June 12, 2015

The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Comments on Notice 2014-52

Dear Commissioner Koskinen:

Enclosed please find comments on Notice 2014-52 (“Comments”). These Comments are submitted on behalf of the American Bar Association Section of Taxation and have not been approved by the House of Delegates or the Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

The Section would be pleased to discuss the Comments with you or your staff if that would be helpful.

Sincerely,

Armando Gomez
Chair, Section of Taxation

Enclosure

c: Mark J. Mazur, Assistant Secretary (Tax Policy), Department of the Treasury
    Emily S. McMahon, Deputy Assistant Secretary (Tax Policy), Department of the Treasury
    Robert Stack, Deputy Assistant Secretary (International Tax Affairs), Department of the Treasury
    Danielle Rolfe, International Tax Counsel, Department of the Treasury
    William J. Wilkins, Chief Counsel, Internal Revenue Service
    Erik Corwin, Deputy Chief Counsel (Technical), Internal Revenue Service
    Steven Musher, Associate Chief Counsel (International), Internal Revenue Service
AMERICAN BAR ASSOCIATION
SECTION OF TAXATION

COMMENTS ON NOTICE 2014-52

These comments (“Comments”) are submitted on behalf of the American Bar Association Section of Taxation (the “Section”) and have not been approved by the House of Delegates or Board of Governors of the American Bar Association. Accordingly, they should not be construed as representing the position of the American Bar Association.

Principal responsibility for preparing these Comments was exercised by David G. Shapiro of the Section’s Committee on Foreign Activities of U.S. Taxpayers (“FAUST”) and Committee on U.S. Activities of Foreigners and Tax Treaties (“USAFTT). Substantive contributions were made by Pamela Fuller, Philip Hirschfeld, William Paul, Joseph Ryan, and Mitchell Weiss. Helpful comments were provided by Ian Bristol, Peter Connors, and Abraham Leitner. Special thanks to Matthew Jensen and Gafar Zaaloff for their assistance with cite checking and format review. The Comments were reviewed by Joseph Calianno, Chair of FAUST and by Michael J. Miller, Chair of USAFTT. Provisions relating to insurance companies were reviewed by Bryan Keene of the Section’s Committee on Insurance Companies. The Comments were further reviewed by Philip Wright on behalf of the Section’s Committee on Government Submissions; by Alan Appel, the Section’s Council Director for FAUST and USAFTT; and by Peter Blessing, the Section’s Vice Chair (Government Relations).

Although the members of the Section who participated in preparing these Comments have clients who might be affected by the federal tax principles addressed by these Comments, no such member or the firm or organization to which such member belongs has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these Comments.

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Date: June 12, 2015
EXECUTIVE SUMMARY

On September 22, 2014, the Department of Treasury (“Treasury”) and the Internal Revenue Service (the “Service”) issued Notice 2014-52 (the “Notice”), describing regulations that Treasury and the Service intend to issue to address transactions that would avoid the purposes of section 7874,1 as well as to address tax avoidance by corporate groups that have completed certain transactions described in section 7874. While we acknowledge the concerns, we are concerned that some of the proposed rules could affect ordinary-course business transactions and other transactions that should be outside the scope of the inversion regulations, and could create unnecessary uncertainty and expense in administration, and in some cases could produce unintended results.

We also note that other commentators have raised questions regarding the extent to which Treasury and the Service have regulatory authority to promulgate the rules described in the Notice. Those questions are beyond the scope of these Comments, which address how the rules described in the Notice ought to be implemented if Treasury and the Service decide to issue regulations implementing the Notice.

Summary of comments regarding Section 2 of the Notice

We recommend that regulations regarding foreign group nonqualified property include valuation safe harbors for assets of a privately-traded foreign acquirer (“FA”). If FA maintains audited consolidated financial statements in accordance with U.S. generally accepted accounting principles (“GAAP”) or International Financial Reporting Standards (“IFRS”), it should be able to rely upon the valuation of its assets as of the date of the most recent audited financial statements unless it has acquired or disposed of a material amount of assets outside the ordinary course of business. Similarly, if a company that does not ordinarily maintain audited financial statements has obtained a recent comprehensive valuation of its assets, we recommend that it be allowed to rely on the valuation as of that date, unless the company has acquired or disposed of a material amount of assets outside the ordinary course of business. A “material” acquisition or disposition could be defined, for instance, as an acquisition or disposition representing 5 percent or more of the combined value of FA’s assets.

With regard to foreign banks, foreign insurers, and foreign reinsurers, we recommend that, in the regulations implementing the Notice, the exclusions from foreign group nonqualified property either explicitly incorporate the relevant language of sections 954(h) and 954(i) (and, in the latter regard, section 953(e)) or clarify that the exclusions from foreign group nonqualified property that incorporate sections 954(h) and 954(i) will apply regardless of the sunset of sections 954(h), 954(i), and 953(e). We also recommend that the regulations implementing the Notice clarify that these exclusions, as well as the exclusions from foreign group nonqualified property that incorporate the PFIC active banking exception of section 1297(b)(2)(A) and (as we recommend) the PFIC active insurance exception of section 1297(b)(2)(B), potentially apply to the property held by FA and its pre-acquisition foreign and domestic subsidiaries that are members of the EAG.

