign-parented group**"); and (ii) after the domestic entity acquisition, the transferring corporation either (A) is an EAG member, or (B) would be an EAG member, absent one or more transfers (other than by issuance), in a transaction (or series of transactions) after and related to the domestic entity acquisition, of stock of the foreign acquiring corporation by one or more members of the foreign-parented group.[104] Additionally, if the Foreign-Parented Group Exception applies to a transaction, then for purposes of the Internal Group Restructuring Exception, the EAG determination and the determination of EAG-owned stock are made after the domestic entity acquisition and without regard to one or more transfers (other than by issuance) in a transaction or series of transactions related to the domestic entity acquisition of foreign acquiring corporation stock by a member of the foreign-parented group.[105]

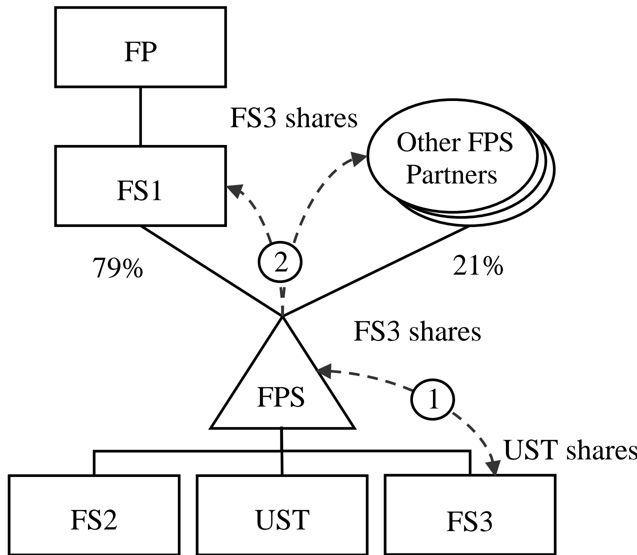
The Transferred Stock Rules are predicated on entities being treated as EAG members, and thus the Deemed Corporation Rule is necessary. For example, if a partnership that is owned by EAG members is a former domestic entity shareholder and subsequently transfers "by reason of" stock pursuant to the same plan or series of related transactions as a domestic entity acquisition, the Transferred Stock Rules would not apply to such transfer but for the Deemed Corporation Rule. To illustrate this point, consider Example 9 depicted below.

[103] Treas. Reg. § 1.7874-6(c)(1).

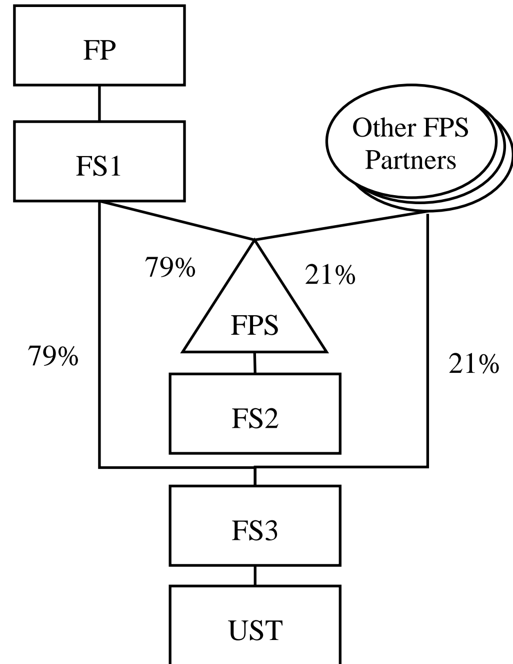
[104] Treas. Reg. § 1.7874-6(c)(2).

[105] Treas. Reg. § 1.7874-1(c)(2)(iii). This is an exception to the general rule that all transactions related to a domestic entity acquisition are taken into account in applying the EAG Rules. *See* Treas. Reg. § 1.7874-1(g). The Transferred Stock Rules also generally take into account all transactions related to a domestic entity acquisition. *See* Treas. Reg. § 1.7874-6(e).

Example 9: Transaction




Example 9: Resulting Structure



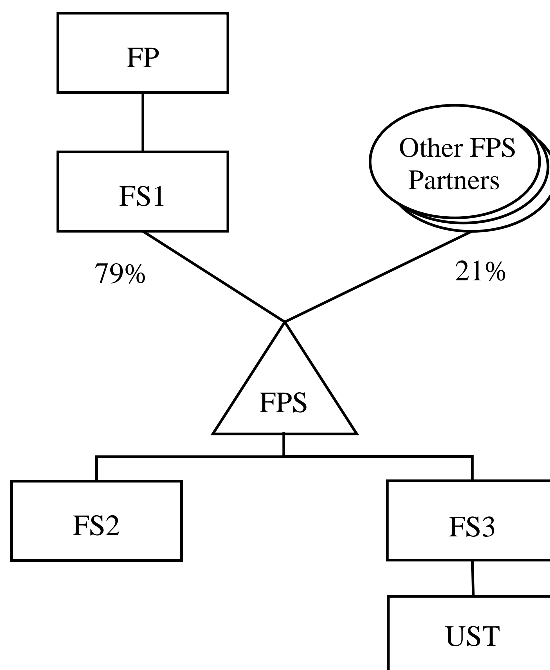

In Example 9, FPS (i) transfers all of the issued and outstanding shares in UST to F3, and then (ii) distributes all of the issued and outstanding shares in F3 to its partners in accordance with their FPS partnership interests.

The Deemed Corporation Rule in the Transferred Stock Rules treats FPS as a corporation that is a member of the EAG because FS1, an EAG member, directly owns more than 50 percent of the value of FPS. Since FPS is a corporation for purposes of the Transferred Stock Rules, FPS is a transferring corporation, and thus, the FS3 shares distributed by FPS are transferred stock. The transaction in Example 9 satisfies the requirements of the Foreign-Parented Group Exception: (i) before the domestic entity acquisition, FPS and UST, are members of the same foreign-parented group (because FPS is treated as a corporation under the Deemed Corporation Rule); and (ii) after the domestic entity acquisition, FPS (as a deemed corporation) is a member of the EAG. Accordingly, the FS3 shares distributed by FPS are treated as held by members of the EAG for purposes of applying the EAG Rules, notwithstanding that FPS is not treated as an EAG member under the EAG Rules.

The transaction would not satisfy the Internal Group Restructuring Exception, because FP does not directly or indirectly own at least 80 percent of the voting power or value in UST before the transaction or FS3 after the transaction. Also, if, consistent with our above recommendation, the Partnership Look-Through Rule applies to determine the members of the EAG, the transaction would not satisfy the Loss of Control Exception because FPS, the former domestic entity shareholder, owns 100 percent of FS2, a member of the EAG, after the transaction. Thus, subject to other adjustments, the numerator and denominator of the ownership fraction would each be zero.

If, however, FPS does not distribute to its partners the FS3 shares (see Alternative Resulting Structure below), then none of the FS3 shares would be transferred stock and the Transferred Stock Rules would not apply to the transaction. Accordingly, if the Partnership Look-Through Rule applies to determine the EAG for purposes of the EAG Rules, then the ownership percentage, subject to other adjustments, would be 100. The FS3 shares owned by FS1 would be disregarded under the General EAG Rule and the FS3 shares owned by the Other FPS Partners would be included in the numerator and denominator of the ownership fraction because the transaction would not satisfy the requirements for the Internal Group Restructuring Exception or the Loss of Control Exception for the reasons stated above.

