As we head into the Fall and our Boston meetings, I am quite pleased to report that the Tax Committee has been active and growing. Our Boston meeting will include several CLE and non CLE sessions, including a technical but topical panel on the issue of "state aid" in Europe and the European reaction to perceived preferential tax treatment given by some countries to some companies, including US multinationals. We will also be co-sponsoring programs on the law of microbreweries and how to maximize the value and reduce the cost of corporate legal services. Finally, our annual committee meeting will include a discussion of the Presidential candidate's tax plans, which promises to be lively.

The Tax Committee has been active in BLS and in the ABA generally. We now have Tax Committee liaisons to the BLS Content and Membership Committees, and the ABA Section of Taxation. We are still seeking a liaison to the Pro Bono Committee, and I look forward to hearing from any interested parties.

Last year the Tax Committee held several well attended and well received webinars on various tax issues. We will be renewing our webinar series this Fall and I hope that we can discuss some ideas in Boston for CLE and non CLE webinars on tax topics of relevance.

This will be another active year for our committee, and we are always seeking suggestions, content and speakers. As always, please encourage our younger lawyers to take an active role in this committee. We offer an opportunity for young lawyers to gain exposure and sharpen skills.

I am looking forward to seeing you in Boston in September.

Roger Royse
Chair, Taxation Committee

I am pleased to present our Spring-Summer issue of Business Tax Quarterly. This issue includes updates on some important tax developments since our last issue, as well as some more "timeless" articles examining common planning that we all need to know more about.

In the update category, we have articles on the much talked-about proposed debt/equity regulations with potentially pervasive impact on tax planning; the infamous corporate inversion regulations issued the same day; employment tax regulations for partners who work for their partnership; and proposed regulations on U.S. tax compliance for foreign-owned U.S. LLCs. And in the practice pointers category, we have an update on Up-C structures; "zeroing out" planning for incorporated professional practices; and helpful suggestions for advising the Board of a client preparing to go public.

Finally, I would like to mention a few staffing matters. First, I'd like to express my thanks to my co-editor Jennifer Riley, who has worked closely with me since we started this newsletter a few years ago. Jennifer is taking a well-deserved leave of...
absence so that she can, among other things, spend more time on her day job. And I would like to welcome and thank Jacob Heyka, who has stepped in as assistant editor. Jacob is an extremely capable law student who has worked with us on some of our programming and was able to step in quickly to help me pull together this issue of the newsletter. Welcome, Jacob. Last but not least in the staffing category, I would like to welcome another member of our Editorial Board. Phyllis Horn Epstein brings considerable newsletter editorial experience, including being a past editor of the ABA Tax Section newsletter.

Several of you responded to my e-mail to the committee a few months ago, expressing interest in helping out on the newsletter. I look forward to speaking further with each of you to see how best to contribute. In that regard, what we could use most is content, and I'll be very pleased to help you decide on a worthwhile topic.

I wish you all an enjoyable and relaxing rest of summer.

Mike

Michael Kliegman

Feature Articles

What To Do When Your Board Goes Global  
By Barbara Klementz

We are seeing an accelerating trend among U.S. companies to add non-U.S. residents to their Board of Directors. This makes sense: as more and more companies "go global" and expand in ever more countries, their Boards should reflect the global nature of the company.

What takes many companies by surprise, however, is that the tax treatment of cash compensation paid and equity awards granted to the non-U.S. directors can be quite complex. In addition, for the equity awards, companies will need to consider regulatory restrictions such as securities law requirements and ensure that the grants can fall under an exemption.

Read more....

Practice Pointers on the Up-C Structure  
By Ze'ev D. Eiger, Claire Elizabeth Logan and Remmelt A. Reigersman

In a structure commonly referred to as an "up-C," an existing limited liability company or other partnership form (referred to here for convenience as "LLC") undertakes a public offering through a newly formed corporation, which is structured as a holding company that owns an interest in the LLC. Private companies owned principally by individuals or by private equity sponsors are frequently organized as LLCs or other entities that are considered partnerships for tax purposes. These entities are not taxed at the entity level, subjecting the owners to only one layer of income tax. Traditionally, if the owners wanted to undertake a public offering of the entity's securities, the owners would re-organize the LLC or partnership as a corporation and offer and sell that company's common stock to the public in the offering. Increasingly, owners are employing the up-C structure as an alternative. Use of the up-C approach allows the LLC or other entity to undertake a public offering, albeit through a holding company, while maintaining the partnership status for the LLC, where the principal assets and operations of the business remain. This structure is particularly attractive to private equity-backed companies because it maintains many of the tax benefits of a partnership, offers an ongoing exit strategy, and enables the sponsors to preserve some control over the business.

Read more....
Proposed Regulations for Foreign-Owned US LLCs Move Toward Increased Financial Transparency
By Aaron P. Nocjar, Robert Rizzi, Beth D. Tractenberg and Lisa M. Zarlenga

On May 5, the US Department of the Treasury (Treasury) announced proposed regulations to increase the reporting and record maintenance requirements of US disregarded entities owned by foreign persons. If these proposed regulations are finalized, such disregarded entities would also be required to obtain an employer identification number (EIN) by filing an IRS Form SS-4 and disclosing significant information to the IRS about their ownership.

This is not the first time that the Obama Administration has proposed to require certain US disregarded entities to obtain an EIN. The Administration's Fiscal Year 2016 and 2017 Revenue Proposals (Greenbook) contained legislative proposals that would require all entities formed in the United States to apply for an EIN. The budget proposal would also impose penalties for failure to obtain an EIN or to update responsible party and other information contained in the application, and would allow the IRS to share responsible party information with law enforcement without a court order to combat financial crimes.

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Neither a Partner nor Employee Be: Treasury and the IRS Issue Regulations Clarifying the Employment Tax Treatment of Partners in Partnerships
By Reginald J. Clark, Adam B. Cohen, Michael A. Hepburn, Paul R. Lang, Daniel R. McKeithen, Alice Murtos, and Wes Sheumaker

The Treasury Department (Treasury) and the Internal Revenue Service (Service) have issued temporary regulations (Regulations) clarifying the federal employment tax treatment of the owners of partnerships and other entities classified as partnerships for federal tax purposes. In general, the Regulations clarify that, where a partnership owns a disregarded entity (such as a single member LLC that has not elected to be treated as a corporation), the partners of that partnership are not permitted to be treated as employees of the disregarded entity for federal employment tax purposes (i.e., for FICA, FUTA, and income tax withholding purposes and reporting purposes). Rather, the partners are subject to self-employment tax on net earnings from self-employment resulting from the partnership's activities, including the activities of the disregarded entity.

Read more....

Caution in use of the "Zero Out" Technique in Incorporated Professional Practices

A recent Tax Court case (Brinks Gilson & Lione PC, TC Memo 2016-20) points out the need for caution in the "zero out" technique by professional practices that operate as professional corporations or professional associations under local law that are taxed as "C" corporations and that compute taxable income on the cash basis. Under this technique, a practice group will typically "bonus out" all remaining undistributed profits prior to the end of the corporation's tax year and thereby eliminate or dramatically reduce any taxable income on which the corporation will pay state and federal taxes for that year.

Read more....

Proposed Debt-Equity Regulations Have Dramatic Implications for Corporate Tax Planning and Compliance
By Thomas W. Giegerich and Michael J. Wilder

On April 4, 2016, the Internal Revenue Service (IRS) and US Department of the Treasury (Treasury)-without advance warning-released proposed regulations under section 385 (the Proposed Regulations) that will, if finalized in their current form, have dramatic implications for US corporate tax planning and compliance.
Certain aspects of the rules when finalized are intended to apply retroactively to corporate debt issued in specified circumstances on or after April 4, 2016. US government officials have indicated they intend to finalize the Proposed Regulations as early as the end of August, and many large corporate taxpayers are acting now, rather than waiting, to evaluate the Proposed Regulations’ potential effects on their existing and future US tax planning strategies and compliance regimes.

Read more....

IRS and Treasury Issue Temporary Regulations Intended to Limit Ability of Corporations to Invert and Reduce the Tax Benefits of Inversion Transactions

On April 4, 2016, the Internal Revenue Service (the "IRS") and the Treasury Department (the "Treasury") issued new temporary regulations (the "Temporary Regulations") that address inversion transactions and certain post-inversion transactions. Most notably, the Temporary Regulations add rules that limit so-called "serial inversions." As described in more detail below, these new rules disregard the value of a foreign corporation's unrelated domestic entity acquisitions for the purposes of determining the Ownership Fraction (defined below), if such unrelated acquisitions closed within the three-year period prior to signing a new deal.

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What To Do When Your Board Goes Global

May 3 2016
Baker & McKenzie - Barbara Klementz

Full Article: http://www.lexology.com/library/detail.aspx?g=f0f0b6c4-e9ea-475b-8360-0435a45c3960&l=7RAGH3W

We are seeing an accelerating trend among U.S. companies to add non-U.S. residents to their Board of Directors. This makes sense: as more and more companies "go global" and expand in ever more countries, their Boards should reflect the global nature of the company.

What takes many companies by surprise, however, is that the tax treatment of cash compensation paid and equity awards granted to the non-U.S. directors can be quite complex. In addition, for the equity awards, companies will need to consider regulatory restrictions such as securities law requirements and ensure that the grants can fall under an exemption.

U.S. Tax Obligations for the Company

On the tax side, most companies are aware that compensation paid to non-U.S. directors (including equity awards) is usually subject to a flat U.S. withholding tax of 30%.

However, companies will first need to verify that the director is not a U.S. tax resident before withholding tax. This means he or she cannot be a U.S. citizen or permanent resident (green card holder) or spend 183 days or more in the U.S. in any tax year (or as determined under a special three-year look-back formula).

