



KPMG report: Initial analysis of final regulations addressing "inversions"

July 12, 2018



The Treasury Department and IRS on July 11, 2018, released [final regulations](#)¹ [PDF 377 KB] addressing “inversions”—the generic term for a domestic corporation’s adoption of a foreign-parented corporate structure—and certain post-inversion restructuring transactions (the “Final Regulations”).

The Final Regulations primarily adopt temporary regulations issued on April 4, 2016 (the “Temporary Regulations”), with several changes and clarifications. The Temporary Regulations were scheduled to expire on April 4, 2019.

This report provides initial analysis, impressions, and observations about the Final Regulations.

¹ The Final Regulations were published in the Federal Register on July 12, 2018.

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Background

Section 7874 applies to the direct or indirect acquisition by a foreign corporation (“Foreign Acquiring”) of substantially all of either (i) the properties directly or indirectly held by a domestic corporation or (ii) the properties of a trade or business of a domestic partnership (such corporation or partnership, the “Domestic Entity” and such acquisition, the “Domestic Entity Acquisition”), in each case, if:

- Immediately after the Domestic Entity Acquisition, the former Domestic Entity shareholders or partners, as applicable, have a certain percentage of continued ownership (by vote or value) in Foreign Acquiring by reason of owning their interests in the Domestic Entity (if expressed as a fraction, the “Ownership Fraction,” and if expressed as a percentage, the “Ownership Percentage”); and
- Foreign Acquiring’s expanded affiliated group (“EAG”) does not have substantial business activities in Foreign Acquiring’s country of creation or organization as compared to the EAG’s worldwide business activities (the “SBA Exception”); an EAG is generally defined as a section 1504(a) affiliated group determined (i) without regard to section 1504(b)(3)’s prohibition on the inclusion of foreign corporations in the group, and (ii) by reducing the applicable ownership requirement from at least 80%, as measured by vote and value, to more than 50%, as measured by vote and value.

If the Ownership Percentage is at least 80%, section 7874 considers Foreign Acquiring a “surrogate foreign corporation” that is treated as a domestic corporation for all purposes of the Internal Revenue Code—i.e., section 7874 essentially prevents an inversion from occurring for U.S. federal income tax purposes.

If, however, the Ownership Percentage is at least 60% but less than 80%, section 7874 considers Foreign Acquiring a surrogate foreign corporation that is respected as a foreign corporation for U.S. federal income tax purposes, but the Domestic Entity and certain related U.S. persons are considered “Expatriated Entities” and, as a result, are limited in using losses and other U.S. federal income tax attributes with respect to income or gain recognized on certain property transfers and licenses during the inversion and the following 10 years (such income or gain, the “Inversion Gain” and such period, the “Applicable Period”).

On April 4, 2016, the Treasury Department and IRS released the Temporary Regulations, which, together with proposed regulations under section 385, marked the Treasury Department’s and the IRS’s most comprehensive anti-inversion measures.

The Temporary Regulations primarily addressed anti-inversion measures initially described in Notice 2014-52 and Notice 2015-79 (the “Notices”) by providing detailed rules regarding the application of the matters described therein. The Temporary Regulations also included rules that were not described in the Notices, including:

- Identifying a Foreign Acquiring when a Domestic Entity Acquisition is effected through multiple steps

- Disregarding Foreign Acquiring stock attributable to certain prior Domestic Entity Acquisitions
- Requiring a controlled foreign corporation (“CFC”) to recognize gain upon the transfer of assets to certain foreign affiliates
- Clarifying the application of certain aspects of the SBA Exception

On January 13, 2017, the Treasury Department and IRS released final and temporary regulations which (i) finalized Treas. Reg. § 1.7874-4T (as modified by the Temporary Regulations) relating to the treatment of “Disqualified Stock” (the “Disqualified Stock Rules”), and (ii) modified the scope of several de minimis exceptions in the Temporary Regulations.

Regulations Addressing Certain Transactions Structured to Avoid the Purposes of Section 7874

Multiple-Step Acquisition of Domestic Entity Property

Temporary Regulations

The acquisition of stock of a foreign corporation that directly or indirectly owns stock of a domestic corporation or domestic partnership generally does not constitute an indirect acquisition of any properties held by the Domestic Entity. The Temporary Regulations, however, included an exception to this rule that generally provided that when (i) a foreign corporation (the “Initial Acquiring Corporation”) directly or indirectly acquired substantially all of the properties held directly or indirectly by the Domestic Entity (the “Initial Acquisition”), and (ii) pursuant to the same plan or series or related transactions as the Initial Acquisition, a foreign corporation (the “Subsequent Acquiring Corporation”) directly or indirectly acquired substantially all of the properties held directly or indirectly by the Initial Acquiring Corporation (the “Subsequent Acquisition”), then the Subsequent Acquisition is treated as a Domestic Entity Acquisition and the Subsequent Acquiring Corporation was treated as Foreign Acquiring.

For purposes of determining if section 7874 applied to the Subsequent Acquisition, stock of the Subsequent Acquiring Corporation received by shareholders of the Initial Acquiring Corporation in the Subsequent Acquisition by reason of holding stock in the Initial Acquiring Corporation was treated as held by reason of holding stock or partnership interests in the Domestic Entity, but only to the extent such Initial Acquiring Corporation stock was held by reason of holding stock or partnership interests in the Domestic Entity.

If there was more than one Subsequent Acquisition (i.e., another foreign corporation directly or indirectly acquired, pursuant to the same plan or series of related transactions as the Subsequent Acquisition, substantially all the properties held directly or indirectly

by the Subsequent Acquiring Corporation), the Temporary Regulations applied to each of the acquisitions.

The Temporary Regulations did not affect the potential application of section 7874 to the Initial Acquisition (i.e., in determining whether section 7874 applied to the Initial Acquisition, the Subsequent Acquisition and all related transactions after the Subsequent Acquisition were not taken into account). Furthermore, if the Subsequent Acquiring Corporation was a surrogate foreign corporation that was respected as a foreign corporation for federal income tax purposes, the Applicable Period began on the first date that properties were acquired as part of the Initial Acquisition. Determinations relating to whether or not a Subsequent Acquisition occurred were made by reference to the rules applicable to determining whether a Domestic Entity Acquisition has occurred.

Final Regulations

The Final Regulations adopt the rules as described in the Temporary Regulations without substantial modification.

Calculation of the Ownership Percentage

Coordination of Provisions with EAG Rules

Treas. Reg. § 1.7874-1 (the “EAG Rules”) provides rules relating to the treatment of Foreign Acquiring stock for purposes of the Ownership Percentage when such stock is held by a member of Foreign Acquiring’s EAG. In general, Foreign Acquiring stock that is held by an EAG member is excluded from the numerator and denominator of the Ownership Fraction. However, there are certain exceptions by which the Foreign Acquiring stock is excluded from the numerator, but not the denominator, of the Ownership Fraction. For purposes of the general rule and the exceptions, the percentage ownership of Foreign Acquiring is a critical measurement.