Example 9: Alternative Resulting Structure




We believe that the application of Section 7874 to the Resulting Structure and the Alternative Resulting Structure in Example 9 should produce the same results—*i.e.*, the Section 7874 results should not depend on whether FPS distributes its FS3 stock. Accordingly, we believe that the Transferred Stock Rules and the EAG Rules should treat partnerships the same. As announced, the Transferred Stock Rules included the Partnership Look-Through Rule but not the Deemed Corporation Rule.[106] The Deemed Corporation Rule was added to the Transferred Stock Rules without explanation when the rules were issued as temporary regulations in 2016. Because the inclusion of the Deemed Corporation Rule was deliberate and part of a more recent, comprehensive regulation package, we assume that the reasons for including the Deemed Corporation Rule in the Transferred Stock Rules are still relevant today. If this assumption is

[106] Notice 2014-52 ("For purposes of this section 2.03(b), including for purposes of applying section 1504(a), each partner in a partnership is treated as holding its proportionate share of stock held by the partnership, as determined under the rules and principles of sections 701 through 777.").

correct, we recommend that Treasury and the IRS conform the treatment of partnerships in the Transferred Stock Rules and the EAG Rules by adding the Deemed Corporation Rule to Treas. Reg. § 1.7874-1.

### D. Partnership Incorporations

"By reason of" stock includes, but is not limited to, foreign corporation stock described in the transactions listed in Treas. Reg. § 1.7874-2(f)(1). As is relevant to partnerships, this non-exhaustive list includes: (i) foreign corporation stock received in exchange for, or with respect to, an interest in a partnership (the "**Partnership Interest Exchange Rule**");[107] and (ii) if the Partnership Interest Exchange Rule does not apply, foreign corporation stock received by a domestic partnership in exchange for all or part of its properties (the "**Partnership Incorporation Rule**").[108] In a case where the Partnership Incorporation Rule applies, "each partner in the domestic partnership shall be treated as holding its proportionate share of the stock of the foreign corporation by reason of holding an interest in the domestic partnership."[109]

The Partnership Incorporation Rule prevents taxpayers from arguing that a partnership inversion does not occur where a domestic partnership transfers substantially all the properties constituting a trade or business to a foreign corporation in exchange for stock in such corporation, but does not distribute such stock to its partners. Example 10 in Treas. Reg. § 1.7874-2(k) illustrates the application of the Partnership Incorporation Rule:

> (i) Facts
>
> Individuals A and B equally own DPS. DPS transfers substantially all of its properties constituting a trade or business to FA, a newly formed corporation, solely in exchange for FA stock. DPS retains the FA stock after the transaction.
>
> (ii) Analysis
>
> Under [the Partnership Incorporation Rule], for purposes of [the Ownership Requirement], individuals A and B are treated as holding a proportionate amount (that is, an equal amount) of the FA stock held by DPS by reason of holding an interest in DPS.

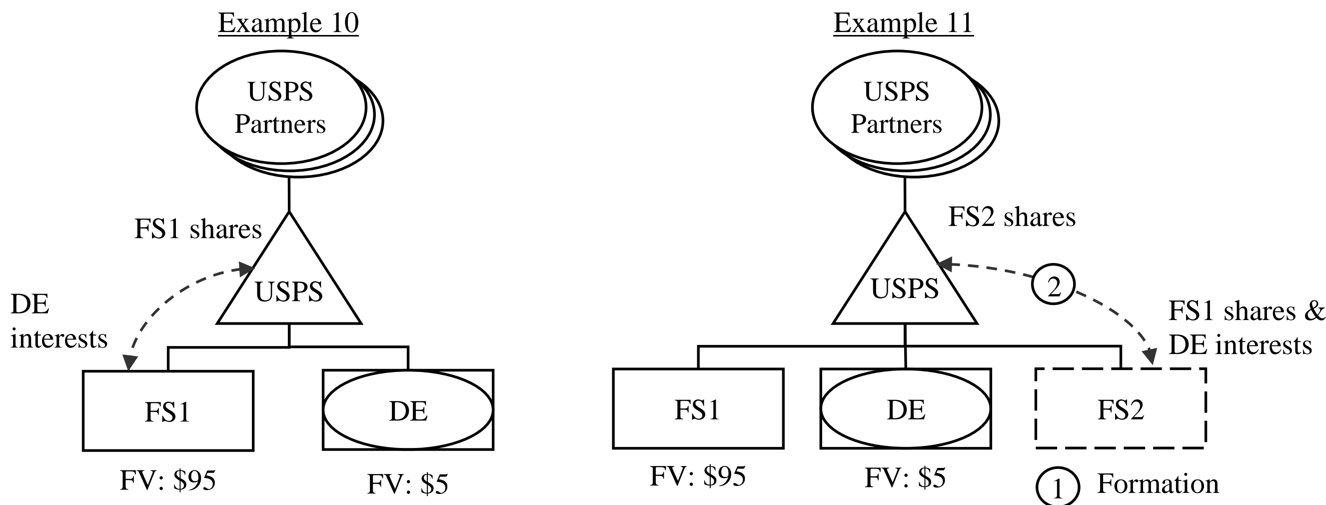
The application of the Partnership Incorporation Rule to situations that only involve the transfer of trade or business assets makes sense from a Section 7874 policy perspective. The application of the rule to situations where a domestic partnership also transfers nontrade or business property to a foreign corporation, however, produces counterintuitive results that suggest the rule should be revised. Specifically, the Partnership Incorporation Rule treats all foreign acquiring corporation stock received by a domestic partnership in exchange for its properties as "by reason of" stock (*i.e.*, foreign acquiring corporation stock received by reason of holding interests in the domestic partnership) without regard to whether such properties constitute a trade or business of the domestic partnership. This approach can lead to very

[107] Treas. Reg. § 1.7874-2(f)(1)(ii).

[108] Treas. Reg. § 1.7874-2(f)(1)(iii).

[109] *Id.*

different results for similar transactions, as illustrated below in Examples 10 and 11. In both examples, the activities of DE, a disregarded entity, constitute a trade or business of USPS, and the FS stock is not property that comprises part of the trade or business.[110]




In Example 10, USPS transfers all the issued and outstanding interests in DE to FS1 in exchange for additional FS1 shares. This transfer is a domestic entity acquisition because it results in FS1 acquiring all the properties of USPS's trade or business. Under the Partnership Incorporation Rule, the $5 of FS1 stock received by USPS in exchange for its DE interests is "by reason of" stock, and the ownership percentage is five percent, subject to other adjustments in the Section 7874 regulations. Importantly, the FS shares historically owned by USPS are not subject to the Partnership Incorporation Rule because the shares are not received in exchange for USPS's properties.

