NEW YORK STATE BAR ASSOCIATION
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Report No. 1534
November 3, 2026

The Honorable Scott Bessent
Secretary of the Department of the Treasury, and Acting Commissioner of the Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

The Honorable Kevin Salinger
Acting Assistant Secretary (Tax Policy) of the Department of the Treasury, and Acting Chief Counsel of the Internal Revenue Service
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Re: NYSBA Tax Section Report No. 1534 – Report on Simplification of Regulations Under Section 7874 of the Internal Revenue Code

Dear Secretary Bessent and Acting Assistant Secretary Salinger:

Please see attached Report No. 1533 of the Tax Section of the New York State Bar Association (the "Report") presenting options for the simplification and, where warranted, narrowing of five sets of anti-inversion regulations under section 7874 of the Internal Revenue Code. The Report responds to Executive Orders 14192 and 14219, which direct agencies to reduce regulatory burdens and simplify existing rules, and considers whether the current regulations remain appropriately calibrated in light of significant changes to the domestic and international tax landscape.

The Report focuses on the disqualified stock rule, the non-ordinary course distributions rule, the serial acquiror rule, the third-country transaction rule, and the passive assets rule. It recommends that the Treasury Department ("Treasury") and the Internal Revenue Service (the "IRS") consider a range of simplification measures, including greater use of purpose-based standards and safe harbors for ordinary-course activity; more workable de

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minimis exceptions; nexus requirements and shorter look-back periods; and, where appropriate, substantial narrowing or withdrawal of rules whose compliance burdens may now outweigh their policy benefits. In general, the options presented are not mutually exclusive and Treasury and the IRS could adopt different options for different rules.

The Report emphasizes that any revisions should preserve the core protections of section 7874. At the same time, whatever approach Treasury and the IRS adopt, we believe the cumulative effect of the section 7874 regulations on the ownership fraction should remain consistent with, rather than fundamentally alter, the statutory thresholds, and should be proportionate to the policy concerns that underlie the statute in the current environment.

We appreciate the opportunity to comment on these important issues and thank Treasury and the IRS for considering the views of the Tax Section. If you have any questions or would like to discuss any aspect of the Report, please do not hesitate to contact us. We would be pleased to assist in any way.

Respectfully submitted,



Lawrence M. Garrett
Chair

Enclosure

cc:

Rebecca Burch
Deputy Assistant Secretary for International Tax Affairs
Department of the Treasury

James Wang
International Tax Counsel
Department of the Treasury

Isaac Wood
Deputy International Tax Counsel
Department of the Treasury

Brenda Zent
Special Advisor to the International Tax Counsel
Department of the Treasury

Peter Blessing
Associate Chief Counsel (International)
Internal Revenue Service

Mallory Mendrala
Acting Deputy Associate Chief Counsel (Technical)
Office of the Associate Chief Counsel (International)
Internal Revenue Service

John Merrick
Senior Level Counsel
Office of the Associate Chief Counsel (International)
Internal Revenue Service

Robert Williams, Jr.
Senior Counsel
Office of the Associate Chief Counsel (International)
Internal Revenue Service

Report No. 1534

New York State Bar Association Tax Section

Report on Simplification of Regulations Under Section 7874 of the Internal Revenue Code

November 3, 2026

Opinions expressed are those of the Tax Section and do not represent those of the New York State Bar Association unless and until they have been adopted by its House of Delegates or Executive Committee

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I. Executive Summary

This report (the "**Report**") [1] of the New York State Bar Association ("**NYSBA**") Tax Section presents options for the simplification and, where warranted, narrowing of five sets of anti-inversion Regulations promulgated under Section 7874 of the Internal Revenue Code.[2] The Report is responsive to Executive Order 14192[3] and Executive Order 14219 (the "**Executive Orders**"),[4] which direct agencies to reduce regulatory burdens and simplify existing rules. These reflect an executive branch policy to focus resources on regulations "squarely authorized by constitutional Federal statutes" and a requirement to identify regulations that "impose significant costs upon private parties that are not outweighed by public benefits."[5]

In the current environment, the cost-benefit calculus for aggressive anti-inversion Regulations has shifted. A number of changes to domestic tax law have reduced the ability for domestic corporations to reduce their U.S. tax liability through, and therefore reduced their incentives to undertake, inversion transactions. These include the reduction of the corporate tax rate from 35% to 21%, changes to the United States' international tax system, including the enactment of the Section 245A participation exemption, and the enactment of statutes (like the interest deduction limitations of Section 163(j) and the BEAT tax of Section 59A) that reduce the potential benefits of domestic base erosion transactions. The domestic tax law also contains new incentives for U.S.-based operations (such as the deduction for foreign-derived deduction eligible income in Section 250 and the accelerated deductions for domestic research and experimentation costs in Section 174A). At the same time, changes to the broader international tax framework, such as the Side-by-Side Safe Harbour and Pillar Two project, as well as other OECD recommendations under the BEPS Project, have decreased potential inverters' ability to reduce their worldwide tax liability by migrating their group parent outside the United States. The anti-inversion rules once policed transactions that were a significant public policy concern, and their scope, complexity and (in certain cases) overbreadth reflected that concern. However, the evolution of both the domestic and broader international tax rules has mitigated this concern, and, in the current environment, we

[1] The principal authors of this Report are Adam Kool and Joseph Tootle, with substantial assistance from Anna Gleason, Jon Herlin, and Max Nobel. Helpful comments were received from Kimberly Blanchard, Robert Cassanos, Tijana Dvornic, Lawrence Garrett, Kevin M. Jacobs, Deborah L. Paul, Arvind Ravichandran, Yaron Reich, Richard Reinhold, David M. Schizer, Michael Schler, Peter Schuur, Vikram Sharma, Wade Sutton, Davis Wang, Laura Williams, Sara Zablotney, and Libin Zhang. This Report reflects solely the views of the Tax Section and not those of its individual members or any other party.

[2] Unless otherwise noted, references herein to "**Section**" are to sections of the Internal Revenue Code of 1986 (the "**Code**"), as amended, references herein to "**Prop. Treas. Reg. §**" are to sections of proposed regulations ("**Proposed Regulations**") promulgated under the Code, and references herein to "**Treas. Reg. §**" are to sections of the regulations (the "**Regulations**") promulgated under the Code.

[3] Exec. Order No. 14192, 90 Fed. Reg. 9,065 (Jan. 31, 2025).

[4] Exec. Order No. 14219, 90 Fed. Reg. 10,583 (Feb. 19, 2025).

[5] *Id.*

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believe that the core benefits of the existing anti-inversion rules can be retained while simplification can reduce the cost and complexity they impose on taxpayers.

This report addresses potential simplification options for five rules: (1) the disqualified stock rule under Treas. Reg. § 1.7874-4; (2) the non-ordinary course distributions ("**NOCD**") rule under Treas. Reg. § 1.7874-10; (3) the serial acquiror rule under Treas. Reg. § 1.7874-8; (4) the third-country transaction rule under Treas. Reg. § 1.7874-9; and (5) the passive assets rule under Treas. Reg. § 1.7874-7. For each, we provide an analysis of the rule's operation, the relevant statutory text, the context and policy implications, examples, and potential options for simplification for the Department of the Treasury ("**Treasury,**" including, as applicable, the Internal Revenue Service, or "**IRS**").

Our analysis proceeds from several foundational principles. First, we note that the 60% and 80% thresholds in Section 7874 are deliberate congressional bright lines that serve critical administrability and market-certainty functions. Regulations that effectively move these thresholds downward should be supportable by sound policy rationale. Second, our analysis is grounded in the statutory text of (A) Section 7874(c)(4), which disregards transfers to and from a corporation where they are part of a plan a principal purpose of which is to avoid the purposes of Section 7874, (B) Section 7874(c)(6), which authorizes certain exclusions from the ownership fraction "as appropriate," and (C) Section 7874(g), which authorizes Regulations "necessary to prevent the avoidance of the purposes of this section." Third, our analysis acknowledges that the domestic and international tax landscape has substantially reduced the tax benefits of inversion, which we believe warrants a recalibration of the Section 7874 Regulations in light of the decreased attractiveness of abusive inversion transactions in the current environment. Importantly, the recommendations in this Report take no view as to the scope of Treasury's regulatory authority under Section 7874. Rather, discussion in this Report regarding the Regulations' relationship to statutory language reflects the Executive Orders' direction to focus resources on Regulations "squarely authorized by constitutional Federal statutes" and our view that efforts to simplify and streamline Regulations are best achieved through Regulations that echo and amplify specific policy choices embodied in the text of Section 7874 (i.e., that alignment with the statute is relevant as a policy matter).[6]

In making recommendations with respect to Regulations issued under Section 7874, we are mindful that in many cases Regulations issued under Section 367 apply similar concepts. Although we generally do not discuss Section 367 in this Report, we recommend that for situations in which the Section 367 Regulations import concepts from Section 7874 (such as in the case of NOCDs), Treasury implement changes consistently as between Section 7874 and Section 367. While this Report does not discuss other rules under Section 7874 (including the expanded affiliated group ("**EAG**") rule, the domestic partnership acquisition rule or the substantial business activity rule), those other rules may also be candidates for simplification.

[6] *Id*.

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We believe that revisions to the Regulations present the most expedient path for simplification. Treasury could consider as an alternative to new Regulations instituting a private letter ruling program that allows taxpayers to receive favorable rulings if they are able to demonstrate the absence of abuses that Section 7874 is intended to police. However, the private letter ruling process is not normally the best venue for resolving an inherently factual inquiry regarding abuse potential and, in any event, we believe that the inherently factual inquiry would make a private letter ruling process time intensive, which may not be a practicable solution for many merger and acquisition transactions where time may be of the essence. Thus, while the availability of a private letter ruling may be helpful in an unusual case, instituting a private letter ruling process is not a comprehensive solution. Accordingly, our recommendations are focused on revisions to existing Regulations, providing a set of options for Treasury to consider in its efforts to streamline and simplify the application of Section 7874. While the options are meant to be responsive to the Executive Orders, they also address many practical challenges and burdens imposed on taxpayers due to the breadth of the existing rules.

A. Summary of Options

1. Disqualified Stock Rule (Treas. Reg. § 1.7874-4). The disqualified stock rule excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation that is transferred in exchange for "nonqualified property," defined broadly to include cash, marketable securities, and certain other assets.

The disqualified stock rule presents a prime opportunity for meaningful simplification. In the discussion below, we recommend that Treasury consider conditioning disqualification on whether the stock issuance is part of a plan with a principal purpose of avoiding Section 7874. Such a standard would allow Treasury to target genuinely abusive transactions while sparing routine capital raises and ordinary-course M&A activity from unnecessary scrutiny. We outline below specific facts and circumstances that Treasury may wish to identify as indicative of the presence or absence of such a plan, along with proposed safe harbors that would give taxpayers confidence that ordinary-course issuances fall outside the rule's reach. The existing de minimis exception also merits attention: raising the threshold from 5% to at least 20%, including for the Ownership Prong (as defined below), would better calibrate the rule to its policy objectives while easing compliance burdens. Treasury might even consider eliminating the Ownership Prong altogether—or, short of that, refining how ownership is measured. Other worthwhile refinements include tightening the definition of "nonqualified property" and introducing temporal nexus rebuttable presumptions. We also see merit in a quantitative safe harbor and a "netting" concept that would recognize when contributions to a corporation are economically offset by distributions or other corporate contractions such as spin-offs.

2. Non-Ordinary Course Distributions Rule (Treas. Reg. § 1.7874-10). The NOCD rule operates by increasing both the numerator and the denominator of the ownership fraction by creating phantom stock to account for distributions by the domestic entity that are not in the ordinary course of business and are made in connection with the acquisition.

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In pursuit of a more streamlined regulatory framework for NOCDs, Treasury may consider withdrawing the rule entirely, although we acknowledge that full-scale withdrawal may invite abusive "skinny-down" transactions. Alternatively, assuming Treasury retains the NOCD rule in some form, Treasury may consider adding a requirement that for a distribution to be disregarded it must be made pursuant to a plan, a principal purpose of which is to avoid the purposes of Section 7874. To the extent such a plan standard is adopted, we recommend specific facts and circumstances Treasury may highlight as indicative of the presence or absence of a plan. We also propose potential safe harbors to allow taxpayers some level of certainty that a given distribution (or similar transaction) will not be treated as subject to the NOCD rules. As detailed in our discussion below, if Treasury declined to move to a pure facts-and-circumstances analysis and retained some form of irrebuttable presumption consistent with current Treas. Reg. § 1.7874-10, we suggest Treasury consider shortening the look-back period for the existing NOCD rule.

3. Serial Acquiror Rule (Treas. Reg. § 1.7874-8). The serial acquiror rule aggregates stock of the foreign acquiring corporation attributable to prior domestic entity acquisitions in determining the ownership fraction, increasing the fraction by the serial acquisition percentage.

The serial acquiror rule, which prevents taxpayers from structuring around Section 7874 through sequential acquisitions, has proven to be a significant source of complexity. Full withdrawal is one path forward, though we recognize that doing so could reopen planning opportunities the rule was meant to foreclose. If Treasury elects to preserve some version of the rule, several targeted modifications could sharpen its focus. A nexus requirement, for instance, would confine the rule to situations where prior and subsequent acquisitions share a genuine connection—limiting the rule's reach to transactions that warrant aggregation. Shortening the look-back period would achieve a similar effect, concentrating the rule on temporally proximate acquisitions while lightening the compliance load. A de minimis threshold for prior acquisitions would filter out immaterial transactions that add complexity without a meaningful corresponding policy benefit. We explore these and other refinements—including a potential safe harbor for clearly separated acquisitions—in greater detail below.

4. Third-Country Transaction Rule (Treas. Reg. § 1.7874-9). The third-country transaction rule applies to domestic entity acquisitions where a foreign acquiring corporation completes a "covered foreign acquisition" of a foreign acquired entity (the "**foreign target**") and the foreign acquiring corporation is not a tax resident of the foreign target's country of tax residence before the transaction occurred.

The third-country transaction rule extends the application of domestic corporation treatment under Section 7874 beyond its statutory framework to address restructurings that shift a foreign acquiring corporation's tax residence to a third country. Whether this extension remains justified is a fair question. Outright repeal would eliminate a source of considerable complexity, though it could leave the door open for tax-motivated relocations. A more surgical alternative would narrow its application to transactions driven by tax avoidance rather than business purposes. This could be achieved through a principal purpose requirement or similar safeguard, preserving

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the rule's core function while removing its bite in ordinary commercial contexts. We develop these options more fully in the discussion that follows.

5. Passive Assets Rule (Treas. Reg. § 1.7874-7). The passive assets rule excludes from the denominator of the ownership fraction certain stock of the foreign acquiring corporation that is attributable to passive assets held by the foreign group, applying when more than 50% of the gross value of all foreign group property constitutes "foreign group nonqualified property."

The passive assets rule addresses concerns that a foreign acquiring corporation's value may be artificially inflated by cash, marketable securities, or other passive holdings. While the concern is legitimate, the rule's current form imposes substantial burdens that may outweigh its benefits. Treasury could reasonably conclude that withdrawal is appropriate, accepting that some transactions involving passive-heavy acquirors may escape the ownership fraction adjustment. Alternatively, an option would be to use a plan-based standard: property would qualify as foreign group nonqualified property only if held pursuant to a plan with a principal purpose of avoiding Section 7874. A temporal nexus presumption would help operationalize this standard by clarifying when property acquisitions are sufficiently connected to the inversion transaction. Separate from any plan-based reform, raising the de minimis exception threshold to at least 20%—and reconsidering the ownership prong—would provide meaningful relief. Treasury might also establish a minimum ownership threshold for marketable securities classified as equity, so that modest portfolio positions do not trigger the rule. Finally, as we discuss below, the Replacement Property Rule could benefit from an anti-abuse standard that focuses on substance rather than mechanical application.

B. Avoidance Factors

A frequent theme of our recommendations is the suggestion that Regulations based on a demonstrated tax-avoidance purpose would be both practicable and desirable. In connection with this, we also propose sets of facts and circumstances which are relevant to the determination of whether a transaction is structured with a purpose to avoid the purposes of Section 7874. Those include both a general set of avoidance factors broadly applicable to the five rules below, as well as specific factors on a rule-by-rule basis.

II. Background

A. Legislative History and Policy Purpose

1. Corporate Inversions Generally and the 2002 Treasury Inversion Report

An inversion transaction is a transaction in which a U.S.-parented multinational group restructures so that a foreign corporation becomes the group's new corporate parent, typically in a jurisdiction with lower or no corporate taxes, while the group's operations and management remain

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in the United States and substantially unchanged.[7] For example, a number of companies that undertook inversion transactions in the early 2000s continued to be traded on the S&P 500 or another U.S. stock exchange (this was often a pre-condition of obtaining shareholder approval for the inversion), and even disclosed in their securities filings that no material changes to the business's operations were anticipated in light of the inversion.[8]

An inversion transaction can be implemented in many ways.[9] For example, the new foreign parent can acquire all the shares of the U.S. business (potentially in a reorganization that is tax-free at the shareholder level), or it can acquire all or substantially all of the assets of the U.S. business. Alternatively, the U.S. parent can contribute its assets to the foreign corporation, which can drop down those new assets into a U.S. subsidiary. The shareholders of the U.S. parent can also contribute the shares of the U.S. parent to a foreign corporation in exchange for shares in the foreign corporation.[10]

During the early 2000s, Treasury and Congress became increasingly concerned with the impact of corporate inversions such as these. In May 2002, the Treasury Department's Office of Tax Policy issued a report on corporate inversion transactions and their tax policy implications (the "**2002 Treasury Inversion Report**").[11] The report documented a trend of U.S. corporations reincorporating in low-tax jurisdictions (such as Bermuda) while maintaining their operations and management in the United States. The report identified several tax advantages of inversions, including the ability to strip earnings from U.S. affiliates through intercompany debt, and to both access low-taxed foreign earnings without current U.S. tax and reduce U.S. tax on foreign-source income by restructuring foreign subsidiaries and their operations "out-from-under" the U.S. parent.[12] The report also implied that there was a sham element to these transactions, noting, for example, "[t]he ability to achieve a substantial reduction in taxes through a transaction that is complicated technically but virtually transparent operationally is a cause for concern as a policy

[7] U.S. Dep't of the Treasury, Office of Tax Pol'y, Corporate Inversion Transactions: Tax Policy Implications (May 2002) at 3. *See also id.* at 15 ("Although an inversion transaction requires significant restructuring as a corporate law matter, the effect of such a transaction on the actual management and operation of the inverted company generally is limited.").

[8] *Id.* at 15-16.