The Temporary Regulations (and other regulations under section 7874) provided detailed rules which (i) disregarded Foreign Acquiring stock for purposes of the Ownership Percentage, or (ii) deemed the former Domestic Entity shareholders or partners to hold additional Foreign Acquiring stock (by value). Some of these rules contained a coordination rule with the EAG Rules. For example, in Treas. Reg. § 1.7874-4(h) and Treas. Reg. § 1.7874-7T(e), Foreign Acquiring stock that is disregarded under Treas. Reg. § 1.7874-4 and Treas. Reg. § 1.7874-7T, respectively, was taken into account for purposes of applying the EAG Rules.

The Final Regulations create a single set of coordination rules that address the relationship between the EAG Rules and all other rules that impact the Ownership Percentage. More specifically, Treas. Reg. § 1.7874-1(d)(1) provides that Foreign Acquiring stock that is disregarded from the Ownership Percentage under any of the other provisions of the Final Regulations or under section 7874(c)(4) (which disregards a transfer of properties or liabilities if such transfer is part of a plan a principal purpose of

which is to avoid the purposes of section 7874) is taken into account for purposes of applying the EAG Rules. Moreover, Treas. Reg. § 1.7874-1(d)(2) provides that Foreign Acquiring stock that is treated as held by the former Domestic Entity shareholders or partners by operation of the NOCD Rules (defined below) is not taken into account for purposes of applying the EAG Rules.

KPMG observation

Prior to the Final Regulations, only Treas. Reg. § 1.7874-4 and Treas. Reg. § 1.7874-7T contained coordination rules with the EAG Rules. However, there were several other provisions that disregarded Foreign Acquiring stock (or deemed Foreign Acquiring stock to exist) for purposes of the Ownership Percentage. The absence of specific coordination rules for each of these provisions potentially created a presumption that, for purposes of applying the EAG Rules, (i) Foreign Acquiring stock disregarded under these rules should not be taken into account, and (ii) Foreign Acquiring stock deemed to exist under these rules should be taken into account. The Final Regulations provide a uniform set of coordination rules which base the applicability of the EAG Rules on all of the Foreign Acquiring stock that actually exists. In this sense, the Final Regulations bring significant clarity.

De Minimis Exceptions

Temporary Regulations

As discussed in greater detail below, there were several provisions in the Temporary Regulations that modify the calculation of the Ownership Percentage. Several of these provisions were subject to de minimis exceptions, each of which imposed the same requirements for applicability. The provisions were (i) the Cash-Box Rules, (ii) the NOCD Rules, and (iii) the Disqualified Stock Rules (which, as noted above, were separately finalized and are thus beyond the scope of this article).

The de minimis exceptions applied if (i) the Ownership Percentage, determined without regard to the Cash-Box Rules, NOCD Rules, or Disqualified Stock Rules, was less than 5%, and (ii) after the Domestic Entity Acquisition and all related transactions, each former shareholder or partner of the Domestic Entity owns (or is treated as owning under section 318, as modified by section 304(c)) less than 5% (by vote and value) of the stock or partnership interests in each member of the EAG.

As originally issued, requirement (ii) of the de minimis exceptions above was determined by reference to the former shareholders or partners of the Domestic Entity in the aggregate. However, in light of the significant difficulties in identifying all former shareholders or partners of the Domestic Entity, the Treasury Department and IRS modified requirement (ii) to reference each former shareholder or partner of the Domestic Entity.

Final Regulations

The Final Regulations further modify requirement (ii) of the de minimis exceptions in light of perceived difficulties in identifying former shareholders or partners of the Domestic Entity.

Under the Final Regulations, the de minimis exception applies if (i) the Ownership Percentage, determined without regard to the Cash-Box Rules, NOCD Rules, or Disqualified Stock Rules, was less than 5%, and (ii) after the Domestic Entity Acquisition and all related transactions, each former 5% shareholder or 5% partner of the Domestic Entity owns (or is treated as owning under section 318, as modified by section 304(c)) less than 5% (by vote and value) of the stock or partnership interests in each member of the EAG. For this purpose, a former shareholder or partner of a Domestic Entity is a former 5% shareholder or former 5% partner, as relevant, if, before the Domestic Entity Acquisition, such shareholder or partner owned (or is treated as owning under section 318, as modified by section 304(c)) at least 5% (by vote and value) of the stock or partnership interests of the Domestic Entity.

KPMG observation

The Final Regulations represent further liberalization of the de minimis exception. Prior to the Final Regulations, reliance on the de minimis exceptions was, except in extreme cases, difficult due to the inability to properly identify each former shareholder or partner of the Domestic Entity. The Final Regulations reduce the number of relevant former shareholders or partners, and provide greater certainty in relying on the de minimis exceptions without impairing their purposes.

Disregarding Foreign Acquiring Stock Attributable to Excessive Passive Assets

Temporary Regulations

Prior to the Notices and the Temporary Regulations, certain inversions were effected through a domestic corporation's combination with a foreign corporation, the primary assets of which were cash or other liquid assets. The basic effect of these so-called "cash-box inversions" was that the domestic corporation inverted with minimal disruption to its business activities and the shareholder of the foreign cash-box received a premium for serving as an inversion vehicle.

The Temporary Regulations limited the ability of domestic corporations to invert through a combination with a foreign cash-box by disregarding the Foreign Acquiring stock for purposes of the Ownership Fraction to the extent it was attributable to "Foreign Group Nonqualified Property" (defined below). More specifically, Treas. Reg. § 1.7874-7T (the "Cash-Box Rules") provided a general rule that if on the date the Domestic Entity Acquisition and all related transactions are completed, more than 50% of the gross value of all "Foreign Group Property" is Foreign Group Nonqualified Property, then the Foreign Acquiring stock was excluded from the Ownership Fraction denominator in an amount

equal to (i) the value of the Foreign Acquiring stock (not including the Foreign Acquiring stock received by reason of the Domestic Entity stock or partnership interests (as applicable), stock excluded under section 7874(c)(2)(A) and the EAG Rules, and Disqualified Stock) (the “Multiplicand”), multiplied by (ii) the “Foreign Group Nonqualified Property Fraction” (generally the ratio of the Foreign Group Nonqualified Property to the Foreign Group Property, in each case, not taking into account property that gives rise to Disqualified Stock). Foreign Group Property is generally defined as any property held by the “Modified Expanded Affiliated Group” other than property directly or indirectly acquired in the Domestic Entity Acquisition and, to avoid double-counting, stock or an interest in or an obligation of a Modified Expanded Affiliated Group member.

The Modified Expanded Affiliated Group with respect to a Domestic Entity Acquisition was the EAG if Foreign Acquiring was the common parent of the EAG, or if Foreign Acquiring was not the common parent of the EAG, the EAG determined as if Foreign Acquiring was the common parent—i.e., upstream affiliates were not part of a lower-tier Foreign Acquiring’s Modified Expanded Affiliated Group. In addition, Foreign Group Nonqualified Property was, subject to certain exceptions, Foreign Group Property described as nonqualified property for purposes of Treas. Reg. § 1.7874-4 (e.g., cash, marketable securities). One of these exceptions was property that gave rise to income described in section 1297(b)(2)(A) or section 1297(b)(2)(B) (i.e., income derived in the active conduct of a banking business or an insurance business).

Final Regulations

The Final Regulations generally adopt the Cash-Box Rules as described in the Temporary Regulations, with several modifications and clarifications.

