No One Is Doing Inversions Anymore, So Why Does Code Sec. 7874 Apply to My Deal?

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I. Introduction

The word "inversion" conjures up different meanings to different advisers. To a banker or corporate lawyer, the word typically brings to mind an outdated structure relevant, indeed hot, during a frenzied era between 2011 and 2015/2016, when the combination of U.S. tax policy incentives and a very active deal market in certain industries had bankers seeking to match U.S.-based multinationals with a significantly smaller merger partner located in a jurisdiction, such as Ireland, U.K., or elsewhere.

To a chief executive officer or chief financial officer, the word may conjure up reminders of headlines during the same era when the debate over the competitiveness of the U.S. international tax regime seemed to reach its zenith and tax issues and structuring were more prominent in deal structuring than ever before.

But to a tax lawyer, the word should bring to mind a set of statutory and regulatory provisions that all too often have the effect of encroaching on what, pre-2015/2016, would have been a routine cross-border transaction outside the scope of what Congress originally considered when Code Sec. 7874[1] was enacted. This dynamic is the focus of this paper. Barrels of ink have been drained writing about issues related to corporate inversions. This paper takes a more focused approach.

Such prior writings have addressed issues in thoughtful detail relating to the following:

1. The U.S. tax system pre-Tax Cuts and Jobs Act of 2017 (the "TCJA"), grounded in worldwide taxation, a rigorous controlled foreign corporation ("CFC") regime, shrinking foreign tax credit, apportionment of expenses, *etc.*, which was blamed by many for driving multinational companies to seek a structure by which the parent entity would not be a U.S. tax resident.
2. Taxation of shareholders of the U.S. corporation undergoing an inversion transaction.

3. Whether a particular transaction could achieve the goal of the surviving parent company avoiding (i) U.S. tax resident status under Code Sec. 7874(b) and (ii) surrogate foreign corporation status under Code Sec. 7874(a)(2).
4. The myriad of planning techniques to optimize a global tax structure, reallocate debt, migrate intellectual property, and reduce the application of the U.S. CFC rules, all though planning techniques implemented with or following a transaction designed to achieve a corporate expatriation.

The focus of this paper is exclusively on number 3 above. Code Sec. 7874 itself provided a framework of rules designed to "stack the deck" in the government's favor in measuring the "Inversion Fraction," defined below. These rules were expanded and enhanced by the early regulations in the 2005–2012 era and again by the subsequent series of regulations issued between 2014 and January 2017 in rapid succession, which were viewed by some as beyond the scope of what Congress initially envisioned when Code Sec. 7874 was enacted. The rules are designed (1) to "inflate the numerator" and "shrink the denominator" of the critical Inversion Fraction and (2) to otherwise ignore shares or create fictional shares, all in a manner to make it much more likely that a transaction falls within the scope of Code Sec. 7874. The consequences of these numerical adjustments can be, to paraphrase what you might see in a securities tax disclosure, one of the following:

1. A foreign incorporated entity being treated as a U.S. corporation under Code Sec. 7874(b).
2. A foreign incorporated entity being respected as a foreign tax resident, but the worldwide group being subject to the battery of limitations on use of favorable tax attributes, restructuring alternatives, and tax accounting detriments.[2]
3. At the very least, even if there is non-application of number 1 or number 2, restrictions on the use of a foreign parent's equity to acquire U.S. targets in the three years following the subject transaction.[3]

The myriad of special rules designed, among other things, to adjust the inversion fraction and make it more likely that the inversion ratio would reach at least 60% or 80%, as the case may be, were enacted under the Obama Treasury Department. Often, corporate attorneys and business development executives assume that the TCJA, by causing the U.S. tax regime to generally become much more favorable and competitive in the global marketplace, rendered the anti-inversion rules moot and perhaps even loosened those rules. They are surprised to hear that all of the many special and very technical rules enacted in the Obama administration remain fully in place today and that TCJA actually made failing the anti-inversion test a much more serious consequence as compared to pre-TCJA.[4]

II. Code Sec. 7874 Overview

A. General Applicability of Code Sec. 7874

Code Sec. 7874 applies to a foreign corporation (the "Foreign Acquiring Corporation") if, pursuant to a plan (or a series of related transactions),[5] the Foreign Acquiring Corporation:

1. directly or indirectly[6] acquires "substantially all" of the properties held directly or indirectly by a domestic corporation;
2. at least 60% of the stock (by vote or value) of the Foreign Acquiring Corporation is held by former shareholders of the domestic corporation "by reason of" holding stock in the domestic corporation (such stock, "By Reason of Stock," and such percentage, the "Ownership Percentage");[7] and
3. after the acquisition, the "expanded affiliated group"[8] ("EAG") which includes such foreign corporation that does not have "substantial business activities" in its foreign country of organization compared to the total business activities of such EAG.[9]

If each of these three requirements are met, then a "domestic entity acquisition" (a "Domestic Entity Acquisition") has occurred.[10] In that case, the Foreign Acquiring Corporation may either be treated as a "surrogate foreign corporation" or as a U.S. corporation depending upon the Ownership Percentage.

Although the statute limits the application of Code Sec. 7874 to acquisitions of domestic entities by a foreign corporation, the regulations include a small but important caveat. While acquisitions of domestic entities by foreign partnerships generally do not implicate Code Sec. 7874, a foreign partnership that would, but for the qualifying income exception under Code Sec. 7704(c), be treated as a publicly traded partnership is generally treated as a foreign corporation for Code Sec. 7874 purposes.[11] In an extreme example, this can result in the partnership being treated as a domestic corporation. Otherwise, it can result in the partnership being treated as a surrogate foreign corporation for purposes of imposing the harsh tax consequences described in Section II.B.1 and noted as challenging restrictions and limitations with respect to its U.S. affiliates.

B. Applications of Code Sec. 7874 Based on Ownership Percentage

1. Surrogate Foreign Corporation Status

If a Domestic Entity Acquisition has occurred and the Ownership Percentage is at least 60% but less than 80% (and the Third Country rule, described below, does not apply), the Foreign Acquiring Corporation is treated as a "surrogate foreign corporation" for purposes of Code Sec. 7874.[12] As a result of the Foreign Acquiring Corporation being a surrogate foreign corporation, a number of consequences befall the Foreign Acquiring Corporation, its domestic affiliates, and the shareholders of the Foreign Acquiring Corporation.

a) Inversion gain. Following a Domestic Entity Acquisition, the acquired domestic corporation and all of its domestic affiliates (each an "Expatriated Entity")[13] must include in taxable income the full amount of any "inversion gain" recognized during the period beginning on the first date properties are acquired as part of the Domestic Entity Acquisition and ending on the date 10 years following the last date properties are acquired as part of the Domestic Entity Acquisition.[14]

Inversion gain is income or gain recognized by reason of the transfer of stock or other properties by an Expatriated Entity and income received or accrued by reason of a license of any property (other than inventory) by an Expatriated Entity as part of the Domestic Entity Acquisition or, after the Domestic Entity Acquisition, if the transfer or license is to a foreign affiliate.[15]

Expatriated Entities cannot reduce inversion gain with net operating losses or other tax attributes.[16] Moreover, while foreign tax credits under Code Sec. 901 are theoretically available to offset any inversion gain that may be recognized, inversion gain itself is treated as U.S. source income for foreign tax credit purposes.[17]

b) Limits on intercompany financing arrangements. Expatriated entities are also subject to adverse tax consequences as a result of certain intercompany financing arrangements. The regulations under Code Sec. 956 treat certain obligations of foreign affiliates of a "surrogate foreign corporation" acquired by CFCs of an Expatriated Entity as United States property for Code Sec. 956 purposes.[18] This rule, enacted prior to the major reforms on the U.S. international tax regime in TCJA,[19] was intended to prevent a foreign-parented group from accessing untaxed earnings of a CFC through intercompany financing arrangements among a lower-tier CFC and its other foreign affiliates in a manner that circumvents Code Sec. 956.[20]

c) Restrictions on "out from under" planning. Typically, one of the main drivers of expatriating from the United States is to undertake "out from under" planning, or corporate reorganizations designed to remove foreign affiliates from the reach of the CFC rules by reorganizing such foreign subsidiaries under the newly constituted foreign-parented group rather than a U.S.-parented structure. However, certain regulations impose onerous rules to prevent this type of planning where a Domestic Entity Acquisition has occurred. First, Code Sec. 367(b) may apply to cause gain to be recognized on transactions that de-control interests in a CFC of an Expatriated Entity in an effort to dilute existing interests of a CFC held by a United States shareholder following a Domestic Entity Acquisition.[21] In addition, certain transfers or issuances of stock of foreign subsidiaries of an Expatriated Entity may be recharacterized to prevent loss of CFC status.[22] Post-TCJA, this type of "out from under" planning may be greater incentivized given the expanded reach of the CFC rules, making the aforementioned rules and limitations potentially more applicable.

d) TCJA changes

(i) In general. A common misunderstanding by non-tax professionals is that the TCJA, appropriately touted as strongly pro-business, "fixed the inversion problem." By making the United States a more competitive tax regime, the TCJA indeed reduced the attractiveness of an inversion transaction.[23] At the same time, the TCJA enacted three completely new provisions, each specifically targeted at "surrogate foreign corporations" and their affiliates.

(ii) Denial of qualified dividend income treatment. United States shareholders of "surrogate foreign corporations" can no longer claim reduced tax rates applicable to "qualified dividend income" from the receipt of dividends from the "surrogate foreign corporation."[24] For foreign corporations with a significant United States shareholder base, this is a significant deterrent to falling within "surrogate foreign corporation" status, and the risks thereof can create a significant disclosure item for a securities filing.

(iii) More rigorous BEAT hurdle. Under the new base erosion anti-abuse tax ("BEAT") rules, payments treated as cost of goods sold that reduce gross income are generally not base erosion payments that could cause a corporation to be subject to the BEAT.[25] However, payments paid to or accrued by a "surrogate foreign corporation" (or any member of the "surrogate foreign corporation's EAG) treated as reductions to gross income of the U.S. payor are treated as base erosion payments for Code Sec. 59A purposes, which can cause a U.S. affiliate of the surrogate foreign corporation to be subject to the BEAT where it otherwise would not have been in the case of a payment to, or accrued by, a non-surrogate foreign corporation.[26]

(iv) Recapture of favorable Code Sec. 965 rates and FTCs. Finally, the rate imposed on a United States shareholder under the Code Sec. 965 transition tax enacted by the TCJA was generally reduced to 8% or 15.5% (depending on the composition of the deferred earnings, in cash or not) by beneficial deductions against the amount otherwise treated as includable under Code Sec. 951(a)(1).[27] Moreover, the tax imposed could be offset by an available foreign tax credit. If the United States shareholder becomes an Expatriated Entity within 10 years of the enactment of the TCJA, those preferential deductions are immediately recaptured without the ability to offset such recapture by foreign tax credits.[28]

The above restrictions and limitations with regard to "surrogate foreign corporation" status can stay with the new foreign-parented structure for its entire existence (for example, the inability to pay dividends which constitute qualified dividend income and the noted consequences under the BEAT). Even those restrictions that are temporary, to the tune of 10 years, are onerous in the sense that they apply to the entire worldwide group. Suffice it to say that the rules have evolved into a harsh gauntlet, making avoidance of "surrogate foreign corporate" status all the more important.

2. Domestic Corporation Status

If a Domestic Entity Acquisition has occurred and the Ownership Percentage is at least 80%, the Foreign Acquiring Corporation is not respected as a foreign corporation and instead will be treated as a domestic corporation for U.S. federal income tax purposes.[29] Thus, even if a foreign corporation can be respected as such for corporate purposes, the U.S. tax system will see the equivalent of a U.S. incorporated entity if this rule applies, effectively not respecting the tax residency of the Foreign Acquiring Corporation.

While many, of course, will want to avoid this outcome given the continued advantages of a foreign-parented group post-TCJA, there are certainly cases where intentionally structuring into domestic corporation status may be preferable. For example, regulatory or securities law restrictions may differ between listed foreign and domestic corporations. Curiously, the Internal Revenue Code does not provide an encompassing election for foreign corporations to elect into becoming a U.S. tax resident, so Code Sec. 7874(b) could be a means to structure into such status depending on the circumstances.

3. Third-Country Rule

The "Third-Country Rule" applies in a Domestic Entity Acquisition that is a "third-country transaction" to exclude from the denominator of the Ownership Percentage stock of the Foreign Acquiring Corporation that is held by reason of holding stock in an "acquired foreign corporation."[30]

A "third-country transaction" is a Domestic Entity Acquisition that meets three requirements.

1. The Foreign Acquiring Corporation completes a "covered foreign acquisition" pursuant to a plan (or series of related transactions) that includes the Domestic Entity Acquisition.
    a. A "covered foreign acquisition" is, subject to limited exceptions,[31] a transaction in which the Foreign Acquiring Corporation acquires, directly or indirectly, substantially all of the properties held directly or indirectly by a foreign corporation, and after which, the Foreign Acquiring Corporation stock held by reason of owning stock in the foreign acquired corporation is at least 60% by vote or value.[32]
2. After the covered foreign acquisition and all related transactions are complete, the Foreign Acquiring Corporation is not a tax resident of the acquired foreign corporation's country of tax residence before the covered foreign acquisition.
3. The Ownership Percentage determined without regard to the Third-Country Rule is at least 60%.[33]

Although the Third-Country Rule applies as a denominator reduction rule, the Third-Country Rule is essentially a "cliff," in that if it applies, the By Reason of Stock will constitute 100% of the numerator and generally 100% of the denominator, given the effect is to remove from the denominator those shares of the Foreign Acquiring Corporation issued to acquire the foreign acquired corporation. Moreover, the net effect is that if it applies, there is no potential for "surrogate foreign corporation" status. Following a Domestic Entity Acquisition to which the Third-Country Rule applies, either the Foreign Acquiring Corporation escapes the bite of Code Sec. 7874 and is respected as a foreign corporation or the Foreign Acquiring Corporation is a U.S. domestic corporation as a result of the Ownership Percentage being at least 60% (because the Third-Country Rule effectively reduces the threshold for U.S. corporation status from 80% down to 60%).

C. Other Operative Provisions Under Code Sec. 7874

1. In general

Sections II.A and II.B above provide an overview of the consequences of Code Sec. 7874's application, either to cause surrogate foreign corporation or domestic corporation status (and their associated cascading consequences).

Sections III and IV below combine to provide the key focus of this paper, notably how Code Sec. 7874 and its accompanying regulatory scheme, promulgated primarily during the 2014–2017 era, have the result of sweeping transactions into the scope of Code Sec. 7874 that would not have implicated Code Sec. 7874 in earlier years.

In between these two bookends, we note that there are a number of operative rules of Code Sec. 7874 that are more in the nature of the "nuts and bolts" of its application, and stem primarily from the early regulatory era of Code Sec. 7874 during the first five years after its enactment. Below is a non-exhaustive summary of the most common operative rules practitioners encounter in the deal market.

2. Determining By Reason of Stock

The general rule is that By Reason of Stock is stock of a foreign corporation received in exchange for, or with respect to, stock of a domestic corporation. By Reason of Stock includes, for example, stock in a foreign affiliate distributed by a domestic corporation to all of the distributing domestic corporation's shareholders in a transaction otherwise qualifying for nonrecognition under Code Sec. 355.[34] If multiple domestic corporations are acquired pursuant to a plan or series of related transactions, the acquisitions are treated as a single acquisition and all domestic targets are treated as a single domestic entity for Code Sec. 7874 purposes.[35] If applicable, this will ultimately increase the Ownership Percentage by increasing what counts as By Reason of Stock.