Furthermore, companies will need to check if an exemption from U.S. tax withholding exists under a tax treaty with the director's country of residence. Most tax treaties no longer include such an exemption, but there are notable exceptions, such as the U.S.-Canada Tax Treaty, which provides for an exemption from U.S. taxation unless the director has a fixed base or other permanent establishment (e.g., a physical office) in the U.S. If the exemption applies (because the director does not have a fixed base in the U.S.), the director will need to complete a Form 8233 on an annual basis to claim the treaty exemption and the company will need to file a copy of the form with the IRS.

Assuming the director is not a U.S. tax resident and no treaty exemption applies, U.S. federal tax withholding at a flat rate of 30% is required on any U.S.-source compensation paid to the non-U.S. director. U.S.-source compensation is compensation that is earned based on services provided in the U.S. If all of the Board meetings take place in the U.S., it is common for companies to take the position that all compensation is U.S.-source income and, accordingly, withhold U.S. tax on the full amount of the compensation. If, however, some Board meetings are held outside the U.S. or if the company believes it is reasonable to assume that the director prepared for the Board meetings while being outside the U.S., pro-ration of the compensation...
can be appropriate. Companies should develop a clear policy in this regard and apply it consistently.

If U.S. tax withholding is required, companies will also have to report the income paid to the director on an annual basis on Form 1042-S and file a tax return on Form 1042. A copy of the Form 1042-S has to be provided to the director. The forms have to be filed by March 15 of the year following the year in which the compensation was paid. Furthermore, to avoid that companies are subject to a back-up withholding obligation with regard to the compensation, they should obtain a Form W-8BEN from the director every three years. (There are situations where a Form W-8BEN may not be required to avoid back-up withholding, but we believe it is easier and safer to request the form from the director.)

Aside from the U.S. federal tax obligations, companies will also need to assess if they have any state tax obligations in the states in which the director provides services (i.e., typically the state(s) in which Board meetings are held). As an example, in California, companies arguably are not required to withhold California tax on compensation paid to a nonresident director. However, reporting is required, but it should be acceptable to take the position that the federal reporting (i.e., on Form 1042) will satisfy the reporting obligation in California, such that no additional tax report will need to be filed for California.

Lastly, but perhaps most surprisingly, companies may have tax withholding and/or reporting obligations in the director's country of residence. In many countries, because the director is not an employee of the U.S. parent or any of its subsidiaries, no such obligations will exist. However, there are several exceptions to this rule. In Canada, for example, the director will be viewed as an employee and the U.S. company will be required to withhold tax from the director's compensation and report it annually to the Canada Revenue Agency. This means that the U.S. company will in most cases need to obtain a Canadian Business Number to be able to discharge these obligations.

**Director’s Tax Obligations**

Of course, companies should firstly be concerned about their tax obligations, but many will also want to provide at least some information to the director regarding his or her personal tax treatment. Companies should be careful in this regard because conflicts of interest can ensue between the tax position the company may want to take and the director's tax position. Therefore, it usually is a better idea to advise the director to engage a U.S. and local tax advisor to determine his or her personal tax obligations with regard to the compensation paid by the company.

In general terms, however, it is likely that the director will be required to file a personal tax return in the U.S. (on Form 1040-NR). The 30% tax withheld by the company can be applied against the director's personal federal tax liability, but in certain cases, the director may owe additional tax and may be required to make estimated tax payments on a quarterly basis. Similarly, if services are provided in states with state income tax, the director may be subject to state income tax on the director's compensation and required to file a personal tax return at the state level.
In addition, the director usually will be subject to tax in his or her country of residence, which leads to double taxation. Tax treaties can provide relief from such double taxation and the director generally should be able to claim a foreign tax credit for the U.S. tax withheld.

**Special Considerations for Equity Awards**

When granting equity awards to a non-U.S. director, much like for grants to employees, companies will need to assess any regulatory issues in the director's country of residence. Depending on the type of award, exemptions may be available. However, just because the company grants the same type of award to employees in the respective country and can rely on an exemption, it should not assume that the exemption is also available for the grant to a director, because some exemptions are limited to employees (e.g., in the United Kingdom). Therefore, additional exemption filings may be required or, in extreme cases, stock-settled awards may not be a granted.

Finally, on the tax side, we see that many companies allow directors to defer the receipt of the shares (and/or their cash compensation). If properly structured under Section 409A of the Internal Revenue Code, U.S. directors can defer taxation accordingly. However, outside the U.S., this will not always be the case for voluntary deferrals. Consequently, companies should review the tax consequences for deferred awards in the director's country of residence to decide whether offering such an award makes sense from a tax perspective.

**Conclusion**

Non-U.S. directors are becoming a reality for many U.S. companies. Because of the heightened visibility of such individuals, companies are well-advised to thoroughly vet the tax and regulatory issues for compensation paid to such directors, both in the U.S. and in the director's country of residence. This analysis should be reviewed on a regular basis (e.g., annually).

If you are looking for more detailed information, I can highly recommend an article on this topic written by my colleague Sinead Kelly.

*Baker & McKenzie - Barbara Klementz*
Practice Pointers on the Up-C Structure

Morrison & Foerster LLP - Ze’ev D. Eiger, Claire Elizabeth Logan and Remmelt A. Reigersman

May 25 2016

FULL ARTICLE: http://www.lexology.com/library/detail.aspx?g=8017a48a-4f80-4e62-8419-0194a9fc8b4f&l=7RJ0GJW

Introduction

In a structure commonly referred to as an “up-C,” an existing limited liability company or other partnership form (referred to here for convenience as “LLC”) undertakes a public offering through a newly formed corporation, which is structured as a holding company that owns an interest in the LLC. Private companies owned principally by individuals or by private equity sponsors are frequently organized as LLCs or other entities that are considered partnerships for tax purposes. These entities are not taxed at the entity level, subjecting the owners to only one layer of income tax. Traditionally, if the owners wanted to undertake a public offering of the entity’s securities, the owners would re-organize the LLC or partnership as a corporation and offer and sell that company’s common stock to the public in the offering. Increasingly, owners are employing the up-C structure as an alternative. Use of the up-C approach allows the LLC or other entity to undertake a public offering, albeit through a holding company, while maintaining the partnership status for the LLC, where the principal assets and operations of the business remain. This structure is particularly attractive to private equity-backed companies because it maintains many of the tax benefits of a partnership, offers an ongoing exit strategy, and enables the sponsors to preserve some control over the business.

Overview of the Structure

The up-C structure derives its name from the upREIT structure, which has been commonly used by real estate investment trusts since the 1990s. In the up-C structure, the owners of an operating business, organized as a partnership for tax purposes, form a corporation, with shares of Class A and Class B common stock, which becomes the managing member of the existing operating company. The newly formed corporation offers shares of Class A common stock to the public in an IPO. The shares of Class B common stock are issued to the historic owners and entitle the Class B holders to voting rights, but not economic rights (such as dividends or liquidation rights) in the new public company.

Following the IPO, the company will effectively be a holding company and will have as its subsidiary the LLC (as well as any of the LLC’s subsidiaries). The principal assets and operating business will continue to be at (or below) the LLC level.

The company will receive the IPO proceeds from the sale of Class A shares, which it will then use to purchase LLC units from the LLC in connection with becoming the managing member of
the LLC. These can be either newly-issued LLC units or, if the historic owners have determined to make a partial exit from their investment in the company, LLC units held by existing owners.

The following diagrams illustrate (1) a typical pre-IPO partnership structure, (2) a typical up-C structure immediately after formation of a C-Corp, and (3) a typical structure following the IPO of the company:

![Image 1](Click here to view the image)

![Image 2](Click here to view the image)

**Overview of the Benefits**

**Tax Benefits**

The most significant benefits of the up-C structure for historic owners are contained in the terms of a tax receivable agreement (a “TRA”), which is an agreement entered into in connection with the IPO. Each time a historic partner exchanges units of the existing operating company for shares in the now public company, the company will receive a “step-up” in the tax basis of its assets. This tax basis step-up is allocated to the company’s share of the historic business’s assets, and in many cases the step-up is primarily allocable to intangible assets that are amortizable on a straight-line basis over 15 years (also referred to as “Section 197 intangibles”).

The up-C structure allows the company to pay the LLC members for the value of this step-up in basis, creating a market dynamic that permits value to be extracted from the company after the IPO, without decreasing the value of the company in the offering. The company pays a negotiated percentage, 85% or 90%, of the value of the actual state and federal income tax savings to the historic owners, pursuant to the TRA. For tax purposes, these payments are treated as contingent installment sale proceeds, generating both additional step-up and deemed interest deductions for the company. These additional step-up and deemed interest deductions increase the amount of any TRA payments over time.

Because public stockholders tend not to assign full value to the tax attributes of a corporation, they do not discount the value of a corporation to account fully for future payments to be made under a TRA. This has permitted historic owners of a business going public to capture additional value. The public stockholders also benefit from the pass through tax treatment at the LLC level because the up-C structure results in increased cash flow and higher earnings per share for the company.

**Liquidity**

There are significant additional benefits for the historic owners of a business that is contemplating an up-C structure. First, an existing equity owner is able to maintain its current ownership of a private LLC interest, with its tax structure, and remain subject to only one layer of tax. At the same time, the existing equity owners can also achieve liquidity, from time to time, with respect to their LLC interests, by exchanging the LLC interests for shares of Class A
common stock of the company which may then be publicly-traded. However, when exchanged for Class A common stock, the securities are “restricted securities” as defined in Rule 144 under the Securities Act of 1933, as amended, unless registered pursuant to an exchange registration statement or a resale registration statement.