In Example 11, USPS transfers all the issued and outstanding interests in DE and all the issued and outstanding shares in FS1 to newly formed FS2 in exchange for FS2 shares. Similar to Example 10, this transfer is a domestic entity acquisition because it results in FS2 acquiring all the properties of USPS's trade or business. Unlike Example 10, however, it appears that the Partnership Incorporation Rule applies to treat all $100 of FS2 stock received in the exchange as "by reason of" stock and the ownership percentage is 100 percent, subject to other adjustments in

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[110] As noted above, the Partnership Incorporation Rule provides that "by reason of" stock includes foreign corporation stock received by a domestic partnership "in exchange for all or part of its properties." *Id*. As also noted above, when the Partnership Incorporation Rule applies, "each partner in the domestic partnership shall be treated as holding its proportionate share of *the stock of the foreign corporation* by reason of holding an interest in the domestic partnership." *Id.* (emphasis added). It could be argued that the phrase "the stock of the foreign corporation" should be interpreted to refer to *all* foreign acquiring corporation stock owned by the domestic partnership, not just the foreign acquiring corporation stock subject to the Partnership Incorporation Rule (*i.e.*, the stock received by the domestic partnership in exchange for all or part of its properties). We believe that this interpretation is incorrect. Rather, we believe that the phrase "the stock of the foreign corporation" should refer to only the stock subject to the Partnership Incorporation Rule, as interpreting the phrase otherwise would produce absurd results. For example, the application of such an interpretation to Example 10 would result in FS1 becoming a domestic corporation under Section 7874(b) notwithstanding that FS1's operations represent 95 percent of USPS's value and are already owned through a foreign subsidiary.

the Section 7874 regulations. Here, the FS2 shares received by USPS in exchange for its historically owned FS1 shares are subject to the Partnership Incorporation Rule because FS2 shares are received in exchange for USPS's properties, notwithstanding that FS1 shares are not trade or business assets.

There does not appear to be a policy rationale for the different treatment of the transactions in Examples 10 and 11. Therefore, we recommend amending the Partnership Incorporation Rule such that, in the case of a partnership incorporation, the amount of "by reason of" stock is limited to the foreign acquiring corporation stock received in exchange for the trade or business assets transferred by the domestic partnership to the foreign corporation.[111] To prevent domestic partnerships from manipulating the ownership percentage by transferring liquid, nontrade or business properties to a foreign corporation, we also recommend revising Treas. Reg. § 1.7874-4(c)(1)(i) to treat foreign acquiring corporation stock transferred to a domestic partnership in exchange for nonqualified property in a transaction related to a domestic entity acquisition as disqualified stock.[112]

### E. Substantially Similar Interests

The regulations contain rules that treat instruments as stock in a corporation or an interest in a partnership for purposes of Section 7874. Treas. Reg. § 1.7874-2(h) (the "**Option Rule**") treats an option with respect to a corporation or a partnership as stock in the corporation, or an interest in the partnership, as applicable, with a value equal to the option holder's claim on the equity of the corporation or the partnership (*i.e.*, the value of the stock or interest that can be acquired by exercising the option, less the option strike price).[113] The Option Rule also treats an option as exercised for purposes of determining the voting power of a foreign corporation under Section 7874 if a principal purpose of the issuance or transfer of the option is to avoid the foreign corporation as being treated as a surrogate foreign corporation.[114] For purposes of the Option Rule, an option is defined broadly to includes any interest similar to an option, including, but not limited to, a warrant, a convertible debt instrument, an instrument other than debt that is convertible into stock or a partnership interest, a put, stock or a partnership interest subject to risk of forfeiture, a contract to acquire or sell stock or a partnership interest, and an exchangeable share or exchangeable partnership interest.[115]

Treas. Reg. § 1.7874-2(i)(1) (the "**Substantially Similar Interest Rule**") is a backstop to the Option Rule that addresses "transactions intended to avoid section 7874 by using interests

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[111] *Cf.* Treas. Reg. § 1.7874-2(f)(2) (allocating foreign acquiring corporation stock issued in exchange for, or with respect to, equity in the domestic entity and "other property" to the equity and property based on the relative value of each). To create parity between partnership incorporations and transfers of partnership interests, we would also support applying this approach to dispositions of partnership interests such that the ownership percentage with respect to all partnership inversions is determined by reference to a domestic partnership's trade or business properties.

[112] See Treas. Reg. § 1.7874-4(c)(1)(i) (including as disqualified stock "transferred to a person *other than the domestic entity* in exchange for nonqualified property") (emphasis added).

[113] Treas. Reg. § 1.7874-2(h)(1).

[114] Treas. Reg. § 1.7874-2(h)(2).

[115] Treas. Reg. § 1.7874-2(h)(5).

(such as stock or partnership interests) that, although not in form exchangeable or convertible into stock of a foreign corporation, are structured to be substantially equivalent to an equity interest in the foreign corporation."[116] Specifically, the Substantially Similar Interest Rule provides that, "for the purposes of Section 7874, any interest (including stock or a partnership interest) that is not otherwise treated as stock of a foreign corporation (including under [the Option Rule]) shall be treated as stock of the foreign corporation" if two conditions are satisfied:

(i) "the interest provides the holder distribution rights that are substantially similar in all material respects to the distribution rights provided by stock in the foreign corporation [(the "**Distribution Rights Condition**")], and

(ii) treating the interest as stock of the foreign corporation has the effect of treating the foreign corporation as a surrogate foreign corporation under Section 7874(a)(2)(B)."[117]

For purposes of the Distribution Rights Condition, "distribution rights include rights to dividends (or partnership distributions), distributions in redemption of the interest (in whole or in part), distributions in liquidation, or other similar distributions that represent a return on, or of, the holder's investment in the interest."[118]

The following example from the regulations illustrates the application of the Substantially Similar Interest Rule to partnership interests:

(i) Facts

(A) Individuals A and B equally own DC1. FA, a newly formed corporation, issues stock in a public offering for cash. Individuals A and B and FA organize FPS. FA transfers part of the cash from the public offering to FPS in exchange for a class A partnership interest. FA does not hold any significant assets other than the class A partnership interest. Individuals A and B transfer their DC1 stock to FPS in exchange for class B partnership interests.

(B) The class B partnership interests entitle individuals A and B to cash distributions from FPS approximately equal to any dividend distributions made by FA with respect to its publicly traded stock. In certain circumstances, the class B partnership interests also permit individuals A and B to require FPS to redeem the interests in exchange for cash equal to the value of an amount of FA stock as determined on the redemption date. The class B partnership interests do not provide individuals A or B voting rights with respect to FA.

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[116] T.D. 9453, 74 Fed. Reg. 27920, 27924 (Jun. 12, 2009).

[117] Treas. Reg. § 1.7874-2(i)(1).

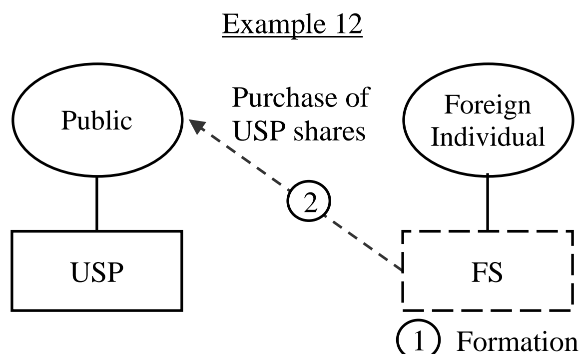
[118] Treas. Reg. § 1.7874-2(i)(1)(i).