3. Treatment of Options

Options with respect to a corporation, either the Foreign Acquiring Corporation or domestic acquired entity, are treated as stock of the respective entity solely to the extent of the holders' "claim on the equity" of such entity.[36] "Claim on the equity" of an entity equals the value of the stock or interest that may be acquired pursuant to the option, less the strike price (if any).[37] In addition, "options" for this purpose include "interests similar to an option," including warrants, convertible securities, or convertible partnership interests.[38]

4. Acquisition by a Second Foreign Corporation of a Foreign Corporation that Acquired a U.S. Corporation

This rule gives rise to some of the more interesting factual situations that can sweep transactions into Code Sec. 7874 in counterintuitive manners. Where there is an acquisition of substantially all of the properties of a domestic entity by an initial Foreign Acquiring Corporation pursuant to a plan that includes another transaction (the "initial transaction") and such other transaction involves the acquisition of substantially all of the properties of the initial Foreign Acquiring Corporation by a second Foreign Acquiring Corporation (the "subsequent transaction"), the subsequent transaction is effectively treated as the acquisition of substantially all of the properties of a domestic entity.[39] Where this rule applies, stock in the second Foreign Acquiring Corporation held by reason of holding stock in the initial Foreign Acquiring Corporation is treated as By Reason of Stock in the second Foreign Acquiring Corporation, but only to the extent such stock in the initial Foreign Acquiring Corporation was held by reason of holding stock in the domestic target entity acquired in the initial transaction.[40] This rule prevents the purging of By Reason of Stock through a subsequent transaction in which the Foreign Acquiring Corporation is itself acquired, and the rule requires tracing based on the underlying value of the domestic entity acquired in the initial transaction.

5. Certain Multistep Acquisitions

As for determining whether an acquisition of substantially all of the assets of a domestic entity has occurred, there are also a series of rules designed to push more transactions which the government considered potentially suspect into the orbit of Code Sec. 7874. Code Sec. 7874(a)(2)(B) generally looks at all "related transactions" in determining the occurrence of a Domestic Entity Acquisition. However, for "creeping" acquisitions over a two-year time period both preceding and following the point when the Ownership Percentage is at least 60%, such acquisitions are deemed to be part of the same plan for purposes of determining whether "substantially all" of the properties of a domestic entity has been completed.[41] This is separate from the multiple domestic target rule described in Section II.C.2 above.[42]

6. Bankruptcy and Insolvency

Creditor claims in a domestic corporation can be treated as stock in such domestic corporation if the corporation is either in a title 11 or similar case[43] or its liabilities exceed the value of its assets.[44] If this rule applies, creditors can be deemed shareholders for purposes of Code Sec. 7874 upon the consummation of the bankruptcy case or a domestic corporation's insolvency, meaning certain bankruptcy or distressed work-outs involving the transfer of equity in a foreign corporation can give rise to Code Sec. 7874 complications.

III. Adjustments to the Inversion Fraction

As discussed above, the key to determining application of Code Sec. 7874 is the all-important Ownership Percentage representing the continuity of equity ownership by former shareholders of the domestic corporation in the Foreign Acquiring Corporation. The bankers and business people might look at the pro forma capital tables for a given deal and assume that the rules are irrelevant to their transaction. Code Sec. 7874 regulations, however, impose a complex and nuanced set of rules that have the net effect of increasing the Ownership Percentage, in some cases to a material degree.

A. Inversion Fraction

For purposes of determining whether a Domestic Entity Acquisition has occurred, the Ownership Percentage is determined using a fraction, the numerator of which is the By Reason of Stock of the Foreign Acquiring Corporation and the denominator of which is the outstanding stock of the Foreign Acquiring Corporation (the "Inversion Fraction").[45]

Stock of a foreign corporation received in exchange for, or with respect to, stock of a domestic corporation is By Reason of Stock.[46]

The statute and Treasury Regulations provide a myriad of intricate computational rules for adjusting the Inversion Fraction, essentially increasing the likelihood of applying Code Sec. 7874 by increasing the numerator and decreasing the denominator. Many of these rules were issued in response to a single transaction (or perhaps even hypothetical transaction discussed in panels, articles, and the business press). The Treasury and IRS set up a regulatory scheme aimed at preventing taxpayers from engaging in what the government perceived as abusive transactions that might otherwise circumvent Code Sec. 7874. As will be discussed in this Section III, these rules have a broad reach and may implicate many cross border deals, including transactions where one might never expect to see Code Sec. 7874 issues, such as a merger of equals or, in extreme cases, the recent "special purpose acquisition company" ("SPAC") phenomenon, where shareholders of a domestic SPAC receive limited amounts of stock of the Foreign Acquiring Corporation. The following discussion provides a high-level summary of some of these rules. Because the Ownership Percentage is based on a fractional computation, like any fraction will be higher if the numerator increases and/or the denominator decreases.

B. Inflation of the Numerator

1. Non-Ordinary Course Distributions

Except as provided in a *de minimis* rule,[47] for purposes of determining the Ownership Percentage (with respect to value only, not vote), former shareholders of the acquired domestic corporation may be treated as having received By Reason of Stock with a fair market value equal to the "non-ordinary course distributions" ("NOCDs") made by the domestic entity during a look-back period.[48] The stock of the Foreign Acquiring Corporation treated as received under these rules is in addition to stock of the Foreign Acquiring Corporation otherwise treated as By Reason of Stock. This has the effect of inflating the numerator of the Inversion Fraction.

The NOCD rules, which were targeted at structures and transactions designed to shrink the value of the acquired domestic corporation, are the primary regime that has the result of counting equity, that is, again, adding it to the numerator, where it does not actually exist in the deal economics. As rigorous and as challenging as these rules can be, they are relatively compartmentalized and are nowhere near the level of complexity and potential traps as can be created by the denominator reduction rules described in Section III.C below.

The determination of NOCDs is made based on a look-back period of three years split into three one-year look-back periods.[49] The NOCDs for a given one-year period equal the excess, if any, of 110% of the sum of the distributions made over the past three one-year periods multiplied by a fraction, the numerator of which is the number of days in the look-back year and the denominator of which is the total number of days in the past three one-year periods.[50] While the rules can apply in a variety of circumstances, two particular noteworthy areas include (i) situations where the domestic corporation has participated in a spin-off (including spin-offs that qualify for nonrecognition under Code Sec. 355), and (ii) deals involving a domestic corporation that has itself been acquisitive in the years leading up to the potential Code Sec. 7874 transaction. In some cases, the authors have dealt with (i) and (ii) in the same transaction, raising a host of computational issues.

a) Spin-Offs and the NOCD Rules. For purposes of the NOCD rules, a distribution generally means any distribution made by a corporation with respect to its stock, other than certain enumerated exceptions.[51] Most notably, distributions qualifying for nonrecognition under Code Sec. 355 are nevertheless treated as subject to the NOCD rules. Thus, despite the rigorous requirements to qualify as a tax-free distribution of property under Code Sec. 355, including satisfying the applicable business purpose requirement, no special exception is afforded to Code Sec. 355 distributions. As such, a spin-off can constitute an NOCD in the same manner as a cash dividend for the purposes of Code Sec. 7874 depending on the dividend or share buyback history of the distributing corporation.

In fact, the regulations provide a harsher rule applicable to certain Code Sec. 355 transactions, essentially recharacterizing the transaction in a manner to, again, inflate the numerator of the Ownership Percentage. If during the applicable 36-month look-back period, a domestic corporation ("Distributing") distributes the stock of a domestic controlled corporation ("Controlled") in a transaction governed under Code Sec. 355 and the fair market value of the Controlled stock exceeds 50% of the fair market value of the stock of Distributing immediately before the distribution, then the NOCD rules effectively reverse the transaction to treat Controlled as having distributed the stock of Distributing.[52] In essence, the regulations presume that Code Sec. 7874 was the motivation behind the smaller company spinning out the larger company, so that, absent this rule, the larger company could avoid the taint of an NOCD in a subsequent combination with Foreign Acquiring Corporation.

The import of this rule is that if Controlled was acquired by a Foreign Acquiring Corporation, it ostensibly made no distributions to which the NOCD rules would apply. However, the NOCD rules construct a fiction whereby Controlled made a distribution equal to the value of the stock of Distributing, potentially pushing Controlled back into the NOCD rules despite it never having made a distribution in form or in substance.

b) NOCDs with Respect to Predecessors. The NOCD rules apply not only to the U.S. target entity acquired by a Foreign Acquiring Corporation but also any "predecessor" of that U.S. target entity. A corporation is a predecessor with respect to a relevant entity (essentially the domestic target in the inversion transaction) if (i) the relevant entity completes a "predecessor acquisition" and (ii) after the predecessor acquisition and all related transactions are complete, the "tentative predecessor ownership percentage" is at least 10%.[53] The "tentative predecessor ownership percentage" rule essentially provides that if 10% or more of the relevant entity equity is held by reason of holding equity in the acquired domestic entity, then the acquired domestic entity is a predecessor for purposes of the NOCD rules. Practically speaking, if a U.S. parent corporation acquires the stock of a U.S. target for U.S. parent stock and after the acquisition and related transactions, the U.S. target shareholders own at least 10% of the U.S. parent, then the U.S. target corporation is a "predecessor" and, as such, if U.S. parent is acquired by a Foreign Acquiring Corporation, the NOCD calculations for the U.S. parent must include those of the U.S. target.

c) Interaction with EAG Rules. While the NOCD rules generally create more outstanding stock (that is treated as By Reason of Stock) for purposes of the Ownership Percentage, this is not the case for all purposes of Code Sec. 7874. For purposes of applying the general exclusionary rule described in Section IV below (and for purposes of determining whether the otherwise helpful "internal group restructuring" or "loss of control" exceptions apply), stock included in the numerator of the Inversion Fraction under the NOCD rules is not taken into account.[54]

2. Counting By Reason of Stock

While not technically an adjustment to the numerator of the Inversion Fraction, the starting point in determining the Inversion Fraction is to determine what counts as By Reason of Stock of the Foreign Acquiring Corporation in the first instance. As noted in Section II.C.2, multiple domestic targets can be treated as a single domestic entity for Code Sec. 7874 purposes if acquired pursuant to the same plan, effectively increasing the numerator of the Inversion Fraction as a result.[55]

C. Reduction of the Denominator

1. General Regulatory Authority

It was clear that Congress intended Treasury and IRS to have exceedingly broad regulatory authority. Code Sec. 7874(g) reads like no other Code Section in the sense of providing that authority. This subsection reads:

> 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 ....

In addition, Treasury has broad regulatory authority to "prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations … *to treat stock as not stock*."[56]

It is this authority that forms the basis of the rules outlined below pursuant to which certain shares of the Foreign Acquiring Corporation are removed from the denominator of the Ownership Percentage, thereby making it more likely for Code Sec. 7874 to apply. The rules are discussed in further detail below, but in a nutshell can be summarized as follows:

1. Disregarding stock issued by the Foreign Acquiring Corporation in exchange for certain passive assets in a transaction related to the Domestic Entity Acquisition.
2. Disregarding a percentage of stock of the Foreign Acquiring Corporation in the case of such Foreign Acquiring Corporation having excess passive assets.
3. Disregarding a percentage of stock of the Foreign Acquiring Corporation attributable to prior Domestic Entity Acquisitions completed in the preceding 36 months.

Each are discussed in turn below.

2. Disqualified Stock

Stock of the Foreign Acquiring Corporation that is "sold in a public offering related to" the Domestic Entity Acquisition is not taken into account for purposes of determining the Ownership Percentage under Code Sec. 7874(c)(2)(B).

The regulations expand on the statutory exclusion and make clear that stock that is treated as "disqualified stock" ("Disqualified Stock") is treated as stock described in Code Sec. 7874(c)(2)(B).[57] Accordingly, subject to certain exceptions such as a *de minimis* rule,[58] Disqualified Stock is excluded from the denominator of the Inversion Fraction.[59]

Disqualified Stock is stock of the Foreign Acquiring Corporation that is transferred in an exchange related to the Domestic Entity Acquisition that is either (i) an exchange for "nonqualified property" or (ii) an exchange for property with "associated obligations."[60]

An exchange for "nonqualified property" means an exchange in which the Foreign Acquiring Corporation stock is transferred[61] to a person other than the domestic entity for nonqualified property.[62]

Nonqualified property is:

a. cash or cash equivalents;
b. marketable securities as defined in Code Sec. 453(f)(2), subject to certain exceptions;
c. certain obligations; and
d. any other property acquired with a principal purpose of avoiding the purpose of Code Sec. 7874.[63]

An exchange for property with "associated obligations" is, subject to certain limitations, a transfer of Foreign Acquiring Corporation stock by a transferor to a transferee in exchange for property, and, pursuant to the same plan or series of related transactions, the transferee subsequently transfers such stock in exchange for the satisfaction or assumption of one or more obligations of the transferee or a person related to the transferee within the meaning of Code Sec. 267 or Code Sec. 707(b).[64]

Importantly, Disqualified Stock is not counted for purposes of diluting the Ownership Percentage of the former domestic entity shareholders for purposes of Code Sec. 7874(a)(2)(B) (*i.e.*, it is not treated as outstanding stock of the Foreign Acquiring Corporation that is not By Reason of Stock). Such stock is, however, taken into account for purposes of determining whether an entity is a member of an EAG for purposes of applying the general exclusionary rule described in Section IV below (and for purposes of determining whether the otherwise helpful "internal group restructuring" or "loss of control" exceptions apply).[65] As such, the Disqualified Stock rules do not otherwise apply to remove the subject stock from the calculation of EAG status.

3. Cash-Box Rule

Another adjustment that may be required to the Inversion Fraction is found in Reg. §1.7874-7, commonly referred to as the "cash-box" rules.

At a high level, for purpose of determining the Ownership Percentage by value (but not vote), the cash-box rules exclude certain stock[66] of the Foreign Acquiring Corporation from the denominator of the Inversion Fraction if, on the completion date,[67] more than 50% of the gross value of all "foreign group property" constitutes "foreign group nonqualified property."[68]

The bucket of foreign group property generally includes all property of the EAG of the Foreign Acquiring Corporation (determined as if the Foreign Acquiring Corporation were the common parent) other than property acquired in the Domestic Entity Acquisition, and stock and certain obligations of members of the EAG.[69]

Foreign group nonqualified property is generally the same as "nonqualified property" under the Disqualified Stock rules as described in III.C.2 above (*e.g.*, cash or cash equivalents, certain marketable securities, *etc.*), other than certain assets that produce income derived from the active conduct of a banking, finance or similar business, or an active insurance business.[70]

In effect, the cash-box rules create a cliff effect, subjecting all Foreign Acquiring Corporations with over 50% "passive" assets as of the completion date to the rules and requiring the exclusion of some amount of Foreign Acquiring Corporation stock from the denominator based on the amount of such passive assets within the EAG.

The purpose of the cash-box rules was to prevent having a Foreign Acquiring Corporation with predominately passive-type assets, which might be "old and cold" and thus not subject to the Disqualified Stock rules of Section III.C.2 above, from shopping itself as a target for a domestic entity seeking to move offshore.

Stock excluded under the cash-box rule, similar to stock excluded due to being Disqualified Stock, is also taken into account for purposes of determining whether an entity is a member of an EAG for purposes of applying the general exclusionary rule described in Section IV below (and for purposes of determining whether the otherwise helpful "internal group restructuring" or "loss of control" exceptions apply).[71]

4. Serial Acquisition Rule

The "serial acquisition" rules of Reg. §1.7874-8 provide another set of potential adjustments to the denominator of the Inversion Fraction.