The company will also have flexibility in using its equity to make strategic acquisitions or compensate its employees. It will be able to issue shares of Class A common stock (or for employees, options to purchase Class A common stock), but it could also issue LLC units to a strategic partner for whom the tax and other attributes of LLC ownership are attractive. Further, in any proposed acquisition or sale of the company, the purchase price could be increased significantly due to the value of the basis step-up.

*Voting control*

In connection with the IPO, the company will amend its certificate of incorporation and bylaws to provide that each LLC member will receive one or more shares of a newly-created Class B common stock. These shares of Class B common stock will vote along with the shares of Class A common stock, and will allow the holder to participate in any stockholder vote on an as-converted basis (i.e., each historic member of the LLC is able to vote as if it had already converted all of its holdings of LLC units for shares of Class A common stock, maintaining control over the business for the historic owners in line with their continued economic interests). Through this mechanism, the historic owners will continue to exercise control of the newly public company commensurate with their economic interest in the operating business.

*Documentation Requirements*

To effectuate the up-C structure, the newly-formed company will enter into various arrangements with the LLC and its historic owners. These include a TRA, an exchange agreement, and a registration rights agreement.

Under the TRA, the company agrees to make payments to the historic owners based on a percentage of the amount of savings realized by the company due to the increase in tax basis resulting from the exchange of LLC units. The customary distribution in tax savings is 85% to the historic investors and 15% to the company. Additionally, the TRA may provide for a lump sum payment to the historic investors in the event of a merger, asset sale, or other form of business combination or change in control. Notably, receipt of payment under the TRA is often not contingent on continued ownership in the company.1

The exchange agreement will provide for the exchange of LLC units for shares of Class A common stock of the company. The agreement will be subject to certain transfer restrictions and other protections meant to minimize the burden on the company. For instance, the exchange agreement may restrict holders of LLC units from exchanging for shares of Class A common stock for a period of a year after the IPO and may require such exchanges to be made in increments of at least 1,000 LLC units at a time.
The company may also enter into a registration rights agreement with certain holders of Class A common stock (or other securities convertible into or exchangeable or exercisable for shares of Class A common stock, including the LLC units), which gives such holders the right to request that the company use its reasonable efforts to file with the Securities and Exchange Commission either an exchange registration statement or a resale registration statement covering the Class A common stock. Restrictions may be placed on resale registration rights, such as requiring a minimum amount of expected net proceeds before proceeding. Additionally, the registration rights agreement may also provide for “piggyback” registration rights, whereby other holders of LLC units have the right to include their shares of Class A common stock in any proposed resale registration statement.

**SEC-Required Disclosures**

The details of the up-C structure must be disclosed in the registration statement at the time of the IPO. The disclosure should focus on the following sections of the registration statement:

- Under the heading “Organizational Structure,” there should be a description of the formation/reorganization transactions (e.g., the formation of the corporation as a holding company to the LLC and the amendment of the LLC agreement), the transactions to be undertaken in connection with the IPO, and the post-IPO structure;
- Under the heading “Description of Capital Stock,” there should be a description of the two class structure, which explains, for example, voting rights, liquidation rights, rights to receive dividends, preemptive rights, or any other rights associated with the ownership of shares of Class A or Class B common stock; and
- Under the heading “Certain Relationships and Related Party Transactions,” there should be a description of, where applicable, the amended LLC agreement, the TRA, the exchange agreement, the registration rights agreement and any arrangement or transaction which qualifies as a “related party transaction.”

**Use of the up-C Structure**

Though some additional organizational complexity is introduced with the up-C structure, it provides a number of advantages to entities organized as partnerships pursuing an IPO. Historically, the up-C structure has not been widely utilized; however, issuers with larger market capitalizations, and with private equity owners are increasingly considering it as an alternative. As shown in the attached Annex A, many high profile companies, like Shack Shake Inc., employed the up-C structure to access the public market.

Click [here](#) to view Annex A

To view all formatting for this article (eg, tables, footnotes), please access the original [here](https://www.morrisonfoerster.com/publications/Corporate-and-Investment-Banking-UPC-Structure).
Proposed Regulations for Foreign-Owned US LLCs Move Toward Increased Financial Transparency

Steptoe & Johnson LLP - Aaron P. Nocjar, Robert Rizzi, Beth D. Tractenberg and Lisa M. Zarlenga

FULL ARTICLE: http://www.lexology.com/library/detail.aspx?g=404d013b-ddf3-4f0f-9a37-01aa04293934&l=7RJ0GK5

May 23 2016

Introduction

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This is not the first time that the Obama Administration has proposed to require certain US disregarded entities to obtain an EIN. The Administration’s Fiscal Year 2016 and 2017 Revenue Proposals (Greenbook) contained legislative proposals that would require all entities formed in the United States to apply for an EIN. The budget proposal would also impose penalties for failure to obtain an EIN or to update responsible party and other information contained in the application, and would allow the IRS to share responsible party information with law enforcement without a court order to combat financial crimes.

Concurrent with the release of the proposed regulations, Treasury announced final Financial Crimes Enforcement Network (FinCEN) regulations increasing customer due diligence requirements for financial institutions and proposed legislation that would require a company to know and report beneficial ownership information to Treasury at the time of the company’s creation. Together with proposed regulations, these items are part of a multi-pronged effort to increase financial transparency and disclosure of beneficial ownership. In a letter to House Speaker Paul Ryan, also on May 5, Treasury Secretary Jacob J. Lew stated that these items are intended to address gaps in existing law “that allow bad actors to deliberately use U.S. companies to hide money laundering, tax evasion, and other illicit financial acts.” Secretary Lew also requested that Congress take further action by approving pending tax treaties and providing full reciprocity to its Foreign Account Tax Compliance Act (FATCA) partners.

Background
Current regulations under section 7701 classify a business entity with two or more members as either a corporation or a partnership, and a business entity with a single owner as either a corporation or an entity disregarded as separate from its owner (disregarded entity). This classification affects the way the entity is treated throughout the tax code, including for certain reporting requirements. While the proposed regulations would not change how an entity’s classification is determined, they would subject foreign-owned US disregarded entities to information reporting and disclosure rules under section 6038A currently applicable only to US corporations meeting a certain foreign ownership threshold.

When an entity, such as a limited liability company (LLC), is classified as a corporation for tax purposes, general ownership and accounting information is available to the IRS through the return filing and EIN application requirements. For example, all corporations organized in the US must file annual income tax returns, which may include schedules requiring the identification of owners exceeding specified ownership thresholds. In addition, section 6038A subjects US corporations that are at least 25% foreign-owned to specific information and record maintenance requirements. Such corporations are required to file an annual return on IRS Form 5472, Information Return of a 25% Foreign-Owned US Corporation or a Foreign Corporation Engaged in a US Trade or Business (Under Sections 6038A and 6038C of the Internal Revenue Code), with respect to each related party with which the reporting corporation has had any “reportable transactions.” See Treas. Reg. § 1.6038A-2. In addition, such corporations must keep permanent books of account or records as required by section 6001 that are sufficient to establish the accuracy of the federal income tax return of the corporation, including information, documents, or records to the extent they may be relevant to determine the correct US tax treatment of transactions with related parties. See Treas. Reg. § 1.6038A-3.

Generally no US income or information return must be filed for a disregarded entity that is formed in the United States and wholly owned by a foreign person if neither the disregarded entity nor its owner received any US source income or was engaged in a US trade or business during the taxable year. Moreover, if a disregarded entity only receives certain types of US source income, such as portfolio interest or US source income that is fully withheld upon at source, its owner may not have a US return filing requirement. Because a US single-member LLC is classified as a disregarded entity by default rather than by election and has no separate federal tax return filing requirements, there is typically no federal income tax requirement for it to obtain an EIN (although there may be non-income tax reasons to do so).

Proposed Regulations

In the preamble to the proposed regulations, the IRS indicated that “the absence of specific return filing and associated recordkeeping requirements for foreign-owned, single-member domestic entities hinders law enforcement efforts and compliance with international standards of transparency and cooperation in the area of tax information exchange,” making it “difficult for the United States to carry out the obligations it has undertaken in its tax treaties, tax information exchange agreements, and similar international agreements to provide other jurisdictions with relevant information on U.S. entities with owners that are tax resident in the partner jurisdiction or otherwise have a tax nexus with respect to the partner jurisdiction.” Moreover, the IRS states that “the lack of ready access to information on ownership of, and transactions involving, these
entities also makes it difficult for the IRS to ascertain whether the entity or its owner is liable for any federal tax.”

The proposed regulations would treat a US disregarded entity wholly owned by a foreign person as a US corporation separate from its owner for the limited purposes of the reporting, record maintenance, and associated compliance requirements that apply to 25% foreign-owned domestic corporations under section 6038A. The proposed regulations would also add an additional catch-all category of “reportable transactions” for section 6038A purposes, which would include any sale, assignment, lease, license, loan, advance, contribution, or other transfer of any interest in or a right to use any property or money, whether or not formally documented, as well as the performance of any services for the benefit of, or on behalf of, a related foreign person.

As a result, under the proposed regulations, foreign-owned US disregarded entities would be required to file an IRS Form 5472 information return and maintain records with respect to all transactions with foreign related parties. A transaction between a US disregarded entity and its foreign owner (or another disregarded entity of the same owner) would be considered a reportable transaction for purposes of the section 6038A reporting and record maintenance requirements, even though, because it involves a disregarded entity, it generally would not be considered a transaction for other income tax purposes. The proposed regulations would also provide that the exceptions to the record maintenance requirements in Treas. Reg. § 1.6038A-1(h) and (i) for small corporations and de minimis transactions will not apply to such entities.

