
NAEPC
Journal
of Estate & Tax Planning
Click here to view the Third Quarter 2014 Issue

Notice 2014-52, Rules Regarding Inversions and Related Transactions

SECTION 1. OVERVIEW

The Department of the Treasury (Treasury Department) and the Internal Revenue Service (IRS) are concerned that certain recent inversion transactions are inconsistent with the purposes of sections 7874 and 367 of the Internal Revenue Code (Code). The Treasury Department and the IRS understand that certain inversion transactions are motivated in substantial part by the ability to engage in certain tax avoidance transactions after the inversion that would not be possible in the absence of the inversion. In light of these concerns, this notice announces that the Treasury Department and the IRS intend to issue regulations under sections 304(b)(5)(B), 367, 956(e), 7701 (l), and 7874 of the Code.

Section 2 of this notice describes regulations that the Treasury Department and the IRS intend to issue that will address transactions that are structured to avoid the purposes of sections 7874 and 367 by (i) for purposes of section 7874, disregarding certain stock of a foreign acquiring corporation that holds a significant amount of passive assets; (ii) for purposes of sections 7874 and 367, disregarding certain non-ordinary course distributions; and (iii) for purposes of section 7874, providing guidance on the treatment of certain transfers of stock of a foreign acquiring corporation (through a spin-off or otherwise) that occur after an acquisition.

Section 3 of this notice describes regulations that the Treasury Department and the IRS intend to issue that will address certain tax avoidance by (i) preventing the avoidance of section 956 through post-inversion acquisitions by controlled foreign corporations (CFCs) of obligations of (or equity investments in) the new foreign parent corporation or certain foreign affiliates; (ii) preventing the avoidance of U.S. tax on pre-inversion earnings and profits of CFCs through post-inversion transactions that otherwise would terminate the CFC status of foreign subsidiaries and/or substantially dilute the U.S. shareholders' interest in those earnings and profits; and (iii) limiting the ability to remove untaxed foreign earnings and profits of CFCs through related party stock sales subject to section 304.

Section 4 of this notice provides the effective dates of the regulations described in this notice. Section 5 of this notice requests comments and provides contact information for purposes of submitting comments.

SECTION 2. REGULATIONS TO ADDRESS INVERSION TRANSACTIONS

.01 Regulations under Section 7874 to Disregard Certain Stock Attributable to Passive Assets

(a) Section 7874 Background

A foreign corporation (foreign acquiring corporation) generally is treated as a surrogate foreign corporation under section 7874(a)(2)(B) if pursuant to a plan (or a series of related transactions) (i) the foreign acquiring corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (acquisition); (ii) after the acquisition, at least 60 percent 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 is referred to at times in this notice as "stock held by reason of"); and (iii) after the acquisition, the expanded affiliated group (EAG) that includes the foreign

acquiring corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized, when compared to the total business activities of the EAG. Similar provisions apply if a foreign acquiring corporation acquires substantially all of the properties constituting a trade or business of a domestic partnership. The domestic corporation or the domestic partnership described in this paragraph is referred to at times in this notice as the "domestic entity." For purposes of this notice, a reference to a domestic corporation, a domestic partnership, or a domestic entity includes a successor. Furthermore, the term "EAG" has the meaning provided in §1.7874-4T(i)(3), and the term "inversion transaction" means an acquisition in which the foreign acquiring corporation is treated as a surrogate foreign corporation under section 7874(a)(2).

Section 7874(a)(1) provides that the taxable income of an "expatriated entity" for any year that includes any portion of the applicable period (as defined in section 7874(d)(1)) shall in no event be less than the inversion gain (as defined in section 7874(d)(2)) of the entity for the taxable year. Pursuant to section 7874(a)(2)(A), the term expatriated entity means a domestic corporation or a domestic partnership referred to in section 7874(a)(2)(B)(i) (in other words, a domestic entity), or any United States person who is related (within the meaning of section 267(b) or 707(b)(1)) to such domestic corporation or domestic partnership.

Under section 7874(c)(4), a transfer of properties or liabilities (including by contribution or distribution) is disregarded if the transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874. In addition, section 7874(c)(6) grants the Secretary authority to prescribe regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat stock as not stock. Finally, section 7874(g) grants the Secretary authority to provide regulations necessary to carry out section 7874, including regulations adjusting the application of section 7874 as necessary to prevent the avoidance of the purposes of section 7874, including the avoidance of such purposes through (i) the use of related persons, pass-through or other non-corporate entities, or other intermediaries, or (ii) transactions designed to have persons cease to be (or not become) members of expanded affiliated groups or related persons.

Under section 7874(c)(2)(B) (statutory public offering rule), stock of the foreign acquiring corporation that is sold in a public offering related to the acquisition described in section 7874(a)(2)(B)(i) is excluded from the denominator of the fraction used for purposes of calculating the ownership percentage described in section 7874(a)(2)(B)(ii) (ownership fraction). The statutory public offering rule furthers the policy that section 7874 is intended to curtail transactions that allow the benefits of an inversion but "permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion." S. Rep. No. 192, 108th Cong., 1st. Sess., at 142 (2003); Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 108th Congress (JCS-5-05) (May 31, 2005), at 343.

Section 1.7874-4T modifies the statutory public offering rule. The preamble to §1.7874-4T provides that "the IRS and Treasury Department believe that stock of the foreign acquiring corporation transferred in exchange for certain property in a transaction related to the acquisition, but not through a public offering, presents the same opportunity to inappropriately reduce the ownership fraction." TD 9654, 2014-6 IRB 461. Accordingly, §1.7874-4T(b) provides that, subject to a de minimis exception, "disqualified stock" is not included in the denominator of the ownership fraction. Disqualified stock generally includes stock of the foreign acquiring corporation that is transferred to a person (other than the domestic entity) in exchange for "nonqualified property." The term nonqualified property means (i) cash or cash equivalents, (ii) marketable securities, (iii) certain obligations, or (iv) any other property acquired in a transaction related to the acquisition with a principal purpose of avoiding the purposes of section 7874.

(b) Transactions at Issue and Regulations to be Issued

The Treasury Department and the IRS are aware that taxpayers may be engaging in transactions with a foreign corporation that has substantial cash and other liquid assets in order to facilitate an inversion to avoid the application of section 7874. Although §1.7874-4T addresses cases in which

nonqualified property held directly or indirectly by the foreign acquiring corporation is received in exchange for stock of the foreign acquiring corporation in a transaction related to the acquisition, that regulation will not apply to nonqualified property held directly or indirectly by the foreign acquiring corporation that was not acquired by the foreign acquiring corporation in a transaction related to the acquisition. As a result of this limitation in the application of §1.7874-4T, stock of the foreign acquiring corporation may be included in the denominator of the ownership fraction, thereby decreasing the ownership fraction, even though a substantial portion of the value of such stock is attributable to nonqualified property.

The Treasury Department and the IRS intend to issue regulations under section 7874(c)(6) providing that, if more than 50 percent of the gross value of all "foreign group property" constitutes "foreign group nonqualified property," a portion of the stock of the foreign acquiring corporation will be excluded from the denominator of the ownership fraction, as described below. This 50 percent test is applied after the acquisition and all transactions related to the acquisition, if any, are completed.

For this purpose, foreign group property means any property (including property that gives rise to disqualified stock upon application of §1.7874-4T) held by the EAG after the acquisition (and all transactions related to the acquisition, if any) are completed, other than the following property: (i) property that is directly or indirectly acquired in the acquisition and that, at the time of the acquisition, was held directly or indirectly by the domestic entity; and (ii) to avoid double counting, stock or a partnership interest in a member of the EAG and an obligation described in §1.7874-4T(i)(7)(iii)(A) (that is, an obligation of a member of the EAG).

Except as provided in the immediately succeeding sentence, foreign group nonqualified property means foreign group property that is described in §1.7874-4T(i)(7) other than property that gives rise to income described in section 1297(b)(2)(A) or section 954(h) or (i) (determined by substituting the term "foreign corporation" for the term "controlled foreign corporation"). Foreign group property that otherwise would not be foreign group nonqualified property nevertheless is treated as foreign group nonqualified property if, in a transaction related to the acquisition, such property (substitute property) is acquired in exchange for other property (transferred property) that would be foreign group nonqualified property had such transferred property not been exchanged for the substitute property.