First, the Final Regulations provide that the Foreign Acquiring stock that is disregarded under these rules is disregarded for purposes of determining the Ownership Percentage by value, but not by vote. Based on the preamble to the Final Regulations (the “Preamble”), the Treasury Department and IRS determined that excluding this stock for purposes of determining the Ownership Percentage by vote would present significant administrative difficulties. More specifically, because an “amount” of Foreign Acquiring stock, rather than specific shares, is excluded under these rules, special rules would be needed in the case of a Foreign Acquiring with multiple classes of stock possessing disparate voting power.

Second, the Final Regulations reduce the types of Foreign Acquiring stock that are included in the Multiplicand. More specifically, Foreign Acquiring stock that is disregarded under any of the other provisions of the Final Regulations or under section 7874(c)(4) is excluded from the Multiplicand.

Third, in response to a comment, the Final Regulations clarify that section 7874(c)(4) can apply in determining the applicability of the Cash-Box Rules. For example, a transfer of property or liabilities can be disregarded if the transfer is part of a plan to cause Foreign Acquiring’s Foreign Group Nonqualified Property to be 50% or less of the gross value of Foreign Acquiring’s Foreign Group Property.

Fourth, in response to a comment, the Final Regulations clarify the exception to the definition of Foreign Group Nonqualified Property for property that gives rise to income described in section 1297(b)(2)(A) or section 1297(b)(2)(B). More specifically, the determination of whether the property gives rise to income described in section 1297(b)(2)(A) or section 1297(b)(2)(B) is made without regard to other rules governing passive foreign investment companies (such as section 1298(b)(2) and section 1298(b)(3)).

KPMG observation

The Final Regulations, like the Temporary Regulations, exclude from the denominator of the Ownership Fraction an amount of Foreign Acquiring stock attributable to Foreign Group Nonqualified Property. However, unlike the Temporary Regulations, the Final Regulations make clear that the exclusion is for purposes of determining the Ownership Percentage by value, but not by vote. This modification is consistent with how the Treasury Department and IRS addressed similar issues in the NOCD Rules and the Serial Inversion Rules (discussed below).

Reducing the scope of the Multiplicand to exclude Foreign Acquiring stock that is disregarded under any of the other provisions of the Final Regulations or under section 7874(c)(4) effectively prevents an over-exclusion of Foreign Acquiring stock.

[Disregarding Foreign Acquiring Stock in Serial Inversions](#)

Temporary Regulations

Under the anti-inversion rules that existed prior to the Temporary Regulations, if Foreign Acquiring completed two or more Domestic Entity Acquisitions pursuant to a plan or series of related transactions, then, for purposes of the Ownership Percentage, the Domestic Entity Acquisitions are treated as a single Domestic Entity Acquisition and the Domestic Entities are treated as a single Domestic Entity.

Notwithstanding that the anti-inversion rules already addressed multiple Domestic Entity Acquisitions, the Temporary Regulations added an additional rule applicable to a Foreign Acquiring who had previously completed a Domestic Entity Acquisition within 36 months of the Domestic Entity Acquisition (the “Serial Inversion Rules”). More specifically, the Temporary Regulations disregarded certain Foreign Acquiring stock received in the Domestic Entity Acquisition (the “Relevant Domestic Entity Acquisition”) for purposes of computing the Ownership Percentage where Foreign Acquiring (including a predecessor) had completed one or more prior Domestic Entity Acquisitions (each, a “Prior Domestic Entity Acquisition”), regardless of whether such acquisitions were pursuant to the same plan.

The Temporary Regulations defined a Prior Domestic Entity Acquisition as a Domestic Entity Acquisition that occurs within the 36-month period ending on the first date on which

the contract to effect the Relevant Domestic Entity Acquisition was a “binding contract” (i.e., when the contract became enforceable under the applicable law against the parties), subject to certain exceptions.

Where there has been a Prior Domestic Entity Acquisition, the Foreign Acquiring stock was excluded (the “Excluded Amount”) from the denominator of the Ownership Fraction for purposes of determining the Ownership Percentage by value, but not vote, in the Relevant Domestic Entity Acquisition based on the current value of the Foreign Acquiring shares that were issued in the Prior Domestic Entity Acquisition (adjusted to take into account intervening stock redemptions, stock splits, stock distributions, recapitalizations, and similar transactions). The Excluded Amount was calculated separately for each Prior Domestic Entity Acquisition and each legal class of shares in Foreign Acquiring held by former shareholders or partners of the Domestic Entity in such Prior Domestic Entity Acquisition by reason of their ownership of such Domestic Entity (the “Prior Acquisition Shares”). The Excluded Amount for each legal class of shares was generally the product of the total number of Prior Acquisition Shares (adjusted to account for certain redemptions and other capital structure changes mentioned above) and the fair market value of a single share of the relevant legal class of shares on the date the Relevant Domestic Entity Acquisition and all related transactions are completed.

Final Regulations

The Final Regulations generally adopt the Serial Inversion Rules as described in the Temporary Regulations, with several modifications and clarifications.

First, in response to a comment, the Final Regulations clarify that the definition of Prior Acquisition Shares does not include Foreign Acquiring stock that is deemed held in the Prior Domestic Entity Acquisition by operation of the NOCD Rules or section 7874(c)(4). Second, in response to a comment, the Final Regulations include an additional exception to the definition of Prior Domestic Entity Acquisition. Specifically, a Domestic Entity Acquisition is not a Prior Domestic Entity Acquisition if (i) the Prior Domestic Entity Acquisition qualifies for the “internal group restructuring” exception in the EAG Rules, and (ii) the Domestic Entity Acquisition occurs within a foreign-parented group (i.e., an EAG in which a foreign corporation is the common parent). In the Preamble, the Treasury Department and IRS explained that these types of Domestic Entity Acquisitions do not raise the policy concerns that motivated the Serial Inversion Rules.

Third, in response to a comment, the Final Regulations define a predecessor by reference to the definition provided in the NOCD Rules (discussed below).

KPMG observation

The Serial Inversion Rules are the subject of ongoing litigation. In *Chamber of Commerce of the United States v. Internal Revenue Service*, 2017 WL 4682049 (W.D. Tex. 2017), the court invalidated the Serial Inversion Rules on the basis that the Treasury Department and IRS had not provided the requisite notice and comment. However, the court

concluded that the Serial Inversion Rules were substantively valid. The litigation is currently pending before the Fifth Circuit Court of Appeals.

Disregarding Foreign Acquiring Stock in Third-Country Transactions

Temporary Regulations

Following the enactment of section 7874, many inversions were accomplished through the combination of a Domestic Entity and a foreign corporation (the “Foreign Target”). For example, Foreign Acquiring would not only acquire the stock or property of a Domestic Entity, but would also acquire the stock or property of a Foreign Target. In general, the Foreign Acquiring stock held by former shareholders or partners of the Foreign Target was included in the denominator of the Ownership Fraction, thus reducing the Ownership Percentage.