(ii) Analysis

The non-liquidating distribution rights provided by the class B partnership interests are substantially similar in all material respects to the dividend rights provided by the FA stock. Because FA does not hold any significant assets other than the class A partnership interest, the value of the class B partnership interests held by individuals A and B is approximately equal to a corresponding amount of FA stock. The distribution rights on liquidation (or redemption) provided by the class B partnership interests, therefore, are substantially similar in all material respects to distribution rights on liquidation (or redemption) provided by the FA stock. Thus, the distribution rights provided by the class B partnership interests are substantially similar in all material respects to the distribution rights provided by the publicly traded FA stock. As a result, if treating the class B partnership interests as FA stock would have the effect of treating FA as a surrogate foreign corporation, under paragraph (i)(1) of this section the class B partnership interests will be treated as FA stock for purposes of section 7874.[119]

As discussed below, we believe additional guidance is needed to appropriately narrow the scope of the Substantially Similar Interest Rule in several important respects. For the purpose of further analysis, consider the following example:[120]

<u>Example 12</u>




In Example 12, Foreign Individual forms FS, a foreign corporation, solely to acquire and hold investments in USP, a publicly traded domestic corporation. Assume that Foreign Individual contributes cash to FS in exchange for one newly issued FS share, and then FS uses the cash to buy a single share of USP stock from the public. In this example, there is a concern

[119] Treas. Reg. § 1.7874-2(k)(2), *Example 18. See also* Treas. Reg. § 1.7874-2(k)(2), *Example 17* (demonstrating the application of the Substantially Similar Interest Rule to corporate stock in a similar situation). This Substantially Similar Interest Rule would have the effect of treating FA as a surrogate foreign corporation if the acquisition of the class A partnership interests resulted in FA indirectly acquiring substantially all of the assets of DC1 (e.g., if the class A partnership interest represented 90 percent of the capital and profits interests in FPS such that FA were treated as indirectly acquiring 90 percent of DC1's assets under Treas. Reg. § 1.7874-2(c)(1)) and FA did not otherwise fail the Lack of Substantial Business Activities Requirement. Absent the application of the Substantially Similar Interest Rule, former shareholders of DC1 would not be treated as having received shares of FA by reason of their ownership of FPS interests. The Substantially Similar Interest Rule, therefore, ensures that the value of the Class B partnership interests is included in the "by reason of" numerator under section 7874(a)(2)(B)(ii)(I).

[120] Example 12 does not involve a partnership, but the Substantially Similar Interest Rule applies the same to partnerships and corporations.

that FS's acquisition of USP stock could result in an inversion of USP by reason of the Substantially Similar Interest Rule. Specifically, because FS is a special purpose vehicle the sole purpose of which is to acquire and hold interests in USP, the distribution rights with respect to the FS stock could be viewed as "substantially similar" to the distribution rights with respect to the USP stock. Further, if USP interests were treated as FS stock, the Substantially Similar Interest Rule could be interpreted as applying for purposes of the Acquisition Requirement, deeming an exchange by *all* the USP shareholders of their USP stock for FP stock, which exchange could be treated as an indirect acquisition of all of the assets of USP.[121]

That the acquisition of a single USP share in Example 12 could result in an inversion by reason of the Substantially Similar Interest Rule is clearly inappropriate as a matter of policy. While this is a risk under the current regulations, we do not believe that it represents the correct interpretation of the Substantially Similar Interest Rule. We recommend that Treasury and the IRS clarify the proper scope of the Substantially Similar Interest Rule to ensure that acquisitions similar to the transaction illustrated in Example 12, including transactions involving domestic partnerships, are not subject to Section 7874.

First, Treasury and the IRS should clarify that the Distribution Rights Condition is not satisfied unless the holders of interests in an entity (the "**original interests**") exchange the original interests either for interests in another entity or new interests in the same entity but with distribution rights that differ from the distribution rights with respect to the original interests, or the distribution rights with respect to the original interests are otherwise modified, including by reason of any legal or contractual arrangement between the holders of the original interests and the foreign corporation. In other words, for the Substantially Similar Interest Rule to apply, the shareholders that are deemed to hold stock in a foreign corporation by reason of the rule must have "participated" in the transaction in some manner. Applying this standard to Example 12, because the USP shareholders did not exchange their USP interests for new interests, or their distribution rights with respect to such interests were not otherwise modified, the Substantially Similar Interest Rule would not apply.

Second, Treasury and the IRS should clarify that the Distribution Rights Condition is not satisfied unless, after an exchange or modification, the terms of the interest itself, or any other legal or contractual arrangement that affect the distribution rights with respect to the interest, provide the holder distribution rights that are tied to or derivative of, and are substantially similar in all material respects to, the distribution rights provided by stock in the foreign corporation.[122] In other words, Treasury and the IRS should clarify that interests in an entity will not be treated as "substantially similar" to stock of a foreign corporation merely because the underlying assets are identical (*e.g.*, where the foreign corporation is merely a holding company for interests in

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[121] *See* Treas. Reg. § 1.7874-2(c)(1)(i).

[122] We would also point out that these rights, whether within the terms of the interest or by any other contractual or legal arrangement, need not be enforceable solely against the foreign corporation. For example, in an "Up-C" structure, where a foreign public corporation forms a partnership with the former owners of a domestic entity, the partnership interest held by former domestic entity owners should still be treated as a "substantially similar" to the foreign public corporation stock if, instead of an exchange mechanism by which partners exchange their partnership interest for foreign public corporation stock, the partnership has an obligation to redeem the partnership interests from the partners based on the value of the stock in the foreign public corporation.

such entity). We believe this is the better interpretation of the Substantially Similar Interest Rule as currently drafted, but the example in the regulations muddies the waters by reiterating in the analysis that the foreign corporation "does not hold any significant assets other than the class A partnership interest." We believe that, in Example 12, whether FS owns assets other than the USP stock should be treated as irrelevant to whether an "interest [in USP] provides the holder distribution *rights* that are substantially similar in all material respects to the distribution rights provided by stock in [FS]." Absent such rights, either in the instrument itself or pursuant to legal or contractual arrangements between the parties, the economics of FS and USP could meaningfully diverge; for example, FS could subsequently acquire assets that cause a public shareholder's distribution rights with respect to USP stock to no longer track Foreign Individual's distributions rights with respect to FS stock. Even the *possibility* of such economic divergence would cause a reasonable investor in USP not to view its USP stock as "substantially similar" to FS stock.

Third, Treasury and the IRS should clarify that the Substantially Similar Interest Rule does not apply merely because the terms of the stock in a foreign corporation provide distribution rights that are similar in all material respects to those provided by interests in another entity. In Example 12, even if the FS stock explicitly provided Foreign Individual distribution rights that are tied to the distribution rights provided by USP (*e.g.*, FS obligates itself to distribute all distributions received from USP), it would still be inappropriate to treat USP stock as "substantially similar" to the FS stock. While the holder of the FS stock would enjoy the benefit of distribution rights similar to that of a holder of USP stock, this is not a "right" that inures to the benefit of the holder of the USP stock. Indeed, FS and Foreign Individual could at any time change the distribution rights with respect to FS without the participation of the USP shareholders.