If the 50 percent threshold is satisfied, the portion of the stock of the foreign acquiring corporation that will be excluded from the denominator of the ownership fraction is the product of (i) the value of the stock of the foreign acquiring corporation other than (a) stock described in section 7874(a)(2)(B)(ii) (that is, stock held by reason of), and (b) stock excluded from the denominator of the ownership fraction under either §1.7874-1(b) (because it is held by a member of the EAG) or §1.7874-4T(b) (because it is disqualified stock); and (ii) a fraction (foreign group nonqualified property fraction), the numerator of which is the gross value of all foreign group nonqualified property, and the denominator of which is the gross value of all foreign group property. Solely for purposes of the preceding sentence, property received by the foreign acquiring corporation that gives rise to disqualified stock (within the meaning of §1.7874-4T(c)) that is excluded from the denominator of the ownership fraction pursuant to §1.7874-4T(b) is excluded from both the numerator and the denominator of the foreign group nonqualified property fraction.

The regulations to be issued also will contain a rule that incorporates the principles of §1.7874-4T(h) (regarding the interaction of the expanded affiliated group rules with the rule that excludes disqualified stock from the denominator of the ownership fraction) with respect to stock of the foreign acquiring corporation that is excluded from the denominator of the ownership fraction under the rules described in this section 2.01(b).

The following example illustrates the regulations described in this section 2.01(b):

Example. (i) Facts. FA, a foreign corporation, has 20 shares of a single class of stock outstanding, all of which are owned by Individual A. FA acquires all the stock of DT, a domestic corporation, solely in exchange for 76 shares of newly issued FA stock (DT acquisition). In a transaction related to the DT acquisition, FA issues four shares of stock to Individual A in exchange for $50x of cash.

After the DT acquisition, in addition to the DT stock and $50x of cash received from Individual A, FA holds Asset A (gross value of $150x), which is foreign group nonqualified property, and Asset B (gross value of $100x), which is not foreign group nonqualified property.

(ii) Analysis. The four shares of FA stock issued to Individual A in exchange for $50x of cash, which is nonqualified property, are disqualified stock and excluded from the denominator of the ownership fraction pursuant to §1.7874-4T(b). After the DT acquisition, in addition to the DT stock, FA has foreign group property with a gross value of $300x, $200x of which is foreign group nonqualified property (Asset A and cash of $50x). Accordingly, 66.67% of the gross value of all the foreign group property constitutes foreign group nonqualified property ($200x/$300x). Because the 50 percent threshold is satisfied, a portion of the FA stock will be excluded from the denominator of the ownership fraction under this section 2.01(b). Because FA has only one class of stock outstanding, the multiplicand of the computation is 20 shares (100 shares of FA stock outstanding less the 76 shares of FA stock that are held by reason of and the four shares of disqualified stock). Those 20 shares are multiplied by the foreign group disqualified property fraction. The numerator of the fraction is $150x ($200x less $50x of cash that gives rise to disqualified stock) and the denominator is $250x ($300x less the $50x of cash). Thus, the portion of the FA stock that is excluded from the denominator of the ownership fraction under this section 2.01(b), is the product of 20 shares multiplied by $150x / $250x, or 12 shares. As a result, the denominator of the ownership fraction is 84 shares (100 shares reduced by four shares of disqualified stock excluded under §1.7874-4T(b) and 12 shares excluded under this section 2.01(b)), with the result that the ownership fraction is 90.4 percent (76/84).

.02 Regulations under Sections 7874 and 367 to Disregard Certain Distributions by the Domestic Entity

(a) Section 367(a) Background

Subject to certain exceptions, section 367(a)(1) generally provides that if a United States person transfers property to a foreign corporation in an exchange described in section 332, 351, 354, 356, or 361, the foreign corporation shall not be considered a corporation for purposes of determining the extent to which the United States person recognizes gain on such transfer. Section 1.367(a)-3(c) provides an exception to the general rule of section 367(a)(1) for certain transfers by a U.S. person of stock or securities of a domestic corporation (the U.S. target company) to a foreign corporation. This exception only applies, however, if the U.S. target company complies with the reporting requirements in §1.367(a)-3(c)(6) and if the four conditions set forth in §1.367(a)-3(c)(1)(i) through (iv) are satisfied. The condition set forth in §1.367(a)-3(c)(1)(iv) requires the active trade or business test (as defined in §1.367(a)-3(c)(3)) to be satisfied, which, in turn, requires the substantiality test (as defined in §1.367(a)-3(c)(3)(iii)) to be satisfied (among other requirements). The substantiality test is satisfied if, at the time of the transfer, the fair market value of the transferee foreign corporation is at least equal to the fair market value of the U.S. target company. For this purpose, the fair market value of the transferee foreign corporation generally does not include assets acquired outside the ordinary course of business within the 36-month period preceding the exchange if they produce, or are held for the production of, passive income or are acquired for the principal purpose of satisfying the substantiality test.

(b) *Transactions at Issue and Regulations to be Issued*

The Treasury Department and the IRS are aware that a domestic entity may distribute property to its former shareholders (within the meaning of §1.7874-2(b)(2)) or former partners (within the meaning of §1.7874-2(b)(3)), in order to reduce the ownership fraction by reducing the numerator. Similarly, to avoid the application of section 367(a)(1), a U.S. target company may distribute property to its

shareholders in contemplation of an acquisition to satisfy the substantiality test. To address these transactions, the Treasury Department and the IRS intend to issue regulations under sections 7874 and 367, as described below.

For purposes of applying section 7874(c)(4) (which disregards transfers of properties or liabilities if the transfer is part of a plan a principal purpose of which is to avoid the purposes of section 7874), non-ordinary course distributions (defined below) made by the domestic entity (including a predecessor) during the 36-month period ending on the acquisition date (within the meaning of §1.7874-3T(d)(1)) will be treated as part of a plan a principal purpose of which is to avoid the purposes of section 7874. Accordingly, such distributions will be disregarded for purposes of section 7874.

For purposes of this notice, non-ordinary course distributions mean the excess of all distributions made during a taxable year by the domestic entity with respect to its stock or partnership interests, as applicable, over 110 percent of the average of such distributions during the thirty-six month period immediately preceding such taxable year. A distribution means any distribution, regardless of whether it is treated as a dividend or whether, for example, it qualifies under section 355. Thus, a distribution includes any distribution made by the domestic entity in redemption of its stock, such as a distribution to which section 302(a) applies. A distribution also includes a transfer of money or other property to the owners of the domestic entity that is made in connection with the acquisition described in section 7874(a)(2)(B)(i) to the extent the money or other property is directly or indirectly provided by the domestic entity. For example, if the acquisition of the domestic entity by the foreign acquiring corporation qualifies as a reorganization under section 368(a) and the shareholders of the domestic entity receive other property or “boot” (within the meaning of section 356) in connection with the reorganization, then, to the extent the boot is directly or indirectly provided by the domestic entity for purposes of section 356, the domestic entity is treated as having made a distribution in the amount of that boot for purposes of this section 2.02(b)).

Section 1.367(a)-3(c) will be modified to include a rule that incorporates the principles described above for purposes of the substantiality test.

.03 Regulations under Section 7874 Regarding Subsequent Transfers of Stock of the Foreign Acquiring Corporation

(a) Section 7874 Background and Transactions at Issue

Section 7874(c)(2)(A) provides that stock of a foreign acquiring corporation that is held by members of the EAG is not included in the numerator or the denominator of the ownership fraction (statutory EAG rule). To illustrate the application of the statutory EAG rule, assume a domestic corporation (DC) is wholly owned by a U.S. parent corporation (USP), and that USP transfers all the DC stock to a newly formed foreign corporation (FA) in exchange for all of the stock of FA. Absent the statutory EAG rule, the ownership fraction would be 100 percent and the foreign acquiring corporation would be treated as a domestic corporation (assuming the EAG does not have substantial business activities in the relevant foreign country). However, under the statutory EAG rule, the stock of FA held by USP is excluded from the numerator and the denominator of the ownership fraction, so that the numerator and the denominator of the ownership fraction are zero and FA is respected as a foreign corporation.