Prior to the Notices and the Temporary Regulations, the tax residences of Foreign Acquiring and the Foreign Target were not relevant considerations. However, the Temporary Regulations provided that if a Domestic Entity Acquisition was a “Third Country Transaction,” the Foreign Acquiring stock held by reason of holding “Acquired Foreign Corporation” stock that would otherwise be included in the denominator of the Ownership Fraction was excluded from the denominator of the Ownership Fraction—i.e., the Ownership Percentage is increased (the “Third Country Rules”). A Domestic Entity Acquisition was a Third Country Transaction if (i) Foreign Acquiring completed a “Covered Foreign Acquisition” (as defined below) pursuant to a plan or series of related transactions that included the Domestic Entity Acquisition, (ii) after the Covered Foreign Acquisition and all related transactions, Foreign Acquiring was not subject to tax as a resident in the foreign country in which the Acquired Foreign Corporation was subject to tax as a resident before the Covered Foreign Acquisition and all related transactions, and (iii) the Ownership Percentage was at least 60% (determined without regard to the Third Country Rules). Note that a change in the country of tax residence (e.g., through a change of place of management) is treated as a transaction; thus, any such change in anticipation of a Covered Foreign Acquisition is a related transaction and the tax residency of the Acquired Foreign Corporation prior to such tax residency change is the relevant jurisdiction for this test.

An Acquired Foreign Corporation is a foreign corporation that is acquired in a transaction in which Foreign Acquiring directly or indirectly acquires substantially all of the properties held directly or indirectly by an Acquired Foreign Corporation (“Foreign Acquisition”). A Covered Foreign Acquisition means a Foreign Acquisition in which, following the Foreign Acquisition and all related transactions (but not the Domestic Entity Acquisition), the former shareholders of the Acquired Foreign Corporation own at least 60% (by vote or value) of Foreign Acquiring.

Determinations relating to whether a Foreign Acquisition has occurred and whether Foreign Acquiring stock is held by reason of holding stock in an Acquired Foreign Corporation are made by reference to the rules applicable to making such determinations

in the context of a Domestic Entity Acquisition. Similarly, with certain exceptions, the rules for determining the Ownership Percentage apply in determining the percentage ownership of Foreign Acquiring held by the former shareholders of the Acquired Foreign Corporation.

Final Regulations

The Final Regulations generally adopt the Third Country Rules as described in the Temporary Regulations, with several modifications and clarifications.

First, the Final Regulations replace “subject to tax as a resident” with “a tax resident,” which is defined by cross-reference as a “body corporate liable to tax under the laws of the country as a resident.” As explained in the Preamble, this definition removes ambiguity relating to jurisdictions that do not impose an income tax and to the treatment of entities that are fiscally transparent under local law.

Second, in response to a comment, the Final Regulations provide two exceptions to the Third Country Rules. The first exception provides that a Foreign Acquisition is not a Covered Foreign Acquisition if the Acquired Foreign Corporation (determined before the Foreign Acquisition and all related transactions) and Foreign Acquiring (determined after the Foreign Acquisition and all related transactions) are created or organized under the laws of countries that do not impose an income tax, provided that neither the Acquired Foreign Corporation nor Foreign Acquiring are a tax resident of another country. In the Preamble, the Treasury Department and IRS state that such circumstances indicate that tax planning was not a motivating factor in the change of jurisdiction.

The second exception is based on the SBA Exception and provides that a Foreign Acquisition is not a Covered Foreign Acquisition if (i) Foreign Acquiring is a tax resident of a foreign country, and (ii) Foreign Acquiring’s EAG has substantial business activities in the country in which Foreign Acquiring is a tax resident. For these purposes, the principles of Treas. Reg. § 1.7874-3 (which provide rules for the SBA Exception) apply, and the determination is made without regard to the Domestic Entity Acquisition. Based on the Preamble, the Treasury Department and IRS believe that such circumstances indicate that tax planning was not a significant motivating factor in the change of jurisdiction.

Third, in response to a comment, the Final Regulations provide that if Foreign Acquiring changes its tax residence in a manner that otherwise wouldn’t result in a Foreign Acquisition (e.g., changing the location of Foreign Acquiring’s management and control), Foreign Acquiring is treated as (i) both Foreign Acquiring and the Acquired Foreign Corporation, and (ii) directly or indirectly acquiring all of the properties held directly or indirectly by the Acquired Foreign Corporation in exchange for Foreign Acquiring stock.

KPMG observation

The two new exceptions in the Final Regulations are consistent with the policy underlying

the Third Country Rules. Comments had requested an additional exception that, if adopted, would have been based on a comparison of treaty benefits. However, the Treasury Department and IRS declined to add such an exception, stating that such an exception would not properly account for local country tax advantages other than withholding tax rates.

The new rule in the Final Regulations addressing Foreign Acquiring's change in tax residency effectively imposes the Third Country Rules on Domestic Entity Acquisitions in which there is no Foreign Acquisition. For example, assume FA, a foreign corporation, is a tax resident of Country X. In connection with a Domestic Entity Acquisition, FA relocates its management to Country Y and, under the laws of Country Y, becomes a tax resident of Country Y. Prior to the Final Regulations, FA's Domestic Entity Acquisition arguably was not a Third Country Transaction, as FA did not complete a Foreign Acquisition. Under the Final Regulations, assuming the new exceptions do not apply, FA's Domestic Entity Acquisition is a Third Country Transaction. More specifically, FA is treated as (i) both Foreign Acquiring and the Acquired Foreign Corporation, and (ii) acquiring all of the properties held directly or indirectly by FA (as the Country X Acquired Foreign Corporation) in exchange for stock of FA (as the Country Y Foreign Acquiring).

NOCD Rules

Temporary Regulations

Under section 7874(c)(4), as noted above, a transfer of properties or liabilities (including by contribution or distribution) is disregarded if such transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874. In addition to and pursuant to section 7874(c)(4), the Temporary Regulations provided rules relating to "non-ordinary course distributions" (or "NOCDs") made by a Domestic Entity (the "NOCD Rules").

The Temporary Regulations provided that for purposes of determining the Ownership Percentage (by value, but not by vote), the former shareholders or partners of the Domestic Entity were treated as receiving, by reason of holding stock or partnership interests in the Domestic Entity, Foreign Acquiring stock (in addition to Foreign Acquiring stock actually received by the former shareholders or partners of the Domestic Entity) with a fair market value equal to the amount of NOCDs during the "Look-Back Period."

The Look-Back Period was generally the 36-month period ending on the date the Domestic Entity Acquisition and all related transactions were completed (but can be shorter if the Domestic Entity was not in existence for the full 36-month period preceding the Domestic Entity Acquisition). Similarly, a "Look-Back Year" generally was one of the 12-month periods that comprise the Look-Back Period (e.g., if the Look-Back Period is 36 months, the three consecutive 12-month periods preceding the Domestic Entity Acquisition were Look-Back Years).

With respect to a Look-Back Year, NOCDs meant the excess of all distributions made during the Look-Back Year over the "NOCD Threshold" for the Look-Back Year. The

NOCD Threshold for a Look-Back Year was generally equal to 110% of the sum of all distributions made during the “Distribution History Period” with respect to the Look-Back Year, multiplied by a fraction, the numerator of which was the number of days in the Look-Back Year and the denominator of which was the number of days in the Distribution History Period with respect to the Look-Back Year.