[9] For a discussion of corporate expatriations generally and various structures around the turn of the millennium that were used to implement them, see Willard B. Taylor, *Corporate Expatriations–Why Not?*, 78 TAXES 146 (2000). The menu of structuring options discussed here is by no means exhaustive.

[10] These methods are not exhaustive, and the many forms that an inversion transaction can take arguably make it difficult to design bright-line mechanical rules that police inversion transactions that are effective without being overbroad.

[11] U.S. Dep't of the Treasury, Office of Tax Pol'y, Corporate Inversion Transactions: Tax Policy Implications (May 2002) ("**2002 Treasury Inversion Report**").

[12] *Id.* at 13-14.

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matter."[13] The report recommended legislative action to address the problems posed by inversion transactions.

Beyond its immediate focus on inversion transactions, however, the report emphasized that any tax reforms should also address the competitive disadvantages for U.S. multinationals doing business abroad, because of how U.S. foreign income was then taxed.[14] As the report noted, "we should not underestimate the benefits to be gained from reducing the complexity of the current rules. Our system of international tax rules should not be allowed to disadvantage U.S.-based companies competing in the global marketplace."[15]

2. The American Jobs Creation Act of 2004

Section 7874 of the Code was enacted by the American Jobs Creation Act ("**AJCA**") in 2004 to address corporate inversions, which Congress perceived as having a deleterious effect on the U.S. tax base.[16] Around the time of the 2002 Treasury Inversion Report, multiple members of Congress also made strong remarks indicating that they viewed corporate inversion transactions as unpatriotic and harmful to the taxpaying public.[17]

For example, Max Baucus, a Democratic senator and chairman of the Finance Committee at the time, said: "When a criminal gets off because of a technicality in the law, people are outraged. Well, I want to be clear – I am just as outraged when a corporation takes a technical, manipulative reading of the tax code and robs the rest of the tax-paying public."[18] In the early 2000s, more than 30 bills on inversion transactions were ultimately introduced in Congress prior to the passage of Section 7874.[19] Floor statements by the Senators putting forward these bills indicated that they viewed inversion transactions as shams and akin to abusive tax shelters; they

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[13] *Id.* at 2.

[14] *Id.* at 20.

[15] *Id.* at 3.

[16] American Jobs Creation Act of 2004, Pub. L. No. 108-357, § 801, 118 Stat. 1562 (2004).

[17] *See, e.g.*, John D. McKinnon, *Senators Plan Curbs on Relocating to Bermuda, Other Tax Havens*, WALL ST. J. (Mar. 22, 2002). We recognize that legislative history may not be considered to be relevant or dispositive in analyzing or applying the text of a statute (at least in certain cases). Throughout this Report, we discuss legislative history for the purpose of assisting Treasury in (i) assessing how the statute was understood when it was enacted and how conditions have changed and (ii) determining whether, as a policy matter, regulatory guidance is aligned with the objectives underlying the statute.

[18] *Id.*

[19] Michael S. Kirsch, *The Congressional Response to Corporate Expatriations: The Tension Between Symbols and Substance in the Taxation of Multinational Corporations*, 24 VA. TAX REV. 475, 503 (2005); *see also* Joseph A. Tootle, *The Regulation of Corporate Inversions and "Substantial Business Activities"*, 33 VA. TAX REV. 353, 371 (2013) (discussing comments made by various senators and the legislative history of Section 7874).

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focused in particular on re-incorporations in tax haven jurisdictions such as Bermuda.[20] The legislative history also indicates, however, that they were primarily concerned with inversion transactions in which there was substantial continuity of ownership by former shareholders or partners, but insubstantial changes to the activities of the business. Accordingly, the legislative history suggests that Section 7874 was not intended to prohibit or discourage *all* inversion transactions, provided the transaction had a substantial transformative impact on the business and was not purely tax motivated.[21]

Section 7874 was ultimately enacted as part of the AJCA in 2004.[22] The House bill and Senate amendment took different approaches. The House bill proposed treating the inverted corporation as a foreign corporation in all cases but subjected the U.S. target to the special gain recognition rules where there was 60% continuity of ownership, while the Senate amendment proposed a broader approach with graduated consequences, including treating the foreign corporation as a domestic corporation in cases of 80% continuity of ownership. The Conference agreement adopted a two-tiered structure, with the 60% and 80% thresholds that incorporated elements of both the House and Senate's approaches.[23] Thus, the 60% and 80% continuity of ownership thresholds in Section 7874(a)(2)(B) and Section 7874(b) respectively reflect deliberate Congressional choices to police inversion transactions based on continuing ownership, with the severity of the remedy being based on the degree of shareholder continuity.

Moreover, the final bill was accompanied by a short explanation of the rationale underpinning Section 7874. Specifically, the Joint Committee on Taxation's General Explanation (the "**Blue Book**") describes the "Reasons for Change" as follows:

> The Congress believed that inversion transactions resulting in a minimal presence in a foreign country of incorporation were a means of avoiding U.S. tax and should be curtailed. In particular, these transactions permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion, but with the result that the inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on domestic operations. The Congress believed that corporate inversion transactions were a symptom of larger problems with our current

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[20] Tootle, *supra* note 19, at 376 (citing *Corporate Tax Shelters: Looking Under the Roof: Hearing Before the S. Comm. on Finance*, 107th Cong. 14 (2002) (statement of Sen. Charles Grassley)).

[21] *See, e.g.*, Jasper L. Cummings, Jr., *Avoiding Accidental Inversions*, 146 TAX NOTES 775 (2015) ("Congress was entirely motivated, as far as we know, by the naked inversion… … in which, for example, DT [domestic target] becomes a subsidiary of its wholly owned foreign subsidiary, FA, of which DT's former shareholders become the 100 percent owners (and substantial business activity does not occur in the home country).").

[22] H.R. Rep. No. 108-755, at 567 (2004) (Conf. Rep.).

[23] Jefferson P. VanderWolk, *Inversions under Section 7874 of the Internal Revenue Code: Flawed Legislation, Flawed Guidance*, 30 NW. J. INT'L L. & BUS. 699, 701 (2010). For the Senate bill, see Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong., at 253 (2003). For the House bill, see American Jobs Creation Act of 2003, H.R. 2896, 108th Cong., at 168 (2003).

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system for taxing U.S.-based global businesses and were also indicative of the unfair advantages that our tax laws conveyed to foreign ownership.

The Act addressed the underlying problems with the U.S. system of taxing U.S.-based global businesses, and this provision removes the incentives for entering into inversion transactions. The Congress believed that certain inversion transactions have little or no non-tax effect or purpose and should be disregarded for U.S. tax purposes. The Congress believed that other inversion transactions may have sufficient non-tax effect and purpose to be respected, but warrant that any applicable corporate-level "toll charges" for establishing the inverted structure not be offset by tax attributes such as net operating losses or foreign tax credits.[24]

This rationale echoes the remarks by various Congressmen that many inversion transactions are abusive tax avoidance, with little to no business purpose, and for this reason they should be discouraged by the tax law.

In sum, Congress's choice to implement a two-tiered remedy structure based on the degree of continuing ownership targeted only inversion transactions without material changes to the relevant business (as measured by Section 7874's stock ownership tests). This is clear from the text and structure of the statute. This conventional understanding of the statute at the time it was enacted was evident in statements in the Congressional record, the 2002 Treasury Inversion Report, and the Blue Book. Even though foreign-based groups that acquire domestic businesses could implement the same U.S. tax reduction strategies as inverters,[25] Congress did not extend Section 7874 to more transformative acquisition transactions.

B. Mechanics of Section 7874

Section 7874 operates through two key definitions. An "expatriated entity" is a domestic corporation (or domestic partnership) that is acquired by a "surrogate foreign corporation."[26] A "surrogate foreign corporation" is a foreign corporation that, pursuant to a plan or a series of related transactions: (1) completes the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (or substantially all of the properties constituting a trade or business of a domestic partnership); (2) after the acquisition, at least 60% of the stock of the foreign corporation (by vote or value) is held by former shareholders (or former partners) of the domestic entity by reason of holding stock in (or a partnership interest in) such entity; and (3) after the acquisition, the EAG that includes the foreign corporation does not have

[24] Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress, JCS-5-05 at 343 (2005).

[25] *See* 2002 Treasury Inversion Report, *supra* note 11, at 25.

[26] *See* Section 7874(a)(2)(A).

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substantial business activities in the foreign corporation's country of organization when compared to the total business activities of such EAG.[27]

As noted above, Section 7874 establishes two tiers of consequences based on the "ownership fraction"—the numerator of which is the stock of the foreign acquiring corporation held by former shareholders or partners of the domestic entity "by reason of" their prior ownership of the acquired domestic entity and the denominator of which is the stock of the foreign acquiring corporation.[28] Where the ownership percentage (i.e., the quotient of the ownership fraction) is at least 60% but less than 80%, the foreign corporation is treated as a surrogate foreign corporation.[29] The expatriated entity (and related persons) remain subject to U.S. tax on any "inversion gain" during the 10-year period following the inversion, which generally must be determined without respect to certain tax attributes like net operating losses and foreign tax credits.[30] Where the ownership percentage is 80% or more, the foreign acquiring corporation is treated as a domestic corporation for all purposes of the Code.[31]

The ownership fraction is determined by reference to the stock of the foreign acquiring corporation, with certain adjustments. Section 7874(c)(2)(A) provides that, in determining the ownership fraction, stock held by members of the EAG is not taken into account. Section 7874(c)(2)(B) provides that, in determining the ownership fraction, stock of the foreign acquiring corporation that is sold in a public offering related to the relevant domestic entity acquisition shall not be taken into account (the "**statutory public offering rule**").[32]

Section 7874 also includes a number of principle-based anti-avoidance rules and delegations. Section 7874(c)(4) provides that transfers of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of this Section 7874.[33] Section 7874(c)(6) grants the Secretary authority to prescribe Regulations "as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations—(A) to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock, and (B) to treat stock as not stock."[34] Section 7874(g) provides a more general grant of authority

[27] *See* Section 7874(a)(2)(B).

[28] *See* Treas. Reg. § 1.7874-12(a)(17) (defining "ownership fraction"); Section 7874(a)(2)(B)(ii); Section 7874(b).

[29] *See* Section 7874(a)(2)(B)(ii). *See also* Section 7874(d)(1) (defining the "applicable period").

[30] *See* Section 7874(a)(1) (general rule); Section 7874(d)(2) (defining "inversion gain").

[31] Section 7874(b).

[32] Section 7874(c)(2)(B).

[33] Section 7874(c)(4).

[34] Section 7874(c)(6).

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to the Treasury to promulgate Regulations to carry out the purposes of Section 7874 (including for two specified avoidance cases).[35]

Finally, the statute includes an exception for cases in which the EAG has substantial business activities in the country of the foreign acquiring corporation's organization.[36]

C. Relevant Changes in the Law and Their Relationship to Section 7874

Since Section 7874 was passed into law, significant changes in the U.S. tax law and in international tax law more broadly have been enacted. In the aggregate, these changes reduce the incentive for a U.S.-parented corporate group to undertake an inversion transaction or relocate a business outside the U.S. compared to the tax regimes in place when Section 7874 was enacted. Some of the changes in law make it less advantageous to invert from the perspective of reducing U.S. income taxation, others make it less punitive to remain U.S. parented with respect to the taxation of foreign subsidiaries, and still others make it less advantageous from a non-U.S. tax standpoint to invert. This section provides a high-level overview of the most relevant changes in the law.

1. Regulations Targeting Inversions in Related Areas

Treasury and Congress have also used regulatory authority outside of Section 7874 to curtail much of the post-inversion "out-from-under" planning that historically made inversions attractive. In 2010, Congress enacted Section 304(b)(5)(B), which excludes a foreign acquiring corporation's earnings and profits for purposes of determining the amount treated as a dividend in a Section 304 transaction if more than 50% of the deemed dividend would be neither subject to U.S. tax nor includible in a CFC's earnings and profits,[37] and 2016 Regulations tightened the rule by measuring that 50% test solely by reference to the foreign acquiring corporation's earnings and profits.[38] Separately, the 2016 Regulations under Section 385[39] limited the ability of related parties to create intercompany debt for U.S. federal income tax purposes in certain contexts, including where a U.S. corporation distributes a note to a foreign parent corporation.[40] The preamble specifically cited interest stripping by inverted groups as a key motivation for these rules.[41] As a

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[35] Section 7874(g) ("The Secretary shall provide such regulations as are necessary to carry out this section, including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section, including the avoidance of such purposes through—(1) the use of related persons, pass-through or other noncorporate entities, or other intermediaries, or (2) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.").

[36] Section 7874(a)(2)(B)(iii); Treas. Reg. § 1.7874-3.

[37] Education Jobs and Medicaid Assistance Act of 2010, Pub. L. No. 111-226, § 215, 124 Stat. 2389 (2010).

[38] T.D. 9761, 81 Fed. Reg. 20,858 (Apr. 8, 2016); Treas. Reg. § 1.304-7(b).

[39] T.D. 9790, 81 Fed. Reg. 72,858–72,984 (Oct. 21, 2016).

[40] *Id.* at 72,941.

[41] *Id.* at 72,942.

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result, earnings-stripping and out-from-under techniques targeted by Section 7874 are less effective than they once were.[42]

2. The Tax Cuts and Jobs Act of 2017

The Tax Cuts and Jobs Act (the "**TCJA**")[43] reduced the corporate tax rate from 35% to 21%, thereby narrowing the corporate income tax rate differential between the United States and many foreign jurisdictions and reducing some of the benefit of incorporating or reincorporating outside the United States.[44]

The TCJA also enacted the Section 245A participation exemption, which provides a 100% deduction for certain foreign-source dividends received from specified 10% owned foreign corporations. This generally permits U.S. parented multinational groups to repatriate 100% of their controlled foreign corporations' ("**CFCs**") earnings without giving rise to taxable dividend income in the United States, and moved the U.S. international taxation regime closer to the territorial systems used by jurisdictions targeted by former inverters.[45]

The TCJA introduced the base erosion and anti-abuse tax (known as the "**BEAT**").[46] The BEAT imposes a 10% (for taxable years beginning before 2026) minimum tax on deductible "base erosion" payments by domestic corporations to related foreign parties. The TCJA also replaced former Section 163(j) with much more broadly applicable and effective interest deduction limitations. As a result, U.S. multinationals' ability to use inversion transactions to earnings-strip is more limited.

The TCJA's changes to Section 367(d) increased a U.S. multinational's potential costs to transfer intellectual property to foreign affiliates (e.g., in an "out-from-under" transaction), while the TCJA's enactment of the foreign-derived intangible income or FDII rules incentivized keeping intellectual property onshore.[47] Its repeal of the "active trade or business exception" from Section 367(a)(3) further limited prior methods of shifting operations offshore in a tax-deferred manner. The TCJA's repeal of Section 958(b)(4) also limited the efficacy of certain "out-from-under"

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[42] Treas. Reg. § 1.385-3(b).

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

[44] *See* Section 11.

[45] *See* 2002 Treasury Inversion Report, *supra* note 11, at 29 (providing "the recent inversion activity has been referred to sometimes as 'self-help territoriality'").

[46] *See* Section 59A.

[47] *See, e.g.*, Kristina L. Novak, Mark P. Thomas & Cym H. Lowell, *Treatment of Intangibles Under New US Tax Regime*, 25 INT'L TRANSFER PRICING J. 259, 261 (2018); *see also* Benjamin M. Willis, *Does the TCJA Encourage Outbound Transfers to Partnerships*, 164 TAX NOTES FEDERAL 881 (Aug. 5, 2019) (comparing treatment of transfers in corporate and partnership contexts).

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transactions by expanding the situations in which an entity remained a CFC if owned within the same multinational group.[48]

The TCJA enacted the global intangible low-taxed income or GILTI regime, which greatly expanded the scope of CFC income subject to U.S. residual taxation.[49] Like subpart F, the impact of GILTI on a U.S. multinational's U.S. corporate income taxes may be mitigated by the application of foreign tax credits or the "high-tax exclusion." While the enactment of GILTI alone may not have decreased a U.S. multinational's incentives to invert, changes in the broader international tax law (namely the OECD's Pillar Two Project) have reduced the number of foreign jurisdictions that use pure territorial taxation systems.

3. Pillar Two and the Side-by-Side Safe Harbour

Another major change to the international tax law since the 2002 Treasury Inversion Report and the enactment of Section 7874 is Pillar Two of the OECD/G20 Inclusive Framework for Base Erosion and Profit Shifting ("**Pillar Two**"), a multilateral approach endorsed by approximately 135 jurisdictions on October 8, 2021.[50] It was further refined in the Side-by-Side Safe Harbour crafted by the United States and the OECD in 2025.

Pillar Two is "intended to ensure large multinational enterprise groups ("**MNEs**") pay a minimum level of tax on the income arising in each of the jurisdictions where they operate."[51] In December 2021, the OECD Inclusive Framework published the Global Anti-Base Erosion Rules ("**GloBE Rules**") in order to implement this goal and the principles of Pillar Two. The GloBE Rules are model rules, and as of December 2025, approximately 60 jurisdictions have enacted or proposed to enact Pillar Two legislation.[52]

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[48] *See* Ethan A. Atticks & Raza Janjua, *A Plea from the Lorax: Addressing the Filing Burdens Caused by Repeal of IRC Section 958(b)(4)*, 103 TAX NOTES INT'L 153 (July 12, 2021) (describing effect of 958(b)(4) repeal to prevent "de-control" transactions).

[49] Under the GILTI rules, a domestic taxpayer is required to include its GILTI for the taxable year in a manner similar to the subpart F income pro rata share rules. GILTI is the excess of the taxpayer's pro rata share of the "tested income" of each CFC owned, directly or indirectly, by the taxpayer and with respect to which the taxpayer is a U.S. Shareholder, over the "tested loss" of each such CFC, less a deemed intangible income return. Tested income and tested loss generally are computed from each CFC's gross income reduced by allocable deductions and excluding, among other items, subpart F income and certain high-tax income. GILTI is not limited by the earnings and profits of the applicable CFC. Corporate taxpayers may claim a Section 250 deduction and a deemed-paid credit for GILTI foreign taxes with a haircut, subject to limitations.

[50] OECD (2021), *Tax Challenges Arising from Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two): Inclusive Framework on BEPS*, OECD/G20 Base Erosion and Profit Shifting Project, OECD Publishing, Paris, https://doi.org/10.1787/782bac33-en.

[51] *Id.* at 7 (Executive Summary).