Because foreign-owned US disregarded entities would have a filing obligation under the proposed rules, they would be required to obtain an EIN by filing an IRS Form SS-4 and disclosing significant information to the IRS about their ownership. On the Form SS-4, the entity would be required to identify the entity’s “responsible party,” generally the individual who has a level of control over, or entitlement to, the funds or assets in the entity that, as a practical matter, enables the individual, directly or indirectly, to control, manage, or direct the entity and the disposition of its funds and assets. The form also requires the responsible party to provide his or her social security number (SSN), individual taxpayer identification number (ITIN), or EIN. If the responsible party does not have an SSN/ITIN/EIN, he or she would first be required to complete a separate application to obtain one for him or herself before applying for the EIN for the entity. An entity applying for an EIN is required to update the IRS when there is a change in the responsible party, but there is no penalty for the failure to do so. However, the annual requirement to file the Form 5472 imposed by the proposed regulations will effectively require disregarded entities to provide current ownership information to the IRS.

The preamble notes that the IRS is also considering modifications to corporate, partnership, and other tax or information returns (or their instructions) to require the filer of these returns to identify all the foreign and US disregarded entities it owns.

**Final FinCEN Regulations and Proposed Legislation**

In a press release announcing the proposed IRS reporting regulations, Treasury also announced final FinCEN regulations increasing customer due diligence requirements for financial
institutions and proposed legislation that would require companies to know and report beneficial ownership information to Treasury at the time of the companies’ creation. The proposed legislation also contains technical amendments to the current Geographic Targeting Order (GTO) authority which would clarify FinCEN’s ability to collect information under GTOs, such as bank wire transfer information.¹ The most recent GTOs temporarily require certain US title insurance companies to record and report the beneficial ownership information of legal entities making “all-cash” purchases of high-value residential real estate in the Borough of Manhattan in New York City, New York, and Miami-Dade County, Florida. It is possible that Treasury will expand the GTOs to other areas that attract significant foreign investment in US real estate, such as other parts of New York City and Los Angeles.

Recommended Steps

The proposed IRS reporting regulations, final FinCEN regulations, and proposed legislation are part of a trend towards increased disclosure of cross-border entities and transactions. Given Secretary Lew’s comments and global trends toward increasing financial transparency and disclosure of beneficial ownership, additional US action in this area is likely. Foreign owners of US disregarded entities should consider what actions they would need to take to enable them to comply with the new level of reporting, disclosure and record-keeping burdens that would result if the proposed regulations are finalized in their current form. Comments on these proposed regulations are due August 8, 2016.

To view all formatting for this article (eg, tables, footnotes), please access the original here. 
Steptoe & Johnson LLP - Aaron P. Nocjar, Robert Rizzi, Beth D. Tractenberg and Lisa M. Zarlenga
Neither a Partner nor Employee Be: Treasury and the IRS Issue Regulations Clarifying the Employment Tax Treatment of Partners in Partnerships

Sutherland Asbill & Brennan LLP - Reginald J. Clark, Adam B. Cohen, Michael A. Hepburn, Paul R. Lang, Daniel R. McKeithen, Alice Murtos and Wes Sheumaker

FULL ARTICLE: http://www.lexology.com/library/detail.aspx?g=12393444-5a1c-4a68-adc3-6803df3c2e0d&l=7RCQ83P

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The Treasury Department (Treasury) and the Internal Revenue Service (Service) have issued temporary regulations (Regulations) clarifying the federal employment tax treatment of the owners of partnerships and other entities classified as partnerships for federal tax purposes. In general, the Regulations clarify that, where a partnership owns a disregarded entity (such as a single member LLC that has not elected to be treated as a corporation), the partners of that partnership are not permitted to be treated as employees of the disregarded entity for federal employment tax purposes (i.e., for FICA, FUTA, and income tax withholding purposes and reporting purposes). Rather, the partners are subject to self-employment tax on net earnings from self-employment resulting from the partnership’s activities, including the activities of the disregarded entity.

While the Regulations apply to only a limited subset of partnerships – specifically, partnerships that own a disregarded entity – the Regulations nonetheless are meaningful to all partnerships engaged in a trade or business. First and foremost, the Regulations reaffirm the Service’s longstanding position, as set forth in Rev. Rul. 69-184, 1969-1 CB 256, that a partner of a partnership is not permitted to be treated as an employee of the partnership for federal employment tax purposes but is instead considered self-employed and thus subject to federal self-employment tax. Moreover, the preamble (Preamble) to the Regulations includes requests for comments concerning, among other things, how the principles of Rev. Rul. 69-184 should be applied in tiered partnership structures and, more generally, whether there are circumstances in which it may be appropriate to limit the principles of Rev. Rul. 69-184 so as to permit partners to be treated as employees.

Sutherland Observation. The Service has historically taken the somewhat rigid position that an individual who works for a partnership and holds an equity interest in the partnership is not permitted to be treated as both an employee and a partner of that partnership, apparently even in circumstances in which the individual has only a relatively small equity interest, e.g., as a result of holding equity compensation. An employee is subject to FICA and income tax withholding, and W-2 reporting, on wages received as an
employee. In contrast, a partner generally is required to pay self-employment taxes and estimated tax payments on the partner’s distributive share of partnership income and any guaranteed payments, which are reported by the partnership to the partner on Schedule K-1. Also, the tax rules for participation in an employer-sponsored retirement or health plan are different for employees and partners; in particular, a partner cannot participate in a cafeteria plan permitting the payment of pre-tax health insurance premiums. A partnership’s treatment of a person as having dual status – i.e., as both a partner and an employee – may result in adverse tax consequences to the partnership and its partners.

In general, a business entity is disregarded as an entity separate from its owner (i.e., is a disregarded entity) for federal tax purposes if (1) the entity has a single owner and (2) is neither required nor elects to be classified as a corporation. This general rule does not apply for federal employment tax purposes; rather, for such purposes, the entity is treated as a corporation and thus the entity (and not its sole owner) is considered to be the employer of the entity’s employees. However, the general rule treating the entity as a disregarded entity does apply for self-employment tax purposes.

**Background**

The regulations (Prior Regulations) as in effect prior to the issuance of the Regulations include a single example illustrating the application of these rules. In the example, the entity has a single individual owner who is a sole proprietor, and the entity also has employees. The example concludes that the entity is considered a corporation (i.e., a separate entity) for federal employment tax purposes with respect to its employees but is treated as a disregarded entity for purposes of applying the self-employment tax to the entity’s individual owner. Thus, the example concludes that the individual owner is not treated as an employee of the entity for federal employment tax purposes but is instead subject to self-employment tax on the net earnings from self-employment resulting from the entity’s activities.

According to the Preamble, the Treasury and the Service are aware that some taxpayers may have read the Prior Regulations to permit the partners of a partnership that owns a disregarded entity to be treated as employees of the disregarded entity and on that basis to permit such partners to participate in certain tax-favored employee benefit plans. The Preamble notes, however, that the Prior Regulations did not create a distinction between a disregarded entity owned by an individual and a disregarded entity owned by a partnership. Further, the Preamble acknowledges that the Treasury and the Service do not believe that the Prior Regulations altered the holding of Rev. Rul. 69-184 (i.e., that a partner of a partnership is not permitted to be treated as an employee of the partnership for federal employment tax purposes but is instead considered self-employed and thus subject to self-employment tax).

**Explanation of Regulations**

The Regulations clarify that, where a partnership owns a disregarded entity, the rule that the disregarded entity is treated as a corporation for employment tax purposes does not apply to the self-employment tax treatment of any individuals who are partners in the partnership. Accordingly, the Regulations make it clear that the partners are subject to the same self-employment tax rules as partners in a partnership that does not own a disregarded entity.
Requests for Comments

The Preamble acknowledges that the Regulations apply only to partnerships owning a disregarded entity and that the Regulations do not apply to tiered partnership structures. The Preamble indicates that several commenters have requested the Service to provide additional guidance on the application of Rev. Rul. 69-184 to tiered partnership structures (which have also been used as a method to allow a person to hold a partnership interest and simultaneously serve as an employee), and to modify the holding of Rev. Rul. 69-184 to allow partnerships to treat partners as employees in certain circumstances, such as, for example, an employee in a partnership who obtains a small ownership interest in the partnership as an employee compensatory award or incentive. Accordingly, the Preamble requests comments on the appropriate application of Rev. Rul. 69-184 to tiered partnerships, the circumstances in which it may be appropriate to permit partners to also be employees of the partnership, and the impact on employee benefit plans and on employment taxes if Rev. Rul. 69-184 were to be modified to permit partners to also be employees in certain circumstances.

Effective Date

The Regulations apply on the later of (1) August 1, 2016, or (2) the first day of the latest-starting plan year following May 4, 2016, of an affected plan (based on the plans adopted before, and the plans in effect as of, May 4, 2016) sponsored by a disregarded entity. For this purpose, an affected plan includes any qualified plan, health plan, or section 125 cafeteria plan if the plan benefits participants whose employment status is affected by the Regulations. The Preamble indicates that the effective date of the Regulations is intended to allow adequate time for partnerships to make necessary payroll and benefit plan adjustments.
Caution in use of the “Zero Out” Technique in Incorporated Professional Practices

Dickinson Wright PLLC - Ralph Z. Levy, Jr.