For these purposes, a Distribution History Period meant, with respect to each Look-Back Year, the 36-month period preceding the start of the Look-Back Year (but can be shorter if Domestic Target was not formed prior to the 36-month period preceding the Domestic Entity Acquisition). Moreover, where the Domestic Entity was formed less than 12 months before the Look-Back Year, there was no Distribution History Period for that Look-Back Year and, thus, the NOCD Threshold for that Look-Back Year was zero.

Also for these purposes, a “distribution” was defined as (i) any distribution by a corporation with respect to its stock (with specific exceptions), (ii) any distribution by a partnership, (iii) a transfer of money or other property to former shareholders or partners of the Domestic Entity that was made in connection with the Domestic Entity Acquisition to the extent the money or other property was provided directly or indirectly by the Domestic Entity, or (iv) in the case of a “Predecessor,” a transfer of money or other property that was made in connection with the “Predecessor Acquisition” to the extent the money or other property is directly or indirectly provided by the Predecessor. The Temporary Regulations excepted from the definition of distribution a stock distribution to which section 305 applied (including a deemed distribution), a distribution to which section 304(a)(1) applied, and certain distributions pursuant to section 361(c)(1) (i.e., pursuant to an asset reorganization) not otherwise described as a distribution above; these distributions were excluded because they did not reduce the Domestic Entity’s value.

The Temporary Regulations also applied to distributions made by a Predecessor. A corporation or partnership (a “Tentative Predecessor”) was a Predecessor if (i) a corporation or partnership (the “Relevant Entity”) directly or indirectly acquired directly or indirectly substantially all of the properties held directly or indirectly by the Tentative Predecessor (a “Predecessor Acquisition”), and (ii) after the Predecessor Acquisition and all related transactions, the former shareholders or partners of the Tentative Predecessor held, by reason of holding stock or partnership interests in the Tentative Predecessor, at least 10% (by value) of the stock or partnership interests of the Relevant Entity. Determinations relating to whether or not a Predecessor Acquisition had occurred and whether or not the former shareholders or partners of the Tentative Predecessor owned the relevant 10% (by value) of the stock or partnership interests of the Relevant Entity were made by reference to the rules applicable to making such determinations with respect to a Domestic Entity Acquisition. If, however, the Predecessor directly or indirectly held the stock or partnership interests in another entity before the Predecessor Acquisition and all related transactions, the Relevant Entity was not treated as making a Predecessor Acquisition with respect to such lower-tier entities.

The Temporary Regulations also had a special rule relating to the directionality of a distribution under section 355. Specifically, if (i) a corporation (the “Distributing

Corporation”) distributed the stock of another corporation (the “Controlled Corporation”) in a distribution qualifying under section 355, and (ii) immediately before the distribution, the fair market value of the Controlled Corporation stock represented more than 50% of the fair market value of the Distributing Corporation stock, then the Controlled Corporation was treated as distributing the stock of the Distributing Corporation.

The Temporary Regulations also made clear that even if a distribution (or a portion thereof) did not fall within the definition of a NOCD, section 7874(c)(4) could still apply to the distribution (or portion thereof).

Treas. Reg. § 1.367(a)-3(c) provides an exception to the general rule that gain must be recognized by a U.S. person on the outbound transfer of stock of a domestic corporation to a foreign corporation in a non-recognition transaction. Among other requirements that must be met to qualify for the exception, the fair market value of the transferee foreign corporation must be at least equal to the fair market value of the domestic corporation at the time of the outbound transfer. Rules similar to the NOCD Rules also applied in determining the fair market value of the domestic corporation for purposes of the exception in Treas. Reg. § 1.367(a)-3(c)

Final Regulations

The Final Regulations generally adopt the NOCD Rules as described in the Temporary Regulations, with several modifications and clarifications.

First, the Final Regulations modify and clarify the definition of distribution. As noted above, the Temporary Regulations generally excluded from the definition of distribution a distribution pursuant to an asset reorganization. The Final Regulations clarify the scope of this exception by expressly excluding section 355 distributions and making clear that the exception is available only to “acquisitive” asset reorganizations. Also as noted above, the Temporary Regulations generally included in the definition of distribution a distribution by a partnership. The Final Regulations exclude from the definition of distribution a deemed distribution by a partnership pursuant to section 752(b) (which deems a distribution to the extent of any decrease in a partner’s share of partnership liabilities), provided that the transaction giving rise to the distribution does not reduce the partnership’s value.

Second, the Final Regulations modify the applicability of the special rule relating to the directionality of a distribution under section 355. Specifically, the Final Regulations provide that for purposes of determining whether the fair market value of the Controlled Corporation stock represented more than 50% of the fair market value of the Distributing Corporation stock, the fair market value of the Controlled Corporation stock includes any Controlled Corporation stock owned by a related person.

Third, the Final Regulations provide detailed rules for allocating the Foreign Acquiring stock deemed held by reason of the NOCD Rules among the former shareholders or partners of the Domestic Entity. The deemed stock is treated as held by a former

shareholder or partner of the Domestic Entity in accordance with the amount of NOCDs such shareholder or partner is treated as receiving. For this purpose, the Final Regulations provide that a pro rata portion of each distribution made to a shareholder or partner during a Look-Back Year is treated as a NOCD. This determination is made by multiplying the amount of distributions made to such shareholder or partner during the Look-Back Year by a fraction, the numerator of which is the total amount of NOCDs made during the Look-Back Year, and the denominator of which is the total amount of distributions made during the Look-Back Year.

Fourth, in the case of a Domestic Entity Acquisition in which there are multiple Foreign Acquirings, the Final Regulations provide rules for determining which corporation's stock is deemed held by the former shareholders or partners of the Domestic Entity. Specifically, the stock deemed held by the former shareholders or partners of the Domestic Entity is comprised, on a pro rata basis, of stock of each Foreign Acquiring that directly or indirectly provided the consideration in the Domestic Entity Acquisition.

Fifth, as noted above, if Foreign Acquiring completes two or more Domestic Entity Acquisitions pursuant to a plan or series of related transactions, then the Domestic Entity Acquisitions are treated as a single Domestic Entity Acquisition and the Domestic Entities are treated as a single Domestic Entity. The Final Regulations provide rules addressing the application of the NOCD Rules in such a situation. Under the Final Regulations, the NOCD Rules are applied to each Domestic Entity on a separate basis. Thereafter, the NOCDs of each Domestic Entity are aggregated.

KPMG observation

The modifications to the definition of distribution resolve significant ambiguity, particularly with respect to the treatment of deemed distributions under section 752(b). For example, the entry of a new partner to a partnership can result in a shifting of partnership liabilities, which would generally give rise to a deemed distribution under section 752(b) to the pre-existing partners. The new exception clarifies that such a deemed distribution will not be treated as a distribution for purposes of the NOCD Rules. It remains somewhat unclear, however, how to determine the partnership's value. For example, a partnership's repayment of principal on partnership debt generally results in a deemed distribution under section 752(b). If the partnership's value is intended to mean gross value of the partnership's assets, then repayment of principal by the partnership on its debt appears to fall outside the scope of this new exception. If, however, the partnership's value is intended to mean net value (which seems to be the more likely interpretation), then such a repayment would appear to be covered by the exception.