However, application of the statutory EAG rule does not always lead to the appropriate result, for example, when a domestic entity has minority shareholders. To illustrate, assume that DC is owned 90 percent by USP and 10 percent by individual A, and that USP and individual A transfer all of their DC stock to newly formed FA in exchange for 90 percent and 10 percent, respectively, of the stock of FA. Absent an exception to the statutory EAG rule, the stock of FA held by USP would be excluded from the numerator and the denominator of the ownership fraction, such that the ownership fraction would be 100 percent (10/10) and FA would be treated as a domestic corporation.

To address this and other inappropriate results, §1.7874-1 provides two exceptions to the statutory EAG rule: the internal group restructuring exception and the loss of control exception (together with the statutory EAG rule, the EAG rules). See §§1.7874-1(c)(2) and 1.7874-1(c)(3), respectively. When either of these exceptions applies, stock of the foreign acquiring corporation held by members of the EAG is excluded from the numerator but not the denominator of the ownership fraction. Thus, both exceptions have the potential to decrease the ownership fraction. In general, the internal group restructuring exception applies when the domestic entity and the foreign acquiring corporation are members of an affiliated group (membership generally being based on an 80 percent vote and value requirement) with the same common parent both before and after the acquisition. The loss of control exception applies when the former owners of the domestic entity do not hold more than 50 percent of the stock of any member of the EAG after the acquisition.

Section 1.7874-5T addresses the effect on the numerator of the ownership fraction when former shareholders or former partners of the domestic entity receive stock of the foreign acquiring corporation by reason of holding stock or a partnership interest in the domestic entity and then transfer that stock to another person. Specifically, §1.7874-5T(a) provides that stock of the foreign acquiring corporation that is described in section 7874(a)(2)(B)(ii) (that is, stock held by reason of) shall not cease to be so described as a result of any subsequent transfer of the stock by the former shareholder or former partner that received the stock, even if the subsequent transfer is related to the acquisition described in section 7874(a)(2)(B)(i). Accordingly, such stock of the foreign acquiring corporation is included in the numerator of the ownership fraction unless the stock is excluded from the ownership fraction under the EAG rules.

The preamble to §§1.7874-4T and -5T notes that the Treasury Department and the IRS continue to study the extent to which subsequent transfers of stock of the foreign acquiring corporation should be taken into account in applying the EAG rules. TD 9654. The preamble describes certain divisive transactions under section 355 that involve subsequent distributions by a corporation of the stock of the foreign acquiring corporation. For example, assume a divisive transaction under section 355 in which a publicly traded U.S. parent corporation (USP) contributes all the stock of a domestic corporation (DC) to a newly formed foreign acquiring corporation (FA) (which is an acquisition described in section 7874(a)(2)(B)(i)) followed by a distribution of all of the FA stock to its shareholders. Pursuant to §1.7874-5T, the FA stock received by USP does not cease to be described in section 7874(a)(2)(B)(ii) (that is, it continues to be treated as stock held by reason of) as a result of USP's distribution of the FA stock to its shareholders. Accordingly, absent application of the EAG rules, the FA stock is included in the numerator of the ownership fraction. An issue raised by this transaction is the extent to which the distribution should be taken into account in determining whether the FA stock received by USP is treated as stock held by a member of the EAG for purposes of the EAG rules; in other words, the extent to which the EAG should be determined by taking into account any transactions related to the acquisition.

As the preamble further notes, this issue can also arise when the subsequent transfer occurs by reason of a sale or pursuant to a reorganization described in section 368. More specifically, the issue can arise, for example, if: (i) a corporation receives stock of a foreign acquiring corporation in an acquisition described in section 7874(a)(2)(B)(i) and subsequently sells that stock (or a portion of that stock), or (ii) in connection with an acquisitive asset reorganization described in section 368, a target corporation receives stock of the foreign acquiring corporation in exchange for its assets and subsequently distributes that stock of the foreign acquiring corporation to its shareholders pursuant to the plan of reorganization. Finally, the preamble requests comments on whether different results may be appropriate depending on whether the corporation that receives the stock of the foreign acquiring corporation and only temporarily holds that stock is a foreign or a domestic corporation.

Upon further study, the Treasury Department and the IRS have determined that stock of the foreign acquiring corporation that is received by a former corporate shareholder or a former corporate partner that subsequently is transferred in a transaction related to the acquisition should not be treated as held by a member of the EAG for purposes of applying the EAG rules, subject to two exceptions. As a result, absent an exception, that stock generally will be included in the numerator

of the ownership fraction (pursuant to §1.7874-5T) and the denominator of the ownership fraction. One exception applies to "U.S.-parented groups" and the other exception applies to "foreign-parented groups." In general, the U.S.-parented group exception applies to transfers of stock of the foreign acquiring corporation that remain within the U.S.-parented group. The foreign-parented group exception is broader, applying not only to transfers of stock of the foreign acquiring corporation that remain within the foreign-parented group but also to transfers of stock of the foreign acquiring corporation outside the foreign-parented group, subject to the restriction generally that the EAG rules would have applied had the foreign-parented group not transferred any stock of the foreign acquiring corporation outside the group (including stock of the foreign acquiring corporation received in the acquisition and other stock of the foreign acquiring corporation held by the foreign-parented group).

(b) Regulations to be Issued

(i) In General

Except as provided in section 2.03(b)(ii) or (iii) of this notice, if stock of the foreign acquiring corporation described in section 7874(a)(2)(B)(ii) (that is, stock of the foreign acquiring corporation held by reason of) is received by a former corporate shareholder or former corporate partner of the domestic entity (transferring corporation), and, in a transaction (or series of transactions) related to the acquisition, that stock (transferred stock) is subsequently transferred, the transferred stock is not treated as held by a member of the EAG for purposes of applying the EAG rules. Accordingly, the transferred stock is included in the numerator and the denominator of the ownership fraction.

Except as provided in section 2.03(b)(iii) of this notice, all transactions related to the acquisition must be taken into account for purposes of determining an EAG, a U.S.-parented group, and a foreign-parented group.

For purposes of this notice, a U.S.-parented group means an affiliated group that has a domestic corporation as the common parent corporation, and a foreign-parented group means an affiliated group that has a foreign corporation as the common parent corporation. For this purpose, the term affiliated group means an affiliated group as defined in section 1504(a) but without regard to section 1504(b)(3), except that section 1504(a) is applied by substituting "more than 50 percent" for "at least 80 percent" each place it appears.

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

(ii) Exception for Subsequent Transfers Involving a U.S.-Parented Group

Transferred stock is treated as held by a member of the EAG for purposes of the EAG rules if (i) before and after the acquisition, the transferring corporation (or its successor) is a member of a U.S.-parented group; and (ii) after the acquisition, both the person that holds the transferred stock after all related transfers of the transferred stock are completed and the foreign acquiring corporation are members of the U.S.-parented group. Accordingly, under section 7874(c)(2)(A) and §1.7874-1(b), such transferred stock is excluded from the numerator of the ownership fraction, and, depending upon the application of §1.7874-1(c)(2), may be excluded from the denominator of the ownership fraction.

(iii) Exception for Subsequent Transfers Involving a Foreign-Parented Group

Transferred stock is treated as held by a member of the EAG for purposes of the EAG rules if (i) before the acquisition, the transferring corporation and the domestic entity are members of the same foreign-parented group; and (ii) after the acquisition, the transferring corporation is a member of the EAG or would be a member of the EAG absent the subsequent transfer of any stock of the foreign acquiring corporation by a member of the foreign-parented group in a transaction related to the

acquisition (but taking into account all other transactions related to the acquisition). Accordingly, under section 7874(c)(2)(A) and §1.7874-1(b), such transferred stock is excluded from the numerator of the ownership fraction, and, depending upon the application of §1.7874-1(c)(2), may be excluded from the denominator of the ownership fraction.

(iv) Examples

The following examples illustrate the regulations described in this section 2.03(b):

Example 1. (i) Facts. D, a domestic corporation, owns all of the stock of DT, also a domestic corporation, and stock of other subsidiaries. The DT stock does not represent substantially all of the property of D for purposes of section 7874. Pursuant to a reorganization described in section 368(a)(1)(D), D transfers all the stock of DT to FA, a newly formed foreign corporation, in exchange solely for 100 shares of FA stock (DT acquisition) and distributes all of the FA stock to its shareholders pursuant to section 361(c)(1) (subsequent distribution). D is the common parent of a U.S.-parented group before and after the DT acquisition.