When a Foreign Acquiring Corporation has completed one or more prior Domestic Entity Acquisitions, for purposes of determining the Ownership Percentage by value (but not vote), certain amounts of the Foreign Acquiring Corporation's stock with respect to each prior Domestic Entity Acquisition are excluded from the denominator of the Inversion Fraction.[72] This assumes that each acquisition is not treated as part of the same plan or series of transactions, in which case each domestic target entity will be aggregated to be treated as a single domestic entity for all purposes of Code Sec. 7874.[73] The serial acquisition rules apply only after the application of the single plan rule for multiple domestic targets.[74]

The Foreign Acquiring Corporation stock excluded from the denominator as a result of prior Domestic Entity Acquisitions is equal to the sum of the "excluded amounts" computed separately with respect to each prior Domestic Entity Acquisition and each relevant share class.[75]

The excluded amount with respect to each prior Domestic Entity Acquisition equals the product of (1) the total number of prior acquisition shares reduced by the sum of the number of allocable redeemed shares for all redemption testing periods and (2) the fair market value of a single share of stock of the relevant share class on the completion date of such prior Domestic Entity Acquisition.[76]

The "allocable redeemed shares" with respect to each prior Domestic Entity Acquisition and each relevant share class equals the product of (1) the number of redeemed shares during the redemption testing period and (2) a redemption fraction (determined separately with respect to each prior Domestic Entity Acquisition and each relevant share class).[77]

The redemption fraction is determined as follows:

a. the numerator is the total number of prior acquisition shares, reduced by the sum of the number of allocable redeemed shares for all prior redemption testing periods; and
b. the denominator is the sum of (A) the number of outstanding shares of the Foreign Acquiring Corporation as of the end of the last day of the redemption testing period and (B) the number of redeemed shares during the redemption testing period.[78]

The redemption testing period with respect to a prior Domestic Entity Acquisition is generally the period beginning one day after the completion date of the prior Domestic Entity Acquisition and ending on the day prior to the completion date of the relevant Domestic Entity Acquisition.[79]

A prior Domestic Entity Acquisition is, subject to two exceptions, a Domestic Entity Acquisition that occurred within the three-year period ending on the signing date of the relevant Domestic Entity Acquisition.[80]

The first exception to the serial acquisition rule is the *de minimis* exception, which provides that a Domestic Entity Acquisition is not treated as a prior Domestic Entity Acquisition if (1) the Ownership Percentage was less than 5% by vote and value and (2) the fair market value of the By Reason of Stock did not exceed $50 million.[81]

The second exception is the foreign-parented group exception, which provides that a Domestic Entity Acquisition is not treated as a prior Domestic Entity Acquisition if (1) before the Domestic Entity Acquisition and any related transaction, the domestic entity was a member of the foreign-parented EAG (as discussed further below), and (2) the Domestic Entity Acquisition qualified for the internal group restructuring exception (as discussed further below).[82]

IV. Application of the EAG Rules

A. General Exclusion Rule

The EAG rules in essence apply to ignore certain stock in the Foreign Acquiring Corporation held within the EAG that may otherwise constitute By Reason of Stock for purposes of the Inversion Fraction. In most situations, such EAG-held stock, which would otherwise be By Reason of Stock, is removed from the numerator and the denominator of the Inversion Fraction and the Ownership Percentage. In more limited cases, one of the few generous rules in the regulations can apply to exclude such EAG-held stock from the numerator but include such EAG-held stock in the denominator, thus driving down the Ownership Percentage.

An EAG generally means one or more chains of includible corporations (including both domestic and foreign corporations) connected through stock ownership of more than 50% of the total vote and value threshold with a common parent corporation or another includible corporation within the EAG.[83]

For purposes of determining the Ownership Percentage and unless an exception applies, stock held by one or more members of the EAG is excluded from both the numerator and denominator of the Inversion Fraction.[84]

Two exceptions to this rule provide that if the Domestic Entity Acquisition qualifies as an "internal group restructuring" or results in a "loss of control," stock held by one or more members of the EAG is included in the denominator, but not in the numerator, of the Inversion Fraction.[85]

1. Internal Group Restructuring Exception

The "internal group restructuring" rule allows for a "reshuffling" of the corporate deck without Code Sec. 7874 implications by applying the EAG rules to exclude By Reason of Stock from the numerator but include such stock in the denominator. An "internal group restructuring" applies where (i) before a domestic entity acquisition, 80% or more by vote and value of the domestic entity was held directly or indirectly by a common parent of the EAG and (ii) after the domestic entity acquisition, 80% or more by vote and value of the Foreign Acquiring Corporation of such domestic entity is held directly or indirectly by such common EAG parent.[86] In essence, the "internal group restructuring" rule permits an affiliated group of corporations to restructure the corporate group without disastrous Code Sec. 7874 consequences. Not that such a transaction would make sense for general planning and a host of other reasons, but if a U.S. parent corporation wanted to contribute 100% of a U.S. affiliate to a wholly owned foreign affiliate, such transaction would qualify for the internal group restructuring exception and the Inversion Fraction in that case would be 0/100.

2. Loss of Control Exception

The "loss of control" rule is designed to apply in cases of the formation of certain joint venture entities. A "loss of control" occurs where former owners of a domestic entity do not hold, in the aggregate, more than 50% (by vote or value) of any EAG member.[87] In application, this permits a greater than 50% owner of a Foreign Acquiring Corporation to include in the denominator the outstanding stock of the Foreign Acquiring Corporation rather than having such stock excluded for purposes of the general EAG exclusionary rule.[88]

B. Transferred Stock Rules

As is apparent given the rules described above, the Code Sec. 7874 regulatory regime can apply in mechanical, non-intuitive ways. In addition, the status of By Reason of Stock cannot be avoided by transferring stock in a Foreign Acquiring Corporation received as a result of a Domestic Entity Acquisition to a third party pursuant to a binding commitment in place at the time of the acquisition. The By Reason of Stock status sticks to the shares once issued, regardless of what happens to those shares following the acquisition.

However, there is an exception to that "stickiness" if an initial owner of By Reason of Stock were to transfer that stock. In that case, the transitory ownership would be disregarded for other purposes of Code Sec. 7874 where such ownership could be beneficial by treating the initial owner be treated as holding those shares, most notably under the EAG rules. As such, the treatment of By Reason of Stock that is subsequently transferred following a Domestic Entity Acquisition is critical to understanding a key feature of the EAG rules, most importantly in the context of spin-off transactions.

1. "By Reason Of" Stickiness

Stock of a Foreign Acquiring Corporation that is "By Reason of Stock" generally will continue to be treated as By Reason of Stock even upon a subsequent transfer by the former domestic entity shareholder recipient, regardless of whether the subsequent transfer is related to the Domestic Entity Acquisition and, indeed, no matter how hardwired such subsequent transfer is to the exchange of Domestic Entity Acquisition.[89]

For example, if a former domestic corporation shareholder receives Foreign Acquiring Corporation stock in exchange for stock in the domestic corporation and subsequently transfers, pursuant to a related transaction, a portion of such Foreign Acquiring Corporation stock to an unrelated person in exchange for cash, the transferred stock will continue to be treated as By Reason of Stock.[90] Thus, such transferred stock will be included in both the numerator and the denominator of the Inversion Fraction.

2. Interaction with EAG Rules

Transferred By Reason of Stock creates a potential issue under the EAG rules, best illustrated in the context of spin transactions. Where a corporate group, whether a foreign- or U.S.-parented group, transfers a domestic corporate affiliate to a foreign corporate affiliate, the "internal group restructuring" rule described above would otherwise apply to exclude such stock from the numerator and include such stock in the denominator. However, where the stock of the Foreign Acquiring Corporation, some or all of which may be By Reason of Stock, is then distributed by the parent of the group, the EAG has been broken, creating a question of whether the EAG rules can apply to avoid causing a Foreign Acquiring Corporation spun out by the parent corporation to be subject to Code Sec. 7874.

The general exclusion from the Inversion Fraction of stock held by one or more members of the EAG generally does not apply to stock of a Foreign Acquiring Corporation that is treated as "Transferred Stock."[91] As such, such stock will be included in the numerator and the denominator of the Inversion Fraction.[92]

Transferred Stock is generally (1) stock of the Foreign Acquiring Corporation that is By Reason of Stock, (2) that is received by a "transferring corporation," and (3) that is subsequently transferred in a transaction (or series of transactions) related to the Domestic Entity Acquisition.[93] A "transferring corporation" is a corporation that is a former domestic entity shareholder.[94] A former domestic entity shareholder of a domestic entity that is a domestic corporation is any person that held stock in the domestic corporation before the Domestic Entity Acquisition, including any person that holds stock in the domestic corporation both before and after the Domestic Entity Acquisition.[95]

Particularly in the context of spin-off transactions, whether the distributing corporation is a foreign or U.S. corporation is a meaningful distinction. Transferred Stock that qualifies for either the U.S.-parented group exception or the foreign-parented group exception can be excluded in the numerator of the Inversion Fraction, yet such stock may be excluded in the denominator of the Inversion Fraction unless the transaction also qualifies as an "internal group restructuring" or "loss of control" transaction described in Section IV.A above.[96] The U.S.-parented group exception, though, is far more limited than the foreign-parented group exception, as the former is intended to prevent foreign corporate affiliates from escaping the U.S. tax umbrella while the latter is designed to grant flexibility where the foreign corporate affiliate was already held directly or indirectly by a foreign parent, thus not within a U.S. group.

a) U.S.-parented group exception. Assume that a U.S. parent group owns domestic and foreign affiliates. If the U.S. parent contributes a domestic subsidiary to one of its foreign affiliates and no other related transactions occur subsequent to this transaction, the U.S. parent is otherwise a member of the EAG and can avail itself of the "internal group restructuring" exception to avoid adverse applications of Code Sec. 7874. However, Treasury was concerned that this exception could facilitate a spin-off of the foreign corporate affiliate and thereby accomplish a "spin-version".[97] Thus, Treasury thought to regulate under the U.S.-parented group exception by shutting off the EAG rules where there is transferred stock in the context of a U.S.-parented group.

A U.S.-parented group is an affiliated group that has a domestic corporation as the common parent corporation. A member of the U.S.-parented group is an entity included in the U.S.-parented group, including the common parent.[98]

The U.S.-parented group exception only applies if two conditions are met:

1. The transferring corporation was a member of the U.S.-parented group before the Domestic Entity Acquisition;[99] and
2. After the Domestic Entity Acquisition, each of the transferring corporation (or its successor), any person that holds Transferred Stock, and the Foreign Acquiring Corporation are members of a U.S.-parented group, the common parent of which either (A) was a member of the U.S.-parented group before the Domestic Entity Acquisition or (B) is formed in a transaction related to the Domestic Entity Acquisition and, immediately after its formation (and without regard to any related transactions), is a member of the U.S.-parented group.[100]

Note that the U.S.-parented group exception takes into account related transactions in determining its application, meaning that the transfer of By Reason of Stock is taken into account in determining whether the EAG exclusionary rules apply.[101] As such, the otherwise applicable "stickiness" of the By Reason of Stock rules does not apply in preserving EAG membership. As discussed below, this is in contrast to the foreign-parented group exception, which generally ignores transfers of By Reason of Stock to determine applicability of the EAG rules, with one small but important caveat.

b) Foreign-parented group exception. As discussed above, the foreign-parented group exception serves an altogether different purpose, and, while it is one of the most complex rules in a series of complex rules, it is one of the few rules of leniency in Code Sec. 7874 that prevents application of Code Sec. 7874 as long as the structure starts off under a foreign parent and ends up under a foreign parent. Even this rule, however, has its limitations and, as the authors have seen, requires tax attorneys to labor in explaining the intricacies of Code Sec. 7874 to non-tax professionals in a situation where they might be astounded that these issues even come up. These rules can apply in a multitude of situations, such as where a foreign-parented group packages up a division, consisting of U.S. and non-U.S. affiliates, into a foreign holding company in preparation for a disposition of such foreign holding company. Notably, these rules can appropriately protect foreign-to-foreign spin-offs where a foreign parent corporation contributes assets and affiliates, including a domestic corporate entity, to a foreign subsidiary and distributes the stock of the foreign subsidiary to its shareholders. The foreign-parented group exception generally protects the initial domestic entity acquisition from the application of Code Sec. 7874 by preserving the application of the EAG rules, but this protection is not ironclad.

A foreign-parented group is an affiliated group that has a foreign corporation as the common parent corporation. A member of the foreign-parented group is an entity included in the foreign-parented group.[102]

The foreign-parented group exception only applies if two conditions are met:

1. The transferring corporation and the domestic corporation were members of the same foreign-parented group before the Domestic Entity Acquisition;[103] and
2. After the Domestic Entity Acquisition, the transferring corporation (A) is a member of the EAG, or (B) would be a member of the EAG absent one or more transfers (other than by issuance), in a transaction (or series of transactions) after and related to the Domestic Entity Acquisition, of stock of the Foreign Acquiring Corporation by one or more members of the foreign-parented group.[104]

Note that unlike the U.S.-parented group exception, the foreign-parented group exception applies by explicitly ignoring the transfer of the Foreign Acquiring Corporation stock in testing EAG membership, other than in the case of an "issuance" of Foreign Acquiring Corporation shares. Essentially, this rule allows a foreign-parented group to package up a division in a foreign subsidiary (a new corporation or otherwise) and dispose that subsidiary in a range of transactions (*e.g.*, for cash, stock, *etc.*). The "other than by issuance" parenthetical, however, creates a large trap for the unwary. If the Foreign Acquiring Corporation, once transferred by the transferring corporation, *issues* any new shares, whether for qualified or non-qualified property, in a transaction related to the initial domestic entity acquisition, this could break the EAG and otherwise cause the foreign-parented group exception to lose its protective shield, potentially causing the Foreign Acquiring Corporation to be a "surrogate foreign corporation" or domestic corporation depending on the Ownership Percentage.[105]

The foreign-parented group exception, and its basic limitations, is best illustrated by the basic example below, which is reflected as Example 4 under Reg. §1.7874-6(g). The basic facts are that Individual A owns all of FP, which owns all of the stock of US Sub. FP then undergoes a reorganization pursuant to Code Sec. 368(a)(1)(F) and becomes New FP. Because of the fiction of an asset reorganization for U.S. federal income tax principles, this transaction is a domestic entity acquisition by New FP and a transfer of By Reason of Stock by FP (*see* Chart 1).

If in addition to the Code Sec. 368(a)(1)(F) reorganization, New FP issues additional shares to Individual B, the analysis as to whether the foreign-parented group exception changes dramatically due to the "issuance" (rather than transfer) of FP shares (*see* Chart 2).

V. Case Studies

A. Spin-Offs and NOCD Rules

1. Example 1—Ordinary Course Spins

Example 1, depicted in Appendices 1–3, illustrates the basic application of the NOCD rules in the context of a spin-off transaction. Despite the rigorous

CHART 1.

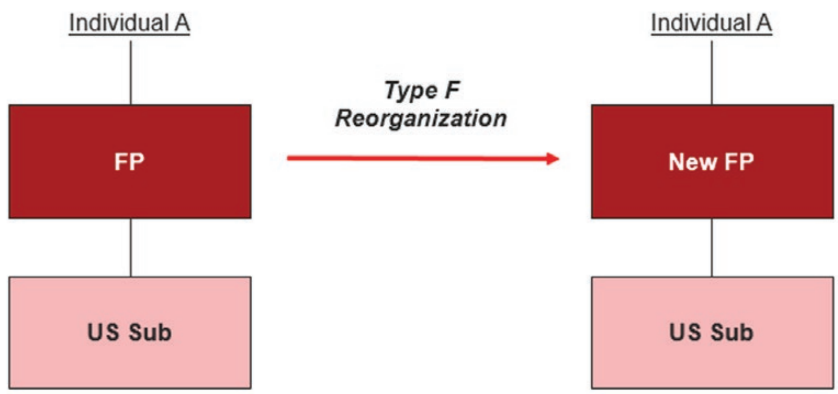
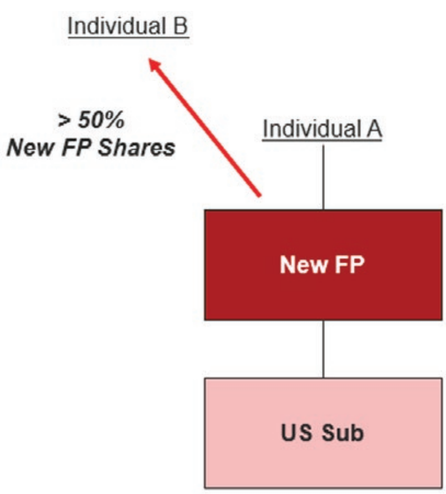


CHART 2.



requirements to meet tax-free qualification under Code Sec. 355 (*e.g.*, corporate business purpose), the distribution by USP of US SpinCo shares in general is a distribution that must be tested as an NOCD under Code Sec. 7874.