The allocation of the deemed Foreign Acquiring stock among the former shareholders or partners of the Domestic Entity appears to only be relevant for purposes of determining to what extent, if any, the deemed Foreign Acquiring stock can be disregarded under the EAG Rules (i.e., one of the former shareholders or partners of the Domestic Entity is in Foreign Acquiring's EAG after the Domestic Entity Acquisition). Otherwise, the deemed Foreign Acquiring stock will be included in the Ownership Fraction.

The new rules relating to the application of the NOCD Rules in cases where there are multiple Foreign Acquirings or multiple Domestic Entities, like the modifications to the definition of distribution, resolve significant ambiguity. For example, assume FA, a foreign corporation, acquires all of the stock of DT1, a domestic corporation, in exchange for FA stock. Pursuant to the same plan as the acquisition of DT1, FA also acquires all of the stock of DT2, a domestic corporation, in exchange for cash. Prior to the Final Regulations, it was unclear whether the de minimis exception to the NOCD Rules could apply to the acquisition of DT2. Because DT1 and DT2 are treated as a single Domestic Entity, it would appear that the requirement in the de minimis exception that the Ownership Percentage be less than 5% could be violated, even though none of the DT2 shareholders own any FA stock (or any stock or partnership interests of a member of FA's EAG) after the acquisition of DT2. However, because the Final Regulations require the NOCD Rules to be applied separately to each Domestic Entity, it is now clearer that the acquisition of DT2 is eligible for the de minimis exception.

Application of the EAG Rules to Subsequent Transfers of Foreign Acquiring Stock

Temporary Regulations

Treas. Reg. § 1.7874-5 provides that Foreign Acquiring stock retains its “by reason of” status if the stock is subsequently transferred, even if the subsequent transfer is related to the Domestic Entity Acquisition. Under this rule, the subsequently transferred Foreign Acquiring stock is included in the Ownership Fraction, unless the EAG Rules apply to disregard the Foreign Acquiring stock from either the numerator and denominator or, in certain circumstances, just the numerator of the Ownership Fraction.

The Temporary Regulations provided that Foreign Acquiring stock that was held by a member of Foreign Acquiring's EAG would, subject to two exceptions, lose its status as held by a member of the EAG when subsequently transferred. The two exceptions provided in the Temporary Regulations were the “U.S.-Parented Group Exception” and the “Foreign-Parented Group Exception.”

Under the U.S.-Parented Group Exception, subsequently transferred Foreign Acquiring stock continues to be treated as held by an EAG member for purposes of the EAG Rules if:

- Before the Domestic Entity Acquisition, the corporation transferring such Foreign Acquiring stock is a member of a “U.S.-Parented Group” (i.e., an EAG with a domestic common parent corporation), and
- After the Domestic Entity Acquisition, each of the transferring corporation (or its successor), any person that holds the transferred Foreign Acquiring stock, and Foreign Acquiring are members of a U.S.-Parented Group, the common parent of which is either:
 - A member of the U.S.-Parented Group referenced in clause (i) before the Domestic

Entity Acquisition (i.e., a pre-existing member of the Domestic Entity's U.S.-Parented Group), or

- A corporation formed in a transaction related to the Domestic Entity Acquisition, if immediately after the formation, such corporation was a member of the U.S.-Parented Group referenced in clause (i) (i.e., a domestic corporation formed in connection with Domestic Entity Acquisition).

Under the Foreign-Parented Group Exception, subsequently transferred Foreign Acquiring stock continues to be treated as held by an EAG member for purposes of the EAG Rules if:

- Before the Domestic Entity Acquisition, the corporation transferring such Foreign Acquiring stock and the Domestic Entity are members of the same “Foreign-Parented Group” (i.e., an EAG with a foreign common parent corporation), and
- After the Domestic Entity Acquisition, the transferring corporation:
 - Is a member of Foreign Acquiring's EAG, or
 - Would be a member of Foreign Acquiring's 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 the Foreign Acquiring stock by one or more members of the Foreign-Parented Group referenced in clause (i).

Final Regulations

The Final Regulations adopt the rules as described in the Temporary Regulations without substantial modification.

SBA Exception

Temporary Regulations

The SBA Exception, as described above, can turn off the application of section 7874 regardless of the Ownership Percentage. Satisfying the SBA Exception generally requires that at least 25% of employees, assets, and income of Foreign Acquiring and its EAG are located or derived in, as applicable, Foreign Acquiring's jurisdiction of incorporation during a relevant testing period. In general, the regulations relating to the SBA Exception were issued separately from the Temporary Regulations. Nonetheless, the Temporary Regulations contained some additional modifications to the SBA Exception.

The Temporary Regulations, among other things, imposed an additional requirement to satisfy the SBA Exception. Specifically, to satisfy the SBA Exception, Foreign Acquiring had to be subject to tax as a resident of its country of creation or organization.

Final Regulations

The Final Regulations adopt the rules as described in the Temporary Regulations with the following modification.

Similar to the Third Country Rules, the Final Regulations replace “subject to tax as a resident” with “a tax resident,” which is defined as a “body corporate liable to tax under the laws of the country as a resident.” As explained in the Preamble, this definition removes ambiguity relating to jurisdictions that do not impose an income tax and to the treatment of entities that are fiscally transparent under local law.

Regulations Addressing Certain Post-Inversion Tax Avoidance Transactions

Changes to Nomenclature to Conform with Repeal of Section 958(b)(4)

The Final Regulations make changes to the definitions and nomenclature of the Temporary Regulations to conform with intervening changes introduced by P.L. 115-97 (the “Tax Reform Act”). These changes relate primarily to the repeal of section 958(b)(4). Section 958(b)(4) provided that stock of a foreign corporation owned by a foreign person would not be attributed to a U.S. person for purposes of determining whether the foreign corporation is a CFC. Following repeal of section 958(b)(4), a foreign corporation may be a CFC, even if it is not owned directly or indirectly by a U.S. person, by reason of “downward attribution.” Indeed, it would generally be the case that most foreign corporations in the EAG would be considered CFCs.

The most significant of these changes are to the definition of “Expatriated Foreign Subsidiary” and “Non-CFC Foreign Related Person.” The Temporary Regulations defined an Expatriated Foreign Subsidiary as a foreign corporation that was a CFC and in which an Expatriated Entity was a U.S. Shareholder (i.e., a U.S. person that directly, indirectly, or constructively owned 10% or more of the vote or value of a foreign corporation). The Temporary Regulations provided an exception to the rule (the “Pre-Existing CFC Exception”), such that a foreign corporation would not be an Expatriated Foreign Subsidiary if, on the completion date of the “Inversion Transaction” (defined as a Domestic Entity Acquisition in which Foreign Acquiring owns at least 60% but less than 80% of the Domestic Entity), the foreign corporation was both a CFC and a member of the EAG, and (ii) on or before the completion date, the domestic entity was not a U.S. Shareholder with respect to the foreign corporation. Additionally, the Temporary Regulations defined Non-CFC Foreign Related Person as a “Foreign Related Person” that is not an Expatriated Foreign Subsidiary. With respect to an Inversion Transaction, a Foreign Related Person was a foreign person that was either related to (under sections 267(b) or 707(b)(1)) or under the same common control as (under section 482) an Expatriated Entity with respect to such Inversion Transaction.