(ii) Analysis. Under §1.7874-2(f)(1), the 100 shares of FA stock received by D in the DT acquisition is stock of a foreign corporation (FA) that is held by reason of holding stock in a domestic corporation (DT). Accordingly, such stock is described in section 7874(a)(2)(B)(ii). Under §1.7874-5T(a), all 100 shares of FA stock retain their status as being described in section 7874(a)(2)(B)(ii) even though D subsequently transfers all of the FA stock to its shareholders in the subsequent distribution. Under section 2.03(b)(i) of this notice, the FA stock received by D is not treated as held by a member of the EAG for purposes of applying the EAG rules. The exception provided in section 2.03(b)(ii) of this notice does not apply because, after the DT acquisition, the shareholders of D and FA are not members of the U.S.-parented group. Accordingly, the ownership fraction is 100/100.

(iii) Alternative facts and analysis. The facts are the same as in paragraph (i) of this example, except that D is a foreign corporation and the common parent of a foreign-parented group. Under section 2.03(b)(iii) of this notice, the FA stock received by D is treated as held by a member of the EAG for purposes of applying the EAG rules because (i) before the DT acquisition, D and DT are members of a foreign-parented group of which D is the common parent, and (ii) D would be a member of the EAG absent the distribution of the FA stock by D to its shareholders in the subsequent distribution. In addition, the DT acquisition qualifies as an internal group restructuring under §1.7874-1(c)(2). Accordingly, the ownership fraction is 0/100.

Example 2. (i) Facts. Individual A owns all the stock of FT, a foreign corporation. FT owns all the stock of DT, a domestic corporation. FT does not own any other property and has no liabilities. Pursuant to a reorganization described in section 368(a)(1)(F), FT transfers all of its DT stock to FA, a newly formed foreign corporation, in exchange for 100 shares of FA stock (DT acquisition) and distributes the FA stock to individual A in liquidation pursuant to section 361(c)(1) (subsequent distribution).

(ii) Analysis. Under §1.7874-2(f)(1), the 100 shares of FA stock received by FT in the reorganization is stock of a foreign corporation (FA) that is held by reason of holding stock in a domestic corporation (DT). Accordingly, such stock is described in section 7874(a)(2)(B)(ii). Under §1.7874-5T(a), all 100 shares of FA stock retain their status as being described in section 7874(a)(2)(B)(ii) even though FT subsequently transfers all of the FA stock to its shareholder (individual A) in the subsequent distribution. Under section 2.03(b)(iii) of this notice, the FA stock received by FT is treated as held

by a member of the EAG for purposes of applying the EAG rules because (i) before the DT acquisition, FT and DT are members of a foreign-parented group (of which FT is the common parent), and (ii) absent the distribution of the FA stock by FT to individual A in the subsequent distribution, FT would be a member of the EAG. In addition, the DT acquisition qualifies as an internal group restructuring under §1.7874-1(c)(2). Accordingly, the ownership fraction is 0/100.

(iii) Alternative facts and analysis. The facts are the same as in paragraph (i) of this example, except that, in a transaction related to the DT acquisition, FA subsequently issues 200 shares of stock to individual B in exchange for qualified property (within the meaning of §1.7874-4T(i)(7)). The exception under section 2.03(b)(iii) of this notice does not apply because, taking into account FA's issuance of 200 shares to individual B, FT would not be a member of the EAG absent the subsequent distribution. Accordingly, the FA stock received by FT is not treated as held by a member of the EAG for purposes of the EAG rules. Accordingly, the ownership fraction is 100/300.

SECTION 3. REGULATIONS TO ADDRESS POST-INVERSION TAX AVOIDANCE TRANSACTIONS

.01 Regulations to Address Acquisitions of Obligations and Stock that Avoid Section 956

(a) Section 956 Background

Section 957(a) defines a CFC as a foreign corporation with respect to which more than 50 percent of the total combined voting power of all classes of stock entitled to vote or the total value of the stock of the corporation is owned (directly, indirectly, or constructively) by United States shareholders (U.S. shareholders). Section 951(b) defines a U.S. shareholder as a U.S. person that owns (directly, indirectly, or constructively) 10 percent or more of the total combined voting power of all classes of stock entitled to vote of the foreign corporation.

Section 951(a)(1) provides that every person that is a U.S. shareholder of a CFC and owns (within the meaning of section 958(a)) stock in the corporation on the last day of the CFC's taxable year must include in its gross income for its taxable year in which or with which such taxable year of the CFC ends the amount determined under section 956 with respect to the shareholder for the year (but only to the extent not excluded from gross income under section 959(a)(2)).

Section 956(a) provides:

In the case of any controlled foreign corporation, the amount determined under this section with respect to any United States shareholder for any taxable year is the lesser of—

1. the excess (if any) of—

1. such shareholder's pro rata share of the average of the amounts of United States property held (directly or indirectly) by the controlled foreign corporation as of the close of each quarter of such taxable year, over
2. the amount of earnings and profits described in section 959(c)(1)(A) with respect to such shareholder, or

2. such shareholder's pro rata share of the applicable earnings of such controlled foreign corporation.

Section 956(c)(1) provides that, for this purpose:

"United States property" means any property acquired after December 31, 1962, which is—

(A) tangible property located in the United States;

(B) stock of a domestic corporation;

(C) an obligation of a United States person; or

(D) any right to the use in the United States of—

(i) a patent or copyright,

(ii) an invention, model, or design (whether or not patented),

(iii) a secret formula or process, or

(iv) any other similar right,

which is acquired or developed by the controlled foreign corporation for use in the United States.

Section 956(c)(2) provides exceptions that apply to the definition of United States property, including exceptions that limit the scope of obligations of U.S. persons and stock of domestic corporations that will be treated as United States property to obligations of sufficiently related U.S. persons and stock of sufficiently related domestic corporations. See sections 956(c)(1)(B) and (C) and 956(c)(2)(F) and (L).

Section 956 is intended to prevent a U.S. shareholder of a CFC from inappropriately deferring U.S. taxation of CFC earnings and profits by "prevent[ing] the repatriation of income to the United States in a manner which does not subject it to U.S. taxation." H.R. Rep. No. 1447, 87th Cong., 2d Sess., at 58 (1962). In the absence of section 956, a U.S. shareholder of a CFC could access the CFC's funds (untaxed earnings and profits) in a variety of ways other than by the payment of an actual taxable dividend, such that there would be no reason for the U.S. shareholder to incur the dividend tax. Section 956 eliminates this disincentive to pay a dividend by ensuring parity of treatment for different ways that CFC earnings can be made available for use in the United States or for use by the U.S. shareholder. Accordingly, under section 956, the investment by a CFC of its earnings and profits in United States property is "taxed to the [CFC's] shareholders on the grounds that this is substantially the equivalent of a dividend." S. Rep. No. 1881, 87th Cong., 2d Sess., at 88 (1962). Section 956(e) provides the Secretary with authority to "prescribe such regulations as may be necessary . . . to prevent the avoidance of the provisions of [section 956] through reorganizations or otherwise."

(b) Transactions at Issue and Regulations to be Issued

An inversion transaction may permit the top corporate parent in the newly inverted group, a group still principally comprised of U.S. shareholders and their CFCs, to avoid section 956 by accessing the untaxed earnings and profits of the CFCs without a current tax to the U.S. shareholders. This is a result that the U.S. shareholders could not achieve before the inversion. The ability of the new foreign parent to access deferred CFC earnings and profits would in many cases eliminate the need for the CFCs to pay dividends to the U.S. shareholders, thereby circumventing the purposes of

section 956. Section 956(e) directs the Secretary to prescribe regulations to prevent the avoidance of the provisions of section 956 through reorganizations or otherwise; an inversion is an example of such a transaction.