This example also illustrates that if the value of US SpinCo equals or exceeds 50% of the value of USP immediately prior to the distribution, the NOCD rules recharacterize the transaction to treat US SpinCo as having made a distribution equal to the value of USP following the spin-off.

2. Example 2—Packaging (and Acquiring) SpinCo

The first part of Example 2, depicted in Appendices 4–6, demonstrates a basic pre-spin-off restructuring transaction where multiple U.S. subsidiaries are contributed to US SpinCo in preparation for a spin-off. Under the predecessor rules, due to the relative value of the U.S. subsidiaries compared to US SpinCo as a whole, the distribution history of each U.S. subsidiary must be accounted for purposes of determining US SpinCo's NOCDs.

As such, when US SpinCo stock is distributed and ultimately acquired in a reverse Morris Trust-type transaction by FH, FH must take into account historical distributions by US SpinCo and each U.S. subsidiary in its NOCD determinations.

B. Asset Acquisition and Non-Qualified Property

1. Example 3—Dichotomy Between an Asset Acquisition and Stock Acquisition

Example 3, depicted in Appendices 7–9, shows that a statutory merger of FP into F NewCo results in an asset acquisition under general U.S. tax principles, giving rise to both By Reason of Stock and Disqualified Stock depending upon (i) the composition of FP's assets and (ii) whether the foreign-parented group exception is available for the FP merger.

F NewCo's acquisition of USP shares will certainly give rise to By Reason of Stock in the numerator.

Depending upon the percentage of ownership held by the legacy FP Public post-closing, the FP merger with and into F NewCo may or may not qualify for the foreign-parented exception. If it does qualify for the foreign-parented exception, there should be no By Reason of Stock with respect to F NewCo's acquisition of FP US Sub included in the numerator of the Inversion Fraction. If, however, the foreign-parented exception does not apply, there would in fact be additional By Reason of Stock in the numerator.

Regardless of the application of the foreign-parented exception, to the extent FP holds non-qualified property, there would be Disqualified Stock of F NewCo removed from the denominator for purposes of the inversion fraction.

C. Cash-Box Rules

1. Example 4—Cash-Box Implications

Example 4, depicted in Appendices 10 and 11, shows how the logic of the cash-box rules differs from that of the Disqualified Stock rules. This example raises how the additional cash contribution by the new money investors creates additional non-qualified group property that must be taken into account for purposes of determining if FP trips the 50% threshold under the cash-box rules.

D. Foreign-Parented Group Exception

1. Example 5—Foreign-Parented Group Exception Shortcoming

Example 5, depicted in Appendices 12–14, demonstrates a number of key issues and is remarkable in the sense that the entire structure involves non-U.S.-parented groups, but nonetheless implicates Code Sec. 7874 in surprising ways. When the authors came across a similar transaction, the reaction from the business and corporate teams was "what would have happened if we never involved a U.S. tax lawyer?"

When FP re-incorporates and becomes New FP (either by merger or other corporate conversion mechanism), it is treated as an asset acquisition. Because FP owns US Sub through a disregarded entity, this is a Domestic Entity Acquisition by New FP. Depending upon the application of the foreign-parented exception, the New FP shares issued that are attributable to US Sub may be excluded from the numerator and/or denominator.

In this case, due to the issuance of New FP shares to F BIGCO, the foreign-parented exception will not apply to FP such that the deemed acquisition of US Sub by New FP will produce By Reason of Stock included in the numerator.

FP's acquisition of the F Holdco division from F BIGCO in exchange for FP shares breaks the EAG between FP and New FP due to the transaction taking the form of an issuance of New FP shares.

In addition, because F BIGCO has contributed U.S. subsidiaries to F HoldCo and F HoldCo is subsequently acquired by New FP in exchange for FP shares, this creates By Reason of Stock results pursuant to Reg. §1.7874-2(c)(4). In this case, the general EAG exclusionary rule applies as between F BIGCO and New FP given that F BIGCO and New FP are members of the same EAG.

2. Example 6—New Investors and Breaking the EAG

Example 6, depicted in Appendices 15–16, posits the same facts as Example 5, except that the F BIGCO and New FP groups no longer constitute an EAG because of the new money investors holding a 20% stake in New FP as part of the same series of transactions.

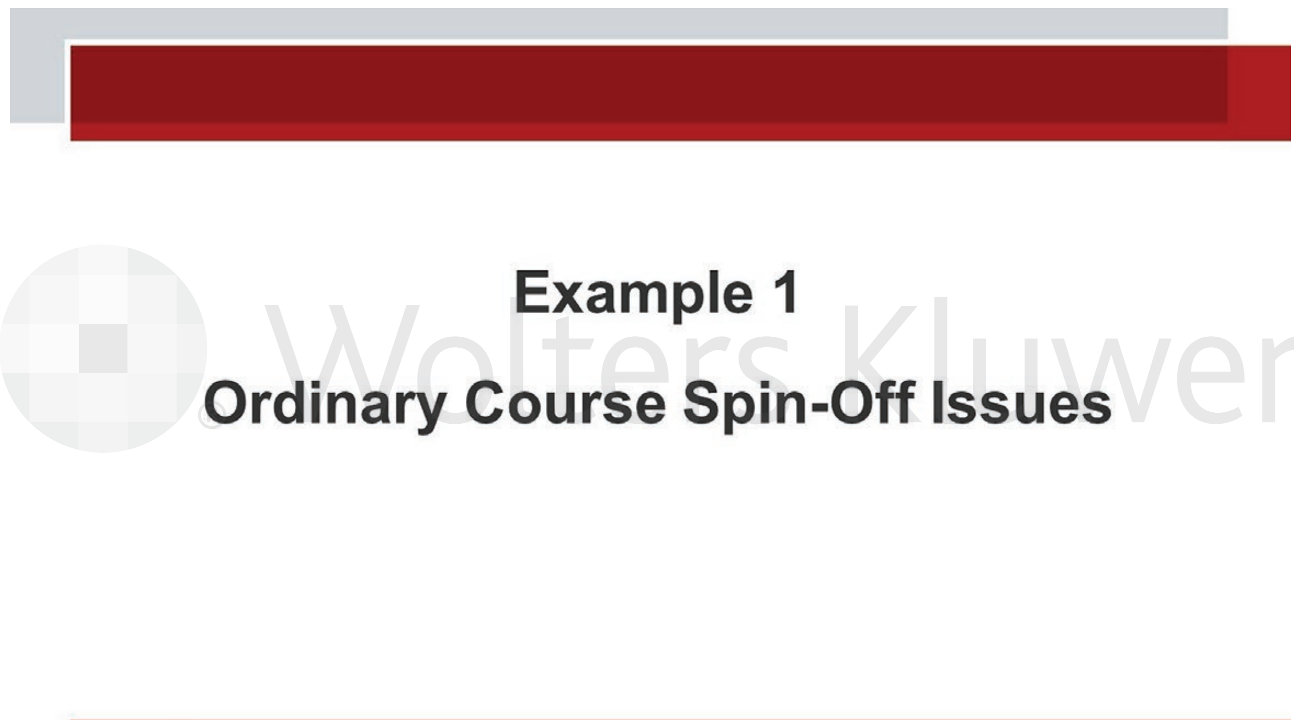
E. Subsequent Acquisitions of Foreign Corporations

1. Example 7—Pre-Spin Restructurings in the Foreign-Parented Groups

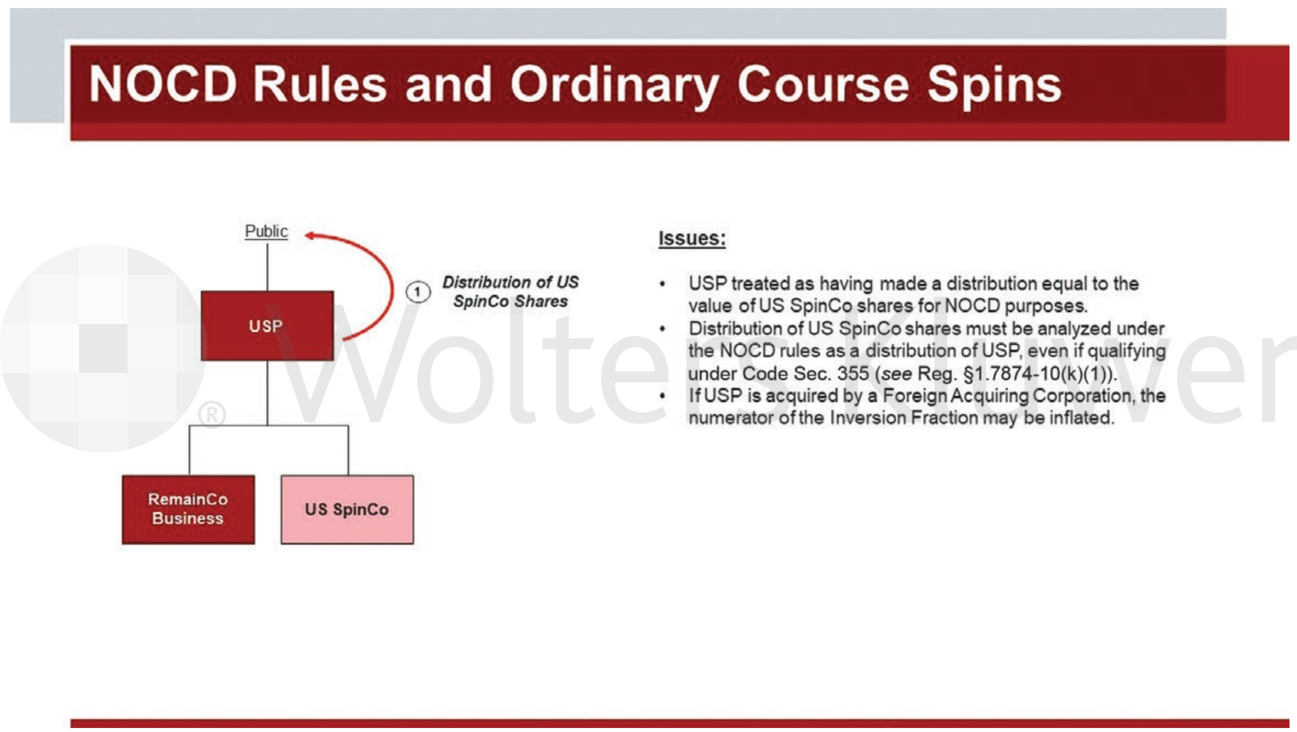
Example 7, depicted in Appendices 17–19, posits a series of steps one may see in a pre-spin restructuring deck. In this case, the ultimate goal is to transfer FH 2 and US Sub to F SpinCo while retaining FH 1 and USP under FP.

To accomplish this, USP distributes US Sub to FH 2. While FH 2 has not issued any shares, has FH 2 indirectly acquired substantially all of the assets of a U.S. corporation under Reg. §1.7874-2? Following this step, FH 1 distributes FH 2 (which now directly holds US Sub), and FP then contributes FH 2 to F SpinCo.

APPENDIX 1.

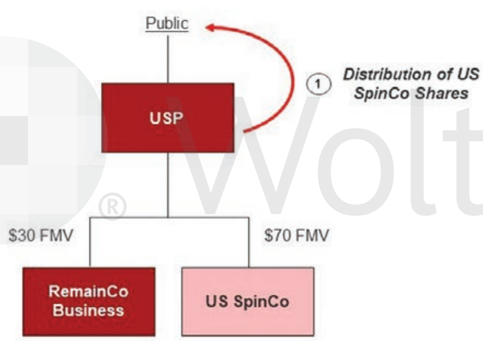


APPENDIX 2.


NOCD Rules and Ordinary Course Spins
Public
USP
1 Distribution of US SpinCo Shares
RemainCo Business
US SpinCo
Issues:
• USP treated as having made a distribution equal to the value of US SpinCo shares for NOCD purposes.
• Distribution of US SpinCo shares must be analyzed under the NOCD rules as a distribution of USP, even if qualifying under Code Sec. 355 (see Reg. §1.7874-10(k)(1)).
• If USP is acquired by a Foreign Acquiring Corporation, the numerator of the Inversion Fraction may be inflated.

APPENDIX 3.