The Final Regulations change these definitions, such that an Expatriated Foreign Subsidiary means a foreign corporation that is a CFC and in which an Expatriated Entity

is a U.S. Shareholder, determined without regard to section 318(a)(3). The changed definition therefore prohibits downward attribution, and thus nullifies the effect of the repeal of section 958(b)(4). The Final Regulations make conforming changes to the term Non-CFC Foreign Related Person, which is referred to in the Final Regulations as “Non-EFS Foreign Related Person,” as well as to other definitions that reference these terms.

KPMG observation

The changes in the Final Regulations are necessary to conform the rules to changes introduced by the Tax Reform Act. These changes were necessary beyond simple nomenclature. Many of the rules relating to post-inversion tax avoidance transactions depended heavily on the status of a foreign corporation as a CFC. As a result, the repeal of section 958(b)(4) had the unintended consequence of rendering many of these provisions inapplicable in certain circumstances.

Consider the following example: DT, a domestic corporation, owns FT, a foreign corporation. FA, a foreign corporation unrelated to DT, owns FS1, a foreign corporation, and FS2, a foreign corporation. FS1 owns USS, a domestic corporation. USS owns FS3, a foreign corporation. FA acquires all of the DT stock in an Inversion Transaction. Assume also the Inversion Transaction occurs prior to the Tax Reform Act.

Prior to the Tax Reform Act, (i) FT would be treated as an Expatriated Foreign Subsidiary, (ii) FA, FS1, and FS2 would be Non-CFC Foreign Related Persons because they are not CFCs to which DT is a U.S. Shareholder, and (iii) FS3, despite being a CFC to which DT is potentially a U.S. Shareholder, would also be a Non-CFC Foreign Related Person because it would satisfy the exception to Expatriated Foreign Subsidiary described above. After the Tax Reform Act, however, FS1 and FS2 become Expatriated CFCs to which DT is a U.S. Shareholder (by virtue of downward attribution of ownership from FA to DT). As a result, FS1 and FS2 would be Expatriated Foreign Subsidiaries of DT unless the Pre-Existing CFC Exception applies. Because the completion date is prior to the Tax Reform Act (and thus prior to the repeal of section 958(b)(4)), they were not CFCs on the completion date. Thus, the Pre-Existing CFC Exception would not apply to FS1 and FS2. Accordingly, prior to the Final Regulations, FS1 and FS2 would not be treated as Non-CFC Foreign Related Persons.

Absent the changes to the definitions by the Final Regulations, many of the rules below would arguably not apply to transactions involving FS1 or FS2. For example, as will be described below, the section 956 regulations would not apply to a loan by FT to FS2 because it is not a loan from an Expatriated Foreign Subsidiary to a Non-CFC Foreign Related Person, but a loan from an Expatriated Foreign Subsidiary to another Expatriated Foreign Subsidiary. Similarly, the recharacterization provisions of the section 7701(l) regulations applied only if one of the parties to the transfer was a “Specified Related Person” (defined below), the definition of which excludes an Expatriated Foreign Subsidiary. Thus, a transfer of property by FS2 to FT in exchange for FT stock would not be subject to recharacterization because FS2 is not a Specified Related Person. Moreover, the Inversion Gain rules generally apply to income or gain from the transfer or

license of property either as part of the Domestic Entity Acquisition or afterward, provided that such subsequent transfer is to a Specified Related Person. Thus, a transfer of FT assets to FS1 would not give rise to Inversion Gain.

By making the above changes and preventing downward attribution, the Final Regulations avoid the unintended consequences of the Tax Reform Act's repeal of section 958(b)(4).

Application of Section 956 to Certain Post-Inversion Transactions

Temporary Regulations

The Temporary Regulations treated as U.S. property an obligation or stock of a foreign person if:

- The obligation or stock was held by an Expatriated Foreign Subsidiary regardless of whether the acquirer was a CFC or an Expanded Foreign Subsidiary when the obligation or stock was acquired;
- The foreign person was a Non-CFC Foreign Related Person regardless of whether the foreign person was a Non-CFC Foreign Related Person when the obligation or stock was acquired; and
- The obligation or stock was acquired during the Applicable Period or in a transaction related to the Inversion Transaction (i.e., an inversion with an Ownership Percentage of at least 60% but less than 80%).

The Temporary Regulations also extended the current section 956 provisions regarding pledges and guarantees to instances where an Expatriated Entity directly or indirectly served as a security for a Non-CFC Foreign Related Person's obligation. The Temporary Regulations provided exceptions for certain ordinary course obligations owed by a Non-CFC Foreign Related Person to an Expatriated Foreign Subsidiary. The Temporary Regulations, however, prohibited the application of the U.S. property exceptions for certain short-term obligations from applying to loans by an Expatriated Foreign Subsidiary to a Non-CFC Foreign Related Person—these provisions are discussed below in detail.

Final Regulations

The Final Regulations generally adopt the Temporary Regulations without substantial modification, other than the changes addressing definitions and nomenclature discussed above.

Anti-Dilution Provisions

Section 7701(l): Recharacterizing Specified Transactions

Temporary Regulations

Generally, section 7701(l) provides the Treasury Department regulatory authority to issue regulations recharacterizing a multiple-party financing transaction as directly between any two or more parties if it is determined the recharacterization is appropriate to prevent U.S. tax avoidance.

The Temporary Regulations provided rules that recharacterized a “Specified Transaction,” which is generally defined as a transaction during the Applicable Period in which stock of an Expatriated Foreign Subsidiary was issued or transferred to a person that, immediately before such issuance or transfer, was a Specified Related Person. A Specified Related Person was defined as (i) a Non-CFC Foreign Related Person, (ii) a domestic partnership in which a Non-CFC Foreign Related Person is a partner, and (iii) a domestic trust in which a Non-CFC Foreign Related Person is a beneficiary. In other words, the section 7701(l) regulations targeted transactions that diluted the ownership of the Domestic Entity’s CFCs such that they ceased to be CFCs. The Temporary Regulations provided two recharacterization regimes, depending on whether the Specified Transaction is an issuance or a transfer; these rules apply for all U.S. federal income tax purposes. In each case, the net effect of the recharacterization regimes was to “undo” the dilutive effect of the Specified Transaction. Because the Temporary Regulations were attempting to prevent dilution of the Domestic Entity’s CFCs, the Temporary Regulations provided a de minimis exception to these recharacterization rules. More specifically, a transaction was not a Specified Transaction if, after the transaction, the Expatriated Foreign Subsidiary (or the transferee corporation in an asset reorganization) is a CFC and there is only a de minimis shift of ownership to Non-CFC Foreign Related Persons.

Final Regulations

The Final Regulations generally adopt the Temporary Regulations without substantial changes, other than the changes addressing definitions and nomenclature discussed above.

Section 367(b): Income Recognition in a Specified Exchange

Temporary Regulations

Prior to the Temporary Regulations, section 367(b) served as a backstop to section 1248, requiring a U.S. Shareholder to recognize a deemed dividend inclusion equal to a foreign corporation’s “section 1248 amount” if an otherwise non-recognition transaction resulted in the loss of section 1248 shareholder status to the foreign corporation’s U.S. Shareholder.