In order to prevent this avoidance of section 956, the Treasury Department and the IRS intend to issue regulations under section 956(e) providing that, solely for purposes of section 956, any obligation or stock of a foreign related person (within the meaning of section 7874(d)(3) other than an "expatriated foreign subsidiary") (such person, a "non-CFC foreign related person") will be treated as United States property within the meaning of section 956(c)(1) to the extent such obligation or stock is acquired by an expatriated foreign subsidiary during the applicable period (within the meaning of section 7874(d)(1)). For purposes of this notice, except as provided in the succeeding sentence, an expatriated foreign subsidiary is a CFC with respect to which an expatriated entity (as defined in section 2.01(a) of this notice) is a U.S. shareholder. An expatriated foreign subsidiary does not include a CFC that is a member of the EAG immediately after the acquisition and all transactions related to the acquisition are completed (completion date) if the domestic entity is not a U.S. shareholder with respect to the CFC on or before the completion date. In addition, for purposes of this section, an expatriated foreign subsidiary that is a pledgor or guarantor of an obligation of a non-CFC foreign related person under the principles of section 956(d) and §1.956-2(c) will be considered as holding such obligation.

The Treasury Department and the IRS are considering, and request comments on, whether any exceptions under section 956(c)(2) or §1.956-2 should apply to an obligation or stock of a foreign related person that is determined to be United States property within the meaning of section 956(c)(1) pursuant to the regulations described in this section 3.01(b). However, the exception to the definition of obligation provided by Notice 88-108, 1988-2 C.B. 446, will not apply to such obligations.

.02 Regulations to Address Transactions to De-Control or Significantly Dilute CFCs

(a) Section 7701(l) Background

Section 7701(l) provides that "[t]he Secretary may prescribe regulations recharacterizing any multiple-party financing transaction as a transaction directly among any 2 or more of such parties where the Secretary determines that such recharacterization is appropriate to prevent avoidance of any tax imposed [under the Code]." The legislative history notes that, as a general matter, "[t]he tax treatment of a transaction may depend on the identity of the parties to the transaction," and cites as an example that whether a loan by a CFC to a related person will result in a section 956 inclusion depends upon whether the borrower is a U.S. person or an unrelated foreign person. H.R. Rep. No. 213, 103rd Cong., 1st Sess., at 654 (1993). The legislative history indicates that regulations could be issued under section 7701(l) to prevent the avoidance of tax under a wide variety of Code sections. "It is intended that the provision apply not solely to back-to-back loan transactions, but also to other financing transactions. For example, it would be within the proper scope of the provision for the Secretary to issue regulations dealing with multiple-party transactions involving debt guarantees or equity investments." H.R. Rep. No. 213, 103rd Cong., 1st Sess., at 655 (1993).

In describing the "reasons for change," the legislative history cites with approval several IRS rulings that disregard conduit entities, and goes on to note, "the committee does not intend that the Secretary be bound, in developing regulations, by the standards on which those rulings are based, if the Secretary deems it necessary or appropriate to adopt other standards in order to properly recharacterize a financing transaction." H.R. Rep. No. 103-111, 103rd Cong., 1st Sess., at 729 (1993). Thus, while Congress intended regulations under section 7701(l) to address conduit transactions, the legislative history indicates a broader purpose and notes that traditional approaches need not be the only appropriate response when taxpayers use financing transactions to avoid any tax imposed by the Code. Consistent with the legislative history, the statute's wording is not limited to conduit fact patterns. In this regard, see §1.7701(l)-3 (regarding fast-pay arrangements), which treats the holders of fast-pay stock in a corporation as having acquired instruments issued by other shareholders of the corporation instead of having acquired interests in the corporation.

(b) Sections 964(e) and 954(c)(6) Background

Section 964(e)(1) provides that if a CFC sells or exchanges stock in any other foreign corporation, gain recognized on such sale or exchange is included in the gross income of the CFC as a dividend to the same extent that it would have been so included under section 1248(a) if the CFC were a United States person. Section 964(e)(2) provides that section 954(c)(3)(A)(i) (the "same country exception" to foreign personal holding company income for interest and dividends) does not apply to any amount treated as a dividend by reason of section 964(e)(1).

Section 954(c)(6)(A) provides that, for purposes of section 954(c), dividends, interest, rents, and royalties received or accrued from a CFC which is a related person shall not be treated as foreign personal holding company income to the extent attributable or properly allocable (determined under rules similar to the rules of subparagraphs (C) and (D) of section 904(d)(3)) to income of the related person which is neither subpart F income nor effectively connected income. Section 954(c)(6)(A) also provides that the Secretary shall prescribe such regulations as may be necessary or appropriate to carry out the provision, including regulations to prevent the abuse of the purposes of the provision. Notice 2007-9, 2007-1 C.B. 401, provides that, for purposes of section 954(c)(6), the term "dividend" includes gains treated as dividends pursuant to sections 964(e).

(c) Section 367(b) Background

Section 367(b)(1) provides that, in the case of an exchange described in section 332, 351, 354, 355, 356, or 361 in connection with which there is no transfer of property described in section 367(a)(1), a foreign corporation shall be considered to be a corporation except to the extent provided in regulations prescribed by the Secretary which are necessary or appropriate to prevent the avoidance of Federal income taxes. Section 367(b)(2) provides that the regulations prescribed pursuant to section 367(b)(1) shall include (but shall not be limited to) regulations dealing with the sale or exchange of stock or securities in a foreign corporation by a United States person, including regulations providing the circumstances under which gain is recognized or deferred, amounts are included in gross income as a dividend, adjustments are made to earnings and profits, or adjustments are made to the basis of stock or securities.

Regulations under section 367(b) generally provide that if the potential application of section 1248 cannot be preserved following the acquisition of the stock or assets of a foreign corporation (foreign acquired corporation) by another foreign corporation in an exchange subject to section 367(b), then certain exchanging shareholders of the foreign acquired corporation must include in income as a dividend the section 1248 amount (as defined in §1.367(b)-2(c)(1)) attributable to the stock of the foreign acquired corporation exchanged. See §1.367(b)-4(b). Specifically, subject to certain exceptions, §1.367(b)-4(b)(1)(i) requires a deemed dividend inclusion if the exchange satisfies two conditions. First, immediately before the exchange, the exchanging shareholder is either (i) a U.S. person that is a section 1248 shareholder with respect to the foreign acquired corporation, or (ii) a foreign corporation in which a U.S. person is a section 1248 shareholder with respect to such foreign corporation and the foreign acquired corporation. See §1.367(b)-4(b)(1)(i)(A). Second, immediately after the exchange, either (i) the stock received by the exchanging shareholder is not stock in a CFC as to which the U.S. person described in the preceding sentence is a section 1248 shareholder, or (ii) the foreign acquiring corporation (for this purpose, as defined in §1.367(b)-4(a)) or the foreign acquired corporation (in the case of an acquisition of the stock of the foreign acquired corporation) is not a CFC as to which the U.S. person is a section 1248 shareholder. See §1.367(b)-4(b)(1)(i)(B).

Section 1.367(b)-4(c)(1) provides that a section 1248 amount included as a deemed dividend under §1.367(b)-4(b) is not included as foreign personal holding company income under section 954(c).

(d) Transactions at Issue

Inversion transactions facilitate the avoidance of section 956 through techniques in addition to those discussed in section 3.01(b) of this notice. After an inversion transaction, the inverted group may cause an expatriated foreign subsidiary to cease to be a CFC using transactions that avoid the imposition of U.S. income tax, so as to avoid U.S. tax on the CFC's pre-inversion earnings and profits. For example, after an inversion transaction, a foreign acquiring corporation could issue a note or transfer property to an expatriated foreign subsidiary in exchange for stock representing at least 50 percent of the voting power and value of the expatriated foreign subsidiary. The expatriated foreign subsidiary would cease to be a CFC, and the U.S. shareholders would no longer be subject to subpart F of the Code with respect to the expatriated foreign subsidiary. As a result, the expatriated foreign subsidiary could make its pre-inversion earnings and profits available to the U.S. shareholders without causing an income inclusion under section 956.