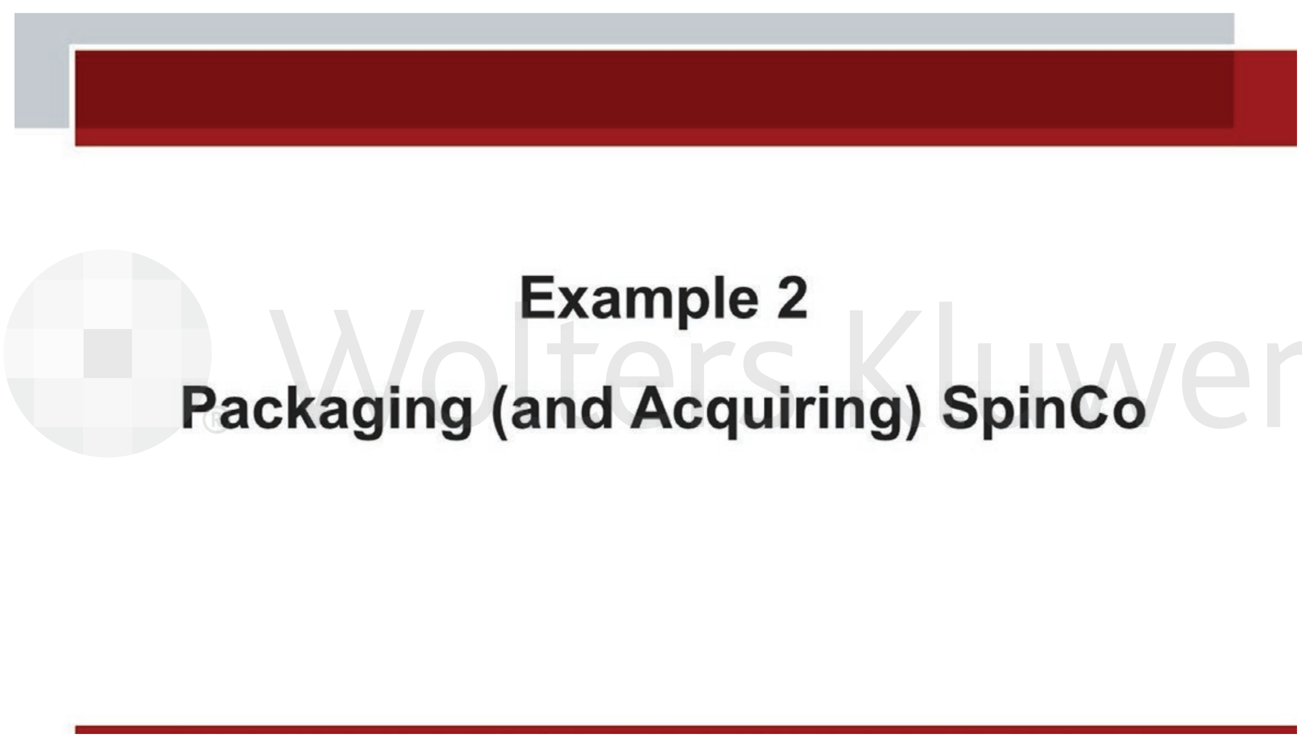
NOCD Rules and Ordinary Course Spins



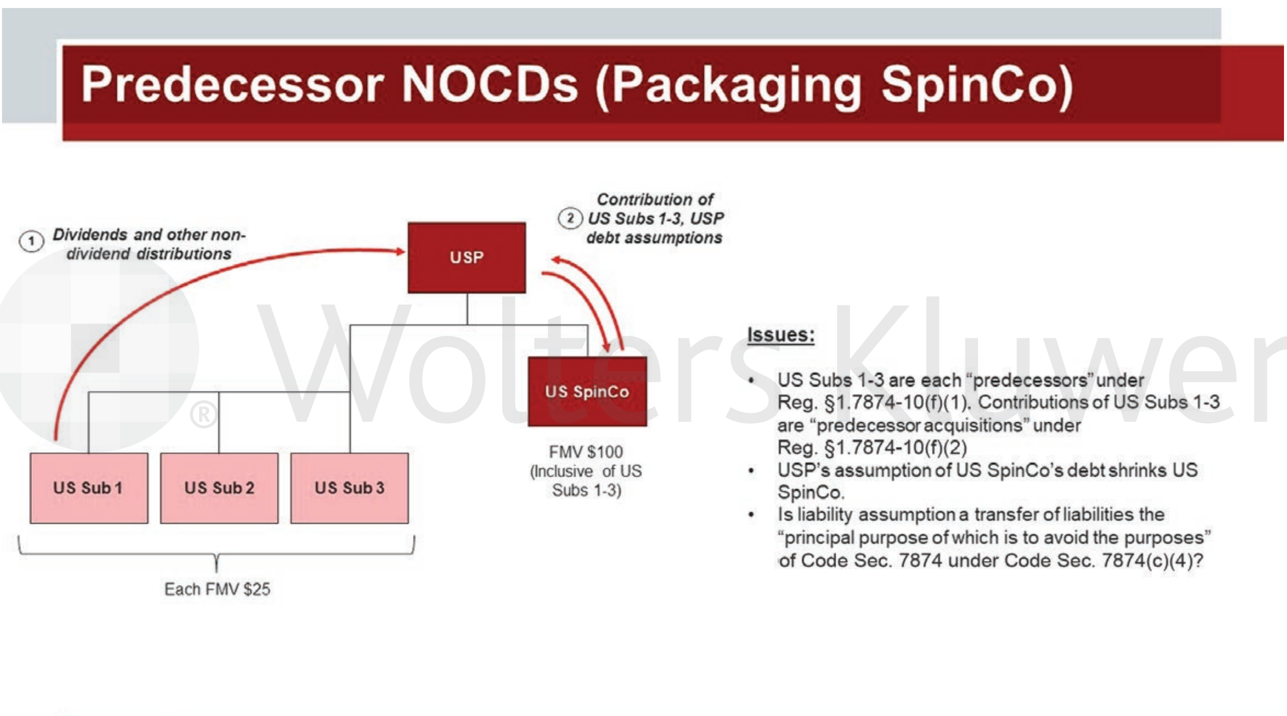
Issues:

- Distribution of US SpinCo shares considered an NOCD, even if qualifying under Code Sec. 355 (*see* Reg. § 1.7874-10(k)(1)).
- If transaction qualifies under Code Sec. 355, US SpinCo treated as having made a distribution equal to $30 for NOCD purposes (even though US SpinCo made no actual distributions in form or substance) (*see* Reg. §1.7874-10(g)).
- If US SpinCo is acquired by a Foreign Acquiring corporation, the numerator of the Inversion Fraction may be inflated.
- If USP is acquired, is USP treated as having made any distribution? Said another way, can Reg. §1.7874-10(g) be helpful to NOCD determination?

APPENDIX 4.



APPENDIX 5.


Predecessor NOCDs (Packaging SpinCo)
1 Dividends and other non-dividend distributions
2 Contribution of US Subs 1-3, USP debt assumptions
USP
US SpinCo
FMV $100 (Inclusive of US Subs 1-3)
US Sub 1
US Sub 2
US Sub 3
Each FMV $25
Issues:
US Subs 1-3 are each "predecessors" under Reg. §1.7874-10(f)(1). Contributions of US Subs 1-3 are "predecessor acquisitions" under Reg. §1.7874-10(f)(2)
USP's assumption of US SpinCo's debt shrinks US SpinCo.
Is liability assumption a transfer of liabilities the "principal purpose of which is to avoid the purposes" of Code Sec. 7874 under Code Sec. 7874(c)(4)?
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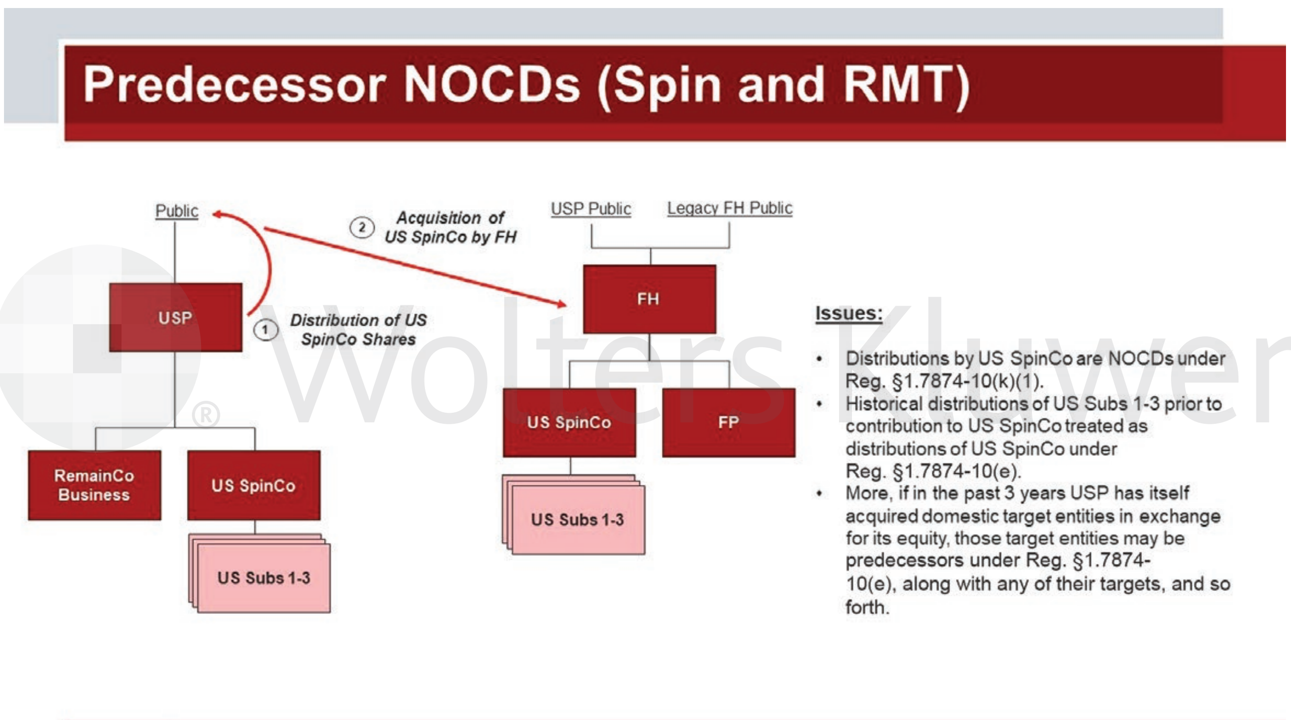
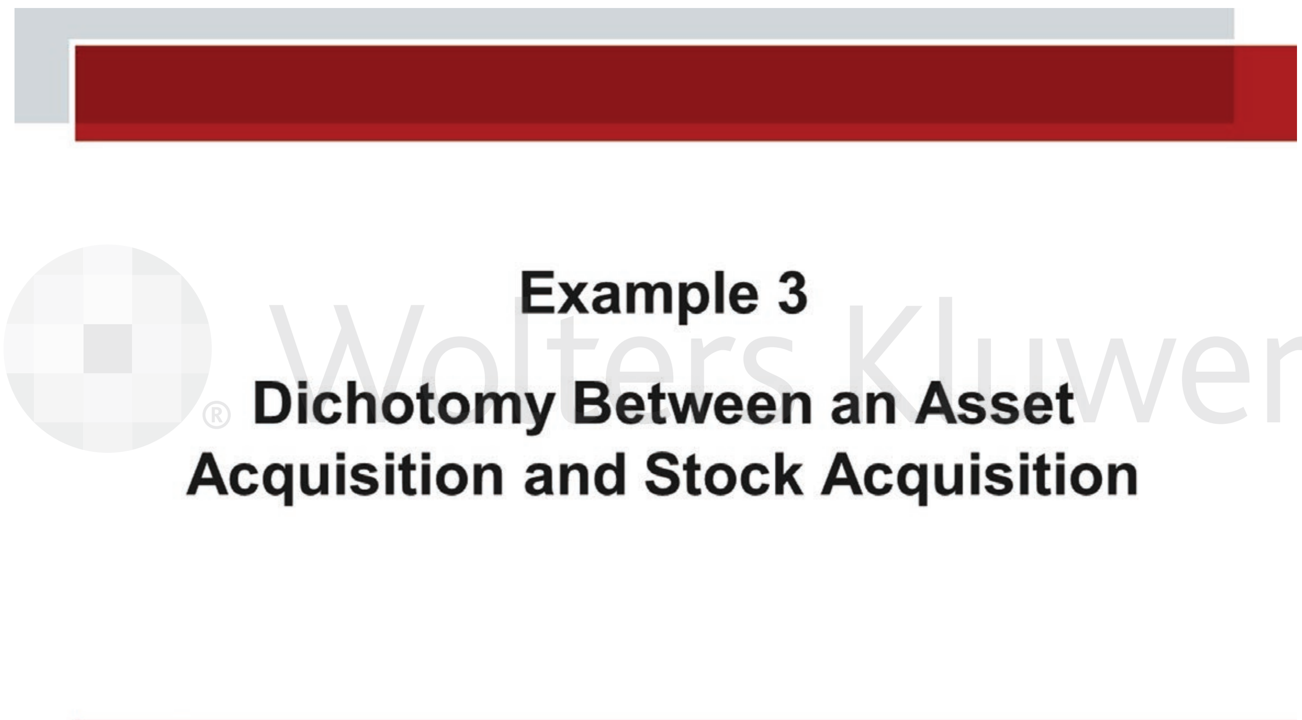
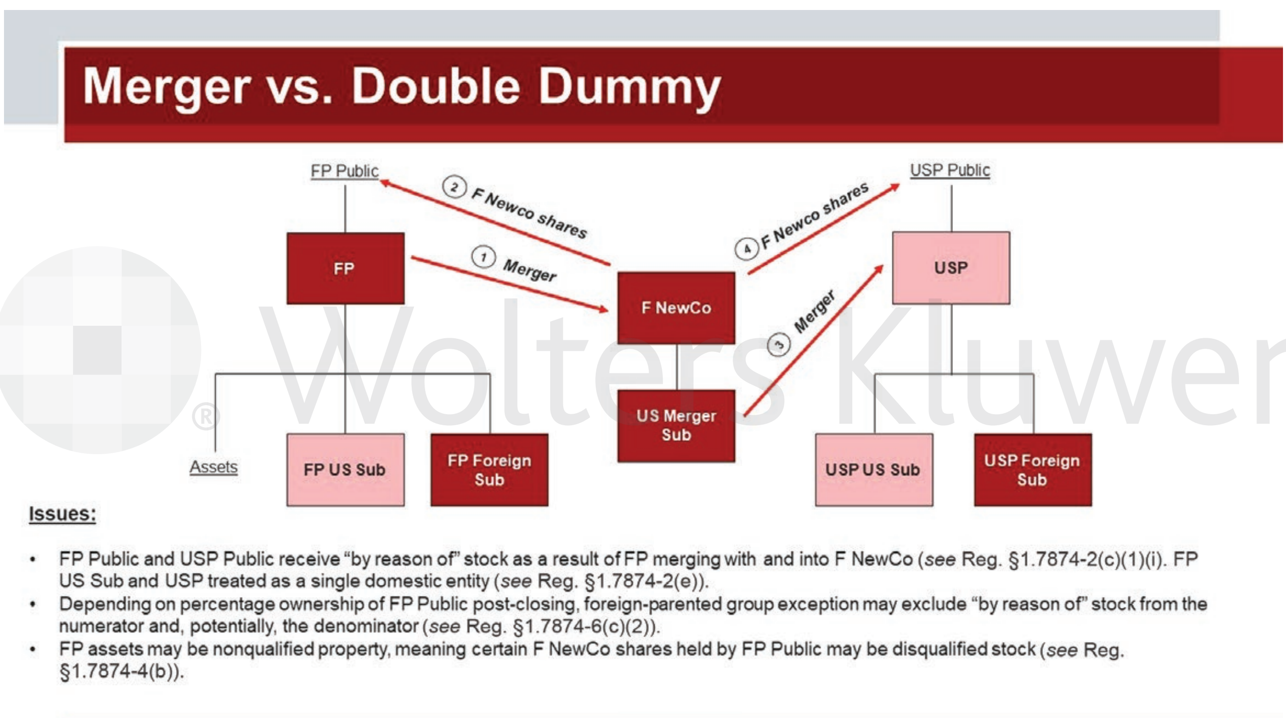
APPENDIX 6.


Predecessor NOCDs (Spin and RMT)
Public
USP
Distribution of US SpinCo Shares
RemainCo Business
US SpinCo
US Subs 1-3
Acquisition of US SpinCo by FH
USP Public
Legacy FH Public
FH
US SpinCo
FP
US Subs 1-3
Issues:
• Distributions by US SpinCo are NOCDs under Reg. §1.7874-10(k)(1).
• Historical distributions of US Subs 1-3 prior to contribution to US SpinCo treated as distributions of US SpinCo under Reg. §1.7874-10(e).
• More, if in the past 3 years USP has itself acquired domestic target entities in exchange for its equity, those target entities may be predecessors under Reg. §1.7874-10(e), along with any of their targets, and so forth.

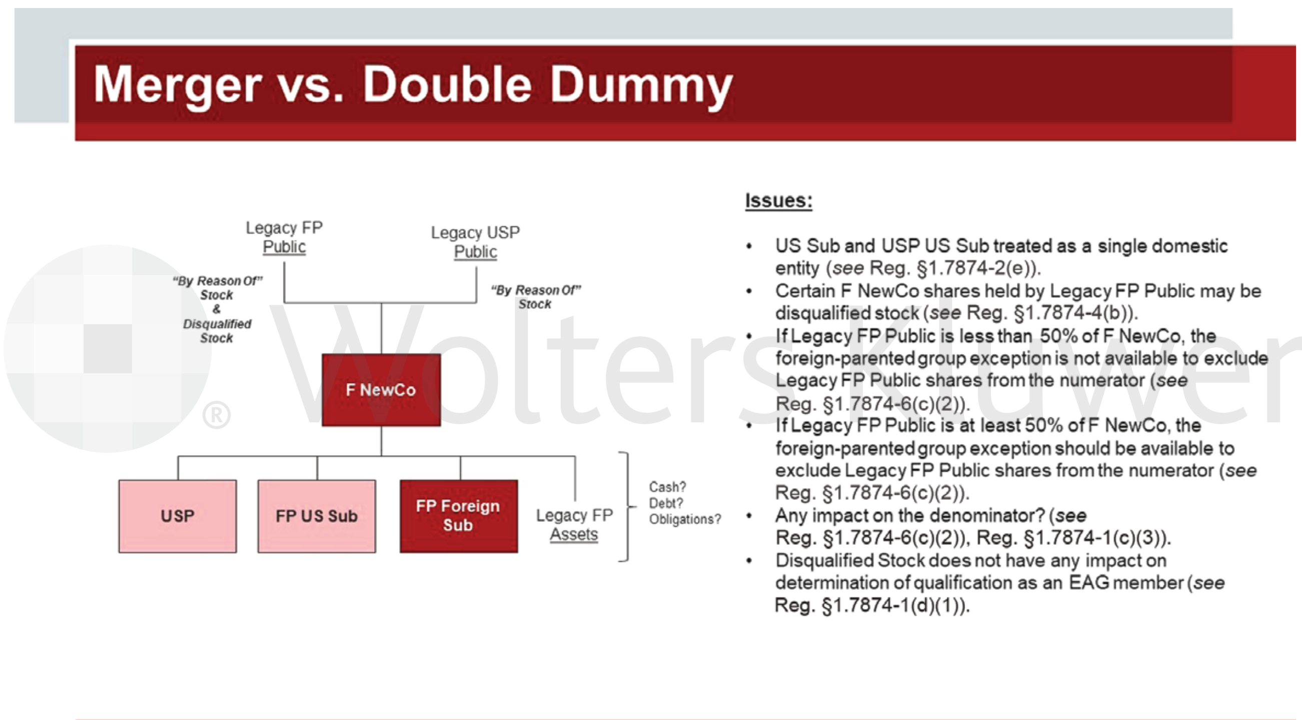
APPENDIX 7.