The Temporary Regulations provided a detailed set of rules that sought to tax certain transactions to dilute ownership in a Domestic Entity's CFCs. Under the Temporary Regulations, if (i) a foreign corporation acquired (A) the stock of a another foreign corporation in an exchange to which section 351 applied, or (B) the stock or assets of another foreign corporation in a reorganization described in section 368(a)(1), and (ii) the exchange was a "Specified Exchange," then the exchanging shareholder (i.e., the shareholder of the foreign target corporation) included the section 1248 amount in income as a deemed dividend and recognized any unrealized appreciation in the stock of the Expatriated Foreign Subsidiary. Similarly, if an Expatriated Foreign Subsidiary transferred property during the Applicable Period to another foreign corporation in an exchange to which section 351 applied, then the Expatriated Foreign Subsidiary recognized any unrealized appreciation in the transferred property.

The Temporary Regulations defined a Specified Exchange as an exchange if (i) immediately before the exchange, the foreign target corporation is an Expatriated Foreign Subsidiary and the exchanging shareholder is either an Expatriated Entity or an Expatriated Foreign Subsidiary, (ii) the exchanging shareholder receives stock of a foreign corporation in exchange for its foreign target corporation stock, and (iii) the exchange occurs during the Applicable Period. Because the Temporary Regulations were attempting to prevent dilution of the Domestic Entity's CFCs, the Temporary Regulations provided a de minimis exception to these income inclusion rules. More specifically, an exchange was not a Specified Exchange if, after the exchange, the Expatriated Foreign Subsidiary (or the transferee corporation in an asset reorganization) is a CFC and there is only a de minimis shift of ownership to Non-CFC Foreign Related Persons.

Final Regulations

The Final Regulations generally adopt the Temporary Regulations without substantial modification, other than the changes addressing definitions and nomenclature discussed above.

Section 304

Temporary Regulations

Generally, section 304 recharacterizes certain related party stock sales as a deemed redemption of the acquiring corporation's stock. If the deemed redemption does not satisfy any of the tests in section 302(b), it will be characterized as a deemed dividend under section 302(d). Such deemed dividend is sourced first from the acquiring corporation's E&P, and then from the target corporation's E&P.

In the context of a so-called "parent-subsubsidiary" section 304 sale—i.e., a subsidiary's purchase of its parent corporation's stock from the parent corporation's shareholders—the deemed dividend attributable to the subsidiary's E&P is treated as though paid directly to the parent corporation's shareholder, bypassing intervening entities. This rule allowed

foreign-parented groups to access a CFC's E&P without residual U.S. tax, for example, by selling stock of the CFC's U.S. Shareholder to the CFC for cash. Section 304(b)(5)(B) limits this opportunity by prohibiting a deemed redemption of a foreign acquiring corporation's stock that results from a section 304 sale from being characterized as a dividend by reference to the foreign acquiring corporation's E&P unless more than 50% of the deemed distribution from the sale would otherwise be subject to U.S. federal income tax or includible in the E&P of a CFC.

The Temporary Regulations provided that the determination of whether more than 50% of the dividends arising under section 304 are subject to tax or includible in the E&P of a CFC will be made by taking into account only the E&P of the acquiring corporation (i.e., the CFC in the example above), and excluded the E&P of the issuing corporation (i.e., the domestic corporation in the example above). The Temporary Regulations also provided rules that disregarded the use of partnerships, options, or other arrangements for purposes of applying the section 304 rules.

Final Regulations

The Final Regulations generally adopt the Temporary Regulations without substantial changes, other than the changes addressing definitions and nomenclature discussed above.

Application of Inversion Gain Regime to Certain Indirect Dispositions

Temporary Regulations

Section 7874(a) provides that the taxable income of an Expatriated Entity for any taxable year during the Applicable Period shall not be less than the Inversion Gain of the Expatriated Entity for the taxable year. Section 7874(d)(2) defines Inversion Gain as the income or gain recognized by the Expatriated Entity by reason of a transfer or license of property during the Applicable Period by an Expatriated Entity, either (i) as part of the Domestic Entity Acquisition, or (ii) after the Domestic Entity Acquisition, provided that (A) the transfer or license is to a Foreign Related Person, and (B) the property is not inventory (as described in section 1221(a)(1)). The Inversion Gain rules effectively serve as a "toll charge," preventing the Expatriated Entity from using its tax attributes to reduce the Inversion Gain.

The Temporary Regulations generally define Inversion Gain as the income (including an amount treated as a dividend under section 78) or gain recognized by the Expatriated Entity by reason of a direct or indirect transfer or license of property during the Applicable Period by an Expatriated Entity, either (i) as part of the Domestic Entity Acquisition, or (ii) after the Domestic Entity Acquisition, provided that (A) the transfer or license is to a Specified Related Person, and (B) the property is not inventory (as described in section 1221(a)(1)). Unlike the statutory framework, the Temporary Regulations included income or gain recognized indirectly by the Expatriated Entity (e.g., subpart F income generated by an Expatriated Entity's CFC on a disposition of property to Foreign Acquiring). The

Temporary Regulations also provided rules for partnerships, such that a partner in a foreign partnership that is a Foreign Related Person is treated as transferring a proportionate share of the property transferred or licensed by such foreign partnership.

Final Regulations

The Final Regulations generally adopt the Temporary Regulations without substantial modification, other than the changes addressing definitions and nomenclature discussed above.

Miscellaneous Rules

New Definitions Section in the Final Regulations

The Final Regulations generally adopt the definitions provided in the Temporary Regulations without substantial modification, other than the changes addressing nomenclature discussed above.

Rules Under Section 956 Relating to the Definition of an Obligation

Temporary Regulations

Prior to the Temporary Regulations, the Treasury Department and the IRS had, through Notices, provided exceptions under section 956 to certain short-term loans from CFCs. More specifically, Notice 88-180 excluded from the definition of “obligation” under section 956 obligations that were collected within 30 days, provided that the CFC did not have loans to related U.S. persons that would constitute U.S. property outstanding during the year for 60 or more days (the “30/60 Day Exception”). In Notice 2008-91, as modified by Notices 2009-10 and 2010-12, the time period was expanded to cover obligations that were collected within 60 days, provided that the CFC did not have outstanding loans to related U.S. persons for 180 or more days (the “60/180 Day Exception”). The purpose of these exceptions was to allow U.S.-based multinationals to use quarter-end loans from their CFCs to reduce third-party debt without triggering income inclusions under section 956.

The Temporary Regulations generally adopted the rules of Notice 88-180 and Notice 2008-91, thus providing exceptions apply to obligations of U.S. persons. Thus, the Temporary Regulations had both the 30/60 Day Exception and the 60/180 Day Exception. However, these exceptions under the Temporary Regulations would not apply to an obligation of a Non-CFC Foreign Related Person that is treated as U.S. property.

Final Regulations

The Final Regulations adopt the 30/60 Day Exception, but do not adopt the rules relating to the 60/180 Day Exception.

Conclusion

The Final Regulations are largely consistent with the Temporary Regulations, with a few important clarifications and modifications. Overall, these modifications and clarifications generally appear to be taxpayer favorable, as they provide several additional exceptions and provide greater certainty in the operation and interaction of the various rules. The issuance of the Final Regulations, together with certain provisions of the Tax Reform Act dealing with inversions, indicate that the government still has a significant interest in deterring inversions.

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