Even if the foreign acquiring corporation acquired less stock of an expatriated foreign subsidiary, such that the expatriated foreign subsidiary remains a CFC, it could nevertheless substantially dilute a U.S. shareholder's ownership of the CFC. As a result, the U.S. shareholder could avoid tax on the CFC's pre-inversion earnings and profits if, for example, the CFC later redeemed, on a non pro rata basis, its stock held by the foreign acquiring corporation. As another example, the U.S. shareholder could avoid tax on a CFC's pre-inversion earnings and profits if the CFC paid a pro rata extraordinary distribution, although in this case the U.S. shareholder could be required to pay some tax.

The Treasury Department and the IRS have determined that it is appropriate, in order to prevent the avoidance of U.S. tax, to issue regulations under section 7701(l) that will recharacterize certain transactions that facilitate the avoidance of U.S. tax on the expatriated foreign subsidiary's pre-inversion earnings and profits. The Treasury Department and the IRS also intend to issue regulations that will modify the application of section 367(b), so as to require an income inclusion in certain nonrecognition transactions that dilute a U.S. shareholder's ownership of a CFC.

(e) Regulations to be Issued

(i) Regulations under section 7701(l)

The Treasury Department and the IRS intend to issue regulations under section 7701(l) providing that a "specified transaction" completed during the applicable period (as defined in section 7874(d)(1)) will be recharacterized in the manner described in section 3.02(e)(i)(A) of this notice, subject to the exceptions described in section 3.02(e)(i)(C) of this notice. For this purpose, a specified transaction is a transaction in which stock in an expatriated foreign subsidiary (as defined in section 3.01(b) of this notice) (specified stock) is transferred (including by issuance) to a "specified related person." For this purpose, a specified related person means a non-CFC foreign related person (as defined in section 3.01(b) of this notice), a U.S. partnership that has one or more partners that is a non-CFC foreign related person, or a U.S. trust that has one or more beneficiaries that is a non-CFC foreign related person.

In addition, the Treasury Department and the IRS intend to issue regulations providing that if a deemed dividend is included in a CFC's income under section 964(e) as a result of a specified transaction that is completed during the applicable period, the deemed dividend will not be excluded from foreign personal holding company income under section 954(c)(6) (to the extent in effect, and notwithstanding the rule described in Notice 2007-9, 2007-1 C.B. 401).

(A) Recharacterization of a Specified Transaction

A specified transaction is recharacterized for all purposes of the Code, as of the date on which the specified transaction occurs, as an arrangement directly between the specified related person and one or more section 958(a) U.S. shareholders of the expatriated foreign subsidiary. However, if the specified transaction is a fast-pay arrangement that is recharacterized under §1.7701(l)-3(c)(2), then the rules of §1.7701(l)-3 will apply instead of the regulations described in this section 3.02(e)(i).

For purposes of this notice, a section 958(a) U.S. shareholder of an expatriated foreign subsidiary is a U.S. shareholder (within the meaning of section 951(b)) with respect to the expatriated foreign subsidiary that owns (within the meaning of section 958(a)) stock in the expatriated foreign subsidiary, but only if such U.S. shareholder is related (within the meaning of section 267(b) or 707 (b)(1)) to the specified related person or is under the same common control (within the meaning of section 482) as the specified related person.

If an expatriated foreign subsidiary issues the specified stock to a specified related person, the specified transaction will be recharacterized as follows: (i) the property transferred by the specified related person to acquire the specified stock (transferred property) will be treated as having been transferred by the specified related person to the section 958(a) U.S. shareholder(s) of the expatriated foreign subsidiary in exchange for instruments deemed issued by the section 958(a) U.S. shareholder(s) (deemed instrument(s)); and (ii) the transferred property or proportionate share thereof will be treated as having been contributed by the section 958(a) U.S. shareholder(s) (through intervening entities, if any, in exchange for equity in such entities) to the expatriated foreign subsidiary in exchange for stock in the expatriated foreign subsidiary. See section 3.02(e)(iii), Example 1, of this notice.

Similar principles will apply to recharacterize a specified transaction in which a shareholder transfers specified stock of the expatriated foreign subsidiary to a specified related person. Section 3.02(e)(1)(iii), Example 2, of this notice illustrates an application of these principles when a shareholder of an expatriated foreign subsidiary transfers stock of an expatriated foreign subsidiary to a partnership that is a specified related person. The Treasury Department and the IRS request comments on this example, and specifically, on alternative recharacterizations that could apply to transfers to partnerships.

(B) Other Rules Relating to the Recharacterization

A deemed instrument described in section 3.02(e)(i)(A) of this notice will have the same terms as the specified stock (other than issuer). Accordingly, if a distribution is made with respect to specified stock of the expatriated foreign subsidiary, matching seriatim distributions with respect to stock will be treated as made by the expatriated foreign subsidiary (through intervening entities, if any) to the section 958(a) U.S. shareholder(s). The section 958(a) U.S. shareholder(s), in turn, will be treated as making payments, with respect to the deemed instrument(s), to the specified related person(s).

An expatriated foreign subsidiary will be treated as the paying agent of a section 958(a) U.S. shareholder of the expatriated foreign subsidiary with respect to the deemed instrument treated as issued by the section 958(a) U.S. shareholder to a specified related person. In addition, rules similar to those described in §1.7701(l)-3(b)(3)(iii) (regarding transactions that affect benefited stock) will apply to transactions affecting specified stock.

(C) Certain Specified Transactions are not Recharacterized

A specified transaction will not be recharacterized under the rules of section 3.02(e)(i)(A) of this notice in two situations. The first exception applies if the specified stock was transferred by a shareholder of the expatriated foreign subsidiary and, under applicable U.S. tax rules, the shareholder either is required to recognize and include in income all of the gain in the specified stock (including gain treated as a deemed dividend pursuant to section 964(e) or 1248(a) or characterized as a dividend pursuant to section 356(a)(2)) or has a deemed dividend included in income with respect to the specified stock under §1.367(b)-4 (including by reason of the regulations described in section 3.02(e)(ii) of this notice that apply to specified exchanges).

The second exception applies if (i) the expatriated foreign subsidiary is a CFC immediately after the specified transaction and all related transactions, and (ii) the amount of stock (by value) in the expatriated foreign subsidiary (and any lower-tier expatriated foreign subsidiary) that is owned, in the aggregate, directly or indirectly by the section 958(a) U.S. shareholders of the expatriated foreign

subsidiary immediately before the specified transaction and any transactions related to the specified transaction does not decrease by more than 10 percent as a result of the specified transaction and any related transactions.

(ii) Regulations under Section 367(b)

The Treasury Department and the IRS intend to amend the regulations under section 367(b) to provide that an exchanging shareholder described in §1.367(b)-4(b)(1)(i)(A) will be required to include in income as a deemed dividend the section 1248 amount attributable to the stock of an expatriated foreign subsidiary exchanged in a "specified exchange," without regard to whether the conditions set forth in §1.367(b)-4(b)(1)(i)(B) are satisfied. The regulations will apply to specified exchanges completed during the applicable period (as defined in section 7874(d)(1)). For this purpose, a specified exchange is an exchange in which a shareholder of an expatriated foreign subsidiary exchanges stock in the expatriated foreign subsidiary for stock in another foreign corporation pursuant to a transaction described in §1.367(b)-4(a). See section 3.02(e)(iii), Example 3, of this notice.

In addition, the regulations will provide an exception that incorporates the principles of the second exception described in section 3.02(e)(i)(C) of this notice (regarding specified transactions that do not decrease, in aggregate, the section 958(a) U.S. shareholders' ownership of stock in an expatriated foreign subsidiary (or lower-tier expatriated foreign subsidiary) by more than 10 percent).

Finally, the regulations will provide that §1.367(b)-4(c)(1) (regarding the exclusion of a deemed dividend from foreign personal holding company income) will not apply to a deemed dividend that results from a specified exchange pursuant to the regulations described in this section 3.02(e)(ii) and that such deemed dividend will not qualify for the exceptions from foreign personal holding company income provided by section 954(c)(3)(A)(i) or section 954(c)(6) (to the extent in effect).

(iii) Examples

The following examples illustrate the regulations described in this section 3.02(e). For each of the examples, assume that FA, a foreign corporation, wholly owns DT, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation that is a CFC. FA wholly owns FS, a foreign corporation. FA acquired DT in an inversion transaction that was completed on January 1, 2015. Accordingly, DT is a domestic entity, FT is an expatriated foreign subsidiary, and FS is a specified related person with respect to FT.