[52] OECD (2026), *Tax Challenges Arising from the Digitalisation of the Economy – Administrative Guidance on the Global Anti-Base Erosion Model Rules (Pillar Two), Central Record for Purposes of the Global Minimum Tax: Inclusive Framework on BEPS*, OECD, https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-

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Pillar Two targets large multinational enterprises with an annual revenue of EUR 750 million or greater.[53] Specifically, it targets income shifting within the corporate group by introducing a global minimum tax at a rate of 15% (subject to various adjustments). The minimum tax is implemented on a country-by-country basis instead of blending the tax rates across all countries in which the corporate group operates, thereby ensuring a minimum baseline of tax is collected in respect of each country. To the extent that the effective tax rate paid by all members of a corporate group within a relevant jurisdiction falls short of the 15% threshold, Pillar Two imposes a top-up tax. The top-up tax may be collected from the ultimate parent entity, or from other entities within the corporate group that are located in Pillar Two jurisdictions. The two key principles in the GloBE Rules that implement the top-up tax and that determine how it is allocated across entities within the corporate group are the income inclusion rule (or "**IIR**") and the undertaxed profits rule (or "**UTPR**"). The IIR is the line of first defense, but in the event that the IIR is not sufficient, the UTPR applies to act as a backstop and further allocate the top-up-tax liability within the corporate group. A discussion of the mechanics of both the IIR and the UTPR is outside the scope of this Report.

On a global scale, Pillar Two reduces incentives to undertake inversion transactions by creating a minimum floor of tax obligations for MNEs with respect to each country in which they operate, regardless of where the income is sourced. This reduces the efficacy of both earnings stripping and "out-from-under" transactions that inverters engaged in.

Notably, the United States and China have not enacted laws implementing the Pillar Two GloBE Rules. However, in January 2026 and following extensive and successful United States advocacy, the United States was the first jurisdiction whose tax laws qualified for Pillar Two's new Side-by-Side Safe Harbour regime. The Side-by-Side Safe Harbour generally ensures that jurisdictions applying a qualifying domestic minimum top-up tax or meeting minimum effective tax rate thresholds under the GloBE Rules will not generate incremental top-up tax liability under Pillar Two with respect to U.S. parented MNEs.[54] Given the recent enactment of the Side-by-Side Safe Harbour, its practical impact on inversion transactions is yet to be determined. It may be argued, however, that the Side-by-Side Safe Harbour reduces incentives for large U.S. parented MNEs to invert because such MNEs may prefer to be subject to the U.S. tax regime without Pillar Two top-up taxes, rather than risk incremental top-up taxes from Pillar Two by restructuring into a new foreign parent. Notably, the NCTI regime (discussed below) applies to a U.S. parented

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minimum-tax/administrative-guidance-globe-rules-pillar-two-central-record-legislation-transitional-qualified-status.pdf. *See also* Jinyan Li, *Pillar 2 as a New International Fiscal Law*, 121 TAX NOTES INT'L 637 (Jan. 26, 2026).

[53] For a more complete discussion of Pillar Two, see NYSBA Tax Section, Report No. 1465, Report on the OECD Global Anti-Base Erosion Model Rules (Pillar Two) (July 21, 2022).

[54] *See* OECD (2026), *Tax Challenges Arising from the Digitalisation of the Economy – Global Anti-Base Erosion Model Rules (Pillar Two), Side-by-Side Package: Inclusive Framework on BEPS*, OECD, https://www.oecd.org/content/dam/oecd/en/topics/policy-sub-issues/global-minimum-tax/side-by-side-package.pdf (introducing the Side-by-Side Package).

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MNE's CFCs on a blended basis, while the Pillar Two regime applies a minimum tax on a country-by-country basis.

4. The One Big Beautiful Bill Act

The One Big Beautiful Bill Act ("**OBBBA**") enacted further significant changes to the international tax regime that likely do not increase (and in some cases may decrease) U.S. multinationals' incentives to undertake inversion transactions.[55]

First, OBBBA restructured GILTI into "Net CFC Tested Income" ("**NCTI**") for taxable years beginning after December 31, 2025, repealing the QBAI exclusion that had allowed taxpayers to reduce their GILTI income inclusion by reference to a CFC's basis in tangible, depreciable property used in the CFC's business.[56] Concurrently, however, the OBBBA also reduced the "GILTI haircut" for the domestic corporation on the foreign taxes deemed paid by the CFC from 20% to 10%, thereby increasing the foreign tax credits that can be claimed in respect of GILTI/NCTI by the domestic corporation going forward.[57] In addition, because of certain sunset provisions in the TCJA version of Section 250(a), under the prior law, GILTI was set to increase to an effective tax rate of 13.125% for a domestic corporate taxpayer beginning in 2026.[58] Under the OBBBA, however, beginning in 2026, the effective NCTI rate for a corporate taxpayer is now fixed at 12.6% due to the Section 250(a)(1)(B) deduction being fixed at 40%. The overall effect of the NCTI regime (a modest decrease to the pre-2026 Section 250 deduction, coupled with a decrease to the GILTI haircut for relevant foreign tax credits) seems unlikely to materially increase a U.S. multinational's incentive to invert.

Second, while the OBBBA's changes to the Section 250 deduction also resulted in a modest decrease (from 37.5% to 33.34%) in the FDII deduction, the OBBBA also simplified the calculation and broadened the base of "qualifying" FDII income.[59] The overall effect of the FDII changes also seems unlikely to materially increase a U.S. multinational's incentive to invert.

Third, BEAT was also extended at a rate of 10.5% (11.5% for certain banks and financial entities).[60] As discussed above, the BEAT decreases the ability to earnings strip.

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[55] Pub. L. No. 119-21, 139 Stat. 72 (2025).

[56] *Id.* at § 70323.

[57] Section 960(d).

[58] Pub. L. 115-97, § 14202.

[59] *See* Section 250(a)(1)(A).

[60] Pub. L. No. 119-21, § 70331(a). *See* Section 59A(b)(1) (general rate) and Section 59A(b)(2) (increased BEAT rate for banks and securities dealers).

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Fourth, the OBBBA reenacted former Section 958(b)(4). However, it enacted new CFC rules (the foreign controlled foreign corporation rules) which continue to target the out-from-under transactions that motivated the TCJA's repeal of Section 958(b)(4).[61]

Fifth, the OBBBA enacted new Section 174A, which establishes immediate deduction for domestic research or experimental expenditures, while amending Section 174(a) to require foreign research and experimental expenditures to be capitalized.[62]

III. Discussion

A. Preliminary Comments

1. General Approach

The 2002 Treasury Inversion Report stated that the then increased inversion activity "is a symptom" of the underlying differences in the U.S. tax treatment of U.S.-based companies and foreign-based companies, and the inversion concerns implicated "can be addressed most effectively and most fully by addressing the underlying causes."[63] The inversion phenomenon approached a fever pitch in the early to mid-2010s, and Treasury and the IRS's regulatory response was strong medicine. Since that period, the underlying differences highlighted in the 2002 Treasury Inversion Report have been narrowed and inversion activity is in remission, if not cured. As such, we believe that in the current environment the rules discussed below can be simplified without increasing the risk of a new wave of inversions.

As a general matter, the existing mechanical, bright-line rules discussed below are presented as anti-avoidance or anti-abuse rules, but due to their complexity and breadth they often apply to transactions well beyond the scope of inversion transactions targeted by Section 7874. They also impose substantial compliance burdens on taxpayers and create myriad traps for the unwary. While the rules also include principle-based anti-avoidance rules, they largely operate to backstop the bright-line rules.

Consistent with the Executive Orders' stated policy of focusing resources on Regulations "squarely authorized by constitutional Federal statutes," we believe a natural starting place for potential simplification is the regulation-directing statutory text itself.[64] As discussed above, each of Sections 7874(c)(4), 7874(c)(6) and 7874(g) target transactions which, while otherwise outside the scope of the statute, avoid the purposes of or are otherwise inappropriate in light of Section 7874. Further, the Executive Orders require Regulations that "impose significant costs upon

[61] Pub. L. No. 119-21, § 70353.

[62] Pub. L. No. 119-21, § 70302.

[63] 2002 Treasury Inversion Report, *supra* note 11, at 20.

[64] Exec. Order No. 14219, 90 Fed. Reg. 10,583, 10,583 (Feb. 19, 2025).

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private parties that are not outweighed by public benefits" to be identified.[65] As such, we believe that changes that make these complex rules less difficult to apply in practice, where doing so does not materially decrease the rules' effectiveness to police inversion transactions, should be prioritized.

In reconsidering Regulations issued under Section 7874, Treasury has the opportunity to utilize, on the one hand, principle-based rules that focus on the facts and circumstances of a given transaction, or alternatively to utilize mechanical rules that render clear results regardless of whether a given transaction in fact presents abusive intent on the part of the taxpayer. Current Regulations under Section 7874 often opt for a mechanical regime that presumes an abusive purpose. As a result, many transactions that lack an abusive intention and that do not in fact offend the policies underpinning Section 7874 are captured within the ambit of the Regulations. While such an approach may have been justified in the context of the U.S. tax regime in place when Regulations under Section 7874 were promulgated, we believe that in today's regulatory environment the goals (aligning the rules to the statute and reducing costs and complexity) can in many cases be achieved by prioritizing general principle-based anti-avoidance rules in a movement away from the existing highly complex and mechanical rules. We believe this approach will not result in a material sacrifice of protection against taxpayers manipulating the ownership fraction. In our experience, the vast majority of inversion transactions that Section 7874 was enacted to curtail readily present evidence of abusive purpose that can be captured through facts-and-circumstances analysis. As a general matter, these transactions clearly demonstrated tax motivation for the applicable reorganization, including reincorporating in a comparatively low-tax jurisdiction and subsequent out-from-under and base erosion transactions, all while the relevant business continued to be operated in much the same manner as before.

While we believe principle-based anti-avoidance rules should be prioritized, we do acknowledge that in certain cases there remains a strong argument for bright-line rules (both in the form of "safe harbors" and "per se" anti-inversion rules) as a backstop to principle-based Regulations. Many of the existing bright-line rules serve important anti-inversion purposes, but the risks to Treasury that motivated these rules have in many cases subsided, and as a result we believe some level of easing of these bright-line rules is appropriate, as discussed below.

2. General Avoidance Determination Factors

The current Regulations include anti-abuse rules, but do not include a list of facts and circumstances that indicate abuse or avoidance. If principle-based anti-avoidance rules are prioritized, the importance of having clearly stated facts and circumstances that indicate avoidance consequently increases. We believe that setting out avoidance facts and circumstances will provide certainty to taxpayers and the IRS, which will therefore aid both taxpayers and the IRS in applying any simplified rules. We believe that some facts and circumstances indicating an intention or effort to avoid the purpose of Section 7874 are common among all of the five rules discussed in this Report. Those are discussed immediately below. Where facts and circumstances indicate

[65] Exec. Order No. 14219, 90 Fed. Reg. 10,583.

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avoidance in the context of a discrete rule, we discuss potential facts and circumstances in the simplification options for the applicable rule below.

In light of the legislative history, policy purpose and mechanics of Section 7874, we believe that the relevant set of facts and circumstances for testing whether a potential inversion transaction (or a component of a broader transaction) has an avoidance purpose generally could include whether: (1) the acquired domestic entity is already foreign-parented (as the acquisition of such an entity does not pose the risks that Section 7874 was enacted to curtail), (2) there is an independent business purpose for the given activity, (3) there is an actual or anticipated reduction to the combined group's post-acquisition effective worldwide tax rate, (4) there are actual or anticipated post-transaction earnings-stripping or "out-from-under" transactions with respect to the acquired domestic entity, (5) the domestic entity acquisition resembles a cash purchase, (6) the foreign acquiror has a history of effecting domestic entity acquisitions that involved post-transaction earnings-stripping or "out-from-under" transactions, (7) the foreign acquiror's EAG has a significant trade or business, and (8) the domestic acquired entity conducts its business in the same manner as it did and with the same financial profile (e.g., debt-to-equity ratio, debt service coverage ratio) that it had, in all material respects, before the transaction (collectively, the "**General Avoidance Determination Factors**").

Consideration could also be given to making factor (1) above a safe harbor for some or all of the rules covered herein, as we do not see a policy justification for applying Section 7874 to an acquisition of a foreign-owned domestic entity, although we acknowledge that Section 7874 itself does not make this distinction.

B. Disqualified Stock Rule (Treas. Reg. § 1.7874-4)

1. Operation of the Rule

Treas. Reg. § 1.7874-4 provides that stock of a foreign acquiring corporation that is "disqualified stock" is excluded from the denominator of the ownership fraction.[66] The exclusion increases the ownership percentage, because the excluded stock would otherwise dilute the ownership fraction by adding to the denominator without adding to the numerator. The rule at its core prevents foreign corporations from circumventing the Section 7874 rules by issuing additional stock to manipulate the ownership fraction and achieve a result contrary to the statute.

Stock is treated as disqualified stock if it is exchanged for "nonqualified property," which is defined broadly to include: (i) cash or cash equivalents; (ii) marketable securities; (iii) certain obligations owed by members of the EAG, certain former shareholders/partners, or related persons; and (iv) any other property acquired with a "principal purpose" of avoiding the purposes of Section 7874.[67] Stock is similarly disqualified if (v) transferred in exchange for property and, pursuant to the same plan or series of related transactions, the transferee subsequently transfers

[66] Treas. Reg. § 1.7874-4(b).

[67] Treas. Reg. § 1.7874-4(c)(1)(i); *see also* Treas. Reg. § 1.7874-4(h)(2) (defining nonqualified property).

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such stock (or property received in exchange for such stock) in satisfaction of, or in exchange for the assumption of, one or more obligations of the transferee or a related person.[68]

The rule is subject to limitations. First, stock is not disqualified to the extent the exchange does not increase the fair market value of the assets of the foreign acquiring corporation or decrease its liabilities.[69] This determination is made without regard to any other transactions that constitute an exchange of disqualified stock under the rules above.[70] Second, a de minimis exception provides that if, after the acquisition, the ownership percentage (calculated without regard to the disqualified stock rule and certain other rules) is less than 5% (by vote and value), and each 5% former domestic entity shareholder or partner owns, actually or constructively, less than 5% (by vote and value) of the stock or partnership interests in each member of the EAG (the "**Ownership Prong**"), the disqualified stock rule does not apply.[71] However, an anti-abuse rule provides that the de minimis exception does not apply to disqualified stock that is transferred in a transaction (or series of transactions) related to the domestic entity acquisition with a principal purpose of avoiding the purposes of section 7874.[72]

The exclusion of stock issued in exchange for "nonqualified property" under the disqualified stock rule was first introduced in Notice 2009-78.[73] Following Notice 2014-52 and Notice 2015-79, Treasury and the IRS issued temporary and final Regulations to expand the definition of "disqualified stock" and "nonqualified property."[74] The disqualified stock rule was finalized in T.D. 9812.[75]

2. Statutory Text and Regulatory Scope

The disqualified stock rule was described by Treasury as being an expansion of the statutory public offering rule in Section 7874(c)(2)(B), which provides that "stock of [the foreign acquiring] corporation which is sold in a public offering related to the acquisition" shall not be taken into account in determining the ownership fraction.[76] Treasury pointed to each of the regulation-directing statutes in promulgating the rule.[77] In considering the approach for potential

[68] Treas. Reg. § 1.7874-4(c)(1)(ii).

[69] Treas. Reg. § 1.7874-4(c)(2). As a result, secondary transfers do not give rise to disqualified stock. *See* Treas. Reg. § 1.7874-4(i), Example 7.

[70] Treas. Reg. § 1.7874-4(c)(2).

[71] Treas. Reg. § 1.7874-4(d)(1).

[72] Treas. Reg. § 1.7874-4(d)(2).

[73] Notice 2009-78, 2009-40 I.R.B. 452.

[74] Notice 2014-52, 2014-42 I.R.B. 712; Notice 2015-79, 2015-49 I.R.B. 775.

[75] T.D. 9812, 82 Fed. Reg. 5,388 (Jan. 18, 2017).

[76] Section 7874(c)(2)(B); *see also* T.D. 9761, 81 Fed. Reg. 20,858, 20,862-63 (Apr. 8, 2016); T.D. 9654, 79 Fed. Reg. 3,094, 3,095 (Jan. 17, 2014).

[77] *See* T.D. 9654, 79 Fed. Reg. at 3,095.

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simplification, the link between the disqualified stock rule and the statutory public offering rule, and the statutory public offering rule's legislative history and policy rationale, are informative.

3. Legislative History and Policy Rationale

The statutory public offering rule is consistent with the conventional understanding of Section 7874 as "curtail[ing] inversion transactions that 'permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion.'"[78] Based solely on the statute as enacted, its narrow scope suggests that either (1) Congress's concern was limited to public capital markets transactions only or (2) Congress ultimately determined the Secretary could reasonably include stock issued for cash or other property, even if related to the acquisition, in the denominator of the ownership fraction in exercising its regulatory authority.[79] This is supported by the fact that while the Senate bill would have excluded both stock issued in public offerings and in private placements, Section 7874(c)(2)(B) ultimately applied only to public offerings.[80]

In concept, an extension of the statutory public offering rule to certain private transactions can reflect a reasonable regulatory judgment that the policy concern extends beyond public capital markets transactions. However, the text of Section 7874(c)(4) would only disregard stock issued with a purpose to avoid Section 7874; despite this, the disqualified stock rule can apply to exclude all stock issued for cash or certain other "nonqualified property" without a purposive inquiry (subject to the narrow de minimis exception).[81]

Taxpayer comments requested clarity for purposes of determining when an issuance of stock is "related to" an acquisition, but the IRS and Treasury have not issued rules addressing these requests.[82]

4. Principal Concerns Raised by the Existing Rule

Relationship to statutory text. Parts of the disqualified stock rule (like the anti-abuse rule) adhere closely to the statute. However, there are other aspects (like its presumptive nature) which expand on the statute in a way that may be unnecessary given the current international tax landscape.

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[78] *Id.* (citing S. REP. NO. 108-192, at 142 (2003); Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress, JCS-5-05, at 343 (2005)).

[79] *Id.*

[80] Jumpstart Our Business Strength (JOBS) Act, S. 1637, 108th Cong. at 262 (2003); S. REP. NO. 108-192, at 143 (2003). *See also* Peter Schuur, *Disqualified Stock, NOCDs and M&A Transactions: Things That Go Bump in the Night*, Tax Forum No. 744, at 10 (Feb. 3, 2025) (Unpublished paper, on file with the authors).

[81] Treasury and the IRS have acknowledged taxpayer concerns regarding the overbreadth of the disqualified stock rule. *See, e.g.*, T.D. 9654, 79 Fed. Reg. at 3,096-99.

[82] *Id.*

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Consistency with Section 7874's policy goals. The disqualified stock rule is consistent with the policy goal of preventing manipulation of the ownership fraction through dilutive capital raises. We have supported and continue to support this goal.[83] However, the breadth of the rule also captures transactions with independent business purpose or independent economic significance, arguably creating a mismatch between the rule's reach and the statute's policy goals.