April 4 2016

A recent Tax Court case (Brinks Gilson & Lione PC, TC Memo 2016-20) points out the need for caution in the “zero out” technique by professional practices that operate as professional corporations or professional associations under local law that are taxed as “C” corporations and that compute taxable income on the cash basis. Under this technique, a practice group will typically “bonus out” all remaining undistributed profits prior to the end of the corporation’s tax year and thereby eliminate or dramatically reduce any taxable income on which the corporation will pay state and federal taxes for that year.

The taxpayer in the Brinks case, a law firm that employed roughly 150 attorneys of whom 65 were shareholders, used this practice to eliminate any corporate level taxes by deducting as a compensation expense the year-end bonuses paid to its attorneys based on practice revenues and amounts paid as compensation to certain members of law firm management for service they performed as officers of the corporation. In resolution of an audit prior to the Tax Court case, the law firm and the Internal Revenue Service had agreed that a portion of the year-end bonuses equal to officers’ compensation would be recharacterized as dividends and thus not deductible.

In upholding the imposition of an accuracy-related penalty on the law firm, the Tax Court concluded that the taxpayer did not have substantial authority to claim a deduction for all year-end bonuses and compensation paid to its officers for services as such. In reaching its conclusion, the court cited several factors that supported its findings:

- Each attorney-shareholder’s annual compensation matched the number of shares owned by the attorney-shareholder in the corporation since the number of shares issued to each attorney was annually adjusted as compensation was adjusted.
- Although the attorney-shareholders were legally entitled to dividends, no dividends had been paid either during the ten years prior to the years subject to the audit or during the audit period.
- The taxpayer’s reliance on its accounting firm to prepare its tax returns did not give it grounds to rebut the imposition of the penalty.
- The taxpayer should have paid dividends to give a reasonable return on the significant amount of capital that each of the attorney-shareholders had invested in the law firm.

Care should be taken in advising incorporated practice groups based on the mistakes made by the law firm in the Brinks case. For example, once issued, shares of stock should only be adjusted as group members are admitted as shareholders or existing group members die, retire or become disabled. The shares of stock owned by each shareholder should not be directly proportionate to
annual compensation entitlement from the practice group. In addition, a reasonable dividend should be paid with a portion of practice group earnings in an amount that provides a market driven return on capital.

Dickinson Wright PLLC - Ralph Z. Levy, Jr.
Proposed Debt-Equity Regulations Have Dramatic Implications for Corporate Tax Planning and Compliance

McDermott Will & Emery - Thomas W. Giegerich and Michael J. Wilder

FULL ARTICLE: http://www.lexology.com/library/detail.aspx?g=b99c6064-9fbf-420c-9bd0-2fc3e919c0d9&l=7RELUQH

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On April 4, 2016, the Internal Revenue Service (IRS) and US Department of the Treasury (Treasury)—without advance warning—released proposed regulations under section 385 (the Proposed Regulations) that will, if finalized in their current form, have dramatic implications for US corporate tax planning and compliance. Certain aspects of the rules when finalized are intended to apply retroactively to corporate debt issued in specified circumstances on or after April 4, 2016. US government officials have indicated they intend to finalize the Proposed Regulations as early as the end of August, and many large corporate taxpayers are acting now, rather than waiting, to evaluate the Proposed Regulations’ potential effects on their existing and future US tax planning strategies and compliance regimes.

The Proposed Regulations impact the US federal tax treatment of many cross-border intercompany loans among affiliated members of a multi-national enterprise (MNE), as well as loans between US corporations under common ownership not filing a consolidated return and loans between members of brother-sister US consolidated return groups. However, the Proposed Regulations generally do not affect loans between members of a single consolidated return group (the Proposed Regulations treat the members of a consolidated group as a single taxpayer).

In broad terms, where applicable, the Proposed Regulations (1) impose new documentation and information requirements for intercompany debt which, if not complied with, will automatically result in the purported debt instrument being characterized as stock for federal income tax purposes; (2) authorize the IRS to characterize a debt instrument as in part debt, and in part stock under certain circumstances (an example is provided focused on expected ability to pay); and (3) mandate recharacterization of an instrument otherwise qualifying as debt for federal income tax purposes as stock if issued in a distribution or certain other circumstances specified in the Proposed Regulations (targeting, among other things, note distributions, exchanges of related party stock for debt instruments, and similar debt-funded distributions or other transactions often used in cross-border tax planning to optimize the capitalization of a US member of a MNE, manage the global effective tax rate (via US interest deductions) or mitigate potential withholding taxes associated with repatriation). Certain exceptions are provided for small non-publicly traded groups, groups without significant amounts of proscribed intercompany debt (i.e., less than $50 million), and certain routine distributions (e.g., distributions of current year earnings and profits), but these exceptions are narrowly drawn. Therefore, if the Proposed
Regulations are finalized, they will significantly impact the tax planning of virtually every publicly-traded MNE and many privately held enterprises as well.

Following is an overview of the most significant rules in the Proposed Regulations. A flow chart on page 7 illustrates the basic application of these rules.

**Section 1.385-2 Documentation and Information Requirements**

_In General._ Section 1.385-2 of the Proposed Regulations sets forth minimum (necessary, but not sufficient) documentation and information requirements for an Expanded Group Instrument or “EGI” (generally a debt instrument (applicable instrument) between parties directly or indirectly at least 80 percent related by vote or value) to be respected as debt for federal income tax purposes, failing which the Proposed Regulations mandate the EGI will be treated as stock. Excepted from the application of the rules is the case of an EGI where no member of the Expanded Group has publicly traded stock and, on the date the instrument first becomes an EGI, (1) total assets do not exceed $100 million on any applicable financial statement and (2) annual total revenues do not exceed $50 million on any applicable financial statement. In addition, the provisions of section 1.385-2 do not extend to instruments not cast in the form of debt, such as sale-repurchase agreements (repos), leases treated as debt and preferred equity certificates.

Section 1.385-2 is proposed to be effective in respect of applicable instruments issued (or deemed issued) after the regulations are finalized (the General Effective Date). Thus, debt instruments issued before the General Effective Date are grandfathered, but such grandfathered instruments can become subject to the final regulations if they are significantly modified and deemed reissued under section 1001 after the General Effective Date.

The Proposed Regulations mandate the timely preparation and maintenance of the following documentation and information:

- Written documentation evidencing an unconditional and legally binding obligation to pay a sum certain on demand or at one or more fixed dates.
- Written documentation establishing that the holder has the rights of a creditor to enforce the obligation.
- Written documentation (e.g., cash flow projections, business forecasts, asset appraisals, determination of financial ratios) containing information establishing the issuer’s financial position supported a reasonable expectation that the issuer intended to, and would be able to, meet its obligations pursuant to the terms of the applicable instrument.
- If an issuer made any payment of interest or principal with respect to the EGI and such payment is claimed to support the treatment of the EGI as indebtedness under general federal tax principles, documentation must include written evidence of such payment.
- If the issuer did not make a payment of interest or principal that was due and payable under the terms and conditions of the EGI, or if any other event of default or similar event has occurred, there must be written documentation evidencing the holder’s reasonable exercise of the diligence and judgment of a creditor (e.g., documentation of the holder’s efforts to assert its rights under the terms of the EGI or any
documentation detailing the holder’s decision to refrain from pursuing any actions to enforce payment).

The Proposed Regulations contain detailed rules as to what constitutes “timely” preparation and specify the records required to be maintained and period for which they must be maintained.

In the case of revolving credit and similar agreements, the documentation requirement may be satisfied by relevant enabling documents such as board of directors’ resolutions, credit agreements, security agreements, as well as any relevant documentation executed with respect to an initial principal balance or increase in the principal balance of the EGI. If an EGI is issued pursuant to a cash pooling arrangement or internal banking service that involves cash sweeps, set-off facilities or similar features, the EGI satisfies the documentation requirements only if the material documentation governing the ongoing operations of the cash pooling arrangement or internal banking service—including any agreements with entities that are not members of the expanded group—conforms to the requirements of section 1.385-2 and contains the relevant legal rights and responsibilities of the parties to the arrangements in conducting the operation of the cash pooling arrangement or internal banking service.

Section 1.385-2 Operating Rules. The operating rules under section 1.385-2 include a “reasonable cause” exception (with reference to the principles set forth in the regulations under section 6724), for instances where the taxpayer is able to establish that a failure to satisfy the documentation and information requirements of section 1.385-2 is due to reasonable cause. In such cases, the Proposed Regulations provide that “appropriate modifications may be made” in determining whether the requirements of this section have been satisfied.

The operating rules also (1) address the application of section 1.385-2 to an applicable instrument becoming or ceasing to be an EGI, including in the case of an applicable instrument ceasing to be between members of a consolidated return group, (2) specify that an EGI issued by a disregarded entity (DRE) that is treated as equity under section 1.385-2 will be treated as an equity interest in the DRE (converting it to a partnership) for federal tax purposes rather than stock in the DRE’s owner and (3) provide that a “controlled partnership” is treated as a member of an expanded group if one or more members of the expanded group own, directly or indirectly, 80 percent of the interests in partnership capital or profits of the controlled partnership and specify that an EGI issued by a controlled partnership that is recharacterized as stock under section 1.385-2 is treated as an equity interest in the controlled partnership.

Finally, section 1.385-2(d) provides that taxpayers may not make affirmative use of the rules of section 1.385-2 to reduce federal tax liability and section 1.385-2(e) provides that if an applicable instrument that is not an EGI is issued with a principal purpose of avoiding the purposes of the section, the applicable instrument will be treated as an EGI subject to the section.