Example 3
Dichotomy Between an Asset Acquisition and Stock Acquisition

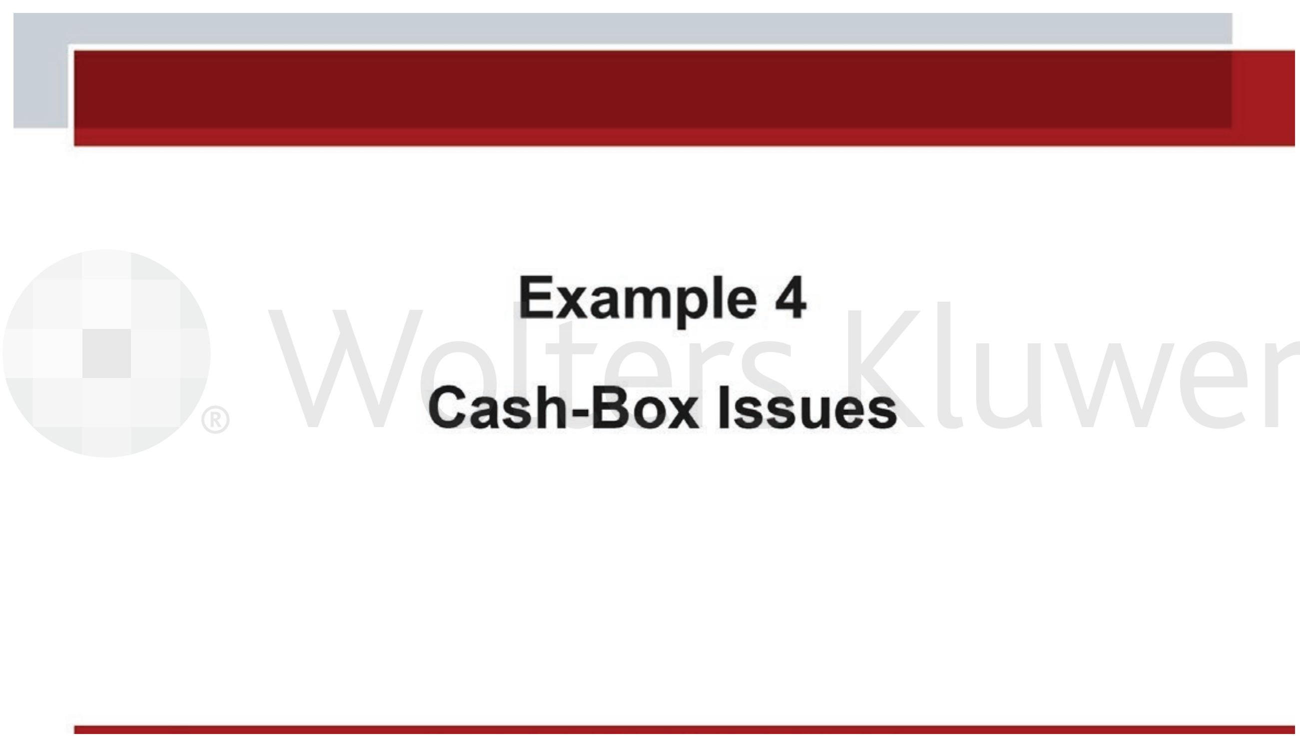
APPENDIX 8.


Merger vs. Double Dummy
FP Public
2 F Newco shares
USP Public
FP
1 Merger
4 F Newco shares
USP
F NewCo
3 Merger
US Merger Sub
Assets
FP US Sub
FP Foreign Sub
USP US Sub
USP Foreign Sub
Issues:
• FP Public and USP Public receive "by reason of" stock as a result of FP merging with and into F NewCo (*see* Reg. §1.7874-2(c)(1)(i). FP US Sub and USP treated as a single domestic entity (*see* Reg. §1.7874-2(e)).
• Depending on percentage ownership of FP Public post-closing, foreign-parented group exception may exclude "by reason of" stock from the numerator and, potentially, the denominator (*see* Reg. §1.7874-6(c)(2)).
• FP assets may be nonqualified property, meaning certain F NewCo shares held by FP Public may be disqualified stock (*see* Reg. §1.7874-4(b)).

APPENDIX 9.

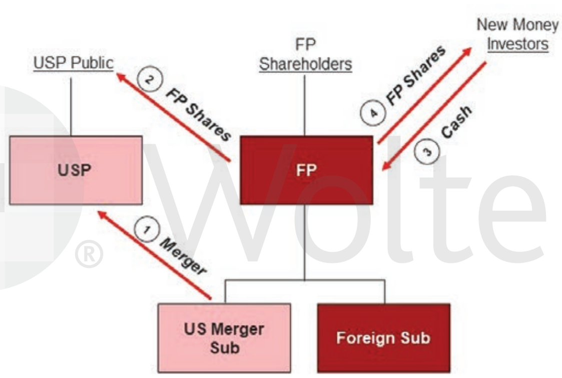

Merger vs. Double Dummy
Legacy FP Public
Legacy USP Public
"By Reason Of" Stock & Disqualified Stock
"By Reason Of" Stock
F NewCo
USP
FP US Sub
FP Foreign Sub
Legacy FP Assets
Cash? Debt? Obligations?
Issues:
• US Sub and USP US Sub treated as a single domestic entity (see Reg. §1.7874-2(e)).
• Certain F NewCo shares held by Legacy FP Public may be disqualified stock (see Reg. §1.7874-4(b)).
• If Legacy FP Public is less than 50% of F NewCo, the foreign-parented group exception is not available to exclude Legacy FP Public shares from the numerator (see Reg. §1.7874-6(c)(2)).
• If Legacy FP Public is at least 50% of F NewCo, the foreign-parented group exception should be available to exclude Legacy FP Public shares from the numerator (see Reg. §1.7874-6(c)(2)).
• Any impact on the denominator? (see Reg. §1.7874-6(c)(2)), Reg. §1.7874-1(c)(3)).
• Disqualified Stock does not have any impact on determination of qualification as an EAG member (see Reg. §1.7874-1(d)(1)).

APPENDIX 10.



APPENDIX 11.

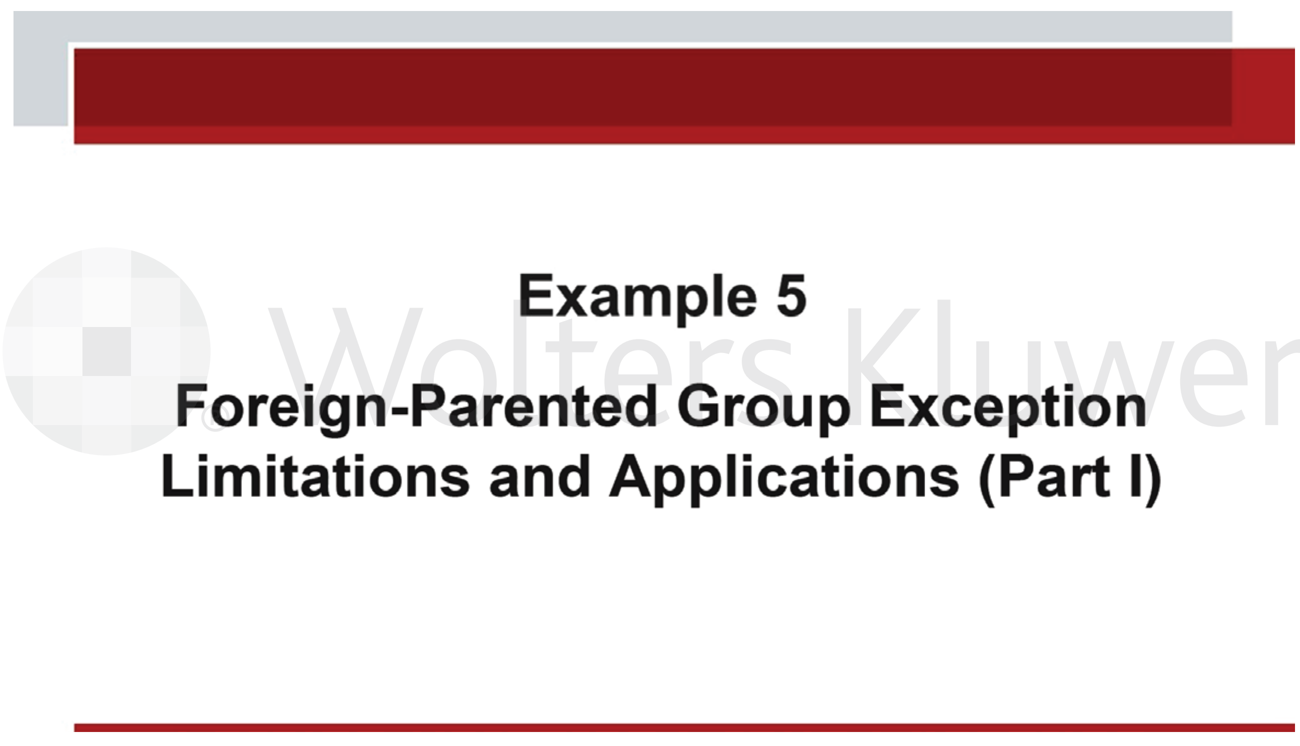
Cash-Box Dichotomy with Disqualified Stock



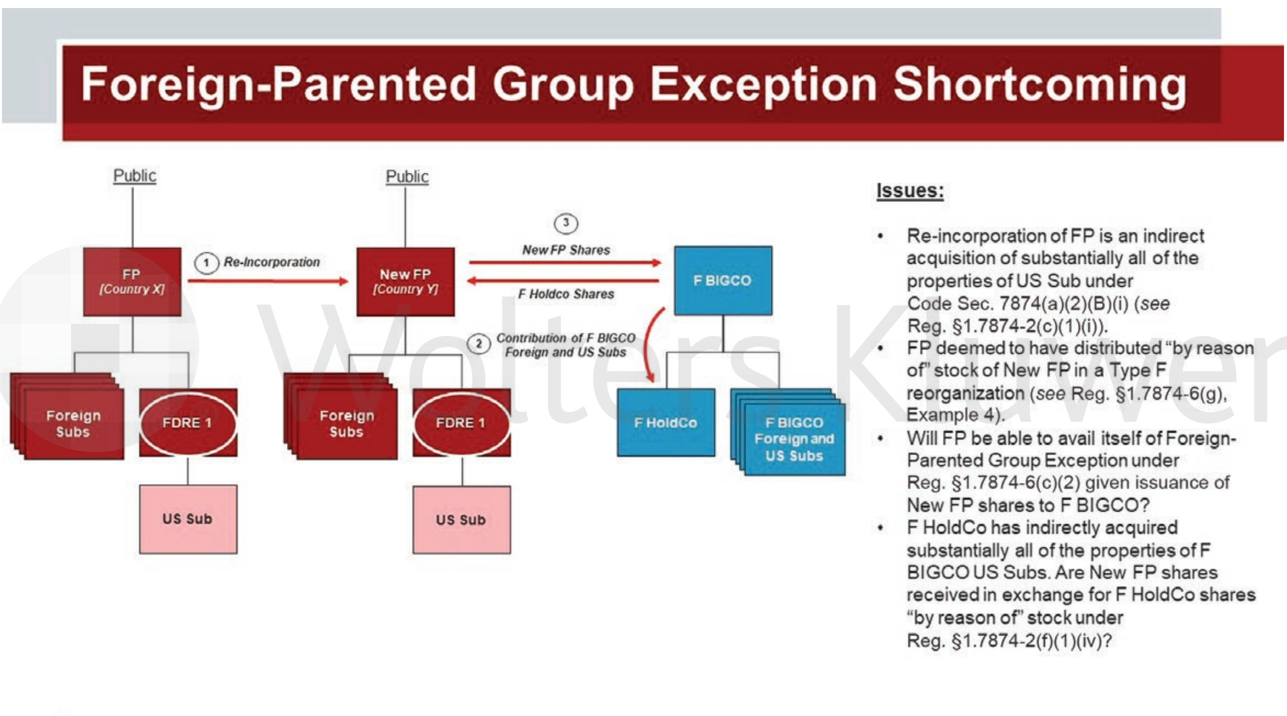
Issues:

- Cash contributed from New Money Investors is nonqualified property, and thus FP Shares issued to New Money Investors are disqualified stock (*see* Reg. §1.7874-4(b)).
- Cash contributed from New Money Investors might be treated as foreign group non-qualified property under Reg. §1.7874-7(e)(1)), even if contributed significantly later in time, but related to, the USP merger transaction.
- Although disqualified stock is not "double counted" for purposes of excluding shares from the denominator under Reg. §1.7874-7(b)(1), cash from the New Money Investors might be taken into account for purposes of determining if the 50% threshold is met under Reg. §1.7874-7(b).

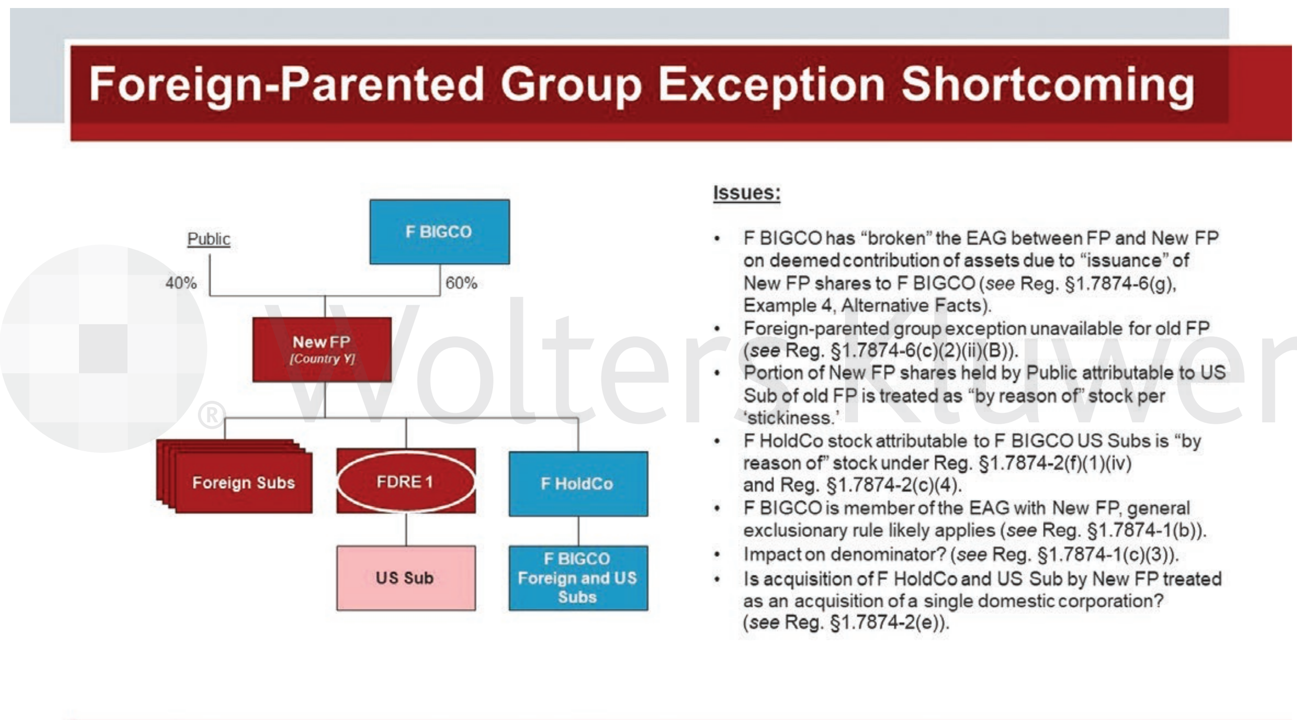
APPENDIX 12.