Administrability. There are aspects of the disqualified stock rule's mechanical nature which provide certainty in application. However, due to its breadth, tracking the total amount of potentially disqualified stock can create substantial compliance burdens for both taxpayers and the IRS. This is exacerbated by the fact that neither taxpayers nor the IRS benefit from any time-based or other rules relevant to determining when an issuance of stock is "related to" an acquisition. Moreover, while the de minimis exception may ease administrability in limited types of transactions, we continue to believe that the 5% threshold for the de minimis exception (including the Ownership Prong) is too low.[84] Finally, the rule's reference to the marketable security definition in Section 453(f)(2) for purposes of defining nonqualified property raises difficult interpretive questions whether property that may otherwise not be liquid (and thus unlikely to raise stuffing concerns) may nonetheless be treated as nonqualified property (e.g., because while it is not listed on an exchange, the property may be quoted through dealer quotation systems).

Negative impact on cross-border M&A. The disqualified stock rule can deter or complicate ordinary-course capital raises, including public offerings and private placements, that are undertaken for business purposes independent of the acquisition. In addition, the rule can deter or complicate cash acquisition of domestic businesses where existing owners (including ongoing managers of such business) "roll over" into the acquiror structure or where such a business is acquired by an investment fund. Specifically, the Ownership Prong effectively precludes taxpayers from relying on the de minimis exception, even where there is no "roll over" continuity of ownership, as it is not possible to determine with certainty the beneficial ownership of the foreign acquiring corporation or domestic acquired entity in most public and private acquisitions, even if neither are aware of the degree of any post-transaction continuity of beneficial ownership. While market participants generally have adapted to the overly broad applications of the disqualified stock rule so as to avoid it applying to many ordinary course cross-border M&A transactions, these adaptations often introduce significant cost and complexity. These adaptations generally may also introduce tax or operational inefficiencies which, though costly, are necessary to incur to avoid the costlier prospect of Section 7874 applying to the relevant transaction.

Traps for the unwary. The rule can capture ordinary-course capital raises and working capital contributions that may have no connection to an inversion transaction. This is particularly problematic for companies that are not contemplating an inversion but that may later become

[83] *See* NYSBA Tax Section, Report No. 1308, Report on Temporary Regulations Under Section 7874 (Sept. 5, 2014) (the "**2014 Report**"), at 1-2.

[84] *Id*. at 12, 16-22.

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involved in a cross-border acquisition. Moreover, the rule's presumptive nature can cause Section 7874 to apply to ordinary course corporate carve-out transactions.

5. Examples

The principal concerns above can be illustrated by the following examples.

> Example 1. Foreign Parent (FP), a publicly traded corporation organized in Country X, is evaluating acquiring Domestic Target (DT) in a stock-for-stock merger. Before the agreement of the acquisition and while non-binding negotiations with DT are ongoing, FP issues $5 billion of new stock in a registered public offering to retire maturing debt held by third parties. The consequent reduction to FP's D/E ratio causes it to be perceived as a more attractive merger partner by participants in its industry and related industries generally. The acquisition of DT is agreed to more than three months later. FP's post-offering, pre-acquisition equity value is $10 billion, DT's equity value is $8 billion, and the post-acquisition equity value of FP is $18 billion. Absent the application of the statutory public offering rule, the ownership fraction would be approx. 44% ($8B / $18B). Under the application of such rule, the ownership fraction would be approx. 61% ($8B / ($18B - $5B)).

Example 1 highlights the question, currently left unanswered by the statute and the existing Regulations, of when or why a public offering may be related to an acquisition. This implicates the principal concerns related to administrability and may have a negative impact on cross-border M&A.

> Example 2. Assume the same facts as in Example 1, but that FP issues $5 billion of privately-placed preferred stock to one or more institutional investors.

Example 2 illustrates how the disqualified stock rule expands the scope of the statutory public offering rule to reach private placements. While the statute explicitly excludes stock sold in public offerings "related to" the acquisition, the disqualified stock rule treats private placements for cash or other nonqualified property similarly. This raises the question of whether this extension of the presumption to privately placed stock is necessary in today's environment, particularly where the private placement has an independent business purpose.

> Example 3. Foreign Parent (FP), a publicly traded corporation organized in Country X, is evaluating entering into a joint venture with Domestic Parent (DP). The joint venture would combine a foreign business of FP with a domestic business of DP. FP operates the foreign business directly and DP operates the domestic business through its wholly-owned subsidiary, DS. Twenty percent of the value of the foreign business is made up of cash and marketable securities that are held for reasonable business needs. The joint venture is organized as a corporation, FJV, in foreign jurisdiction in which DS does not have substantial business activities to permit FJV to obtain favorable debt financing and to facilitate the potential future

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expansion of foreign business. FP contributes the non-U.S. business to FJV in exchange for 45% of FJV's stock and DP contributes DS to FJV for the remaining 55% of FJV's stock. 9% of the FJV stock issued (i.e., 20% of the 45% of FJV's stock issued to FP in exchange for the cash and marketable securities held in connection with the foreign business) is disregarded as disqualified stock, and Section 7874 applies to the formation of FJV. If, on the other hand, FP's foreign business was operated in corporate form and such corporation was contributed to FJV, none of FJV's stock would be disregarded as disqualified stock. Alternatively, if FJV elected to be classified as a partnership for U.S. federal income tax purposes, then there would be no foreign corporate acquiror and Section 7874 would not apply to the transaction (although this election could have negative tax consequences, including under any anti-hybrid rules enacted in FJV's jurisdiction).

Example 3 highlights the disparate treatment of contributions of assets and contributions of stock. When a foreign corporation contributes assets (including working capital in the form of cash and marketable securities) to a joint venture, the stock received for those assets may be treated as disqualified stock. In addition, as illustrated by the final sentences of the Example, the form-over-substance distinctions of the existing rules incentivize or require taxpayers to undertake additional transactional steps to avoid this application, which ultimately only increase the costs and complexity of the relevant transaction.

Example 4. Foreign Parent (FP), a publicly traded corporation organized in Country X, is evaluating acquiring Domestic Target (DT), also a publicly traded corporation, in a stock-for-stock "two-step" forward merger where DT's assets are ultimately acquired by a wholly-owned domestic LLC that is disregarded as separate from FP. DT is a financial institution that holds a large amount of long and short-term investments to support its core business of borrowing to lend. Before the agreement of the acquisition and while non-binding negotiations with FP are ongoing, DT issues $1 billion of new stock in a registered public offering and invests the proceeds in marketable securities to bolster its balance sheet. The consequent reduction to DT's D/E ratio causes it to be perceived as a more attractive merger partner by participants in its industry and related industries generally. The acquisition of DT is agreed to more than three months later. FP's pre-acquisition equity value is $1.5 billion, DT's pre-offering equity value is $.5 billion, its post-offering, pre-acquisition equity value is $1.5 billion, and the post-acquisition equity value of FP is $3 billion. If the disqualified stock rule applies to disregard the FP stock issued to "acquire" such marketable securities, then the ownership fraction would be 75% ($1.5B / ($3B - $1B)).[85] If the disqualified stock rule did not apply to disregard such FP stock, then the ownership fraction would be 50% ($1.5B / $3B), which would be the same result if FP acquired 100% of the

[85] *See* Treas. Reg. § 1.7874-4(i) Example 4(iii) (illustrating this application of the disqualified stock rule, by negative implication).

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stock of DT in a reverse subsidiary merger (rather than 100% of the assets of DT in a forward merger).[86]

Example 4 illustrates the disparate treatment of forward mergers (treated as asset acquisitions) and reverse mergers (treated as stock acquisitions). In a forward merger structure, the disqualified stock rule may apply to exclude stock attributable to marketable securities held by the target, even if those securities are held in the ordinary course of the target's business as a financial institution. In a reverse merger structure, the same transaction would not trigger the disqualified stock rule. This structural distinction creates traps for the unwary and may drive transaction structuring for tax reasons unrelated to Section 7874's policy goals.

> Example 5. IF is a private investment fund that has agreed to acquire, indirectly through New Foreign Parent (NFP), domestic subsidiary (DS) and foreign subsidiary (FS) from Seller, itself a foreign parent of a multinational group. IF's owners are unrelated to Seller and Seller's owners. Together, DS and FS operate a global business, 60% of the value of which belongs to DS and 40% of the value of which belongs to FS. IF organizes NFP in a jurisdiction in which FS does not have substantial business activities to permit NFP to obtain favorable debt financing and to facilitate the potential future expansion of the business. IF contributes cash used to fund the acquisition of DS and FS to NFP for stock. NFP is classified as a corporation for U.S. federal income tax purposes. In order to reduce the total amount of cash required of IF to fund the acquisition, Seller agrees to "roll" 10% of its stock in each of DS and FS into NFP in exchange for 10% of NFP's stock. 100% of NFP's stock issued to IF is excluded from the denominator of the ownership fraction as disqualified stock, and the ownership fraction is 60% (causing Section 7874 to apply to NFP's acquisition of DS).[87]

Example 5 illustrates how the disqualified stock rule can apply to cash purchases. Although the investment fund (IF) is contributing cash to acquire a business—a transaction with no continuity of ownership by the former domestic entity shareholders other than the limited rollover—the disqualified stock rule excludes 100% of the stock issued to IF from the denominator. This produces an ownership fraction of 60%, triggering Section 7874, even though the transaction does not present the policy concerns that Section 7874 was enacted to address. The de minimis exception does not apply because of the size of Seller's 10% rollover. Similar to Example 3, the application of the disqualified stock rule (and Section 7874) can be avoided if NFP elects to be

[86] *See* Treas. Reg. § 1.7874-4(i) Example 7.

[87] *See* Treas. Reg. § 1.7874-2(f)(2) (providing that "[i]f, pursuant to the same transaction, stock of a foreign corporation [e.g., NFP] is received in exchange for, or with respect to, stock of a domestic corporation [e.g., DS] and other property [e.g., the stock of FS], the stock of the foreign corporation that was received in exchange for, or with respect to, the stock of the domestic corporation shall be determined based on the relative value of the stock of the domestic corporation compared to the aggregate value of such stock and the other property"). *See also*, Treas. Reg. § 1.7874-2(k)(2) Example 8.

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classified as a partnership for U.S. federal income tax purposes, and therefore the disqualified stock rule serves only to increase cost and complexity on these and similar facts.

> Example 6. Assume the same facts as Example 5 above, except that (1) Seller's "roll" is only 4% (i.e., within the de minimis exception, before taking into account any constructive ownership), (2) Seller is also a private investment fund that raises capital from many of the same institutional investors who invest in IF, (3) the sponsors of both IF and Seller are unrelated, (4) their respective investors do not control the acquisition or disposition of IF or Seller's investments, (5) the sponsor of IF does not have actual knowledge of Seller's beneficial ownership, and the sponsor of Seller does not have actual knowledge of IF's beneficial ownership, and (6) due to both market competition considerations and confidentiality restrictions imposed by such owners, neither sponsor is motivated or permitted to disclose such ownership.

Example 6 illustrates the practical difficulties created by the constructive ownership rules applicable to the Ownership Prong of the de minimis exception. Even where the parties are unrelated and have no actual knowledge of each other's ownership composition, the constructive ownership rules may attribute stock ownership in a manner that disqualifies the de minimis exception. Because institutional investors often invest in multiple private equity funds, and because those funds may acquire or dispose of portfolio companies without knowledge of common investor overlap, the parties to an acquisition often are unable to determine whether the Ownership Prong causes the de minimis exception not to apply. Given the material adverse consequences of Section 7874 applying to a transaction, market participants are not willing to rely on the de minimis exception in nearly all cases.

6. Potential Options for Simplification

The existing disqualified stock rule provides a robust defense against manipulation of the ownership fraction to effect an inversion transaction, and its mechanical nature provides certainty to taxpayers and Treasury alike. The rule has been in effect since 2016, and taxpayers have largely adapted to its requirements in structuring cross-border M&A transactions. However, the rule is a significant expansion of Section 7874(c)(4), as it presumes all contributions within its scope are part of an avoidance plan without a purposive inquiry. The rule's breadth can disqualify stock issued pursuant to ordinary-course capital market activities with independent business purpose, which may have only secondary nexus to the acquisition of a domestic entity. Taxpayers' adaptations to the rule have also created compliance costs and transactional complexity disproportionate to the current risk of inversion transactions. We believe Treasury should simplify the rule to better align its application with such risks, and that Treasury's potential simplification of the rule could include any or all of the below approaches.

Option 1: Add a requirement that stock is only disqualified if it is issued as part of a plan, a principal purpose of which is to avoid the purposes of Section 7874. We believe that tying the disqualified stock rule to the purposive standard in Section 7874(c)(4) will simplify the

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application of the disqualified stock rule and further align it with the statute. We believe that a rule disregarding only stock that is issued for nonqualified property as part of a plan, a principal purpose of which is to avoid the purposes of Section 7874 is both closely aligned to the statute and sufficiently protective to the fisc.

Option 2: Add facts and circumstances and safe harbors for establishing whether a stock issuance is part of a plan, a principal purpose of which is to avoid the purposes of Section 7874. Facts and circumstances that a stock issuance and a domestic entity acquisition are "part of a plan, a principal purpose of which is to avoid the purposes of Section 7874" could include the General Avoidance Determination Factors listed in Part III.A.2 above, as well as (1) where the acquired domestic entity or the foreign acquiror is publicly traded, the necessity of a shareholder vote to approve the relevant acquisition which must be obtained after the date of the applicable stock issuance, (2) the passage of a significant period of time between the stock issuance and the agreement to acquire the relevant domestic entity, (3) whether the nonqualified property remains owned, directly or indirectly, by the foreign acquiring corporation immediately after the applicable domestic entity acquisition, (4) the intended use of contributed cash (e.g., as specified in a public registration statement or a private placement memorandum) and (5) the actual use of the contributed cash by the foreign acquiring corporation in a manner unrelated to the domestic entity acquisition.

With respect to the final factor listed above, we believe that the use of the cash in the ordinary course of the foreign acquiring corporation's (or its EAG's) business, to retire existing indebtedness (at least where there is a business purpose to do so independent of the domestic entity acquisition), or to acquire foreign assets may all indicate that no avoidance purpose exists. With respect to the acquisition of foreign assets, we note that a shareholder's acquisition of assets for cash followed by a contribution of such assets to the foreign acquiring corporation would only give rise to disqualified stock under the existing rule where there is an avoidance purpose. The cash remaining on the foreign acquiring corporation's balance sheet, or its use to make passive investments unrelated to the foreign acquiring corporation's (or its EAG's) business, suggests "stuffing" and therefore may indicate an avoidance purpose exists. So too may the foreign acquiring corporation's early retirement of its existing indebtedness, at least where there is no business purpose to do so independent of the domestic entity acquisition, since such repayment increases the foreign acquiring corporation's equity value in a manner similar to keeping the contributed cash on hand. A post-closing distribution of contributed cash to shareholders likely would also indicate an avoidance purpose. The use of the cash to acquire domestic assets may indicate an avoidance purpose, especially where the assets are acquired from the domestic acquired entity or where one or more General Avoidance Determination Factors indicative of avoidance are present. Where there is very significant shareholder continuity between the acquired domestic entity and the foreign acquiring corporation, such that the acquisition of the domestic corporation does not resemble a cash purchase, the foreign acquiring corporation's use of contributed cash to purchase stock of the domestic corporation could indicate an avoidance purpose.

We acknowledge that Treasury has previously indicated that the actual use of the cash is not relevant, including by asserting that the use of the cash from a public offering is not relevant

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for purposes of the statutory public offering rule.[88] We continue to believe that the use of the cash should be relevant for purposes of applying the disqualified stock rule, and that doing so is consistent with an overall approach to simplify the disqualified stock rule and reduce its negative impact on cross-border M&A. We note that the statutory public offering rule applies only where the offering is related to the tested acquisition and that the intended and actual use of the proceeds may be probative of whether such a relationship exists. Even if the disqualified stock rules are not simplified by shifting towards a purpose-based test, a bright-line exception to the definition of "nonqualified property" could be added to the rules. Under this approach, the definition of "nonqualified property" would still include cash, but a specific exception could be available depending upon the use of the cash. This exception could look to whether the cash was used in the ordinary course of the foreign acquiring corporation's (or its EAG's) trade or business or to acquire "qualified property" (e.g., foreign assets other than passive assets).

Evaluating the use of contributed cash would require a rule connecting the relevant cash with the foreign acquiring corporation's expenditures. Treasury could consider placing the burden on the taxpayer, which would minimize taxpayer optionality but would increase administrative burdens on taxpayers in evaluating whether what is ultimately an anti-abuse rule applies to relevant transactions. Alternatively, to reduce administrative burdens, Treasury could consider permitting taxpayers to use one of the following methods, consistently applied: (i) actual tracing of the cash, similar to the approach in the Regulations under Section 163; (ii) pro rata allocations of the cash to the corporation's cash expenditures following the contribution; (iii) first in, first out use of the contributed cash; or (iv) last in, first out use of the contributed cash.

As a "plan" requirement necessarily means that the issuance of the relevant stock is "related to" a domestic entity acquisition, we do not believe any further facts and circumstances tests or descriptions are required for purposes of the "related to" requirement. While the statutory public offering rule requires the application of the "related to" requirement without any independent "plan" requirement, taxpayers undertaking a public offering (as in Example 1 above) should have Easufficient certainty in applying relevant facts and circumstances from the above (e.g., facts and circumstances (1) - (4)).

Option 3: Increase the de minimis exception threshold, including for the Ownership Prong, from 5% to at least 20%. Even if a principle-based rule is prioritized, we recommend retaining the de minimis exception. We continue to believe that acquisitions of domestic entities involving all or mostly cash should not be covered by Section 7874, and accordingly that the existing de minimis exception threshold is too low.[89] We continue to believe that a threshold of at least 20% for the de minimis exception (subject to the potential elimination of the Ownership

[88] *See* T.D. 9654, 79 Fed. Reg. 3,094, 3097 (Jan. 2014) (providing "[t]he IRS and the Treasury Department believe that the use of the offering proceeds is irrelevant to the application of the statutory public offering rule. Neither the statute nor the legislative history indicates that Congress intended for the statutory public offering rule to apply based on the use of the proceeds.").

[89] For a detailed discussion of the related considerations and rationale, see the 2014 Report, *supra* note 83, at 16-22.