Bifurcation of Debt between Modified Expanded Group Members: Section 1.385-1(d)

Section 1.385-1(d) provides that the IRS may treat an EGI between members of a “Modified Expanded Group” (an Expanded Group but substituting 50 percent for 80 percent as the relationship threshold) as in part indebtedness and in part stock “to the extent that an analysis, as
of the issuance of the EGI, of the relevant facts and circumstances concerning the EGI (taking into account any application of section 1.385-2) under general federal tax principles results in a determination that the EGI is properly treated for federal tax purposes as indebtedness in part and stock in part.” The sole example provided involves a case where the IRS’s analysis supports a reasonable expectation that, as of the issuance of the EGI, only a portion of the principal amount of an EGI will be repaid. The issuer of an EGI, the holder of an EGI, and any other person relying on the characterization of an EGI as indebtedness for federal tax purposes would continue to be bound by the issuer’s initial characterization (i.e., no affirmative use of bifurcation by taxpayers is permitted).

The debt bifurcation provision applies to all corporate instruments issued in form as debt, without exception, effective as of the General Effective Date but, for purposes of sections 1.385-3 and 1.385-4, as of the accelerated effective date provided for in those sections (see discussion below). Like the provisions of section 1.385-2, this bifurcated debt provision does not extend to instruments not issued in the form of debt.

**Debt Recharacterization Rules of Section 1.385-3**

Subject to certain exceptions discussed below, section 1.385-3 provides rules for recasting debt instruments as stock when the instruments are issued in certain transactions. The term “debt instrument” is defined as an interest that would, but for the application of section 1.385-3, be treated as debt under general federal income tax principles (and, unlike section 1.385-1(d) and section 1.385-2, section 1.385-3 can apply to repos, leases treated as debt, preferred equity certificates and other instruments that in substance, but not form, constitute debt for federal tax purposes).

**Recasts under General Rule.** Under the “General Rule” in section 1.385-3(b)(2)), debt instruments issued under the following circumstances will be recast as stock: (1) debt issued by a corporation to a related corporate shareholder as a distribution, (2) certain debt issued by a corporation in exchange for stock of an affiliate (for example, a share repurchase for a note or a purchase of affiliate shares for a note in what otherwise would be a section 304 transaction) and (3) certain debt issued as part of an internal asset reorganization (e.g., a cross chain transfer of assets in exchange for a note distributed to parent company in a “D” reorganization).

The Proposed Regulations are aimed at effectively overturning the result in Kraft Foods Co. v. Commissioner, 232 F.2d 118 (2d Cir. 1956), a case in which the Second Circuit Court of Appeals determined that debentures issued by a corporate subsidiary to its sole corporate shareholder as a dividend should be respected as indebtedness for federal income tax purposes. In the preamble to the Proposed Regulations, the IRS and the Treasury note that the factors in cases like Kraft, “including the parent-subsidiary relationship, the fact that no new capital is introduced in connection with a distribution of debentures, and the typical lack of a substantial non-tax business purpose,” support the conclusion that “the issuance of a debt instrument in a distribution is a transaction that frequently has minimal or nonexistent non-tax effects . . . allowing the related parties to obtain significant federal tax benefits at little or no cost.” The IRS and Treasury have determined that in such cases it is appropriate to treat a debt instrument as stock.
Under the “Funding Rule” in section 1.385-3(b)(3), the provisions of section 1.385-3 also apply to any debt instrument that is a “principal purpose debt instrument”—a debt instrument “to the extent it is issued by a corporation (funded member) to a member of the funded member’s expanded group in exchange for property with a principal purpose of funding [certain specified types of a] distribution or acquisition” (paralleling the transactions addressed by the General Rule). The reference to “to the extent” signifies that the treatment of an instrument can be bifurcated under the recharacterization rules of section 1.385-3 as well as under section 1.385-1(d). For example, if a corporation with no earnings and profits borrows $100 from an affiliate and then distributes $80 of cash to its parent corporation, $80 of the loan will be recast as stock and $20 of the loan will continue to be treated as debt. No further rules are provided for how to treat the bifurcated instrument (e.g., how to allocate future interest and principal payments between the stock and debt portions of the instrument).

Under a non-rebuttable per se rule, a debt instrument is treated as issued with a principal purpose of funding a proscribed distribution or acquisition if it is issued by the funded member during the 72 month period beginning 36 months before the date of the distribution or acquisition, and ending 36 months after the date of the distribution or acquisition. This per se rule is subject to a very narrow “ordinary course exception” for a debt instrument that arises in the issuer’s trade or business in connection with the purchase of property or the receipt of services, as well certain other narrow exceptions (that also apply to the General Rule and which are described below). There is currently no general exception for cash sweeps or similar arrangements, although the government is willing to further consider whether some exceptions for these arrangements would be appropriate.

Recasts under Anti-Abuse Rule. Finally, under an anti-abuse rule set forth in section 1.385-3(b)(4), a debt instrument is treated as stock if it is issued with a principal purpose of avoiding the application of section 1.385-3 or section 1.385-4 (not otherwise discussed in this article, section 1.385-4 provides rules for applying section 1.385-3 to consolidated groups when an interest ceases to be a consolidated group debt instrument or becomes a consolidated group debt instrument). In addition, an interest that is not a debt instrument (for example, a contract to which section 483 applies or a non-periodic swap payment) is treated as stock if issued with a principal purpose of avoiding the application of the rules. The anti-avoidance rule may apply, for example, if a debt instrument is issued to, and later acquired from, a person who is not a member of the issuer’s Expanded Group with a principal purpose of avoiding the application of the rules. A number of additional examples are provided.

Exceptions to Application of Section 1.385-3

Section 1.385-3(c) contains a number of important exceptions:

1. **Exception for Current Earnings and Profits.** Section 1.385-3(c) provides that, for purposes of the application of the General Rule (section 1.385-2(b)(2)) and the Funding Rule (section 1.385-2(b)(3)) to a member of an Expanded Group with respect to a taxable year, the aggregate amount of any distributions or acquisitions that are described in the General Rule or the Funding Rule are reduced by an amount equal to the member’s current year earnings and profits. This reduction is applied to the transactions based on
the order in which the distributions and acquisitions occur. It is not clear from the preamble why the exception is provided solely for distributions from current (as opposed to current and accumulated earnings and profits), but the government has since stated that the exception is intended only to protect ordinary course distributions and not all dividend distributions.

2. **Threshold Exception.** A debt instrument is not treated as stock under section 1.385-3 if, immediately after the debt instrument is issued, the aggregate adjusted issue price of debt instruments held by members of the Expanded Group otherwise caught by the rules does not exceed $50 million. Once this threshold is exceeded, the Threshold Exception will not apply to any debt instrument issued by members of the Expanded Group for so long as any debt instrument that previously was treated as indebtedness solely because of the Threshold Exception remains outstanding.

3. **Exception for Funded Acquisitions of Subsidiary Stock by Issuance.** An acquisition of Expanded Group stock will not be treated as described in the Funding Rule if the acquisition results from a transfer of property by a funded member (the transferor) to an Expanded Group member (the issuer) in exchange for stock of the issuer, provided that, for the 36-month period immediately following the issuance, the transferor holds, directly or indirectly, more than 50 percent of the total combined voting power of all classes of stock of the issuer entitled to vote and more than 50 percent of the total value of the stock of the issuer.

**Section 1.385-3 Operating Rules**

Section 1.385-3(d) sets forth various operating rules for the application of the section, including rules addressing excepted debt that that then ceases to qualify for an exception and debt treated as stock which then ceases to be between members of an Expanded Group. A comprehensive discussion of these rules is beyond the scope of this article. A few highlights are as follows:

1. **Treatment of Partnerships.** A controlled partnership is treated as an aggregate of its partners. Thus, for example, when a corporation that is a member of an Expanded Group becomes a partner in a partnership that is a controlled partnership with respect to that Expanded Group, the corporation is treated as acquiring its proportionate share of the controlled partnership’s assets. In addition, each Expanded Group partner in a controlled partnership is treated as issuing its proportionate share (based on its share of partnership profits) of any debt instrument issued by the controlled partnership. To the extent that this application of the aggregate approach causes a debt instrument issued by a controlled partnership to be recharacterized under section 1.385-3(b), then the holder of the recharacterized debt instrument is treated as holding stock in the Expanded Group partners. The controlled partnership rules do not provide guidance regarding all the collateral recasts that result from the aggregate approach, the additional recasts that will be required when the recharacterized debt is later repaid, or any implications under the existing partnership rules (e.g., under section 752).

2. **Treatment of Disregarded Entities.** If a debt instrument of a disregarded entity is treated as stock under section 1.385-3, the debt instrument is treated as stock in the entity’s owner rather than as an equity interest in the entity, which prevents the disregarded entity from becoming a partnership with two equity owners. (This is the opposite of the rule in
section 1.385-2, which (as described above) causes a disregarded entity that issues debt without sufficient documentation to become a partnership when the debt is recharacterized as stock.)

3. *No Affirmative Use.* The rules of section 1.385-3 and section 1.385-4 do not apply to the extent a person enters into a transaction that otherwise would be subject to the rules with a principal purpose of reducing the federal tax liability of any member of the Expanded Group that includes the issuer and the holder of the debt instrument by disregarding the treatment of the debt instrument that would occur without regard to this section. (Some have referred to this as “the government always wins rule,” and they have expressed the view that the existence of this rule (among others) makes the Proposed Regulations especially vulnerable to a validity challenge.)

**Section 1.385-3 Effective Date**

Section 1.385-3 applies to any debt instrument issued on or after April 4, 2016, and to any debt instrument treated as issued before that date as a result of an entity classification election made under section 301.7701-3 that is filed on or after this date. For purposes of the principal purpose test set forth in section 1.385-3(b)(3)(iv), a distribution or acquisition described in the Funding Rule that occurs before April 4 (other than a distribution or acquisition that is treated as occurring before that date as a result of an entity classification election made under section 301.7701-3 that is filed on or after that date) is not taken into account. Once again, care should be exercised to ensure that grandfathered debt instruments issued before April 4, 2016 do not inadvertently become subject to the rules through a significant modification occurring after April 4, 2016.