Finally, the Substantially Similar Interest Rule, when applicable, treats an interest as stock in a foreign corporation; however, the rule does not explicitly provide that, if applicable, the foreign corporation is treated as issuing its stock in exchange for the relevant interest or an interest in the domestic entity transferred in exchange for the relevant interest for all purposes of Section 7874, including for purposes of the Acquisition Requirement. Therefore, it is not clear whether the Substantially Similar Interest Rule can cause a domestic entity acquisition to occur, or, alternatively, whether it applies only for purposes of the Ownership Requirement where a domestic entity acquisition occurs without regard to the rule. Regardless of the scope of the rule under current law, we believe that the Substantially Similar Interest Rule should apply solely for purposes of the Ownership Requirement and should not apply to deem an acquisition for purposes of the Acquisition Requirement where the foreign corporation has no right or obligation to directly or indirectly acquire the properties of the domestic entity pursuant to the terms of the instrument or other arrangements. Thus, we believe that Treasury and the IRS should clarify that the Substantially Similar Interest Rule does not apply for purposes of the Acquisition Requirement unless: (i) the holder is entitled to exchange the interest for stock in the foreign corporation or a person that is either more than 50 percent owned, directly or indirectly, by vote or value or controlled, within the meaning of Section 482, by the foreign corporation (such person, a "**related person**"); (ii) the holder is otherwise entitled to compel the foreign corporation or a related person to acquire or redeem the interest; (iii) the foreign corporation or a related person has the right to acquire or redeem the interest; or (iv) the interest is part of a plan or series of related transactions that provides the foreign corporation or a related person with the

benefits and burdens of substantially all of a domestic corporation's properties or substantially all the properties constituting a domestic partnership's trade or business.

### F. De Minimis Exception

Each of the Disqualified Stock Rules, the Excessive Passive Asset Rules, and the rules related to NOCDs to Treas. Reg. § 1.7874-10 (the "**NOCD Rules**") provide an exception to their application (the "**De Minimis Exception**") if the following two conditions are satisfied:

(i) The ownership percentage, determined without regard to the Disqualified Stock Rules, the Excessive Passive Asset Rules, and the NOCD Rules, is less than five (by vote and value) (the "**Ownership Percentage Condition**"); and

(ii) On the completion date, each five percent former domestic entity shareholder or five percent former domestic entity partner, as applicable, owns (applying the attribution rules of Section 318(a) with the modifications described in Section 304(c)(3)(B)) less than five percent (by vote and value) of the stock of (or a partnership interest in) each member of the EAG (the "**Five Percent Owner Condition**").[123]

For purposes of the Five Percent Owner Condition, a "**five percent former domestic entity shareholder**" or "**five percent former domestic entity partner**" (each a "**five percent former domestic entity owner**") is a former domestic entity shareholder or former domestic entity partner (each a "**former domestic entity owner**") that, before the domestic entity acquisition, owned (applying the attribution rules of Section 318(a) with the modifications described in Section 304(c)(3)(B)) at least five percent (by vote and value) of the stock of (or a partnership interest in) the domestic entity.[124]

The original version of the De Minimis Exception was added to the Disqualified Stock Rules in 2014. This version of the exception was more difficult to satisfy than the current version, because the Five Percent Owner Condition was satisfied only if the former domestic entity owners, *in the aggregate*, owned (by applying Section 318(a), as modified by Section 304(c)(3)(B)), less than five percent of the vote and value of the stock or partnership interests in each member of the foreign acquiring corporation's EAG.[125] Thus, this version of the Five Percent Owner Condition would have aggregated *all* former domestic entity owners as a single class for purposes of determining whether the five-percent ownership threshold was satisfied.

This original version of the De Minimis Exception was also added to the Excessive Passive Asset Rules and NOCD Rules in 2016.[126] Treasury and the IRS explained this exception was intended to prevent the Excessive Passive Asset Rules and NOCD Rules from applying "to a

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[123] Treas. Reg. §§ 1.7874-4(d)(1), -7(c), -10(d). Note that, while the Disqualified Stock Rules employ the Deemed Corporation Rule and the Excessive Passive Asset Rules employ both the Deemed Corporation Rule and the Partnership Look-Through Rule, the NOCD Rules do not include any rule addressing the treatment of partnerships.

[124] Treas. Reg. §§ 1.7874-4(d)(1)(ii), -7(c)(2), -10(d)(2).

[125] Treas. Reg. § 1.7874-4T(d)(1)(ii) (2014).

[126] *See* T.D. 9761, Fed. Reg. 20857 (Apr. 8, 2016).

domestic entity acquisition that, given minimal actual ownership continuity, largely resembles a cash purchase by the foreign acquiring corporation of the stock of (or interests in) the domestic entity."[127]

In response to comments that the original version of the De Minimis Exception was too limited in its application, Treasury amended the Five Percent Owner Condition when it finalized the Disqualified Stock Rules in 2017.[128] As amended, this condition was satisfied if *each* former domestic entity owner owned (by applying Section 318(a), as modified by Section 304(c)(3)(B)), less than five percent of the vote and value of the stock or partnership interests in each member of the foreign acquiring corporation's EAG.[129] Thus, the amended Five Percent Owner Condition applied the five-percent ownership threshold separately to each former domestic entity owner, not to all former domestic entity shareholders and former domestic entity partners as a single class.

Treasury revised the scope of the Five Percent Owner Condition of the De Minimis Exception to the current version when it finalized the Excessive Passive Asset Rules and the NOCD Rules in 2018. As finalized, unlike the original version, the Five Percent Owner Condition, determined the five-percent threshold on a shareholder-by-shareholder basis rather

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[127] T.D. 9812, 82 Fed. Reg. 5388 (Jan. 18, 2017). *See also* Notice 2015-79, § 3.02(b), I.R.B. 2015-49 (Nov. 19, 2015) ("Commenters have noted that the rules announced in section 2.02(b) of Notice 2014-52 could cause section 7874 to apply to an acquisition even though the former owners of the domestic entity actually own no, or only a de minimis amount of, stock in the foreign acquiring corporation after the acquisition. In general, this could occur when stock of the foreign acquiring corporation is disregarded for purposes of section 7874. For example, assume that, pursuant to a plan to purchase the stock of a domestic corporation, which made a non-ordinary course distribution, the purchaser forms a newly formed foreign acquiring corporation with cash and the foreign acquiring corporation uses the cash to purchase the stock of the domestic corporation. In applying the ownership percentage, the stock held by the shareholders of the foreign acquiring corporation is disregarded under § 1.7874-4T(b) (which disregards certain stock of the foreign acquiring corporation received in exchange for nonqualified properly). This result is similar to a result that could occur under § 1.7874-4T(b), absent the de minimis exception provided in § 1.7874-4T(d)(1), when the former shareholders of the domestic entity in fact acquire a small interest in the foreign acquiring corporation by reason of having held an interest in the domestic entity. The Treasury Department and the IRS have determined that the policy reasons for providing the de minimis exception in § 1.7874-4T are equally applicable to the regulations described in section 2.02(b) of Notice 2014-52.").