Example 5
Foreign-Parented Group Exception
Limitations and Applications (Part I)

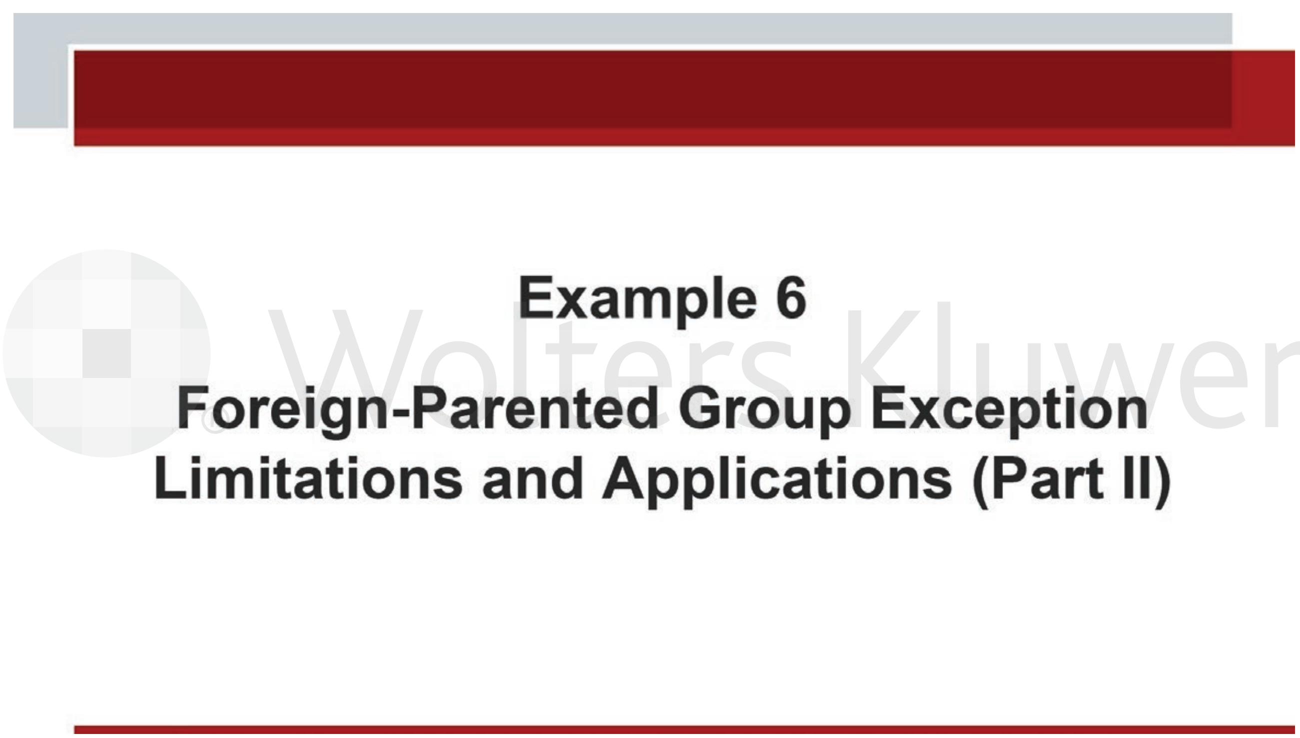
APPENDIX 13.


Foreign-Parented Group Exception Shortcoming
Public
Public
FP
[Country X]
1 Re-Incorporation
New FP
[Country Y]
3
New FP Shares
F Holdco Shares
F BIGCO
2 Contribution of F BIGCO Foreign and US Subs
Foreign Subs
FDRE 1
Foreign Subs
FDRE 1
F HoldCo
F BIGCO Foreign and US Subs
US Sub
US Sub
Issues:
• Re-incorporation of FP is an indirect acquisition of substantially all of the properties of US Sub under Code Sec. 7874(a)(2)(B)(i) (see Reg. §1.7874-2(c)(1)(i)).
• FP deemed to have distributed "by reason of" stock of New FP in a Type F reorganization (see Reg. §1.7874-6(g), Example 4).
• Will FP be able to avail itself of Foreign-Parented Group Exception under Reg. §1.7874-6(c)(2) given issuance of New FP shares to F BIGCO?
• F HoldCo has indirectly acquired substantially all of the properties of F BIGCO US Subs. Are New FP shares received in exchange for F HoldCo shares "by reason of" stock under Reg. §1.7874-2(f)(1)(iv)?

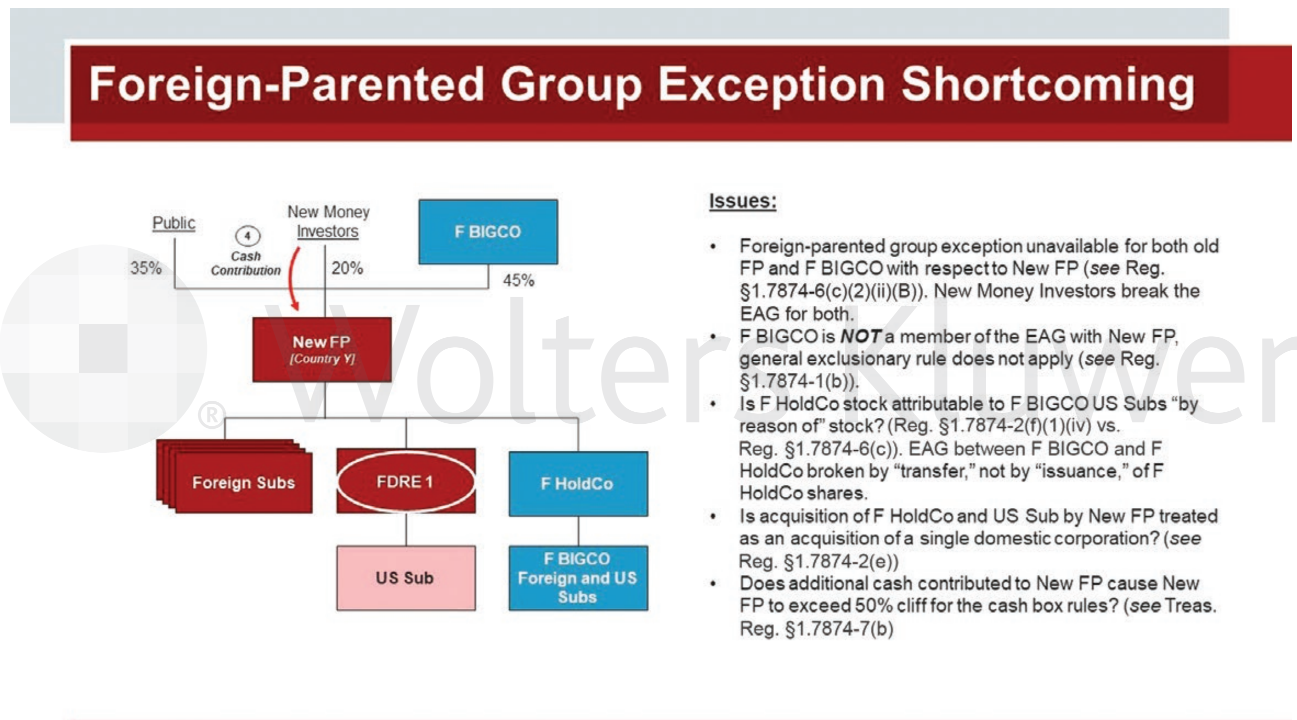
APPENDIX 14.


Foreign-Parented Group Exception Shortcoming
Public
F BIGCO
40%
60%
New FP
[Country Y]
Foreign Subs
FDRE 1
F HoldCo
US Sub
F BIGCO Foreign and US Subs
Issues:
• F BIGCO has "broken" the EAG between FP and New FP on deemed contribution of assets due to "issuance" of New FP shares to F BIGCO (see Reg. §1.7874-6(g), Example 4, Alternative Facts).
• Foreign-parented group exception unavailable for old FP (see Reg. §1.7874-6(c)(2)(ii)(B)).
• Portion of New FP shares held by Public attributable to US Sub of old FP is treated as "by reason of" stock per 'stickiness.'
• F HoldCo stock attributable to F BIGCO US Subs is "by reason of" stock under Reg. §1.7874-2(f)(1)(iv) and Reg. §1.7874-2(c)(4).
• F BIGCO is member of the EAG with New FP, general exclusionary rule likely applies (see Reg. §1.7874-1(b)).
• Impact on denominator? (see Reg. §1.7874-1(c)(3)).
• Is acquisition of F HoldCo and US Sub by New FP treated as an acquisition of a single domestic corporation? (see Reg. §1.7874-2(e)).

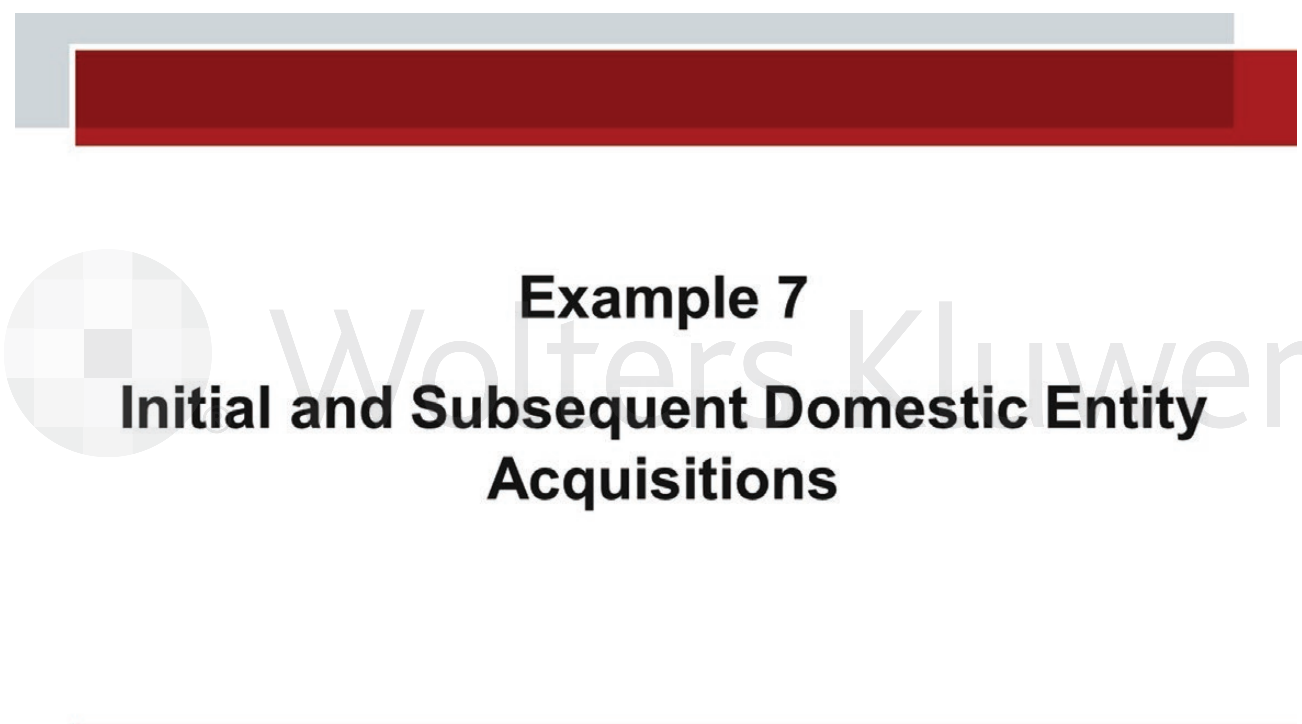
APPENDIX 15.


Example 6
Foreign-Parented Group Exception
Limitations and Applications (Part II)
Wolters Kluwer

APPENDIX 16.

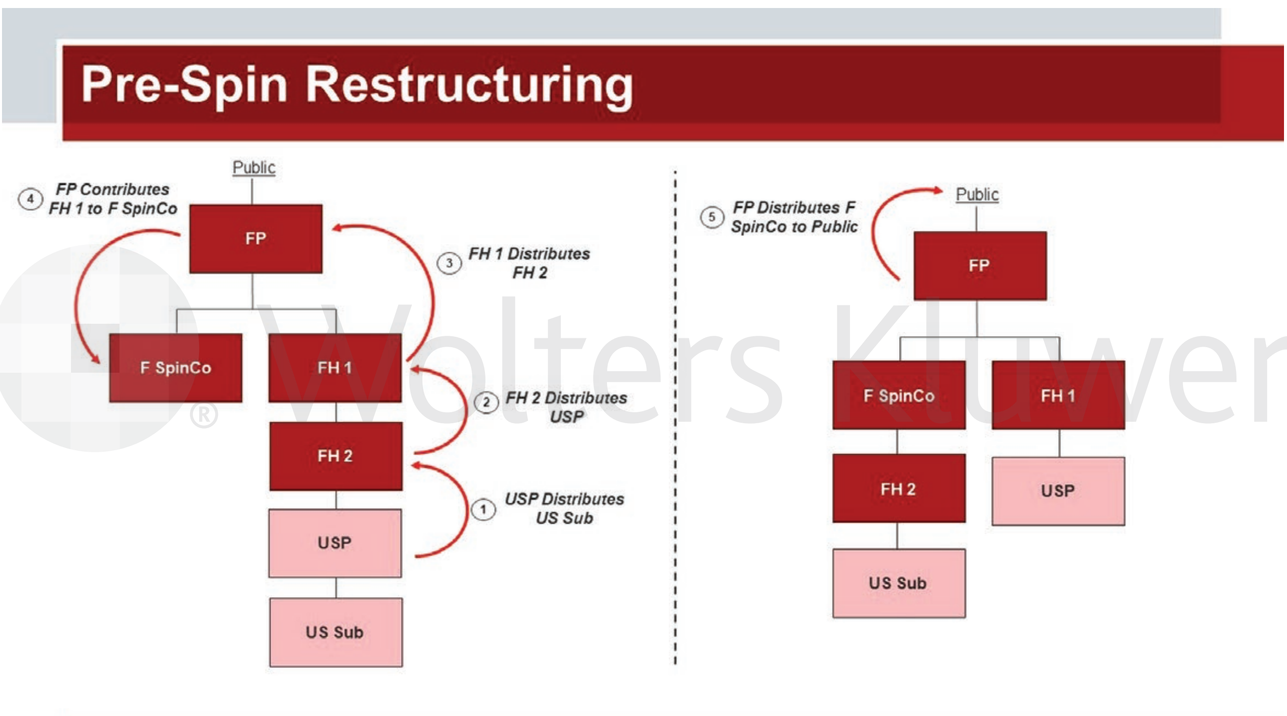

Foreign-Parented Group Exception Shortcoming
Public
35%
4
Cash Contribution
New Money Investors
20%
F BIGCO
45%
New FP [Country Y]
Foreign Subs
FDRE 1
F HoldCo
US Sub
F BIGCO Foreign and US Subs
Issues:
• Foreign-parented group exception unavailable for both old FP and F BIGCO with respect to New FP (see Reg. §1.7874-6(c)(2)(ii)(B)). New Money Investors break the EAG for both.
• F BIGCO is NOT a member of the EAG with New FP, general exclusionary rule does not apply (see Reg. §1.7874-1(b)).
• Is F HoldCo stock attributable to F BIGCO US Subs "by reason of" stock? (Reg. §1.7874-2(f)(1)(iv) vs. Reg. §1.7874-6(c)). EAG between F BIGCO and F HoldCo broken by "transfer," not by "issuance," of F HoldCo shares.
• Is acquisition of F HoldCo and US Sub by New FP treated as an acquisition of a single domestic corporation? (see Reg. §1.7874-2(e))
• Does additional cash contributed to New FP cause New FP to exceed 50% cliff for the cash box rules? (see Treas. Reg. §1.7874-7(b)

APPENDIX 17.