Example 1. (i) Facts. On February 1, 2015, FA acquires $10x of FT stock from FT, representing 60 percent of total voting power and value of the stock of FT, in exchange for $10x of cash.

(ii) Analysis. (A) FA's acquisition of the FT stock from FT is a specified transaction, because stock of an expatriated foreign subsidiary was transferred (by issuance) to a specified related person (FA).

(B) FA's acquisition of the FT stock is recharacterized as follows, with the result that FT continues to be a CFC:

(1) DT is treated as having issued a deemed instrument to FA in exchange for $10x of cash.

(2) DT is treated as having contributed the $10x of cash to FT in exchange for FT stock.

(C) Any distribution with respect to the FT stock actually acquired by FA will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instrument that DT is treated as having issued to FA. FT is treated as the paying agent of DT with respect to the deemed instrument issued by DT to FA.

(iii) Alternative facts and analysis. The facts are the same as in paragraph (i) of this example, except that instead of acquiring FT stock from FT in exchange for $10x of cash, FA acquires 60% of the FT stock held by DT in exchange for $4x of cash in a fully taxable transaction. In this case, the specified transaction is not recharacterized under section 3.02(e)(i)(A) of this notice pursuant to the first exception described in section 3.02(e)(i)(C) of this notice. This is because DT is required to recognize and include in income all of the gain (including any gain treated as a deemed dividend pursuant to section 1248(a)) with respect to the FT stock transferred to FA.

Example 2. (i) Facts. On February 1, 2015, DT transfers all of the stock of FT to FPRS, a foreign partnership, in exchange for 40% of the capital and profits interests in the partnership. Furthermore, FA contributes property to FPRS in exchange for the other 60% of the capital and profits interests.

(ii) Analysis. (A) DT's transfer of the FT stock is a specified transaction, because stock of an expatriated foreign subsidiary was transferred to a specified related person (FPRS).

(B) Under the principles of section 3.02(e)(i)(A) of this notice, DT's transfer of the FT stock is recharacterized as follows, with the result that FT continues to be a CFC:

(1) FPRS is treated as having issued 40% of its capital and profits interests to DT in exchange for a deemed instrument treated as having been issued by DT.

(2) DT is treated as continuing to own all of the stock of FT.

(C) Any distribution with respect to the FT stock actually acquired by FPRS will be treated as a distribution to DT, which, in turn, will be treated as making a matching distribution with respect to the deemed instrument that DT is treated as having issued to FPRS. FT is treated as the paying agent of DT with respect to the deemed instrument issued by DT to FPRS.

Example 3. (i) Facts. On February 1, 2015, DT exchanges all of the stock of FT solely in exchange for 60% of the stock of FS pursuant to a reorganization described in section 368(a)(1)(B). Immediately before the exchange, FT is a CFC in which DT is a section 1248 shareholder. Immediately after the exchange, FS and FT are CFCs in which DT is a section 1248 shareholder.

(ii) Analysis. (A) DT's exchange of the FT stock is a specified exchange described in section 3.02(e)(ii) of this notice, because DT exchanged stock of an expatriated foreign subsidiary (FT) for stock in a foreign corporation (FS) pursuant to a transaction described in §1.367(b)-4(a) (which includes a reorganization described in section 368(a)(1)(B)). Although the specified exchange is also a specified transaction because there is a transfer of FT stock to a specified related person (FS), the exchange is not recharacterized under section 3.02(e)(i)(A) of this notice pursuant to the first exception in section 3.02(e)(i)(C) of this notice.

(B) Under §1.367(b)-4(b)(1)(i), as modified by the regulations described in section 3.02(e)(ii) of this notice, DT must include in income the section 1248 amount with respect to the FT stock exchanged, without regard to the fact that immediately after the exchange, (i) the FS stock received by DT in the exchange is stock in a corporation that is a CFC as to which DT is a section 1248 shareholder, and (ii) FT is a CFC as to which DT is a section 1248 shareholder.

(iv) Request for Comments

The Treasury Department and the IRS are considering whether to provide an exception to the application of the regulations described in this section 3.02(e), such that a taxpayer's chosen form would be respected, when (1) a specified transaction is undertaken in order to integrate similar or complementary businesses, and (2) after the inversion transaction, the inverted group in fact does not exploit that form in order to avoid U.S. taxation on the expatriated foreign subsidiary's pre-inversion earnings and profits. For example, the exception could be limited to situations in which the expatriated foreign subsidiary does not, during the applicable period (within the meaning of section 7874(d)(1)), engage in any avoidance transactions, such as, for example, acquiring United States property (including obligations or stock treated as United States property under the regulations described in section 3.01(b) of this notice), paying extraordinary dividends out of pre-inversion earnings and profits, or engaging in non pro rata redemptions of the new foreign shareholder in order to bail out pre-inversion earnings and profits.

In addition to comments on whether any such exception is warranted, the Treasury Department and the IRS request comments on the types of transactions that taxpayers can use to avoid tax on a CFC's pre-inversion earnings after a specified transaction and that therefore should serve as triggers for denying the exception. The Treasury Department and the IRS also request comments on the provisions that would be necessary to administer any such exception. For example, in order to avoid the recharacterization of any specified transaction, the regulations could require a taxpayer to (i) extend the statute of limitations with respect to the U.S. tax consequences of the specified transaction until the close of the third full taxable year following the close of the applicable period; (ii) agree to certify annually that there have been no avoidance transactions for the taxable year, or, if there is an avoidance transaction, to file amended returns, as appropriate; and (iii) maintain sufficient documentation regarding, for example, accounts tracking pre-inversion earnings and profits described in section 959(c)(3) and the extent to which such earnings and profits are reduced during the applicable period.

.03 Regulations under Section 304 to Prevent the Removal of Untaxed Foreign Earnings and Profits

(a) Section 304(b)(5)(B) Background

Section 304(a)(1) generally provides that, for purposes of sections 302 and 303, if one or more persons are in control of each of two corporations and in return for property one of the corporations (acquiring corporation) acquires stock in the other corporation (issuing corporation) from the person (or persons) so in control, then (unless section 304(a)(2) applies) the property shall be treated as a distribution in redemption of the stock of the acquiring corporation.

Section 304(a)(2) provides that, for purposes of sections 302 and 303, if in return for property, one corporation acquires from a shareholder of another corporation stock in such other corporation, and the issuing corporation controls the acquiring corporation, then the property shall be treated as a distribution in redemption of the stock of the issuing corporation.

Section 304(b)(2) provides that, in the case of any acquisition to which section 304(a) applies, the determination of the amount that is a dividend (and the source thereof) shall be made as if the property were distributed by the acquiring corporation to the extent of its earnings and profits, and then by the issuing corporation to the extent of its earnings and profits.

Section 304(b)(5)(B) limits the earnings and profits taken into account under section 304(b)(2) where the acquiring corporation is foreign. Specifically, section 304(b)(5)(B) provides that no earnings and profits are taken into account for purposes of section 304(b)(2)(A) (and section 304(b)(2)(A) shall not apply) if more than 50 percent of the dividends arising from such acquisition (determined without regard to section 304(b)(5)(B)) would neither be subject to tax for the taxable year in which the dividends arise, nor be included in the earnings and profits of a CFC. The Staff of the Joint Committee on Taxation's technical explanation of section 304(b)(5)(B) provides:

The provision prevents the foreign acquiring corporation's E&P from permanently escaping U.S. taxation by being deemed to be distributed directly to a foreign person (i.e., the transferor) without an intermediate distribution to a domestic corporation in the chain of ownership between the acquiring corporation and the transferor corporation.

Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010, at 28 (August 10, 2010).

Section 304(b)(5)(C) provides that the Secretary shall prescribe such regulations as are necessary to carry out the purposes of section 304(b)(5).

Dividends paid by a domestic corporation to a foreign person generally are subject to a 30-percent gross basis tax under section 871(a) or 881(a), and to withholding under section 1441 or 1442, unless reduced or eliminated pursuant to an applicable income tax treaty.