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Prong discussed below) is better aligned with Section 7874's policy goals.[90] This modification of the de minimis exception would address the concerns highlighted in Example 5 above while adequately policing former shareholders' *continuing* ownership of the acquired domestic entity through the foreign acquiror *by reason of* their former ownership in such domestic entity. We believe that the application of the de minimis exception could continue to be subject to an anti-abuse rule (although if a plan-based approach more generally is implemented for the disqualified stock rule while the de minimis exception remains as a carve-out, this anti-abuse rule should be tailored to prevent it from swallowing the exception).[91]

Option 4: Eliminate the Ownership Prong. The Ownership Prong (which disapplies the de minimis exception based on foreign acquiror group stock held *other than* by reason of owning stock in the acquired domestic entity) arguably is inconsistent with Section 7874's overall framework, which turns on *by reason of* stock. It could (and we believe should) reasonably be eliminated on this basis and for the reasons discussed immediately below.[92] Similar to the above, an anti-abuse rule could continue to police transactions where a former shareholder of the acquired domestic entity's ownership of foreign acquiror stock manipulates the ownership fraction in a way that would otherwise facilitate an inversion transaction.

Option 5: If the Ownership Prong is not eliminated, modify the applicable ownership rules. We believe that the stock ownership rules applicable to the Ownership Prong are too broad in three respects. First, the Ownership Prong takes into account a former shareholder of the acquired domestic entity's ownership in each member of the foreign acquiror's EAG, even though only stock owned, directly or indirectly, in the foreign acquiror can affect the ownership fraction. Second, the Ownership Prong takes into account stock that is constructively owned, even though only stock owned, directly or indirectly, in the foreign acquiror can affect the ownership fraction. Third, the Ownership Prong takes into account all stock directly, indirectly or constructively owned by such a former shareholder, even if neither the acquired domestic entity nor the foreign parent have actual knowledge of such ownership. Conceptually, the mechanical approach of the Ownership Prong does not align with the fact that each of Section 7874(c)(4), Section 7874(c)(6) and Section 7874(g) look to avoidance transactions or transactions that are otherwise inappropriate in light of Section 7874. As a practical matter, it gives rise to the intractable problem illustrated by Example 6, as neither the acquired domestic entity nor the foreign acquiror may have insight into the others' indirect shareholder base. This is especially true in the case of publicly traded entities participating in a cross border transaction because a publicly traded entity's shares typically are held in "street name" and therefore the tax owner of the entity's shares is difficult to determine. Similar issues arise with respect to a private investment fund, since a privately held entity's shareholder base is often confidential from a contractual or commercial standpoint (especially with

[90] *Id.*

[91] As noted below, we believe that the de minimis exceptions throughout the Section 7874 Regulations should be harmonized and applied consistently. Accordingly, to the extent the de minimis exception for purposes of the disqualified stock rule is adjusted, we recommend corresponding adjustments to analogous exceptions.

[92] *See* the 2014 Report, *supra* note 83, at 21.

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respect to indirect ownership of the investment fund through entities). Accordingly, if the Ownership Prong is not eliminated, it could be modified to take into account only stock (1) that is directly or indirectly owned in the foreign acquiror and (2) with respect to which the foreign acquiror had actual knowledge that the former domestic entity shareholder was a direct or indirect shareholder of the acquired domestic corporation.[93]

We believe that a foreign acquiring corporation should be deemed to have actual knowledge of (A) any controlling shareholder thereof and (B) publicly available information. For (B), we believe it would be reasonable to take only information contained in SEC filings on Schedule 13D and Schedule 13G into account.[94]

Treasury may consider whether any actual knowledge standard also includes a "reasonable due diligence" requirement.[95] On the one hand, Section 7874(c)(4) requires a plan to avoid the purpose of Section 7874, and it is difficult to see how a domestic acquired entity and foreign acquiring corporation could avoid the purpose of Section 7874(c)(4) without having actual knowledge of overlapping ownership, exclusive of any due diligence. On the other hand, a reasonable due diligence standard would prevent such parties from disclaiming actual knowledge, avoiding a burdensome evidentiary bar for Treasury and the IRS.

Option 6: Narrow the definition of "nonqualified property." While stock issued in exchange for an isolated contribution of cash and marketable securities can, in many cases, reasonably be treated as nonqualified property, cash and marketable securities contributed as part of a larger contribution of property that is not nonqualified property (such as a trade or business or real estate investment) does not raise the same level of ownership fraction manipulation concerns, as illustrated in Example 3 above. As such, stock issued in exchange for cash and marketable securities as part of such a larger contribution of property made by the contributing shareholder (or related person) could either be excluded from the definition of "nonqualified property" altogether or included in the definition solely to the extent that the value of the cash and marketable securities exceed a fixed percentage of the value of all such property contributed (taking into account any goodwill or going concern value). That value could be fixed based on a reasonable estimate of working capital of *bona fide* businesses generally (e.g., 20%). This potential option, if implemented, could be subject to an anti-abuse rule (e.g., the existing anti-abuse rule in Treas. Reg. § 1.7874-4(h)(2)(iv) if a purpose-based approach is not adopted).

Option 7: Add temporal nexus rebuttable presumptions. Include a bright-line rebuttable presumption that stock issued for nonqualified property is not "related to" an acquisition (or is not "part of a plan") if it is issued outside a defined window ending on the first public

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[93] *See* NYSBA Tax Section, Report No. 1445, Report on Section 304 in Public M&A Transactions, (Nov. 19, 2020) (the "**2020 Report**"), at 22-27 for a discussion of similar concerns, and an analogous proposal, for purposes of applying Section 318 attribution in the context of another anti-abuse provision.

[94] *See id*. at 24.

[95] *See, e.g.*, the "readily available" concept in Rev. Proc. 2019-40.

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announcement or signing of the domestic entity acquisition agreement. Stock issued outside this window would only be treated as disqualified stock if, under a "strong proof" standard, the facts and circumstances (such as those discussed above) establish that the relevant issuance is part of a plan a principal purpose of which is to avoid the purposes of Section 7874. This should eliminate the risk that ordinary-course capital raises predating any acquisition plan would be captured. We believe this window should be no shorter than three months. We also believe that a longer window of up to six months would be reasonable.

If a taxpayer-favorable presumption described above is adopted, Treasury may consider including a corresponding bright-line rebuttable presumption that stock issued for nonqualified property is "related to" an acquisition (or is "part of a plan") if it is issued inside a defined window ending on the first public announcement or signing of the domestic entity acquisition agreement of the applicable acquisition. Stock issued inside this window would be treated as disqualified stock unless, under a "strong proof" standard, the facts and circumstances (such as those discussed above) establish that the relevant issuance is not part of a plan a principal purpose of which is to avoid the purposes of Section 7874. We believe this window for a taxpayer-adverse presumption should mirror any taxpayer-favorable presumption described above to ensure symmetry between the two provisions.

Option 8: Add a quantitative rebuttable presumption in the Taxpayer's favor. Provide that stock issuances for nonqualified property that do not exceed a specified percentage of the foreign acquiring corporation's market capitalization (*e.g.*, 10%) are rebuttably presumed not to be disqualified stock. This would allow ordinary-course capital market activities below the safe harbor threshold without risk of disqualification. Similar to the above, we believe any such safe harbor could still be subject to an anti-abuse rule.

Option 9: Add a "netting" rule. The purpose of the disqualified stock rule is to prevent manipulation of the ownership fraction via shareholder "stuffing" of nonqualified property into the foreign acquiring corporation. That stuffing concern requires the nonqualified property to reside in the foreign corporation's EAG. As such, the amount of foreign acquiror stock disregarded under the disqualified stock rule could be reduced (but not below zero) to take into account distributions of nonqualified property to the foreign acquiror's shareholders within a reasonable time period. In implementing this netting rule, Treasury may consider drawing from the Regulations issued under Section 4501(c)(3).

C. Non-Ordinary Course Distributions Rule (Treas. Reg. § 1.7874-10)

1. Operation of the Rule

Treas. Reg. § 1.7874-10 adjusts the ownership fraction to account for non-ordinary course distributions ("**NOCDs**") made by the domestic entity (or a member of its EAG) in connection with the acquisition.[96] The rule operates by increasing both the numerator and the denominator of

[96] Treas. Reg. § 1.7874-10.

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the ownership fraction. Former domestic entity shareholders or partners are treated as receiving stock in the foreign acquiring corporation with a fair market value equal to the amount of any NOCDs they received, thereby counteracting the effects of the NOCD.

A NOCD is generally defined as any distribution made by a domestic entity (or a member of its EAG) during the look-back period that is not a distribution in the ordinary course of business.[97] The definition of "distribution" is broad and includes, among other types of distributions, "a transfer of money or other property to the former domestic entity shareholders or former domestic entity partners that is made in connection with the domestic entity acquisition to the extent the money or other property is directly or indirectly provided by the domestic entity."[98] The rule looks to capture distributions in amounts that are in excess of ordinary course distributions, based on a mechanical formula that sets a certain threshold for what is considered an ordinary course distribution.[99] The look-back period runs from 36 months before the signing date through the closing date.[100] The regulation includes a de minimis exception for distributions that, in the aggregate, do not exceed a specified threshold, but the threshold is set at a relatively low level.[101]

Treasury announced in Notice 2014-52 that it intended to issue Regulations treating any non-ordinary course distributions during the 36-month period preceding an acquisition as part of a plan to avoid the purposes of Section 7874.[102] For these purposes, NOCDs were "the excess of all distributions made during a taxable year by the domestic entity with respect to its stock or partnership interests, as applicable, over 110% of the average of such distributions during the thirty-six month period immediately preceding such taxable year."[103] This was followed by Notice 2015-79, which responded to public comment and announced an intent to include a de minimis exception in the Regulations.[104] In 2016, T.D. 9761 created the first version of the NOCD rule in

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[97] Treas. Reg. § 1.7874-10(k)(6) (defining NOCD). The more technical definition is as follows: "NOCDs mean, with respect to a look-back year, the excess of all distributions made during the look-back year over the NOCD threshold for the look-back year." In turn, the "NOCD threshold" operates as a proxy for ordinary course distributions and is defined as follows: "NOCD threshold means, with respect to a look-back year, the following: (i) If the look-back year has at least a 12-month distribution history period, 110% of the sum of all distributions made during the distribution history period multiplied by a fraction. The numerator of the fraction is the number of days in the look-back year and the denominator is the number of days in the distribution history period with respect to the look-back year. (ii) If the look-back year has no distribution history period, zero." Treas. Reg. § 1.7874-10(k)(7).

[98] Treas. Reg. § 1.7874-10(k)(1) (defining "distribution" generally) and Treas. Reg. § 1.7874-10(k)(1)(iii) for the specific definition.

[99] Treas. Reg. § 1.7874-10(k)(6).

[100] Treas. Reg. § 1.7874-10(k)(4) (look-back period).

[101] Treas. Reg. § 1.7874-10(d) (de minimis exception).

[102] Notice 2014-52, 2014-42 I.R.B. 712, 714 (2014).

[103] *Id.*

[104] Notice 2015-79, 2015-49 I.R.B. 775 at 782-83 (2015).

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the 1.7874-10T temporary Regulations.[105] The temporary Regulations were amended by T.D. 9812.[106] The NOCD rule was then finalized as part of T.D. 9834 in 2018.[107] The preamble to T.D. 9834 explained that the rule addresses the concern that a domestic entity could reduce its value before an inversion transaction by distributing assets to its shareholders, thereby reducing the numerator of the ownership fraction and lowering the percentage of the foreign acquiror held by former domestic entity shareholders.[108]

2. Statutory Text and Regulatory Scope

Like the disqualified stock rule, the NOCD rule relies primarily on the regulatory grant in Section 7874(g) and the statutory text in Section 7874(c)(4), which provides "[t]he transfer of properties . . . including by . . . distribution . . . shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of [Section 7874]."[109] Also, like the disqualified stock rule, the NOCD rule does not require an avoidance plan but creates an irrebuttable presumption that distributions made within the look-back period are part of a plan to avoid Section 7874 and, as such, should be disregarded for purposes of the ownership fraction.[110] The 36-month look-back period, the breadth of what counts as a distribution "in connection with"[111] the domestic entity acquisition, and the mechanical application of the rule collectively create a rule that can reach distributions with no meaningful nexus to an inversion plan.

3. Legislative History and Policy Rationale

It is notable that the legislative history of Section 7874 does not specifically address pre-acquisition distributions or the adjustment of the domestic entity's value. The Conference Report and JCT Blue Book focus on the mechanics of the ownership fraction and the exclusion of stock held by EAG members and stock sold in public offerings, without discussing adjustments to the ownership fraction based on pre-transaction distributions.[112] The policy concern is real—absent

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[105] T.D. 9761, 81 Fed. Reg. 20,858 (Apr. 8, 2016).

[106] T.D. 9812, 82 Fed. Reg. 5,388 (Jan. 18, 2017).

[107] T.D. 9834, 83 Fed. Reg. 32,524 (July 12, 2018).

[108] T.D. 9834, 83 Fed. Reg. at 32,525-30 (July 12, 2018) (preamble discussing the policy basis for the NOCD, serial acquiror, and third-country transaction rules). *See also* T.D. 9761, 81 Fed. Reg. at 20,861 (Apr. 8, 2016).

[109] *See* T.D. 9761, 81 Fed. Reg. at 20,861 (Apr. 8, 2016).

[110] *See* Notice 2014-52, 2014-42 I.R.B. 712, 714 (2014) ("[F]or purposes of applying section 7874(c)(4) (which disregards transfers of properties or liabilities if the transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874), non-ordinary course distributions (defined below) made by the domestic entity (including a predecessor) during the 36-month period ending on the acquisition date (within the meaning of §1.7874-3T(d)(1)) *will be treated as part of a plan a principal purpose of which is to avoid the purposes of section 7874*. Accordingly, such distributions will be disregarded for purposes of section 7874.") (emphasis added).

[111] Treas. Reg. § 1.7874-10(k)(1)(iii).

[112] H.R. Conf. Rep. No. 108-755, at 491-95 (2004); Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress, JCS–5–05 (2005).

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some adjustment, a domestic entity could distribute a large special dividend immediately before signing an inversion transaction, shrinking its value and potentially bringing the ownership fraction below a threshold. However, the current regulatory implementation is significantly more expansive than would be necessary to address this targeted concern.

4. Principal Concerns Raised by the Existing Rule

Relationship to the statutory text. As discussed above, the NOCD rule implements Section 7874(c)(4) which calls for the disregarding of distributions that are part of an avoidance plan, but determines whether distributions are part of such a plan mechanically, without a purposive analysis.

Administrability. While the rule is arguably more administrable in that it provides objective criteria for measuring NOCDs, the relevant analysis often involves highly complex and long-reaching analysis that requires careful study of a target corporation's distribution history, which can be especially complex with respect to the acquisition of a domestic entity that is a member of a larger corporate group (e.g., a domestic target in a carve-out transaction).

Impact on cross-border M&A. The rule deters capital return activities, including regular dividend increases, share repurchases, and spin-offs, by creating uncertainty about their treatment in the event of a subsequent cross-border transaction. This chilling effect is particularly acute for companies that regularly return capital to shareholders. The NOCD rule also creates a meaningful asymmetry in the treatment of acquisition financing. If a foreign acquiror borrows money to fund a domestic entity acquisition and the target does not provide credit support for that borrowing, the NOCD rule is not implicated. If, however, the target domestic entity incurs debt to repurchase its shares or pay a dividend in connection with the acquisition, the debt proceeds are potentially treated as an NOCD. This leads to material differences in non-tax financing arrangements due to the inversion rules based solely on how a transaction is financed, which may not reflect any difference in the underlying economics or tax-avoidance risk. While this result may have been an appropriate area of regulatory concern before the TCJA and the enactment of current Section 163(j), it is less clear that the inversion rules should be driving decisions regarding how a transaction is financed given that earnings stripping is now separately policed by Section 163(j). To the extent the policy concern underlying the NOCD rule is that debt-financed distributions could facilitate post-inversion base erosion, Section 163(j) now provides a more direct and calibrated response to that concern.

Traps for the unwary. The rule captures ordinary-course dividends and share repurchases that predate any acquisition discussion by years. The rule also captures spin-off and split-off transactions without regard to whether these fundamental corporate reorganizations were related to or were implemented in connection with the potential inversion transaction. This is a significant trap for the unwary, as public corporations that make routine capital allocation decisions may unknowingly create NOCD exposure that only materializes if a cross-border transaction is pursued years later. Additionally, the NOCD rule can present substantial compliance burdens when a domestic entity is a member of a multinational group of corporations in which distributions and

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contributions among wholly owned entities are very difficult to track and as a result present very difficult compliance burdens for taxpayers, as many years of intercompany transactions must be excavated and analyzed to ensure compliance with the NOCD rules.

5. Examples

> Example 7. Domestic Target (DT), a publicly traded corporation, has a long-standing policy of paying quarterly dividends. In Year 1, DT's board approves a 15% increase in the quarterly dividend, consistent with DT's earnings growth and in line with industry practice. Eighteen months later, DT enters into a merger agreement with Foreign Parent (FP). Under the NOCD rule, DT's increased dividends during the 36-month look-back period could potentially be treated as NOCDs to the extent they exceed the "ordinary course" baseline, even though the increase was approved for business reasons and predated any discussions with FP.

Example 7 illustrates how the NOCD rule can capture ordinary-course dividend increases that have no connection to an inversion transaction. The 36-month look-back period means that a dividend increase approved 18 months before any acquisition discussions—and for reasons entirely unrelated to any future transaction—may nonetheless be treated as an NOCD if the domestic entity later becomes involved in a cross-border acquisition. This creates a trap for the unwary and may chill ordinary-course capital allocation decisions.

> Example 8. DT redeems $500 million of its outstanding stock in an accelerated share repurchase program, consistent with DT's historical practice of returning excess capital to shareholders. The repurchase is completed 30 months before DT enters into a merger agreement with FP. If DT's total equity value is $5 billion, the $500 million adjustment increases the ownership fraction by treating the "by reason of" shares issued to DT shareholders as worth $5.5 billion—a potentially outcome-determinative effect in cases near the 60% or 80% thresholds.

Example 8 illustrates how the NOCD rule can apply to ordinary-course share repurchases that predate any acquisition by years. A repurchase program consistent with a company's historical practice of returning excess capital to shareholders—undertaken 30 months before any acquisition discussions—may nonetheless increase the domestic entity's value for purposes of the ownership fraction. The example also demonstrates how even relatively modest adjustments to the ownership fraction can be outcome-determinative for transactions near the statutory thresholds.

> Example 9. DT is a subsidiary of a foreign-parented multinational group. As is common in large multinational enterprises, DT participates in a group-wide "cash sweep" program under which DT periodically transfers excess cash to a foreign affiliate that serves as the group's centralized treasury function. In addition, in the ordinary course of business, members of the multinational group engage in numerous intercompany transactions—including the provision of goods, services, and licenses—that give rise to intercompany payables and receivables recorded on

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the books and records of the group. FP (unrelated to DT's existing foreign parent) agrees to acquire DT in a transaction in which the ownership fraction is 59% before application of the NOCD rule. Prior to the closing of the acquisition, DT distributes to its foreign parent certain intercompany receivables that arose in the ordinary course of business from intercompany transactions occurring 30 months before the acquisition in order to eliminate any continuing intercompany indebtedness following the closing of the acquisition. The distribution of these receivables constitutes a distribution for purposes of the NOCD rule, resulting in NOCDs. Assume that these NOCDs increase the ownership fraction from 59% to 61%, crossing the 60% threshold. Neither the creation of the intercompany receivables nor the distribution of the receivables to DT's foreign parent was made with any purpose of avoiding the application of Section 7874.