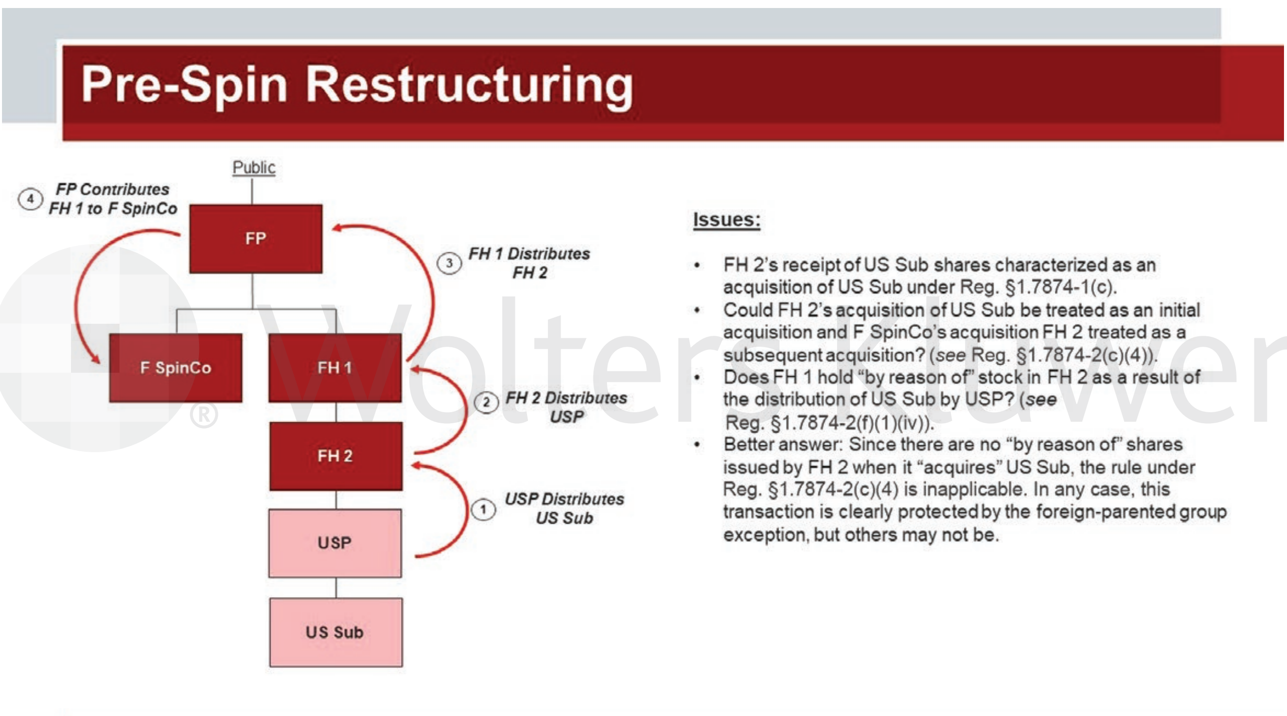


Example 7
Initial and Subsequent Domestic Entity Acquisitions
Wolters Kluwer

APPENDIX 18.


Pre-Spin Restructuring
Public
4 FP Contributes FH 1 to F SpinCo
FP
3 FH 1 Distributes FH 2
F SpinCo
FH 1
2 FH 2 Distributes USP
FH 2
1 USP Distributes US Sub
USP
US Sub
5 FP Distributes F SpinCo to Public
Public
FP
F SpinCo
FH 1
FH 2
USP
US Sub

APPENDIX 19.


Pre-Spin Restructuring
Public
4 FP Contributes FH 1 to F SpinCo
FP
3 FH 1 Distributes FH 2
F SpinCo
FH 1
2 FH 2 Distributes USP
FH 2
1 USP Distributes US Sub
USP
US Sub
Issues:
• FH 2's receipt of US Sub shares characterized as an acquisition of US Sub under Reg. §1.7874-1(c).
• Could FH 2's acquisition of US Sub be treated as an initial acquisition and F SpinCo's acquisition FH 2 treated as a subsequent acquisition? (see Reg. §1.7874-2(c)(4)).
• Does FH 1 hold "by reason of" stock in FH 2 as a result of the distribution of US Sub by USP? (see Reg. §1.7874-2(f)(1)(iv)).
• Better answer: Since there are no "by reason of" shares issued by FH 2 when it "acquires" US Sub, the rule under Reg. §1.7874-2(c)(4) is inapplicable. In any case, this transaction is clearly protected by the foreign-parented group exception, but others may not be.

ENDNOTES

* This paper was first delivered and presented to members of the Washington International Tax Study Group in February 2021.

1 Unless noted otherwise, "Section" or "§" references are to the Internal Revenue Code of 1986, as amended, and the Treasury Regulations promulgated thereunder.

2 *See* II.B.1, *infra*.

3 *See* III.C.3, *infra*.

4 In this regard, it is also worth noting that Congress has recently considered legislation that would further expand the scope of Code Sec. 7874. On December 11, 2021, the Senate Finance Committee released a proposed update to the "Build Back Better Act" (H.R. 5376) bill approved by the House on November 19, 2021. If enacted, the bill would decrease the minimum Ownership Percentage (as defined and discussed below) to 50%, decrease the Ownership Percentage for domestic corporation status to 65% and significantly expand the scope of what constitutes an acquisition of "substantially all" of the properties held directly or indirectly by a domestic corporation, a domestic partnership, or, in some cases, a foreign partnership, even in some cases properties that do not constitute a U.S. trade or business. The status of this proposed legislation is uncertain and the potential impact is beyond the scope of this paper, although the authors of this paper believe the proposal would likely further amplify the importance of the issues raised herein. These proposals were not included in the Treasury Greenbook published on March 28, 2022.

5 Code Sec. 7874 can also apply to the direct or indirect acquisition of substantially all of the properties constituting a trade or business of a domestic partnership. *See* Code Sec. 7874(a)(2)(B)(i). This paper focuses on the acquisition of substantially all of the properties of a domestic corporation.

6 The acquisition of stock of a domestic corporation is considered an indirect acquisition of the properties of such corporation. Reg. §1.7874-2(c)(1)(i), (ii).

7 Code Sec. 7874(a)(2)(B)(ii).

8 For a discussion of the EAG, *see* Section IV, *infra*.

9 Code Sec. 7874(a)(2)(B). The substantial business activities test is a rigorous one, and hardly ever met. *See* Reg. §1.7874-3. Given the focus of this paper, it is not discussed further and the reader should assume that the substantial business activities test is not met in the examples presented.

10 Reg. §1.7874-12(a)(5).

11 Reg. §1.7874-2(g).

12 Code Sec. 7874(a)(2)(B).

13 Code Sec. 7874(a)(2)(A). Relatedness for this purpose is determined within the meaning of Code Sec. 267(b) or Code Sec. 707(b)(1) and broadly includes domestic entities that are or were related to the acquired domestic corporation at the time of or following the Domestic Entity Acquisition. Reg. §1.7874-12(a)(8).

14 Code Secs. 7874(a), (d)(1).

15 Code Sec. 7874(d)(2). Relatedness for this purpose is determined within the meaning of Code Sec. 267(b) or 707(b)(1), and also includes entities under the same common control within the meaning of Code Sec. 482.

16 Code Secs. 7874(a), (e)(1).

17 Code Sec. 7874(e)(1).

18 Reg. §1.956-2(a)(4).

19 *See*, *e.g.*, Code Secs. 245A, 951A, 59A.

20 *See also* Notice 2014-52, IRB 2014-42, 712.

21 Reg. §1.367(b)-4(e).

22 Reg. §1.7701(l)-4.

23 *See* Tax Policy Center's Briefing Book: What are inversions and how will TCJA affect them?, May 2020, *www.taxpolicycenter.org/briefing-book/what-are-inversions-and-how-will-tcja-affect-them*.

24 Code Sec. 1(h)(11)(C)(iii).

25 *See* Code Sec. 59A(d)(1).

26 Code Sec. 59A(d)(4).

27 Code Sec. 965(c)(1).

28 Code Sec. 965(l).

29 Code Sec. 7874(b).

30 Reg. §1.7874-9(b).

31 Reg. §1.7874-9(d)(4)(ii) and (iii).

32 Reg. §1.7874-9(d)(1)-(4). The determination of the percentage of Foreign Acquiring Corporation stock held by reason of owning stock in the foreign acquired corporation is determined pursuant to the operating rules of Reg. §1.7874-9(e)(3).

33 Reg. §1.7874-9(c).

34 Reg. §1.7874-2(k)(2), Example 9.

35 Reg. §1.7874-2(e).

36 Reg. §1.7874-2(h)(1).

37 *Id*.

38 Reg. §1.7874-2(h)(5). The convertible partnership interest rule is designed to target certain "Up-C" structures intended to avoid the application of Code Secs. 7874 and 367(a) where underlying partnership interests are exchangeable into foreign corporate parent shares. A similar rule under Reg. §1.7874-2(i)(1) states that interests that provide a holder substantially similar rights to distributions as stock of a foreign corporation, including a partnership interest, are treated as stock of a foreign corporation. *See also* Reg. §1.7874-2(k), Example 18.

39 Reg. §1.7874-2(c)(4).

40 Reg. §1.7874-2(f)(1)(iv).

41 Code Sec. 7874(c)(3).

42 Reg. §1.7874-2(e).

43 Code Sec. 368(a)(3).

44 Reg. §1.7874-2(i)(2)(i).

45 Reg. §1.7874-12(a)(17).

46 Reg. §1.7874-2(f)(1)(i).

47 Reg. §1.7874-10(d) (disregards the application of the NOCD rules if (i) the Ownership Percentage is less than 5% without regard to the Disqualified Stock or cash-box rules and (ii) each 5% shareholder of the domestic entity owns less than 5% of any EAG member of the Foreign Acquiring Corporation).

48 Reg. §1.7874-10(b).

49 Reg. §1.7874-10(k)(2)–(5).

50 Reg. §1.7874-10(k)(6)–(7).

51 "Distributions" for purposes of the NOCD rules do not apply to distributions of a corporation with respect to its stock governed under Code Secs. 305, 304(a)(1), and 361(c)(1) (other than a distribution to which Code Sec. 355 applies). Reg. §1.7874-10(k)(1).

52 Reg. §1.7874-10(g).

53 Reg. §1.7874-10(f).

54 Reg. §1.7874-1(d)(2).

55 Reg. §1.7874-2(e).

56 Code Sec. 7874(c)(6)(B).

57 Reg. §1.7874-4(b).

58 Reg. §1.7874-4(d) (disregards the application of the Disqualified Stock rules if (i) the Ownership Percentage is less than 5% without regard to the NOCD or cash-box rules and (ii) each 5% shareholder of the domestic entity owns less than 5% of any EAG member of the Foreign Acquiring Corporation).

59 Reg. §1.7874-4(b). Note that the regulations also supplant the statute by stating that Disqualified Stock is the only type of stock described in Code Sec. 7874(c)(2)(B). *Id*.

60 Reg. §1.7874-4(c)(1).

61 For these purposes, a transfer is an issuance, sale, distribution, exchange, or any other disposition of Foreign Acquiring Corporation stock. Reg. §1.7874-4(h)(4).

62 Reg. §1.7874-4(c)(1)(i).

63 Reg. §1.7874-4(h)(1), (2).

64 Reg. §1.7874-4(c)(1)(ii)(A).

65 Reg. §1.7874-1(d)(1).

66 The stock of the Foreign Acquiring Corporation that is excluded is equal to the product of the value of the stock of the Foreign Acquiring Corporation (excluding certain categories of stock, including By Reason of Stock, Disqualified Stock, Transferred Stock (as described below), stock excluded under Reg. §1.7874-8, and stock excluded under Reg. §1.7874-9) and the "foreign group nonqualified property fraction." Reg. §1.7874-7(b).

67 The completion date means the date that the Domestic Entity Acquisition and all transactions related to the Domestic Entity Acquisition are complete. Reg. §1.7874-12(a)(3).

68 Reg. §1.7874-7(b).

69 Reg. §1.7874-7(e)(2), (4).

70 Reg. §1.7874-7(e)(1)(i). Foreign group nonqualified property also includes any foreign group property that, in a transaction related to the domestic entity acquisition, is acquired in exchange for other property, including cash,

if such other property would otherwise be foreign group nonqualified property had the transaction not occurred. Reg. §1.7874-7(e)(1)(ii).

[71] Reg. §1.7874-1(d)(1).

[72] Reg. §1.7874-8(b).

[73] Reg. §1.7874-2(e).

[74] Reg. §1.7874-8(a).

[75] Reg. §1.7874-8(b).

[76] Reg. §1.7874-8(c).

[77] Reg. §1.7874-8(d)(1).

[78] Reg. §1.7874-8(d)(2).

[79] Reg. §1.7874-8(e).

[80] Reg. §1.7874-8(g)(4)(i).

[81] Reg. §1.7874-8(g)(4)(ii)(A).

[82] Reg. §1.7874-8(g)(4)(ii)(B).

[83] Code Secs. 7874(c)(1), 1504(a).

[84] Code Sec. 7874(c)(2)(A), Reg. §1.7874-1(b).

[85] Reg. §1.7874-1(c)(1).

[86] Reg. §1.7874-1(c)(2).

[87] Reg. §1.7874-1(c)(3).

[88] Reg. §1.7874-1(h), Example 7.

[89] Reg. §1.7874-5(a).

[90] Reg. §1.7874-5(b).

[91] Reg. §1.7874-6(b).

[92] *Id*.

[93] Reg. §1.7874-6(f)(2)(i).

[94] Reg. §1.7874-6(f)(3).

[95] Reg. §1.7874-12(a)(13).

[96] Reg. §1.7874-6(c).

[97] As noted above, for Code Sec. 7874 to apply there must be a direct or indirect acquisition of substantially all of the properties of a domestic corporation. Code Sec. 7873(a)(2)(B)(i). The below does not address whether such an acquisition has occurred in the context of any spin-off transaction in describing the application of the U.S.-parented group exception or foreign-parented group exception.

[98] Reg. §1.7874-6(f)(4).

[99] Reg. §1.7874-6(c)(1)(i).

[100] Reg. §1.7874-6(c)(1)(ii).

[101] Reg. §1.7874-6(e).

[102] Reg. §1.7874-6(f)(1).

[103] Reg. §1.7874-6(c)(2)(i).

[104] Reg. §1.7874-6(c)(2)(ii).

[105] *See* Reg. §1.7874-6(g), Example 4, Alternative Facts.