For instruments that otherwise would be treated as stock pursuant to section 1.385-3 prior to issuance of the section 385 regulations in final form, the debt instrument is treated as indebtedness until the date that is 90 days after the date of publication in the Federal Register of the Treasury decision adopting the rule as a final regulation. To the extent that the debt instrument is held by a member of the issuer’s Expanded Group on the date that is 90 days after the date of publication in the Federal Register of the Treasury decision adopting the rule as a final regulation, the debt instrument is deemed to be exchanged for stock on that date. Although this 90 day rule provides flexibility to unwind debt instruments issued after April 4, 2016, close attention should be paid to both the transaction in which the instrument was issued and the unwind transaction, because such transactions may still be subject to the Funding Rule.

**Conclusion**

The Proposed Regulations are an ambitious undertaking. Satisfaction of what historically have been factors to take into account as part of a debt-equity analysis will become necessary (but not sufficient) conditions for treatment of an instrument as debt for federal tax purposes if the Proposed Regulations are finalized. The IRS is also given license to bifurcate an instrument into part debt and part stock on audit. Moreover, an instrument qualifying as debt, both under general federal income tax principles and the provisions of section 1.385-1 and section 1.385-2, can still be automatically recharacterized as stock under section 1.385-3 if the debt is issued in certain contexts. Particularly troubling is the vague and uncertain reach of section 1.385-3, covering as it
does not only easily discernible fact patterns like the distribution of debentures in Kraft Foods, but also highly ambiguous and complex scenarios such as those addressed by the Funding Rule (particularly under the 72 month per se rule). The routine recharacterization of intercompany debt as stock under these rules can trigger, among many other surprising and adverse consequences, a de-consolidation of a subsidiary, a break in section 368(c) control, disqualification of a REIT, inadvertent hook stock, section 304 transactions and subpart F income, to name only a few examples. It also, of course, would create a proliferation of cross-border hybrid instruments (since the instrument in question may satisfy normal conventions for debt characterization). Moreover, it remains to be seen whether (and how) states will implement the rules once finalized (keeping in mind that members of a consolidated return group may file separate state tax returns). Consequently, taxpayers are well-advised to take stock (no pun intended) of their intercompany debt regimes.

Government officials have expressed an active interest in receiving comments on the Proposed Regulations as quickly as possible. Given the scope and complexity of these new rules, it can be anticipated that extensive comments will be forthcoming.

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Corporate Inversion Transactions

IRS and Treasury Issue Temporary Regulations Intended to Limit Ability of Corporations to Invert and Reduce the Tax Benefits of Inversion Transactions

SUMMARY
On April 4, 2016, the Internal Revenue Service (the “IRS”) and the Treasury Department (the “Treasury”) issued new temporary regulations (the “Temporary Regulations”) that address inversion transactions and certain post-inversion transactions. Most notably, the Temporary Regulations add rules that limit so-called “serial inversions.” As described in more detail below, these new rules disregard the value of a foreign corporation’s unrelated domestic entity acquisitions for the purposes of determining the Ownership Fraction (defined below), if such unrelated acquisitions closed within the three-year period prior to signing a new deal.

The rules set forth in the Temporary Regulations are generally otherwise consistent with guidance previously issued in Notice 2014-52 (the “2014 Notice”) and Notice 2015-79 (the “2015 Notice” and, together with the 2014 Notice, the “Notices”), subject to certain modifications, exceptions and additional limitations.

The new rules and modifications will apply to transactions that close on or after April 4, 2016. The other rules provided in the Temporary Regulations that were previously set forth in the Notices will generally apply as described in the original pronouncements.

BACKGROUND
Section 7874 generally targets “inversion” or “expatriation” transactions in which a foreign corporation or publicly traded foreign partnership (in each case, a “foreign acquiring corporation”) acquires substantially all of the assets of a U.S. corporation or partnership (including by way of acquiring the ownership
interests in such corporation or partnership) unless such foreign entity has “substantial business activities” in the jurisdiction of its organization. Whether Section 7874 applies to a transaction therefore depends on the percentage of the combined entity that is held by the U.S. Stockholders (as defined below) (the “Ownership Fraction”).

If at least 80 percent (by vote or value) of the foreign acquiring corporation is held by the former shareholders or partners of the expatriated entity “by reason of holding” stock or a capital or profits interest in the expatriated entity (the “U.S. Stockholders”) and the “substantial business activities” test is not satisfied, the foreign acquiring corporation is treated as a domestic entity for U.S. tax purposes.

If at least 60 percent (by vote or value), but less than 80 percent, is held by the U.S. Stockholders and the “substantial business activities” test is not satisfied, the foreign acquiring corporation is respected as foreign, but is subject to various tax disadvantages, including U.S. tax on any “inversion gain” recognized in the ten years following the transaction (such transactions, “60-80 Transactions”). The majority of announced transactions were such 60-80 Transactions, although since the Notices, which focused on transactions in this range, there have been more transactions where the Ownership Fraction is below 60 percent.

THE REGULATIONS

The Temporary Regulations add the new “serial inversions” rule and otherwise generally implement rules announced in the Notices, subject to certain modifications and additions. The following summary is a review of the relevant updates provided in the Temporary Regulations.

A. LIMITING THE ABILITY OF U.S. CORPORATIONS TO SATISFY THE OWNERSHIP THRESHOLD NECESSARY FOR AN EXPATRIATION TO BE RESPECTED

1. “Serial” Inversions

The most notable new anti-inversion rule in the Temporary Regulations addresses so-called “serial inversions.” This rule is intended to address a case where the foreign acquiring corporation previously acquired one or more domestic entities—in effect making the foreign acquiring corporation larger and the Ownership Fraction easier to satisfy in a subsequent acquisition. Under the new rule, in general, stock of the foreign acquiring corporation will be disregarded (for the purposes of determining the Ownership Fraction) to the extent such stock is attributable to the value of the domestic acquisitions that occurred within three years of the signing date (not the closing date) of the new domestic entity acquisition. Specifically, the rule excludes from the denominator of the Ownership Fraction the foreign acquiring corporation stock received in a prior domestic entity acquisition (less certain adjustments made for redemptions), based on the value of such stock at the closing of the new domestic entity acquisition. This rule only applies to a prior domestic entity acquisition where the Ownership Fraction was greater than five percent or the fair market value of the foreign acquiring corporation stock received by the U.S. Stockholders in such acquisition was greater than $50 million. Notably, prior domestic entity acquisitions

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that are not “inversion transactions” (i.e., where the relevant Ownership Fraction in respect of such prior transaction is less than 60 percent) are not excluded, although prior acquisitions made for cash would generally have no impact (since there would be no stock issued that would need to be excluded).

This rule will generally apply to transactions that close on or after April 4, 2016.

2. Multiple-Step Acquisitions

The Temporary Regulations also provide a new rule intended to prevent a series of related transactions that, when taken together, could cause an indirect acquisition of a domestic entity and avoid the application of Section 7874. In general, Section 7874 regulations provide an exception (the “Foreign Entity Exception”) that an acquisition of a foreign entity is not treated as an acquisition of a domestic subsidiary of the foreign entity (because such a domestic entity is already expatriated). The Temporary Regulations would turn off the Foreign Entity Exception where a domestic entity is first acquired by an initial foreign entity (which may satisfy the “substantial business activities” test or not be subject to the Top Hat rule, as described below) and that initial foreign entity is, pursuant to the same plan or series of related transactions, subsequently acquired by a second foreign acquiring corporation. The new rule would treat the second foreign corporation as acquiring a domestic entity and be subject to the requirements of Section 7874 (i.e., having to satisfy the “substantial business activities” test or Top Hat rule).

This rule will generally apply to transactions that close on or after April 4, 2016.

3. “Top Hat” in a Third Jurisdiction

Prior to the 2015 Notice, many cross-border transactions between a domestic entity and a foreign company (a “Foreign Target”) established a “top hat” parent company in a third jurisdiction (a “Top Hat”) that served as the foreign acquiring corporation in the transaction. This may be done for a variety of reasons, but the 2015 Notice would, in many instances, disregard all stock issued by the Top Hat to the Foreign Target shareholders in the combination for the purposes of calculating the Ownership Fraction, which could result in the Top Hat being treated as a domestic corporation. This can be a surprising result where the “headline” ownership percentage attributable to the Foreign Target, as understood by the market, is far from the 80-percent threshold. In effect, in many cases, the 2015 Notice (as implemented by the Temporary Regulations) lowers the 80-percent threshold for transactions with a Top Hat to 60 percent.

As provided in the Temporary Regulations, which are generally consistent with the 2015 Notice, this rule applies if (i) in a transaction related to the acquisition, a Top Hat directly or indirectly acquires substantially all of the properties held directly or indirectly by the Foreign Target (the “Foreign Target Acquisition”); (ii) the tax residence of the Top Hat is not the same as that of the Foreign Target, as determined before the Foreign Target Acquisition or any transaction related thereto (treating a change of
“management and control” as a transaction for this purpose); and (iii) the transaction is a 60-80 Transaction (without taking into account modifications to the Ownership Fraction pursuant to this rule). For the purposes of determining whether there could be a Foreign Target Acquisition, the Temporary Regulations replace a “60 percent gross value” test in the 2015 Notice with a “continuity of interest” test, which generally requires that 60 percent or more of the stock of the Top Hat be held by former shareholders of the Foreign Target, without taking into account U.S. Stockholders’ ownership of the Top Hat stock.