Example 9 highlights two significant concerns with the current NOCD rule. First, it illustrates the extensive diligence exercise required in connection with acquisitions of domestic subsidiaries of foreign-parented groups. Such subsidiaries routinely participate in intercompany financing arrangements, cash pooling programs, and ordinary-course intercompany transactions that generate payables and receivables over extended periods. Determining whether any of these arrangements give rise to NOCDs—and quantifying their impact on the ownership fraction—requires a detailed forensic review of the target's intercompany account activity, often reaching back 36 months or more. This diligence burden is imposed even where, as in Example 9, none of the relevant transactions were undertaken with any tax-avoidance purpose. Second, and more fundamentally, Example 9 demonstrates how the NOCD rule can trigger Section 7874 consequences due to transaction steps that are driven by commercial motivations (the disentanglement of an acquired business and the seller) rather than tax planning. The intercompany receivables arose from routine business operations conducted years before any acquisition was contemplated, and their distribution was a function of ordinary pre-closing housekeeping rather than a deliberate effort to manipulate the ownership fraction.

6. Potential Options for Simplification

The NOCD rule addresses a real concern about pre-transaction value stripping and has been in effect since 2018. Its mechanical nature provides predictability, and the de minimis exception provides some relief for smaller distributions. However, there are several principal drawbacks to the rule. Like the disqualified stock rule, the NOCD rule is not closely aligned with the purposive approach of Section 7874(c)(4), as it presumes all distributions within its scope are part of an avoidance plan without a purposive inquiry. The rule's breadth captures ordinary-course distributions with no nexus to an inversion. The 36-month look-back period is long relative to the typical transaction timeline. The "ordinary course" standard is ambiguous and difficult to administer. We believe Treasury should simplify the rules to better align their application with such risks.

Option 1: Withdraw. One option would be to withdraw Treas. Reg. § 1.7874-10 in its entirety. The statutory text does not specifically indicate that unrelated pre-transaction

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distributions are a cause for concern. The rule's extended breadth creates traps for ordinary-course activities. In the current environment, the reduced incentive to invert diminishes the marginal benefit of the rule. Moreover, Treasury could apply the statutory provisions of Section 7874(c)(4) to address egregious pre-transaction stripping on a case-by-case basis.

The principal risk of withdrawing the regulation is that it could permit a domestic entity to pay a large special dividend immediately before an inversion transaction to reduce its value below a threshold. However, such a transaction would likely attract IRS scrutiny under general anti-abuse principles, and the practical incentive to execute such a strategy is diminished in the current tax environment.

Option 2: Add a requirement that a distribution is only disregarded if it is issued as part of a plan, a principal purpose of which is to avoid the purposes of Section 7874. We believe that tying the NOCD rule to the purposive standard in Section 7874(c)(4) will simplify the application of the NOCD rule and further align it with the statute. Like the disqualified stock rule, we believe that a rule disregarding only distributions that are made as part of a plan, a principal purpose of which is to avoid the purposes of Section 7874 is both closely aligned to the statute and sufficiently protective to the fisc.

Option 3: Add facts and circumstances and safe harbors for establishing whether a distribution is part of a plan, a principal purpose of which is to avoid the purposes of Section 7874. Facts and circumstances that a distribution and a domestic entity acquisition are "part of a plan, a principal purpose of which is to avoid the purposes of Section 7874" could largely include the General Avoidance Determination Factors, as well as ones analogous to the facts and circumstances discussed in the Potential Options for Simplification of the disqualified stock rule above, but by substituting "distribution" for "contribution" where that word appears.

Option 4: Shorten the look-back period for the existing NOCD rule. Reduce the look-back period from 36 months to 12 months before the earlier of the first public announcement or signing of the domestic entity acquisition agreement. A 12-month period more closely approximates the reasonable timeframe within which distributions are most likely to be "in connection with" a specific acquisition.[113]

Option 5: If a rule requiring an avoidance plan is issued, add temporal nexus rebuttable presumptions. Include a bright-line rebuttable presumption that a distribution is not "in connection with" an acquisition (or is not "part of a plan") if it is declared outside a defined window ending on the first public announcement or signing of the domestic entity acquisition agreement. Distributions outside this window would only be disregarded if, under a "strong proof" standard, the facts and circumstances (such as those discussed above) establish that the relevant

[113] We have previously recommended a 24 month look-back period. *See* NYSBA Tax Section, Report No. 1324, Report on the Non-Ordinary Course Distribution Rules, (July 6, 2015) at 8. However, given the incentives to invert have changed since that recommendation, we believe a 12 month look-back period should provide sufficient protection to the fisc.

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distribution is part of a plan a principal purpose of which is to avoid the purposes of Section 7874. This should eliminate the risk that ordinary-course distributions predating any acquisition plan would be captured. We believe this window should be no shorter than three months. We also believe that a longer window of up to six months would be reasonable.

Treasury may also include a corresponding bright-line rebuttable presumption that a distribution is "in connection with" an acquisition (or is "part of a plan") if it is declared inside a defined window ending on the closing date of the applicable acquisition. Distributions made inside this window would be disregarded unless, under a "strong proof" standard, the facts and circumstances (such as those discussed above) establish that the relevant distribution is not part of a plan a principal purpose of which is to avoid the purposes of Section 7874. We believe this window should begin no earlier than one month before the first public announcement or signing of the domestic entity acquisition agreement. We also believe that beginning the window up to three months before the applicable signing date would be reasonable. If a taxpayer-favorable presumption is adopted, we recommend a corresponding presumption that a distribution is made in connection with an applicable acquisition to the extent the distribution is made within the window adopted by Treasury. In such a case, the distribution would be treated as made in connection with the acquisition unless the taxpayer satisfies the "strong proof" standard described above.

Option 6: Adjust de minimis exception. Implement changes to make the de minimis exception more workable in practice, consistent with the proposed approach to the disqualified stock rule under Treas. Reg. § 1.7874-4 above.

Option 7: Exclude ordinary-course dividends. Provide a per se exclusion for regular quarterly or semi-annual dividends declared by the board of directors consistent with the entity's established dividend policy, regardless of whether the amount has increased. Dividend increases that are consistent with the entity's earnings growth and industry practice should not be treated as NOCDs. The recommended per se exclusion could also be structured as a rebuttable presumption in the taxpayer's favor to address situations in which a taxpayer adjusts its ordinary course dividend policy in anticipation of an acquisition.

Option 8: Exclude ordinary-course share repurchases. Provide a safe harbor for share repurchases conducted pursuant to a plan adopted before the beginning of the look-back period (*e.g.*, a publicly announced repurchase program or a written repurchase plan intended to satisfy the conditions of Rule 10b5-1 under the Securities Exchange Act of 1934, as amended).[114]

Option 9: Provide Special Relief for Carve-Out Transactions. Acquisitions of a domestic target that is a member of a larger multinational group present especially challenging and burdensome diligence exercises, and the distributions captured by the NOCD rule in this context are rarely implemented with any intention of modifying the result under Section 7874. Accordingly, even if the suggestions described above are not adopted in all contexts, we strongly

[114] 17 C.F.R. § 240.10b5-1

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recommend that Treasury consider special relief for acquisitions of domestic entities to the extent the potential NOCD is a distribution to a member of the EAG to which the domestic entity belongs. This relief may include, for example, an exclusion from the definition of NOCD of distributions of intercompany obligations, distributions arising in the course of a customary cash-sweep program, deemed distributions arising from intercompany transactions occurring in the ordinary course of business (e.g., through inadvertent mispricing of goods or services as between affiliates), or other transactions among affiliates undertaken without a principal purpose of avoiding the application of Section 7874. Even if no explicit relief is given with respect to these intercompany transactions, we suggest that Treasury include an example in revised Regulations that highlights how more general relief may apply in the context of transactions among members of an EAG.

D. Serial Acquiror Rule (Treas. Reg. § 1.7874-8)

1. Operation of the Rule

Treas. Reg. § 1.7874-8 provides a rule for "serial acquisitions" of domestic entities by a foreign acquiring corporation.[115] Under the rule, in determining the ownership fraction for a current acquisition, the denominator in the ownership fraction is effectively adjusted to back out serial acquisitions, with the effect that the foreign acquiror is treated as having an artificially decreased equity value.[116] The practical effect is to aggregate the ownership consequences of multiple domestic entity acquisitions, making it more likely that the current transaction will exceed the 60% or 80% statutory thresholds.

The adjustment to the ownership fraction is computed by reference to the value of stock of the foreign acquiring corporation attributable to prior domestic entity acquisitions during the look-back period, divided by the total value of the foreign acquiring corporation's stock.[117] The look-back period is the 36-month period ending on the signing date of the current acquisition.[118] The rule does not require any connection between the prior and current acquisitions—any domestic entity acquisition during the look-back period is included, regardless of industry, strategic rationale, or deal process.

The serial acquiror rule was introduced as part of T.D. 9761 in 2016 and was finalized as part of T.D. 9834 in 2018.[119] The preamble described the rule as addressing a concern that a foreign corporation could acquire multiple U.S. entities in a series of transactions, each individually below the statutory thresholds, but in the aggregate reaching or exceeding those thresholds.

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[115] Treas. Reg. § 1.7874-8.

[116] Treas. Reg. § 1.7874-8(b) (serial acquisition rule).

[117] Treas. Reg. § 1.7874-8(c) (computing the serial acquisition percentage).

[118] Treas. Reg. § 1.7874-8(g)(4) (defining the look-back period as the 36-month period ending on the signing date).

[119] T.D. 9834, 83 Fed. Reg. 32,524, 32,553-55 (July 12, 2018).

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2. Statutory Text and Regulatory Scope

The serial acquiror rule is promulgated under Sections 7874(c)(6) and 7874(g). Unlike the disqualified stock rule, the serial acquiror rule does not have a direct statutory analog in Section 7874(c)(2). The rule effectively aggregates multiple transactions for purposes of the ownership-fraction test, which extends beyond the transaction-by-transaction analysis described in the statute.[120]

The statutory text of Section 7874(a)(2)(B) defines a surrogate foreign corporation by reference to a single "plan (or a series of related transactions)" involving the acquisition of "substantially all" of the properties of a domestic entity. The serial acquiror rule extends this framework by excluding stock attributable to prior, unrelated acquisitions from the denominator for the current acquisition, even when the prior acquisitions were not part of the same plan or series of related transactions.

Section 7874(c)(6)'s authorization to "treat stock as not stock" in order to "determine whether a corporation is a surrogate foreign corporation" arguably supports adjustments to the ownership fraction to reflect the foreign acquiror's acquisition history. However, the aggregation of unrelated transactions significantly expands the testing framework in comparison to the statute, which only contemplates application on a transaction-by-transaction basis. In light of the current state of international tax policy and enforcement, this expansion is likely unnecessary as a policy matter.

3. Legislative History and Policy Rationale

It is notable that the history of Section 7874 does not address serial acquisitions or the aggregation of multiple domestic entity acquisitions by a single foreign acquiror. The Conference Report and JCT Blue Book describe the ownership-fraction test by reference to a specific acquisition transaction and its former shareholders, without discussing how prior or subsequent acquisitions should affect the analysis. [121]

The policy rationale for the serial acquiror rule reflects Treasury's concern that "a single foreign acquiring corporation may avoid the application of [S]ection 7874 by completing multiple domestic entity acquisitions over a relatively short period of time, in circumstances where [S]ection 7874 would otherwise have applied if the acquisitions had been made at the same time or pursuant to a plan (or series of related transactions)."[122] This concern has some force in the

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[120] For example, Section 7874(a)(2)(A) refers to "*the* domestic corporation or partnership" and Section 7874(a)(2)(B) refers to "*the* acquisition."

[121] *See generally* H.R. Conf. Rep. No. 108-755, at 489-95 (2004); Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress, JCS-5-05, at 344-45 (2005).

[122] T.D. 9761, 81 Fed. Reg. at 20,865 (Apr. 8, 2016).

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abstract, but it assumes a degree of strategic planning that may not be present in all cases. A foreign corporation with an active acquisition strategy that happens to include U.S. targets among other global targets may trigger the rule even though it has no intent to circumvent Section 7874. The serial acquiror rule also artificially favors certain foreign acquirors over others—a foreign acquiror that has not acquired any domestic entity within the look-back period will achieve a more favorable ownership fraction than a foreign acquiror who has invested in acquisitions of domestic entities in the recent past. However, the serial acquiror concern is supported by certain aspects of the statutory framework. That is, the reference to a "plan (or a series of related transactions)" in Section 7874(a)(2)(B) suggests that Congress contemplated that the ownership test should look beyond the formal boundaries of a single transaction in certain circumstances. The question is how far beyond —and specifically whether the regulation's inclusion of unrelated acquisitions within a mechanical 36-month window is appropriate in light of the plan / relatedness inquiry envisioned by the statute.

Notably, Treas. Reg. § 1.7874-2(e) already addresses the acquisition of multiple domestic entities in a single transaction or series of related transactions. Under that rule, when a foreign acquiring corporation acquires substantially all of the properties of two or more domestic entities pursuant to the same plan (or series of related transactions), the acquisitions are aggregated for purposes of determining the ownership fraction. This existing rule addresses the core concern underlying the serial acquiror rule—that a foreign corporation could acquire multiple U.S. entities and structure each acquisition to remain below the statutory thresholds—but does so with an important limiting principle: the rule applies only to acquisitions that are part of the same plan or series of related transactions. In contrast, the serial acquiror rule mechanically aggregates all domestic entity acquisitions within a 36-month look-back period without any requirement that the acquisitions be part of the same plan or otherwise related. As such, the serial acquiror concern that a foreign corporation could deliberately structure multiple acquisitions to circumvent the statutory thresholds is arguably already addressed by Treas. Reg. § 1.7874-2(e), to the extent the acquisitions are in fact part of a coordinated plan. Where the acquisitions are genuinely unrelated, the policy justification for aggregation is significantly weaker, and the application of the serial acquiror rule to such transactions raises the statutory-alignment and policy concerns discussed above.[123]

4. Principal Concerns Raised by the Existing Rule

Relationship to statutory text. Section 7874 is structured around specific acquisition transactions, and the statutory references to a "plan (or a series of related transactions)" suggest a focus on a single set of planned or related transactions. The regulation's mechanical aggregation of unrelated acquisitions is thus a significant expansion on the statute's initial scope. Aggregating unrelated transactions extends beyond the statutory concept of measuring domestic ownership of the foreign acquiror that is "by reason of holding stock in (or a partnership interest in) such [domestic] entity."

[123] *See* Exec. Order No. 14219, 90 Fed. Reg. 10,583., directing agencies to identify regulations "based on anything other than the best reading of the underlying statutory authority or prohibition[.]"

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Administrability. The mechanical nature of the rule provides certainty, but the 36-month look-back and the computation of adjustment to the ownership fraction create significant compliance burdens, particularly for active acquirors. Tracking stock attributable to prior acquisitions over multi-year periods requires detailed records and analysis.

Impact on cross-border M&A. The rule can deter foreign corporations from acquiring U.S. entities because prior acquisitions—even those that were entirely unrelated and independently well below the statutory thresholds—may cause a subsequent acquisition to cross a threshold. This deterrent effect extends to routine, non-inversion-related cross-border M&A.

Traps for the unwary. A foreign corporation that acquires a U.S. company with no intent to invert may find that the serial acquiror rule pushes a subsequent, entirely unrelated U.S. acquisition over a threshold. The rule provides no exception for acquisitions that are demonstrably unrelated.

5. Examples

> Example 10. Foreign Acquiror (FA), a diversified multinational organized in Country X with a total equity value of $210 billion, acquires DT1 (a U.S. pharmaceutical company with equity value $90 billion) in Year 1 in a stock-for-stock transaction. The ownership fraction for the DT1 acquisition, viewed in isolation, is 30%. In Year 3, the value of FA shares remains the same as in year 1 and FA acquires DT2 (a U.S. technology company worth $200 billion) in an unrelated stock-for-stock transaction. The ownership fraction for the DT2 acquisition, viewed in isolation, is 40% ($200 billion / $500 billion). Without the serial acquiror rule, neither transaction exceeds the 60% threshold. Under the rule, the denominator of the ownership fraction is adjusted to back out stock attributable to the DT1 acquisition. Because FA's stock attributable to DT1 represents 30% of FA's total stock at the time of the DT2 signing, the adjusted ownership fraction for the DT2 acquisition would be approximately 49% (i.e., 200/410).

Example 10 illustrates the basic operation of the serial acquiror rule. Although both DT1 and DT2 are entirely unrelated acquisitions—in different industries and with no common plan—the rule mechanically aggregates the stock attributable to DT1 in computing the ownership fraction for DT2. In this example, the adjusted ownership fraction (49%) remains below the 60% threshold, but the example demonstrates how the serial acquiror rule can substantially increase the ownership fraction for an acquisition that, viewed independently, would be well below any statutory threshold.

> Example 11. Same facts as Example 10, except that DT2's value is $320 billion. The adjusted ownership fraction for DT2 would be approximately 60.4% (i.e., 320/530), exceeding the 60% threshold, even though, viewed in isolation, the ownership fraction would be 51.6% (i.e., 320/620). DT2 and FA would be treated as an expatriated entity and surrogate foreign corporation, respectively, with the

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attendant tax consequences—even though the DT2 acquisition, viewed independently, was well below any statutory threshold and FA's acquisition of DT1 had no connection to DT2.

Example 11 illustrates how the serial acquiror rule can cause an acquisition to exceed the 60% threshold even when the acquisition, viewed independently, has an ownership fraction (51.6%) that would not result in any adverse effect under Section 7874. The adjusted ownership fraction of 60.4% triggers surrogate foreign corporation status and the associated tax consequences for FA, notwithstanding that DT2's shareholders have only a 51.6% ownership interest in FA by reason of their prior ownership of DT2. This result is particularly striking because the DT1 and DT2 acquisitions are in different industries and have no common plan or arrangement.