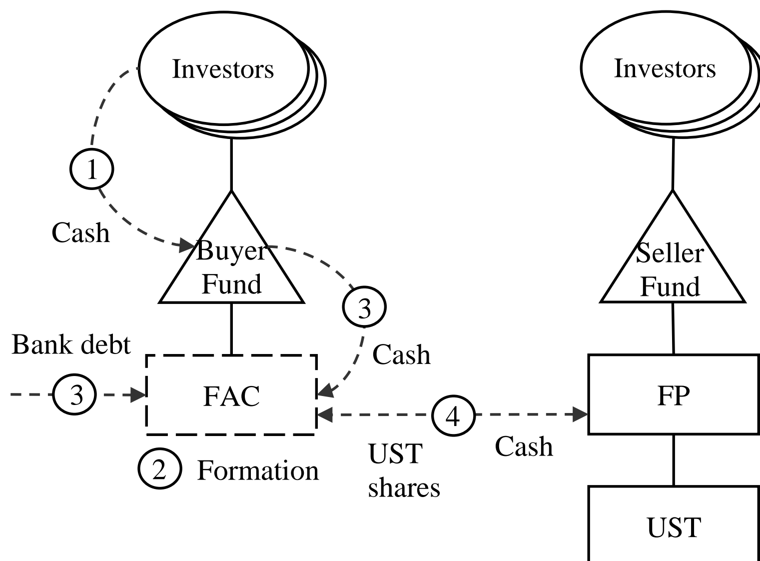
[128] In the preamble to the final regulations, Treasury and the IRS noted comments requesting the precursor to the Five Percent Owner Condition of the De Minimis Exception be eliminated or, alternatively, modified to be determined solely by reference to "by reason of" stock, because "particularly in cases involving a publicly-traded domestic entity or a complex ownership structure, it could be difficult or burdensome to identify each former domestic entity shareholder or former domestic entity partner (including a de minimis former domestic entity shareholder or former domestic entity partner), as applicable, and then determine (taking into account the applicable attribution rules) the former domestic entity shareholders' or former domestic entity partners' collective ownership of the foreign acquiring corporation and each member of the EAG." T.D. 9812, 82 Fed. Reg. 5388, 5393 (Jan. 18, 2017). As a result, taxpayers would often not be able to avail themselves of the De Minimis Exception with respect to a domestic entity acquisition, "notwithstanding that the domestic entity acquisition may largely resemble a purchase." *Id.* However, after consideration of these comments, Treasury and the IRS concluded that "limiting the second requirement to consider only the ownership of former domestic entity shareholders or former domestic entity partners (with applicable attribution rules), individually, rather than the ownership of all former domestic entity shareholders or former domestic entity partners, collectively, strikes the appropriate balance between preventing the de minimis exceptions from applying in inappropriate circumstances and addressing the practical difficulties noted in the comment." *Id.*

[129] *See, e.g.*, Treas. Reg. § 1.7874-4(d)(1)(ii) (2017).

than in the aggregate, and, unlike the earlier revised version, determined the five percent threshold solely with respect to *five percent* former domestic entity owners rather than all former domestic entity owners.

Despite the government's many attempts to reduce the "practical difficulties" presented by the Five Percent Owner Condition, due to the overbreadth of the attribution rules under Section 318, it remains problematic and, in many cases, renders the De Minimis Exception unusable for taxpayers, particularly where partnerships are involved. For example, private equity funds, which generally operate as partnerships, may have limited information on how their limited partners structure their investments in the fund. Also, private equity funds may be forbidden from disclosing the identity of their limited partners to third parties. The attribution rules of Section 318 (as modified by Section 304(c)(3)(B)), and in particular the rules for attribution from and to partnerships in Sections 318(a)(2)(A) and 318(a)(3)(A) create too many attributive possibilities to diligence, causing transactions that are truly cash purchases to be subject to Section 7874 and potentially leaving taxpayers in the unenviable position of trying to prove a negative with potentially limited information.[130] Example 13 illustrates the practical limitations of the De Minimis Exception.

<u>Example 13</u>



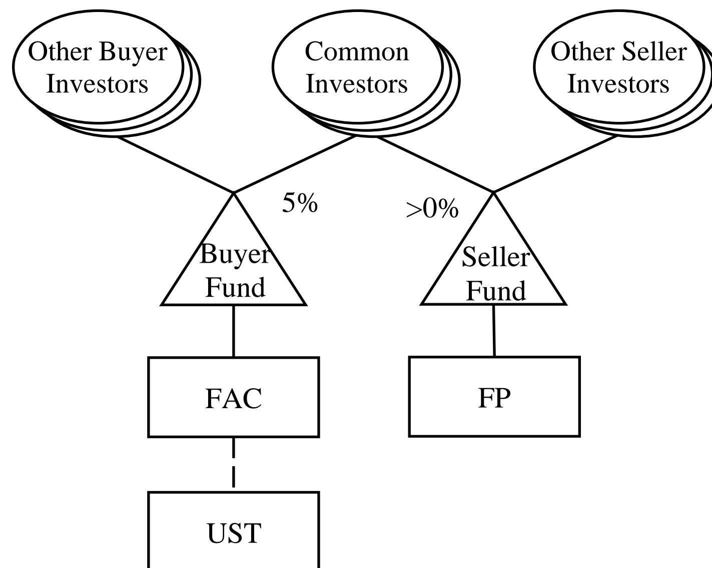

In Example 13, investors contribute cash to Buyer Fund, which uses the cash to equity-fund FAC, a newly formed foreign corporation. FAC uses the cash contributed by Buyer Fund and third-party borrowing proceeds to purchase all the issued and outstanding shares of UST. If the De Minimis Rule does not apply, the FAC shares issued to Buyer Fund will be disregarded under the Disqualified Stock Rules, and the borrowing proceeds transferred to FP will be treated as a distribution for purposes of the NOCD Rules to the extent such proceeds are considered indirectly provided by UST. Thus, notwithstanding that Example 13 is purely a cash purchase in

[130] If characterized as an exception, the burden may generally fall on the taxpayer to prove that the exception applies to a transaction.

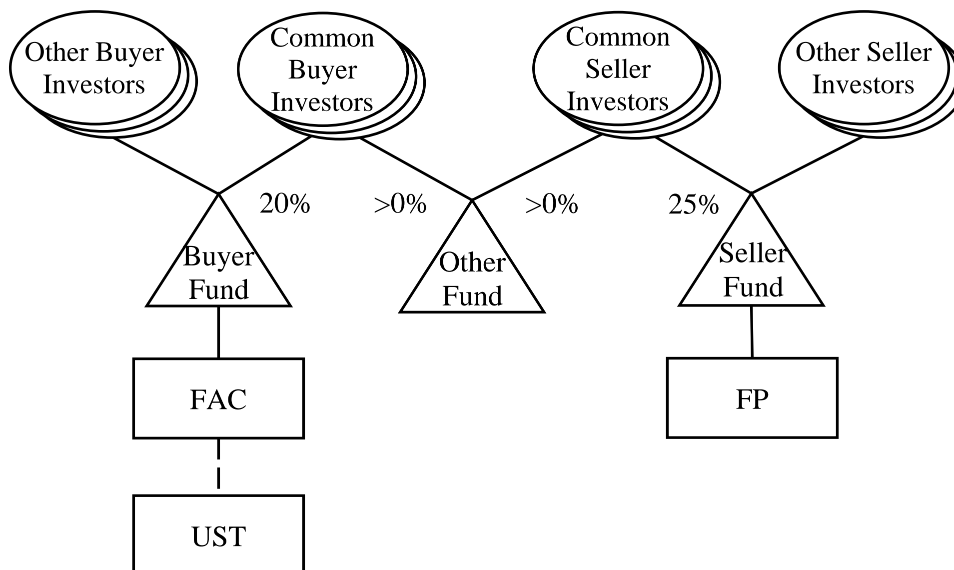
form, the series of transactions could result in FAC being treated as a domestic corporation under Section 7874(b).