The Top Hat rule will generally apply to acquisitions that close on or after November 19, 2015, and taxpayers may elect to apply the revised provisions of this rule included in the Temporary Regulations to transactions that close before April 4, 2016.

4. Foreign Corporation That Is a “Cash Box”

The 2014 Notice announced that future regulations will provide a “cash box” rule whereby a ratable portion of stock will be disregarded for the purposes of the Ownership Fraction to the extent that more than 50 percent of the existing assets of the foreign corporation are “nonqualified property” (i.e., liquid assets, including cash, marketable securities and intercompany obligations). Under the 2014 Notice, assets of an “active” bank or financing business for the purposes of the “passive foreign investment company” (“PFIC”) and “controlled foreign corporation” (“CFC”) rules and assets of an “active” insurance company for the purposes of the CFC rules are not nonqualified property. The 2015 Notice corrected this rule to provide that assets of foreign insurance companies that are “active” for the PFIC rules are also not treated as nonqualified property for this purpose. Further, the 2015 Notice clarified that property held by a domestic insurance company (subject to U.S. taxation, but wholly owned by a foreign acquiror) generally would not be nonqualified property for this purpose.

The Temporary Regulations implement this rule generally as described and modified by the Notices. In addition, the Temporary Regulations provide a “de minimis” exception to the “cash box” rule. The de minimis exception in the Temporary Regulations specifically provide that the “cash box” rule does not apply if (i) the U.S. Stockholders hold less than five percent of the combined company as determined by the Ownership Fraction (without regard to the “cash box” rule) and (ii) the U.S. Stockholders hold less than five percent of the stock of each member of the “expanded affiliated group” (“EAG”). In addition, the Temporary Regulations provide a look-through rule for partnerships in which the foreign corporation owns more than 50 percent (by value) of the interests.

The “cash box” rule generally applies to acquisitions completed on or after September 22, 2014. However, the new rules provided in the Temporary Regulations, such as the “de minimis” exception and the look-through rule for partnerships, will apply to acquisitions completed on or after April 4, 2016.
5. “Skinny-Down” Distributions

A domestic entity contemplating an inversion may decrease its value before the inversion by distributing property to its shareholders in order to reduce the Ownership Fraction, such that the combined company could avoid the application of Section 7874, or avoid the shareholder-level tax under Section 367(a)(1). To limit the effectiveness of these pre-transaction distributions (also known as “skinny-down” distributions), the 2014 Notice announced a rule to be provided in future regulations that would, for the purposes of determining the Ownership Fraction, disregard (and require to be added back) certain pre-transaction distributions by the domestic entity, whether or not such distributions were made with an avoidance purpose. The 2015 Notice provided a “de minimis” exception to this rule.

The determination of “non-ordinary course distributions” under the Temporary Regulations is complex but is generally more certain in its application than adumbrated in the Notices. The Temporary Regulations clarify that the non-ordinary course distribution rule applies solely for the purposes of determining the ownership percentage by value (not by vote). In addition, the Temporary Regulations jettisoned the highly unworkable “taxable year” concept originally proposed in the 2014 Notice and look to just calendar periods to determine non-ordinary course distributions. Further, the Temporary Regulations provide special adjustments for short periods.

Distributions generally include all distributions on stock, such as share buybacks and spin-offs under Section 355. However, the Temporary Regulations provide that distributions for this purpose do not include certain deemed distributions, such as stock distributions. In the context of a distribution under Section 355, a special rule provides that, if the “SpinCo” is larger than the distributing corporation, SpinCo would be deemed to have distributed its former parent. The value of the property distributed will be determined on the date of the distribution.

The Temporary Regulations also capture distributions by a “predecessor” entity of the domestic entity acquired in an inversion transaction, which, for example, may have undergone a reorganization in advance of the expatriation to avoid this non-ordinary course distribution rule. Accordingly, for purposes of calculating non-ordinary course distributions, distributions by an entity that is acquired by or combined with the domestic entity will be included in determining the non-ordinary course distribution calculations.

The Temporary Regulations provide a “de minimis” exception, consistent with the announcement in the 2015 Notice. The exception provides that a domestic entity is not required to “add-back” non-ordinary course distributions if (i) the Ownership Fraction (without taking into account this non-ordinary course distribution rule and certain other modifications) is less than five percent (by vote and value), and (ii) following the transactions, U.S. Stockholders, in aggregate, own less than five percent (by vote and value) of the stock of each EAG member.

The non-ordinary course distribution rule will generally apply to acquisitions completed on or after September 22, 2014. The “de minimis” exception will apply to transactions that close on or after
November 19, 2015 and the new clarifying rule in the Temporary Regulations with respect to distributions that qualify under Section 355 will apply to transactions that close on or after April 4, 2016. However, taxpayers may elect to apply the exception and the clarification to transactions that closed on or after September 22, 2014.

B. POST-INVERSION LIMITATIONS

1. “Hopscotch” Transfers of Controlled Foreign Corporation Earnings and Profits

A U.S. shareholder of a foreign corporation (including a CFC) generally defers recognition of current U.S. tax on its pro rata share of the CFC’s active business income until that income is repatriated. However, Section 956 subjects U.S. shareholders to tax on their pro rata share of the CFC’s deferred profits when the CFC makes investments in certain U.S. property. The 2014 Notice observed that, prior to the 2014 Notice, an inversion transaction may permit the foreign acquiring corporation (after the combination) to circumvent Section 956 and access the CFC’s profits. For example, a CFC may make a loan directly to the new foreign parent (a so-called "hopscotch" loan), which, under prior law, would not be subject to the rules of Section 956. The IRS and Treasury announced in the 2014 Notice that future regulations would provide (solely for the purposes of Section 956) that any obligation or stock of a foreign-related person acquired by a CFC within 10 years after the inversion will be treated as “U.S. property” and, thus, would give rise to taxable income to the U.S. shareholder of the CFC (the acquired domestic entity).

The Temporary Regulations implement the limitation announced in the 2014 Notice, subject to certain modifications. Notably, if a CFC of a domestic entity acquires stock or obligations of a “prospective” foreign acquiring corporation “in a transaction related to the inversion transaction” (i.e., prior to closing), the CFC would be treated as holding “U.S. property” with respect to such stock or obligations.

Other than the modifications provided in the Temporary Regulations, which will apply to obligations or stock acquired on or after April 4, 2016, the “hopscotch” rule will apply to obligations or stock acquired on or after September 22, 2014, but only to inversion transactions that close on or after September 22, 2014.

2. “Asset-Dilution” of Controlled Foreign Corporations

The Temporary Regulations added a new “asset-dilution” rule to the basket of limitations provided in the Notices (and implemented by the Temporary Regulations) with respect to expatriated CFCs, such as limitations on “de-controlling” and “stock-dilution.” The Temporary Regulations require, subject to certain exceptions, an expatriated CFC to recognize all built-in gain in a transfer of assets to a related foreign corporation (that is not a CFC), even if such transfer would qualify as tax-free under Section 351. This “asset dilution” rule effectively puts a toll charge on asset transfers by expatriated CFCs to related non-CFCs.

This rule applies to transfers completed on or after April 4, 2016, but only if the inversion transaction was completed on or after September 22, 2014.
ADDITIONAL GUIDANCE RELEASED

In addition, on April 4, 2016, the IRS and the Treasury issued a notice of proposed rulemaking that, if finalized, will cause very significant changes in the structuring of debt capitalization of U.S. subsidiary groups owned by foreign corporations (and of foreign subsidiaries owned by U.S. corporations). The proposed regulations provide that certain related-party debt would be recharacterized as equity, or as part-debt and part-equity, if, for example, such debt were issued to finance a related-party acquisition or such debt was distributed to a related corporate shareholder. Although the main purpose of the proposed regulations may have been to negate one of the tax benefits of an inversion, their reach extends far beyond the context of inversions and will have an impact on the tax planning of multinational corporations and investments. The proposed regulations will apply to debt issued on or after April 4, 2016; however, such debt will retain its characterization as debt until 90 days after the final regulations are published.

A separate memorandum published by Sullivan & Cromwell LLP entitled “IRS Issues Proposed Regulations Intended to Limit Earnings Stripping but Which—if Finalized—Would Broadly Change the U.S. Tax Treatment of Related-Party Indebtedness” discussing these new rules was made available today.

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1 For additional background on Section 7874, please see the Sullivan & Cromwell LLP publications addressing Section 7874 and related guidance, which may be obtained by following the instructions at the end of this publication.

2 An expanded affiliated group will have “substantial business activities” in the relevant foreign country after the acquisition only if at least 25 percent of the employees, assets, and income of the expanded affiliated group are located in, or in the case of income, derived from, that relevant foreign country. See § 7874(a)(2)(B)(iii); Treas. Reg. § 1.7874-3T(b).

3 For ease of reference, we will refer to all such interests as “stock.”

4 See § 7874(b).

5 “Inversion gain” includes any income or gain recognized by reason of the inversion transaction (which includes gain recognized on the transfer or sale of assets to the non-U.S. corporation) and certain gain and licensing income recognized by an expatriated entity during the ten-year period. See § 7874(d)(2), (f).

6 If multiple Foreign Targets in the same Foreign Target jurisdiction are acquired, then they will be treated as a single entity.

7 Although not clear, this determination would be made under applicable foreign law. It remains unclear how the residence would be determined if tax residence is possible in more than one jurisdiction.

8 See § 1.7874-9T(c).

9 It is unclear whether distributions on or redemptions of convertible debt would be treated as distributions with respect to a corporation’s stock for this purpose.
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