Example 12. FA acquires DT1 on January 1, Year 1 and the ownership fraction in the acquisition is 59%. FA then signs an agreement to acquire DT2 on January 2, Year 4 (36 months and one day after the DT1 acquisition) in a transaction in which the ownership fraction is 59%. The value of FA's shares has not changed since the acquisition of DT1. Under the 36-month look-back period, the serial acquiror rule does not apply to the DT2 transaction. If FA had instead signed the agreement to acquire DT2 on December 31, Year 3 (just before the end of the look-back period), the acquisition of DT1 would be within the window and the ownership fraction after application of the serial acquiror rule would result in FA being treated as a domestic corporation for purposes of Section 7874. This example illustrates how the rule's bright-line look-back period can produce cliff effects based on timing that may be unrelated to any anti-avoidance purpose.

Example 12 illustrates the arbitrary cliff effects produced by the serial acquiror rule's 36-month look-back period. An agreement to acquire DT2 signed 36 months and one day after a prior domestic entity acquisition falls outside the look-back window and is not aggregated; an acquisition agreement signed just two days prior falls within the window and is aggregated, with severe results for FA under Section 7874. The timing difference—which may be driven by commercial considerations entirely unrelated to tax planning—can have extremely significant effects for U.S. tax purposes. This bright-line approach provides certainty but at the cost of capturing transactions with no anti-avoidance purpose with arbitrary and significant differences between nearly identical transactions.

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6. Potential Options for Simplification

The serial acquiror rule addresses a real concern about serial acquisitions designed to circumvent the statutory thresholds, though serial acquisitions are, in practice, uncommon. Its mechanical nature avoids the difficulties of an intent-based inquiry. However, the rule aggregates unrelated acquisitions without any nexus requirement, potentially capturing ordinary-course cross-border M&A. The 36-month look-back is arbitrary relative to the diverse timelines of acquisition programs. Moreover, the rule can produce outcomes inconsistent with the statutory thresholds when applied to individually sub-threshold transactions. Given the foregoing, and the changes in the broader tax landscape since the serial acquiror rule was first issued, we believe the following simplification options should be considered.

Option 1: Withdraw. One option is to withdraw Treas. Reg. § 1.7874-8 in its entirety. The reduced incentive to invert in the current landscape diminishes the practical risk that a foreign corporation would deliberately structure serial acquisitions to stay below the thresholds. Treasury retains the ability to address genuinely related acquisitions under the "plan (or a series of related transactions)" language in the statute.

The principal risk of withdrawal is that it could permit a foreign corporation to acquire multiple U.S. entities in a deliberate series designed to stay below the thresholds. However, this risk is mitigated by the statutory "series of related transactions" language and the rules in Treas. Reg. § 1.7874-2 that address acquisitions of multiple domestic entities pursuant to a plan.

Option 2: Add a nexus requirement. Require that the prior acquisition be "in connection with" the current acquisition, defined as part of the same plan or arrangement or involving overlapping deal participants. Acquisitions that are demonstrably independent—taking into account factors indicative of independence, such as separate deal processes, different industries, no overlapping advisors or counterparties—would not be aggregated.

Option 3: Shorten look-back period. Reduce the look-back period from 36 months to 12 months. A shorter period better approximates the timeframe within which acquisitions might reasonably be part of a coordinated plan. Although we note that 24 months is used in other contexts to assess the connectedness of two transactions (e.g., for purposes of Section 707 or 355(e)), we note that these contexts typically involve related taxpayers (in the case of a partner and a partnership) or a significant degree of control on one party's part (in the case of a spin-off preceded or followed by a pre-negotiated acquisition). Additionally, Section 7874(c)(3) adopts a two-year presumption of a plan where the assets of a single domestic entity are acquired over the course of multiple transactions, but again this is a situation in which only two parties must enter into the plan to achieve a goal inconsistent with the policies of Section 7874. In the case of the acquisition of two separate domestic entities by a foreign corporation, three parties are involved (the foreign acquiror and two unrelated domestic entities), making the prospect of a successful long-term plan in these circumstances less likely. Accordingly, we believe a 12-month look-back is more appropriate than the current 36-month standard.

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Option 4: **Adjust de minimis exception.** Implement changes to make the de minimis exception more workable in practice, consistent with the proposed approach to the disqualified stock rule under Treas. Reg. § 1.7874-4 above.

Option 5: Add a new quantitative de minimis. Exclude prior acquisitions where the stock attributable to the prior domestic entity represents less than 10-20% of the foreign acquiring corporation's total stock value. Small acquisitions are unlikely to be part of a scheme to circumvent the statutory thresholds.

Option 6: Retain with substantial revisions. Treasury could preserve the aggregation principle for acquisitions that are part of a demonstrable plan to circumvent the statutory thresholds, while adding robust safe harbors. This option acknowledges that Treasury appropriately may look beyond a single transaction in some circumstances—for example, where a foreign corporation acquires multiple U.S. entities in rapid succession under a common plan, each time carefully structuring the transaction to remain just below a threshold. The option would retain the aggregation mechanism for such cases but add the following protections:

> (a) A rebuttable presumption that acquisitions separated by more than 12 months are not part of the same plan.
>
> (b) A safe harbor for acquisitions where the foreign acquiror's stock attributable to all prior domestic entity acquisitions during the look-back period does not exceed 10% of the acquiror's total stock value.

This option preserves Treasury's ability to address the most concerning cases while minimizing the rule's impact on ordinary-course M&A. The rebuttable presumption and safe harbor provide administrable bright lines. The principal tradeoff is that retaining any form of aggregation for unrelated transactions is still a significant expansion of the statute's operative effect beyond the amount necessary to ensure that the purposes of Section 7874 are not avoided.

E. Third-Country Transaction Rule (Treas. Reg. § 1.7874-9)

1. Operation of the Rule

Treas. Reg. § 1.7874-9 generally provides that when a domestic entity acquisition is a "third-country transaction," stock of the foreign acquiring corporation held by reason of holding stock in the "acquired foreign corporation" is excluded from the denominator of the ownership fraction.[124]

A domestic entity acquisition is treated as a third-country transaction where the foreign acquiring corporation (1) completes a "covered foreign acquisition" pursuant to the same plan (or series of related transactions) that includes the domestic entity acquisition, (2) after the covered

[124] Treas. Reg. § 1.7874-9(b).

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foreign acquisition and any related transactions, the foreign acquiring corporation is not tax resident in the same country as the "acquired foreign corporation" before the covered foreign acquisition, and (3) the ownership percentage would be at least 60%, determined without regard to the application of the third-country transaction rule.[125]

An acquired foreign corporation is a foreign corporation, substantially all of the direct and indirect properties of which are acquired by a foreign acquiring corporation.[126] There is a covered foreign acquisition only if the percentage of stock (by vote or value) of the foreign acquiring corporation held by reason of holding stock in the acquired foreign corporation is at least 60%, taking into account all related transactions.[127] For purposes of calculating this ownership percentage, the principles of all rules under Section 7874 (including the disqualified stock rule and the NOCD rule) apply, subject to some modification.[128]

Thus, the third-country transaction rule applies only if there is both a 60% or more ownership percentage domestic inversion and a separate 60% or more ownership percentage foreign tax residency inversion. In such cases, the practical effect of the third-country transaction rule is to lower the 80% ownership percentage threshold for treating a foreign acquiring corporation as a domestic corporation to 60%.[129]

Certain exceptions limit the application of the third-country transaction rule. First, the third-country transaction rule does not apply if the EAG has substantial business activities in the country in which the foreign acquiring corporation is a tax resident (relative to the total business activities of the EAG), with such determination made without regard to the domestic entity acquisition.[130] Second, the third-country transaction rule does not apply where (1) both the foreign acquiring corporation and the foreign target are organized in a foreign country that does not impose corporate income tax, and (2) neither the foreign acquiring corporation nor the foreign target is a tax resident of any other foreign country.[131]

The third-country transaction rule was first introduced by Notice 2015-79, was implemented as a temporary regulation by T.D. 9761, and was finalized by T.D. 9834.

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[125] Treas. Reg. § 1.7874-9(c).

[126] Treas. Reg. § 1.7874-9(d)(1), (2). *See* Treas. Reg. § 1.7874-9(e)(2) for purposes of determining whether there is a foreign acquisition.

[127] Treas. Reg. § 1.7874-9(d)(3), (4).

[128] Treas. Reg. § 1.7874-9(e)(3).

[129] *See, e.g.*, Treas. Reg. § 1.7874-9(f) Example.

[130] Treas. Reg. § 1.7874-9(d)(4)(ii).

[131] Treas. Reg. § 1.7874-9(d)(4)(iii).

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2. Statutory Text and Regulatory Scope

There is no direct statutory rule analogous to the third-country transaction rule. Section 7874 is structured around the acquisition of a domestic corporation or domestic partnership by a foreign corporation. Specifically, Section 7874(a)(2)(B) defines a surrogate foreign corporation by reference to the acquisition of substantially all of the properties of a *domestic* corporation. The third-country transaction rule addresses the acquisition of substantially all of the assets of a *foreign* corporation by a second foreign corporation organized in a different jurisdiction.

Section 7874 applies based on the ownership fraction without regard to the specific foreign tax residency of the foreign acquiring corporation. The text of the statute only treats a foreign acquiring corporation as domestic if the 80% ownership is met, whereas the third-country transaction rule extends this treatment to certain transactions which would otherwise only have reached the 60% threshold.[132]

The relevant Treasury Decisions state the third-country transaction rule was issued pursuant to the regulatory directions in Section 7874(c)(6) and Section 7874(g).[133]

3. Legislative History and Policy Rationale

The third-country transaction rule has been described as reducing incentives for entering into inversion transactions by capturing transactions having little or no non-tax effect or purpose.[134] Specifically, the IRS explained that "when a domestic entity acquisition is a third-country transaction, the decision to locate the tax residence of the foreign acquiring corporation in the third country generally is driven by tax planning, including the facilitation of U.S. tax avoidance following the acquisition, and, as a result, generally is contrary to the policies underlying section 7874."[135] The IRS also stated use of a third-country parent is "typically" chosen to "facilitate the use of low- or no-taxed entities," resulting in U.S. base erosion.[136] In its explanation, the IRS noted concerns surrounding treaty-shopping and becoming resident in a third country to access less restrictive regimes for controlled foreign corporations.[137]

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[132] Notice 2015-79, 2015-49 I.R.B. 775, 777 ("[T]he Treasury Department and the IRS have concluded that, when a domestic entity combines with an existing foreign corporation by establishing a new parent for the combined group that is tax resident in a third country, the likelihood that there is a sufficient non-tax business purpose for replacing the U.S. parent with a foreign parent is significantly lower than Congress assumed in establishing the 80-percent threshold."); *see also* Treas. Reg. § 1.7874-9(f) Example (In an acquisition in which only 65% of the foreign acquiring corporation's stock is owned by reason of owning domestic target stock, the ownership percentage is treated as 100%).

[133] *See* T.D. 9761, 81 Fed. Reg. 20,858 (Apr. 8, 2016) and T.D. 9834, 83 Fed. Reg. 32,524 (July 12, 2018).

[134] Notice 2015-79, 2015-49 I.R.B. 775 at 776.

[135] *Id.*

[136] *Id.*

[137] *Id.*

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To the extent relevant as a matter of statutory interpretation, the history of Section 7874 does not directly address third-country transactions. The Conference Report and JCT Blue Book describe the provision's application to the acquisition of a domestic entity by a foreign corporation, without discussing tax-residency reorganization transactions affecting the foreign acquiror itself.[138]

4. Principal Concerns Raised by the Existing Rule

Relationship to statutory text. As discussed above, the third-country transaction rule extends the domestic corporation treatment of Section 7874(b) to cases which would otherwise be covered under Section 7874(a), even though the economic impacts of the transaction may not justify this treatment. Similar to the disqualified stock rules, the third-country transaction rule creates an irrebuttable presumption that all changes to the foreign tax residency of the foreign acquiring corporation (subject to certain limited exceptions) are undertaken for tax avoidance purposes and, as such, are subject to domestic corporation treatment under Section 7874. The presence or absence of an independent business purpose, or of a tax avoidance purpose or result, are not relevant for purposes of applying the rule.

Consistency with Section 7874's policy goals. Viewed broadly, the third-country transaction rule can be viewed as consistent with Section 7874's policy goal of deterring inversion transactions (including avoidance of treaty shopping, as noted above). However, the third-country transaction rule rests on an assumption that locating the tax residence of the combined entity in a third country is "generally" motivated by tax planning and "typically" to facilitate U.S. tax avoidance, while neither the statute nor the legislative history makes such a determination.[139] Cross-border mergers uniformly involve the selection of a parent jurisdiction based (at least in substantial part) on non-tax business purposes, such as regulatory, capital-markets, governance, or operational considerations unrelated to U.S. tax avoidance.

Administrability. The rule's mechanics require tracing ownership through multiple layers of foreign entities and aggregating multiple transactions, which can be highly complex for large multinational groups with multiple acquisitions and equity issuances over time.

Impact on cross-border M&A. The rule can deter or complicate cross-border reorganizations, redomiciliations, and mergers between foreign entities, even when there is an independent business purpose for a change in foreign tax residency.[140] This is a significant concern in an increasingly globalized business environment.

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[138] *See generally* H.R. Conf. Rep. No. 108-755, at 489-95 (2004); Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress, JCS-5-05, at 341-55 (2005).

[139] Notice 2015-79, 2015-49 I.R.B. 775, 776-77 (Nov. 2015).

[140] This can be the case even where the relevant foreign jurisdictions apply a management and control test to determine tax residency (and therefore the legal jurisdiction of formation of the acquiring foreign corporation may

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Traps for the unwary. Foreign corporations that acquired U.S. companies may find that cross-border transactions which may be undertaken for business reasons trigger the third-country transaction rule, with unexpected tax consequences for the multinational group.

5. Examples

> Example 13. F2 is organized and tax resident in Country A, a jurisdiction that has implemented the Pillar Two rules, and intends to acquire DT in a transaction in which the ownership fraction is 65%. DT operates a regulated business in the U.S. and in Country B. Country B's regulatory regime is more favorable for the combined group business than Country A's regulatory regime, lenders are willing to lend to entities that are organized and tax resident in Country B on more favorable terms than to those in Country A, and the combined group intends to expand its business in Country B. Each of Country A and Country B has the same corporate tax rate and there is no material difference in tax treaties applicable to residents of Country A as compared to Country B. Immediately prior to the acquisition of DT, F2 undertakes a reorganization transaction where it becomes wholly-owned by F1, an entity that is organized and tax resident in Country B. F1 then acquires DT in a stock-for-stock acquisition, with former DT shareholders owning 65% of F1 by reason of their former ownership of DT. Under the third-country transaction rule, F1's acquisition of F2 is a covered foreign acquisition, and F1's acquisition of DT results in F1 being treated as a domestic corporation, even though the ownership percentage is only 65% before taking into account the third-country rule (rather than the ordinary 80% required for domestic corporation treatment).

Example 13 illustrates how the third-country transaction rule can apply to a cross-border reorganization undertaken for non-tax business purposes, even where there is no tax advantage to the combined group of organizing in the third-country jurisdiction. The reorganization in this example is driven by regulatory considerations, access to favorable debt financing, and planned business expansion in Country B—none of which relate to U.S. tax avoidance. Nevertheless, because F1 (the new parent) is tax resident in a different country than F2 (the acquired foreign corporation) was before the covered foreign acquisition, the third-country transaction rule applies and treats F1 as a domestic corporation even though the ownership fraction is only 65%. This example highlights the rule's overbreadth and the absence of any purposive inquiry that would distinguish tax-motivated transactions from those with independent business purposes.

6. Potential Options for Simplification

As discussed above, the rule addresses a specific concern about using a third-country entity to facilitate tax avoidance in connection with an inversion transaction. However, the rule can reach

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not control its tax residency), as the controlling directors and officers of the combined group may differ from those of the acquired foreign corporation.

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redomiciliations and other cross-border reorganizations undertaken for legitimate business purposes. Moreover, we believe that the reduced incentives to invert in the current environment warrant revisiting the existence or application of the third-country transaction rule. In this regard, we note that the implementation of a more rigorous version of Section 163(j) and the widespread adoption of the OECD's Pillar Two rules and the BEPS Action 3 recommendations has significantly reduced the ability of market participants to engage in earnings stripping transactions and to benefit from jurisdictions with less restrictive controlled foreign corporation rules. While the potential for treaty shopping remains, we note that the third-country transaction rule may provide for limited protection against treaty-facilitated base erosion, as such base erosion transactions (such as royalty or interest stripping) can be structured with related entities other than the acquiring foreign parent.

We believe that Treasury's potential simplification of the rule could include the following approaches.

Option 1: Withdraw. Given the lack of a compelling anti-avoidance function, the diminished incentives to invert, and the fairly narrow fact patterns that the third country transaction rule polices, we believe withdrawal of the third-country transaction rule is a reasonable simplification approach Treasury can consider. We believe this approach would align the scope of the Regulations more closely with the statute.

Option 2: Narrow the scope of the rule to target tax-motivated transactions. We believe that introducing a purposive standard to the third-country transaction rule would simplify its application (by narrowing the scope of transactions to which it is relevant) and further align it to the statute. We also believe this alignment will not result in a material sacrifice of protection against base erosion in cross-border transactions. The purposive standard could require that the covered foreign acquisition lacks an independent business purpose and has hallmarks of U.S. federal income tax avoidance. Those hallmarks could capture situations in which, compared to the acquired foreign corporation's jurisdiction of tax residency, the acquiring foreign corporation's jurisdiction of tax residency (1) has a materially more favorable income tax treaty with the United States,[141] (2) has materially less restrictive controlled foreign corporation rules and has not (and no jurisdiction in the acquiring corporation's MNE group has) implemented the OECD's Pillar Two rules, or (3) has a materially lower corporate income tax rate, in each case, compared to the acquired foreign corporation's jurisdiction of tax residency.

F. Passive Assets Rule (Treas. Reg. § 1.7874-7)

1. Operation of the Rule

Treas. Reg. § 1.7874-7 (the "**passive assets rule**") excludes from the denominator of the ownership fraction certain stock of the foreign acquiring corporation that is attributable to passive

[141] *See* NYSBA Tax Section, Report No. 1338, Report on Notice 2015-79 (Feb. 25, 2016) (the "**2016 Report**"), at 23-27.