(b) Transactions at Issue and Regulations to be Issued

Taxpayers may be engaging in certain transactions following an inversion transaction that reduce the earnings and profits of a CFC to facilitate repatriation of cash and other property of the CFC. For example, after an inversion transaction, the foreign acquiring corporation may sell a portion of the stock of the domestic corporation acquired in the inversion transaction to a wholly owned CFC of the domestic corporation in exchange for property of the CFC. This sale would be subject to section 304 (a)(2). The exchange of property (for stock of the domestic corporation) by the CFC in many cases will not result in income or gain that gives rise to an income inclusion under section 951, even though the CFC generally will recognize income or gain on the exchange of the property (other than cash) for U.S. tax purposes pursuant to section 1001. For example, the property exchanged may be property used by the CFC in a trade or business, including property held by the CFC through an entity that is disregarded as an entity separate from its owner, as described in §301.7701-2(c)(2)(i). See §1.954-2(e)(1)(ii). The Treasury Department and the IRS understand that taxpayers may interpret section 304(b)(5)(B) to not apply where more than 50 percent of the dividend arising upon application of section 304 is sourced from the domestic corporation, even though, for example, pursuant to an income tax treaty there may be no (or a reduced rate of) U.S. withholding tax imposed on a dividend sourced from the domestic corporation. Under this position, the dividend

sourced from earnings and profits of the CFC would never be subject to U.S. tax. To address these transactions, the Treasury Department and the IRS intend to issue regulations under section 304(b)(5)(C) as described below.

The Treasury Department and the IRS intend to issue regulations providing that, for purposes of applying section 304(b)(5)(B), the determination of whether more than 50 percent of the dividends that arise under section 304(b)(2) is subject to tax or includible in the earnings and profits of a CFC will be made by taking into account only the earnings and profits of the acquiring corporation (and therefore excluding the earnings and profits of the issuing corporation). If a partnership, option (or similar interest), or other arrangement, is used with a principal purpose of avoiding the application of the rule in this section 3.03(b) (for example, to treat a transferor as a CFC), then the partnership, option (or similar interest), or other arrangement will be disregarded for purposes of applying the rule in this section 3.03(b).

The rules of this section 3.03(b) will apply as a general matter, without regard to whether an inversion transaction has occurred.

The following examples illustrate the regulations described in this section 3.03(b):

Example 1. (i) Facts. FA, a foreign corporation that is not a CFC, wholly owns DT, a domestic corporation. DT wholly owns FS1, a CFC. DT has earnings and profits of $51x, and FS1 has earnings and profits of $49x. FA transfers DT stock with a value of $100x to FS1 in exchange for $100x of cash.

(ii) Analysis. Under section 304(a)(2), the $100x of cash is treated as a distribution in redemption of the stock of DT. The redemption of the DT stock is treated as a distribution to which section 301 applies pursuant to section 302(d), which ordinarily would be sourced first from FS1 under section 304(b)(2)(A). Without regard to the application of section 304(b)(5)(B), more than 50 percent of the dividend arising from the acquisition, taking into account only the earnings and profits of FS1 pursuant to this section 3.03(b), would not be subject to tax under Chapter 1 of the Code. In particular, no portion of a dividend from FS1 would be subject to U.S. tax or includible in the earnings and profits of a CFC. Accordingly, section 304(b)(5)(B) applies to the transaction, and no portion of the distribution of $100x is treated under section 301(c)(1) as a dividend (as defined in section 316) out of the earnings and profits of FS1. Furthermore, the $100x of cash is treated as a dividend to the extent of the earnings and profits of DT ($51x).

Example 2. (i) Facts. FA, a foreign corporation that is not a CFC, wholly owns DT, a domestic corporation. DT wholly owns FS1, a CFC. FA and DT own 40 percent and 60 percent, respectively, of the capital and profits interests of PRS, a foreign partnership. PRS wholly owns FS2, a CFC. The FS2 stock has a fair market value of $100x. FS1 has earnings and profits of $150x. PRS transfers all of its FS2 stock to FS1 in exchange for $100x of cash. DT enters into a gain recognition agreement that complies with the requirements set forth in section 4.01 of Notice 2012-15, 2012-9 IRB 424, with respect to the portion (60 percent) of the FS2 stock that DT is deemed to transfer to FS1 in an exchange described in section 367(a)(1). See §1.367(a)-1T(c)(3)(i)(A).

(ii) Analysis. Under section 304(a)(1), PRS and FS1 are treated as if PRS transferred its FS2 stock to FS1 in an exchange described in section 351(a) solely for FS1 stock, and, in turn, FS1 redeemed such FS1 stock in exchange for $100x of cash. The redemption of the FS1 stock is treated as a distribution to which section 301 applies pursuant to section 302(d). Without regard to the application of section 304(b)(5)(B), more than 50 percent of a dividend arising from the acquisition, taking into account only the earnings and profits of FS1 pursuant to this section 3.03(b), would be

subject to tax under Chapter 1 of the Code. In particular, 60 percent of a dividend from FS1 would be included in DT's distributive share of PRS's partnership income and therefore would be subject to tax. Accordingly, section 304(b)(5)(B) does not apply and the entire distribution of $100x is treated under section 301(c)(1) as a dividend (as defined in section 316) out of the earnings and profits of FS1.

SECTION 4. EFFECTIVE DATES

Except as provided in this section 4, the regulations described in (i) section 2.01(b) of this notice (which disregards certain stock of the foreign acquiring corporation attributable to passive assets) will apply to acquisitions completed on or after September 22, 2014; (ii) section 2.02(b) of this notice (which disregards certain distributions by a domestic entity) will apply to acquisitions, or to transfers of domestic stock described in §1.367(a)-3(c), completed on or after September 22, 2014; (iii) section 2.03(b) of this notice (regarding the application of the EAG rules upon a subsequent transfer of stock of the foreign acquiring corporation) will apply to acquisitions completed on or after September 22, 2014; (iv) section 3.01(b) of this notice will apply to acquisitions of obligations or stock of a non-CFC foreign related person by an expatriated foreign subsidiary completed on or after September 22, 2014, but only if the inversion transaction is completed on or after September 22, 2014; (v) section 3.02(e) of this notice will apply to specified transactions and specified exchanges completed on or after September 22, 2014, but only if the inversion transaction is completed on or after September 22, 2014; and (vi) section 3.03(b) of this notice will apply to acquisitions of stock described in section 304 completed on or after September 22, 2014.

Taxpayers may elect to apply the rule in section 2.03(b)(iii) of this notice (regarding subsequent transfers of stock of the foreign acquiring corporation when a domestic entity is a member of a foreign-parented group) to acquisitions completed before September 22, 2014.

No inference is intended regarding the treatment of transactions described in this notice under current law, and the IRS may challenge such transactions under applicable Code provisions or judicial doctrines.

SECTION 5. REQUEST FOR COMMENTS AND CONTACT INFORMATION

The Treasury Department and the IRS expect to issue additional guidance to further limit inversion transactions that are contrary to the purposes of section 7874 and the benefits of post-inversion tax avoidance transactions. In particular, the Treasury Department and the IRS are considering guidance to address strategies that avoid U.S. tax on U.S. operations by shifting or "stripping" U.S.-source earnings to lower-tax jurisdictions, including through intercompany debt. Comments are requested regarding the approaches such guidance should take. Future guidance will apply prospectively; however, the Treasury Department and the IRS expect that, to the extent any tax avoidance guidance applies only to inverted groups, such guidance will apply to groups that completed inversion transactions on or after September 22, 2014.

The Treasury Department is also reviewing its tax treaty policy regarding inverted groups and the extent to which taxpayers inappropriately obtain tax treaty benefits that reduce U.S. withholding taxes on U.S. source income.

Written comments may be submitted to the Office of Associate Chief Counsel (International), Attention: David A. Levine, Internal Revenue Service, 1111 Constitution Avenue, NW, Washington, DC 20224. Alternatively, taxpayers may submit comments electronically to notice.comments@irscounsel.treas.gov. Comments will be available for public inspection and copying. The principal authors of this notice are Mr. Levine and Rose E. Jenkins of the Office of Associate Chief Counsel (International). However, other personnel from the Treasury Department and the IRS participated in its development. For further information regarding this notice, contact Mr. Levine at (202) 317-6937 or Ms. Jenkins at (202) 317-6934 (not a toll-free call).

Page Last Reviewed or Updated: 22-Sep-2014