The Ownership Percentage Condition of the De Minimis Exception is clearly satisfied in Example 13 because cash is the sole consideration provided by FAC for the UST stock (*i.e.,* the ownership percentage, determined without regard to the Disqualified Stock Rules, the Excessive Passive Asset Rules, and the NOCD Rules, is zero). To prove that the Five Percent Owner Condition is satisfied, FAC needs to establish that FP, the sole former five percent domestic entity shareholder of UST, is not treated as constructively owning five percent or more of FAC. As noted above, this exercise will likely be impracticable, if not impossible, for FAC. For example, if Buyer Fund investors that, in the aggregate, constructively own five percent of FAC also constructively own *any* interest in Seller Fund, the FAC shares owned by such investors will be attributed to Seller Fund under Section 318(a)(3)(A) and then to FP under Section 318(a)(3)(C) (see Example 14 below). Alternatively, if Buyer Fund investors that, in the aggregate, constructively own five percent of FAC through Buyer Fund are also partners with Seller Fund investors in a separate partnership that is unrelated to the FAC or FP investments, the FAC shares owned by the Buyer Fund investors and the FP shares owned by Seller Fund investors will be attributed to the separate partnership under Section 318(a)(3)(A) and the FAC shares will then be attributed to FP under Section 318(a)(3)(C) (see Example 15 below). Thus, FP will fail to satisfy the Five Percent Owner Condition unless it can establish that none of the potential permutations of constructive ownership between the Buyer Fund investors and Seller Fund investors gives rise to a proscribed ownership interest. This is a task that will likely be impracticable to establish in simple fact patterns, and impossible to establish in complex fact patterns—the most likely situation for fund-to-fund sales.

<u>Example 14</u>

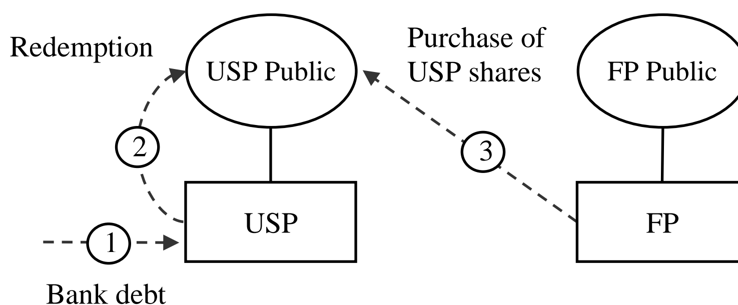


Example 15




The difficulties of proving that the Five Percent Owner Condition of the De Minimis Exception is satisfied are not limited to private equity transactions. Indeed, these difficulties can also apply to public transactions, as illustrated in Example 16.

Example 16




In Example 16, USP uses third-party borrowing proceeds to redeem shares held by the USP Public, and FP purchases the remaining USP shares from the USP Public for cash. If the De Minimis Rule does not apply, the redemption by USP will be treated as a distribution for purposes of the NOCD Rules and will affect the ownership fraction for the transaction. Thus, notwithstanding that Example 16 is purely a cash purchase in form, the series of transactions could produce adverse results under Section 7874.

As in Example 13, the Ownership Percentage Condition of the De Minimis Exception is clearly satisfied in Example 16 because cash is the sole consideration provided by FP for the UST shares (*i.e.,* the ownership percentage, determined without regard to the Disqualified Stock

Rules, the Excessive Passive Asset Rules, and the NOCD Rules, is zero). To prove that the Five Percent Owner Condition is satisfied, FP needs to establish that no member of the USP Public is a former five-percent domestic entity shareholder of USP that constructively owns five percent or more of the vote or value of any EAG member. Although FP may make reasonable assumptions based on publicly available information, the information to prove that this condition is satisfied is simply not available. For example, security filings by material shareholders in USP or FP are typically made on the basis of "street name," and thus do not disclose beneficial ownership. Moreover, even if such filings were made on the basis of beneficial ownership, FP would have no way to determine whether such beneficial owners constructively owned more than five percent of USP or members of FP's EAG under the rules of Section 318.

The stated policy objective of the De Minimis Exception is to prevent the Disqualified Stock Rules, the Excessive Passive Asset Rules, and the NOCD Rules from applying to transactions that are substantively cash purchases. We firmly support this policy objective but believe the De Minimis Exception does not adequately achieve this objective because the second prong is impossible to analyze in many common situations. We recommend that Treasury and the IRS revise the Five Percent Owner Condition to make the De Minimis Exception more useful to taxpayers. In particular, because it is impractical or impossible for taxpayers and the IRS to prove constructive ownership under Section 318, as modified by Section 304(c), in many common transaction forms, we recommend that Treasury and the IRS revise the Five Percent Owner Condition to provide that either: (i) ownership is based on direct or indirect ownership, like the Loss of Control Exception; or (ii) the proscribed level of ownership is presumed not to exist unless a member of the EAG knows, or has reason to know, such ownership exists. If, however, our primary recommendation is not accepted because Treasury and the IRS determine that the Five Percent Owner Condition must include constructive ownership rules, the condition should be revised to provide that either: (y) Section 318(a) applies without regard to downward attribution; or (z) Section 318(a)(2)(A) applies only with respect to a partner that has a meaningful interest in the partnership (*e.g.*, 20 percent).[131]

### G. NOCD Rules

Treasury and the IRS promulgated the NOCD Rules to address transactions in which "a domestic entity . . . distribute[s] property to its former shareholders . . . in order to reduce the ownership fraction by reducing the numerator."[132] To prevent domestic entities from "skinnying down" their value for purposes of the Ownership Requirement, the NOCD Rules disregard certain distributions made by a domestic entity before a domestic entity acquisition that would

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[131] Treasury and the IRS could consider whether their approach to these issues under Section 7874 could build on consideration of similar practical questions under other Code provisions. For example, as discussed in a prior report, similar factual questions arise when applying Section 304, including to acquisitions of public target corporations. *See* NYSBA Tax Section, Report No. 1445, Report on Section 304 in Public M&A Transactions (2020). A similar approach was also recently adopted in Rev. Proc. 2019-40, 2019-43 I.R.B. 982, which permits taxpayers to make presumptions as to a foreign corporation's CFC status in the absence of actual knowledge and after having completed certain prescribed diligence procedures.