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assets held by the foreign group.[142] The rule applies if, on the completion date, more than 50% of the gross value of all "foreign group property" constitutes "foreign group nonqualified property."[143] When the threshold is met, the amount of stock excluded is equal to the product of (i) the value of the stock of the foreign acquiring corporation, other than stock described in Section 7874(a)(2)(B)(ii) (by reason of stock) and certain other stock excluded from the ownership fraction,[144] and (ii) the foreign group nonqualified property fraction.[145]

"Foreign group property" is any property held on the completion date by the "modified expanded affiliated group" ("**MEAG**"), other than (i) property directly or indirectly acquired in the domestic entity acquisition, (ii) stock or a partnership interest in a member of the MEAG, and (iii) an obligation of a member of the MEAG.[146] The MEAG is defined as the EAG determined as if the foreign acquiring corporation were the common parent.[147]

"Foreign group nonqualified property" is generally defined by cross-reference to the nonqualified property definition under the disqualified stock rule (i.e., cash, cash equivalents, marketable securities, certain obligations owed by members of the EAG, certain former shareholders/partners, or related persons, and any other property acquired with a principal purpose of avoiding the purposes of Section 7874).[148] However, there are carve-outs for property that gives rise to income that would qualify for (A) the active banking and financing exception under Section 954(h) or the active insurance exception under Section 954(i) (determined, in both cases, by applying such exception to all foreign corporations, not just controlled foreign corporations) and (B) the active banking exception under Section 1297(b)(2)(A) (determined without regard to the other passive foreign investment company rules).[149] A special rule (the "**Replacement Property Rule**") also provides that property otherwise excluded from the definition of foreign group nonqualified property is treated as foreign group nonqualified property if, in a transaction related

[142] Treas. Reg. § 1.7874-7.

[143] Treas. Reg. § 1.7874-7(b).

[144] This includes stock of the foreign acquiring corporation held by one or more members of the EAG, stock excluded from the denominator of the ownership fraction under the disqualified stock rule, the serial acquiror rule or the third-country transaction rule, and stock disregarded by application of Section 7874(c)(4). Treas. Reg. § 1.7874-7(b)(1).

[145] Treas. Reg. § 1.7874-7(b).

[146] Treas. Reg. § 1.7874-7(e)(2).

[147] Treas. Reg. § 1.7874-7(e)(4)(i).

[148] Treas. Reg. § 1.7874-7(e)(1). *See also* Part III.B.1 *supra*.

[149] Treas. Reg. § 1.7874-7(e)(1). There is also a carve-out for property held by a domestic corporation that is subject to tax as an insurance company, provided that the property is required to support, or is substantially related to, the active conduct of an insurance business. Treas. Reg. § 1.7874-7(e)(1)(i)(D).

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to the domestic entity acquisition, such property was acquired in exchange for other property that would have been foreign group nonqualified property had the exchange not occurred.[150]

The foreign group nonqualified property fraction is calculated as a fraction, the numerator of which is the gross value of all foreign group nonqualified property (other than "excluded property") and the denominator of which is the gross value of all foreign group property (other than "excluded property").[151] "Excluded property" is property that gives rise to stock excluded from the ownership fraction under the disqualified stock rule, the serial acquiror rule, the third-country transaction rule or Section 7874(c)(4).[152] This coordination mechanism prevents double-counting by removing property already accounted for under other stock-exclusion rules.

The rule is also subject to a de minimis exception.[153] The exception applies when (i) the ownership percentage, determined without regard to the passive assets rule, the disqualified stock rule and the NOCD rule, is less than 5% (by vote and value), and (ii) on the completion date, each 5% former domestic entity shareholder or 5% former domestic entity partner owns (applying the attribution rules of Section 318(a) as modified by Section 304(c)(3)(B)) less than 5% (by vote and value) of the stock of (or a partnership interest in) each member of the EAG (similar to the Ownership Prong of the disqualified stock rule de minimis exception).[154] This de minimis exception is similar to the exceptions provided for the disqualified stock rule and the NOCD rule and is designed to prevent the passive assets rule from applying to transactions that largely resemble a cash purchase by the foreign acquiring corporation.[155]

The passive assets rule applies only for purposes of determining the ownership percentage by value, not by vote.[156] The preamble to T.D. 9834 explained that applying the rule to the vote determination could give rise to administrative complexities because the rule does not exclude particular shares of stock but instead excludes an amount of stock; when classes of stock have different voting power, a special allocation rule would be needed.[157] The rule is also subject to Section 7874(c)(4), which provides that transfers of properties or liabilities as part of a plan a principal purpose of which is to avoid the purposes of Section 7874 are disregarded.[158]

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[150] Treas. Reg. § 1.7874-7(e)(1)(ii).

[151] Treas. Reg. § 1.7874-7(e)(3).

[152] Treas. Reg. § 1.7874-7(e)(3)(ii).

[153] Treas. Reg. § 1.7874-7(c).

[154] *Id.*

[155] T.D. 9761, 81 Fed. Reg. 20,858, 20,864 (Apr. 8, 2016).

[156] Treas. Reg. § 1.7874-7(b).

[157] T.D. 9834, 83 Fed. Reg. 32,524, 32,525 (July 12, 2018).

[158] Treas. Reg. § 1.7874-7(a); *see also* § 7874(c)(4).

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The passive assets rule was first announced in Notice 2014-52 and was implemented in temporary Regulations in T.D. 9761.[159] The rule was finalized with modifications in T.D. 9834.[160]

2. Statutory Text and Regulatory Scope

The passive assets rule does not have a direct statutory analog in Section 7874, as it addresses a concern surrounding the composition of the foreign group's asset base, irrespective of whether those assets were acquired in connection with a particular domestic entity acquisition. Absent the rule, stock of the foreign acquiring corporation could be included in the denominator of the ownership fraction even though a substantial portion of its value is attributable to passive assets.

3. Legislative History and Policy Rationale

It is noteworthy that the history of Section 7874 does not specifically address the composition of the foreign acquiring corporation's asset base or the treatment of passive assets held by the foreign group. The Conference Report and JCT Blue Book describe the ownership-fraction test by reference to stock of the foreign acquiring corporation held by former domestic entity shareholders, without discussing adjustments based on the type of assets underlying the value of that stock.[161]

Notice 2014-52 articulates the policy rationale for the rule.[162] Treasury and the IRS explained that they were "aware that taxpayers may be engaging in transactions with a foreign corporation that has substantial cash and other liquid assets in order to facilitate an inversion" and that, because the disqualified stock rule would not apply to nonqualified property historically held by the foreign acquiring corporation, stock attributable to such passive assets could inappropriately dilute the ownership fraction.[163]

4. Principal Concerns Raised by the Existing Rule

Relationship to statutory text. The passive assets rule does not have a direct statutory analog and relies on the general regulatory grants in Sections 7874(c)(6) and 7874(g). The rule operates without regard to a transactional nexus, representing a significant regulatory extension of the statutory framework.

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[159] Notice 2014-52, 2014-42 I.R.B. 712 (Sept. 2014); T.D. 9761, 81 Fed. Reg. at 20,864 (Apr. 8, 2016).

[160] T.D. 9834, 83 Fed. Reg. 32,524, 32,525, 32,551-53 (July 12, 2018).

[161] *See generally* H.R. Conf. Rep. No. 108-755, at 489-95 (2004); Joint Comm. on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress, JCS-5-05, at 343-45 (2005).

[162] Notice 2014-52, 2014-42 I.R.B. 712 (Sept. 2014); Notice 2015-79, 2015-49 I.R.B. 775 (Nov. 2015).

[163] Notice 2014-52, 2014-42 I.R.B. 712 (Sept. 2014); Notice 2015-79, 2015-49 I.R.B. 775 (Nov. 2015); *see also* T.D. 9761, 81 Fed. Reg. 20,858 (Apr. 8, 2016).

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Consistency with Section 7874's policy goals. The passive assets rule is broadly consistent with the policy goal of preventing ownership-fraction manipulation through the use of entities whose value is principally attributable to passive assets. However, the rule's breadth extends beyond the targeted concern of passive assets inversions. The rule applies to all foreign acquiring corporations that meet the more-than-50% threshold, regardless of whether their passive asset composition is a result of tax-motivated planning or the natural characteristics of their business. Financial institutions, insurance companies, holding companies, and other entities that hold substantial cash and marketable securities in the ordinary course of their business may trigger the threshold without any inversion motive. While the carve-outs for certain active financing, insurance, and banking income address some of these concerns, the carve-outs are narrow and do not cover all industries or asset types that may hold passive assets in the ordinary course of their business.

Notably, the disqualified stock rule is available to police "stuffing" transactions in which the foreign acquiring corporation issues equity in respect of passive assets, meaning that the benefit to Treasury of applying a passive assets rule is limited to situations in which a foreign acquiring corporation has amassed a large amount of passive assets in the absence of an equity infusion. In our experience, it is rare that such a large amount of passive assets would sit on the balance sheet of a foreign acquiring corporation absent a compelling non-tax business purpose unrelated to a domestic entity acquisition. As a result, it is especially unlikely that the passive assets rule would prevent an inversion transaction that genuinely violates the policy goals of Section 7874, and instead the passive assets rule serves largely as a trap for the unwary.

Administrability and compliance burden. The passive assets rule is burdensome in that it requires the foreign acquiring corporation to value all foreign group property and to classify each item as qualified or nonqualified property as of the domestic entity acquisition. While valuation of foreign group property would generally be required in connection with the domestic entity acquisition itself,[164] merger and acquisition participants rarely value the components of an acquired business on an asset-by-asset basis. In particular, the Replacement Property Rule requires tracing foreign group nonqualified property (like cash) used to acquire other assets, including operating businesses acquired in the ordinary course of business, for purposes of calculating the foreign group nonqualified property fraction.

Negative impact on cross-border M&A. The passive assets rule can deter or complicate cross-border acquisitions involving foreign entities that hold substantial cash and passive assets for reasons unrelated to inversion planning. A foreign corporation that has accumulated cash from its operating activities, or that holds marketable securities as part of its treasury management, may find that the rule applies to an acquisition of a domestic entity, increasing the ownership fraction and potentially pushing the transaction over a statutory threshold.

[164] T.D. 9761, 81 Fed. Reg. 20,858, 20,865 (Apr. 8, 2016).

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5. Examples

The principal concerns above can be illustrated by the following examples.

> Example 14. FA, an operating business in Country X, holds a diversified portfolio of operating subsidiaries and joint venture interests, and engages in business acquisitions and joint venture investments in the ordinary course of its business. FA proposes to acquire DT in a stock-for-stock transaction. During the course of negotiating the DT acquisition, FA uses cash to acquire a number of businesses and make a number of other investments in operating businesses. A number of the operating businesses acquired are integrated with the DT business post-DT acquisition.

Example 14 illustrates how the passive assets rule complicates calculating the ownership fraction, as it requires foreign acquirors to engage in detailed tracking of cash expenditures and investments due to the application of the Replacement Property Rule, even if there is no tax avoidance motive underlying the relevant acquisition. The Example also highlights the potential valuation questions raised by the application of the passive assets rule, as it may require valuing the acquired operating businesses and other investments acquired pre-DT acquisition at the date of the DT acquisition, and no liquid market for those assets may exist.

> Example 15. Assume the same facts as Example 5, but (1) none of the NFP stock is treated as disqualified stock (e.g., because one or more of the simplification options discussed in Part III.B.6 are adopted) and (2) Seller owns a 49% interest in FS, rather than 100% of FS, and FS's shares are publicly traded.

Example 15 illustrates how the passive assets rule could apply to transactions resembling cash purchases where the disqualified stock rule would not otherwise apply to treat the cash contributed to the foreign purchaser as excluded property for purposes of calculating the foreign group nonqualified property fraction. In the Example, NFP's MEAG may have a foreign group nonqualified property fraction of 100%, as FS would not be included in NFP's MEAG[165] and the FS stock arguably would not otherwise be carved-out from the definition of foreign group nonqualified property.[166] Moreover, the de minimis exception would not apply due to the size of Seller's rollover.

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[165] *See* Treas. Reg. § 1.7874-7(e)(2)(ii), which carves-out stock or a partnership interest in a member of the MEAG from the definition of foreign group property.

[166] *See* the Replacement Property Rule and Treas. Reg. § 1.7874-7(e)(2)(i), which carves-out property that is directly or indirectly acquired in the *domestic entity* acquisition from the definition of foreign group property (emphasis added).

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6. Potential Options for Simplification

The passive assets rule targets a specific abuse that is uncommon in practice, representing more of a trap for the unwary than a useful tool for capturing transactions that would otherwise evade the scope of the Section 7874 rules. Thus, there is room for simplification without, in our view, weakening the Regulations' policing of inversion transactions meaningfully. Simplification options are set out below.

Option 1: Withdraw. One option would be to withdraw Treas. Reg. § 1.7874-7 in its entirety. This is the most straightforward simplification approach. Moreover, given the relative infrequency of transactions that fall within the scope of Treas. Reg. § 1.7874-7 and the availability of other anti-abuse rules (such as the disqualified stock rule and Section 7874(c)(4) itself) to police the excesses targeted by the regulation, withdrawal could serve Treasury's goals of tax simplification with only limited risk to the Treasury.

Alternatively, if Treasury determines it is appropriate to keep some form of Treas. Reg. § 1.7874-7, it may consider the following approaches:

Option 2: Add a requirement that property is only foreign group nonqualified property if it is held as part of a plan, a principal purpose of which is to avoid the purposes of Section 7874. We believe that adding an intent-based requirement will simplify the application of the passive assets rule and further align it with Section 7874's purposes. For example, we believe that a rule treating property as foreign group nonqualified property if it is held as part of a plan, a principal purpose of which is to avoid the purposes of Section 7874 is both closely aligned to the statute and sufficiently protective to the fisc. This approach also has precedent in the "anti-stuffing" rule issued under Section 367 addressing outbound transfers of domestic corporation stock to foreign corporations. Under Treas. Reg. § 1.367(a)-3(c), one condition for nonrecognition treatment for such a transfer is the active trade or business test, which includes a substantiality test. The substantiality test generally requires that the fair market value of the transferee foreign corporation be at least equal to the fair market value of the U.S. target company. However, for such purpose the value of the transferee foreign corporation excludes assets acquired for the principal purpose of satisfying the substantiality test by the transferee foreign corporation within the 36-month period preceding the outbound transfer.[167]

Facts and circumstances indicating that property is held as part of a plan, a principal purpose of which is to avoid the purposes of Section 7874 could include the General Avoidance Determination Factors listed in Part III.A.2 above, as well as (1) the foreign acquiring corporation's acquisition of such property (or cash used to acquire such property) pursuant to an offering describing that the foreign acquiring corporation intends to use its passive assets to search for an acquisition target to combine with (e.g., the foreign acquiring corporation is a "special purpose acquisition company") and (2) a change in the foreign acquiring corporation's operations

[167] Treas. Reg. §§ 1.367(a)-3(c)(3)(iii)(B)(1), -3(c)(3)(iii)(B)(2)(vii) and -3(c)(3)(iii)(B)(2)(viii)(C).

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from conducting a trade or business (including by way of a sale of its business assets) to searching for a domestic acquisition target to combine with.

Option 3: Adjust de minimis exception. Implement changes to make the de minimis exception more workable in practice, consistent with the proposed approach to the disqualified stock rule under Treas. Reg. § 1.7874-4 above.

Option 4: Include a minimum ownership threshold such that marketable securities that are classified as equity for U.S. federal income tax purposes are no longer treated as nonqualified foreign group property. We believe that a significant investment in marketable securities classified as equity for U.S. federal income tax purposes reflects a business relationship with the applicable issuer and thus should not be treated as foreign group nonqualified property. For example, we believe that an ownership threshold of 20% of the value of the equity of the issuer (typically reflecting "significant influence" and the application of the equity method of accounting) would be an appropriate threshold—in such a case, the foreign acquiring corporation is very likely acquiring an interest in the issuer as part of an overall trade or business or investment strategy, rather than as a means to manipulate the ownership fraction under Section 7874.

Option 5: Modify the Replacement Property Rule to apply an anti-abuse standard. We believe that the complexity and compliance burdens imposed by the Replacement Property Rule, including detailed tracking of cash expenditures and exchanges of marketable securities with at least a temporal nexus to the domestic entity acquisition, outweigh the level of protection to the fisc provided by the rule. While foreign acquirors should not be able to avoid the application of the passive assets rule by exchanging nonqualified property for other property, the "related to" standard that the Replacement Property Rule uses causes the rule to apply to acquisitions of property where there is no tax avoidance purpose. Instead of a "related to" standard, the Replacement Property Rule could apply to property acquired as part of a plan, a principal purpose of which is to avoid the purposes of Section 7874 (using the General Avoidance Determination Factors described above in Part III.A.2), which would better align this aspect of the passive assets rule with the disqualified stock rule and the statute itself.

Option 6: Add a temporal nexus rebuttable presumption. If an anti-abuse standard is not used, include a rebuttable presumption that property that would otherwise be treated as foreign group nonqualified property as a result of the application of the Replacement Property Rule is not "related to" an acquisition if it is acquired outside a defined window ending on the signing date of the applicable domestic entity acquisition. Property acquired outside this window would only be treated as foreign group nonqualified property if, under a "strong proof" standard, the facts and circumstances establish that the relevant acquisition is part of a plan a principal purpose of which is to avoid the purposes of Section 7874. This should mitigate the risk that ordinary-course acquisitions predating any firm acquisition plans would be captured. Similar to the option proposed above in the discussion of the disqualified stock rule, we believe this window should be no shorter than three months. We also believe that a longer window of up to six months would be reasonable. As with other rebuttable presumptions described above, we recommend a mirror rebuttable

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presumption in favor of Treasury in the event that the replacement property is acquired within the temporal window that Treasury adopts.

IV. Conclusion

The five sets of Regulations analyzed in this Report—the disqualified stock rule, the NOCD rule, the serial acquiror rule, the third-country transaction rule, and the passive assets rule—were developed during a period when the U.S. international tax regime provided substantial incentives for corporate inversions. The regulatory response was accordingly aggressive, reflecting an understandable concern about the erosion of the U.S. tax base through expatriation transactions.

The landscape has changed. The TCJA's rate reduction, Section 245A, BEAT, and the OECD Pillar Two rules and the Side-by-Side Safe Harbour, among other changes, have collectively diminished the tax incentives that drove inversions. In the current environment, the cost-benefit calculus for each of these Regulations warrants reconsideration.

For each rule, we have presented a menu of simplification options. The options are designed to be responsive to Executive Orders 14192 and 14219. Our analysis proceeds from the foundational principle that the 60% and 80% thresholds in Section 7874 are congressional bright lines that should not be effectively lowered absent a sound policy rationale.

The options presented in this Report are not mutually exclusive. Treasury could adopt different options for different rules, reflecting the varying degrees of expansion of Section 7874's coverage and policy justification for each. At minimum, we encourage Treasury to consider: (i) narrowing the disqualified stock and NOCD rules to better align with the statutory text and to add safe harbors for ordinary-course activities; (ii) adding nexus requirements and shortening look-back periods for the serial acquiror rule; and (iii) substantially narrowing or withdrawing the third-country transaction rule.

Whatever approach Treasury adopts, we believe the cumulative effect of the Regulations on the ownership fraction should remain consistent with, rather than fundamentally alter, the statutory thresholds, and should be proportionate to the policy concerns that underlie the statute in the current environment.

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