[132] Notice 2014-52, § 2.02(b). The Notice also acknowledges that such distributions may be undertaken by a domestic corporation for the purposes of avoiding the application of Section 367(a), by reducing the fair market value of the domestic corporation in order to satisfy the "substantiality requirement" of Treas. Reg. § 1.367(a)-3(c)(3)(iii).

otherwise reduce the ownership percentage. For this purpose, the NOCD Rules define "**distribution**" to include:

(i) any distribution made by a corporation with respect to its stock (other than a distribution to which Section 305 applies, a distribution to which Section 304(a)(1) applies, and, except to the extent described in clauses (iii) and (iv), a distribution pursuant to Section 361(c)(1) (other than a distribution to which Section 355 applies)) (a "**corporate distribution**");

(ii) any distribution by a partnership (other than a distribution pursuant to Section 752(b) to the extent that the transaction giving rise to such distribution does not reduce the value of the partnership) (a "**partnership distribution**");

(iii) a transfer of money or other property to the former domestic entity shareholders or former domestic entity partners that is made in connection with a domestic entity acquisition to the extent such money or other property is directly or indirectly provided by the domestic entity; and

(iv) a transfer of money or other property to the former owners of a predecessor that is made in connection with a predecessor acquisition to the extent such money or other property is directly or indirectly provided by the predecessor.[133]

A distribution pursuant to Section 361(c)(1) (a "**Section 361(c)(1) distribution**") is a distribution of property (including stock of, or "boot" furnished by, an acquiring corporation) pursuant to an acquisitive reorganization.[134] A distribution is treated as made to a partner by a partnership pursuant to Section 752(b) (a "**Section 752(b) distribution**") by reason of a decrease in the partner's share of the liabilities of a partnership or a decrease in the partner's individual liabilities by reason of the assumption by the partnership of such individual liabilities.[135] The exceptions to corporate distributions and partnership distributions, including the exception for Section 361(c) distributions, are intended to apply to transactions that do not reduce the "by reason of" stock received in exchange for interests in the domestic entity.[136]

The application of the NOCD Rules can produce counterintuitive results when a domestic partnership transfers its properties to a buyer in exchange for consideration, and then distributes the consideration to its partners. For example, if a domestic partnership receives foreign acquiring corporation stock in exchange for its assets, and then distributes such stock to its partners, the stock is "by reason of" stock.[137] However, notwithstanding that the foreign acquiring corporation stock is already "by reason of" stock, the distribution of such stock could also be viewed as a "distribution" for purposes of the NOCD Rules, because it is a distribution by a domestic partnership that does not satisfy the narrow exception for Section 752(b)

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[133] Treas. Reg. § 1.7874-10(k)(1)(i)-(iv).

[134] *See* Section 361(c)(1).

[135] *See* Section 752(b).

[136] *See* T.D. 9761, 81 Fed. Reg. 20858, 20869 (Apr. 8, 2016).

[137] *See* Treas. Reg. § 1.7874-2(f)(1)(ii).

distributions. Applying the NOCD Rules to distributions of "by reason of" stock has the absurd effect of potentially doubling the "by reason of" stock, notwithstanding that the distribution of "by reason of" stock obviously does not reduce the amount of "by reason of" stock received by domestic entity owners in the transaction. This double counting issue is not as prevalent in the context of corporate inversions because a Section 361(c)(1) distribution by a domestic acquired corporation of "by reason of" stock pursuant to an asset reorganization satisfies the corporate distribution exception.[138] However, the double counting issue does exist for taxable corporate transactions because the corporate distribution exception only applies to tax-free reorganizations (*i.e.,* Section 361(c)(1) distributions).

To prevent the NOCD Rules from double counting "by reason of" stock, we recommend that Treasury and the IRS clarify that a distribution by a domestic entity (whether a partnership or a corporation, and whether pursuant to a reorganization or taxable transaction) of "by reason **of" stock is not a "distribution" for purposes of the NOCD Rules.[139] We believe that this** clarification would be consistent with the general rule in Treas. Reg. § 1.7874-10(b) that NOCD stock "is in addition to the ["by reason of" stock] otherwise treated as received" by the former owners. Further, the Partnership Incorporation Rule could be read to effectively deem foreign acquiring stock to have been distributed to a domestic partnership's partners, in effect treating the domestic partnership as an aggregate of its partners. Viewed from this perspective, the stock could not be distributed again for purposes of the NOCD Rules.

Similarly, if a domestic partnership receives and distributes property other than "by reason of" stock (*e.g.*, cash) received in the domestic entity acquisition, the distribution of such property is also a "distribution" for purposes of the NOCD Rules. We believe that this rule is overbroad and leads to inappropriate results when the domestic partnership does not directly or indirectly provide this property.[140] For example, if a foreign corporation purchases the trade or business of a domestic partnership in exchange for cash that is not directly or indirectly provided by the domestic partnership, the subsequent distribution of such cash by the partnership should not be subject to the NOCD Rules, because the distribution does not reduce the amount of "by reason of" stock the partners of the domestic partnership receive in the transaction.[141] Again,

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[138] *See* Treas. Reg. § 1.7874-10(k)(1)(i)(C).

[139] *See* Treas. Reg. § 1.7874-10(b) (emphasis added).

[140] A foreign corporation's decision to complete a domestic entity acquisition in exchange for cash instead of stock economically reduces the "by reason of" stock received by the former domestic entity shareholders or former domestic entity partners as an economic matter. The NOCD Rules, however, are not intended to recast all cash purchases as equity transactions. Rather, the rules only treat cash purchases as equity transactions to the extent the domestic entity funds the cash consideration. *See, e.g.*, Notice 2014-52, § 2.02(b) ("A distribution also includes a transfer of money or other property to the owners of the domestic entity that is made in connection with the acquisition described in section 7874(a)(2)(B)(i) to the extent the money or other property is directly or indirectly provided by the domestic entity. For example, if the acquisition of the domestic entity by the foreign acquiring corporation qualifies as a reorganization under section 368(a) and the shareholders of the domestic entity receive other property or "boot" (within the meaning of section 356) in connection with the reorganization, then, to the extent the boot is directly or indirectly provided by the domestic entity for purposes of section 356, the domestic entity is treated as having made a distribution in the amount of that boot for purposes of [the NOCD Rules].")

[141] A domestic partnership should not be treated as "directly or indirectly providing" to its partners the acquisition consideration received solely because such consideration was received in exchange for the domestic partnership's

this issue is not as prevalent in the context of corporate inversions because a Section 361(c)(1) distribution by a domestic corporation of "boot" satisfies the corporate distribution exception to the extent the boot is not directly or indirectly provided by the domestic corporation.[142] However, the issue exists for taxable corporate transactions for the same reason discussed above with respect to distributions of "by reason of" stock – the relevant exception only applies to distributions pursuant to a reorganization.

To prevent the over-application of the NOCD Rules, we recommend that Treasury and the IRS also exclude from the definition of a "distribution" for purposes of the NOCD Rules a distribution by a domestic entity (whether a partnership or corporation) of consideration other than "by reason of" stock received in a domestic entity acquisition, unless the domestic entity directly or indirectly provides such property within the meaning of Treas. Reg. § 1.7874-10(k)(1)(iii). This broad exception for distributions of acquisition consideration would be similar to the general exclusion of "boot" distributions pursuant to corporate reorganizations, thus creating parity under the NOCD rules between domestic entity acquisitions of (i) domestic corporations pursuant to reorganizations, (ii) domestic corporations in taxable transactions, and (iii) domestic partnerships.

properties. A domestic partnership could, however, be treated as providing the acquisition consideration if it is directly or indirectly the source of such consideration. For example, if the foreign acquiring corporation issues debt to obtain the acquisition consideration, the domestic partnership could be viewed as indirectly funding such acquisition consideration if the cash flow from its trade or business is intended to service the debt.

[142] *See* Treas. Reg. § 1.7874-10(k)(1)(i)(C).