1 References to a “section” are to a section of the Internal Revenue Code of 1986, as amended (the “Code”), unless otherwise indicated.
With regard to foreign insurers and foreign reinsurers, we recommend that Treasury and the Service issue an announcement stating that an exclusion from foreign group nonqualified property that incorporates the PFIC active insurance exception of sections 1297(b)(2)(B) will be included in any regulations implementing the Notice. Correspondingly, we recommend that those regulations include the aforementioned exclusion from foreign group nonqualified property for property that gives rise to income described in section 1297(b)(2)(B), as well as the exclusions set forth in the Notice for property that gives rise to income described in sections 954(h), 954(i), or 1297(b)(2)(A).

While we acknowledge that dividends can be used as a tool to decrease the value of a U.S. target corporation (“DT”) relative to FA, we believe that the proposed “anti-skinnying” rules could inappropriately affect transactions that were not intended to avoid the application of section 7874. We therefore recommend that the anti-skinnying rule operate as a presumption, rebuttable with evidence that DT had no plan or intention to enter an inversion transaction at the time of the distribution. We further recommend that, if a corporation has a dividend or stock repurchase policy with scheduled increases (whether on a fixed scale or tied to a percentage of profits), and carried out that distribution policy consistently for the entire 36-month period preceding the relevant period, then cash distributions made during the relevant period not be added back to the value of DT for purposes of determining the “Ownership Fraction” (as defined herein).

We further recommend that, if DT spins off a subsidiary for a valid business purpose, and that spin-off qualifies in all respects under section 355, then the value of the distributed corporation not be added back automatically to the value of DT for purposes of determining the Ownership Fraction, and that section 7874(c)(4) be the applicable test. If anti-abuse rules are required, we recommend that regulations include safe harbors analogous to those in Regulation section 1.355-7.

With regard to the anti-skinnying rule as applied to partnerships, we similarly recommend that the rule be clear that it would not apply to the distribution of assets from a trade or business of a partnership separate from that acquired. We further recommend that the anti-skinnying rule not apply to tax distributions made in the ordinary course of a partnership’s operations, even if those distributions increase significantly during the applicable period because the partnership’s income increases significantly in that time. We view such distributions as more analogous to taxes paid than to dividends in the corporate context.

We recommend that regulations make clear that in the case of a distribution of stock, the anti-skinnying rule be computed with respect to the value of distributed stock, not the voting power thereof.

We recommend that a de minimis exception be added to the anti-skinnying rule, as applied to the substantiability test of Regulation section 1.367(a)-3(c)(3)(iii).

We appreciate that the Notice addresses certain concerns that foreign-to-foreign F reorganizations could create inversions. However, we believe that in some circumstances, even under the proposed rules foreign-to-foreign F reorganizations could create inadvertent inversion transactions. We therefore recommend that any regulations completely exclude foreign-to-
foreign F reorganizations from determinations of whether an inversion has occurred, and look only at all other steps, taken as a whole, as if FA were merely a continuation of the foreign target entity (“FT”).

Finally, we recommend that regulations confirm that even if the rules described in the Notice could cause a transaction to become subject to section 7874 based on a revised computation of the Ownership Fraction, those rules will not apply in a case where the “substantial business activities” test is satisfied.

Comments regarding Section 3 of the Notice

We recommend that carve-outs of sections 956(c)(2)(C), 956(c)(2)(H), 956(c)(2)(I), and 956(c)(2)(J) apply to limit the scope of the proposed “anti-hopscotch” rule under section 956. We recommend that if an expatriated foreign subsidiary is regularly engaged in the business of making loans to unrelated parties, loans made to a non-CFC related foreign corporation in the ordinary course of its business, consistent with past practice, not be treated as United States property. We further recommend an exclusion relating to the acquisition by a CFC of stock of a non-CFC.

We have concerns with the effects under Subchapter K of creating deemed instruments under section 7701(l). We recommend that the proposed recharacterization as applied to partnership structures be rethought. If it is to apply in the partnership context, we recommend that Treasury and the Service consider an approach not involving “hook stock” as described herein, or at least adopt rules to avoid “multiplication” of dividend amounts as a result of partnership allocations, and to avoid special “zero basis” issues upon the deemed termination of the instruments.

Where businesses are combined for valid business reasons, we recommend a business restructuring exception be applied with annual certifications similar to the certifications under the gain recognition agreement regime.

We recommend that regulations under section 304 provide a clear definition of “subject to tax.” We suggest that income be treated as “subject to tax” if it is includible in the gross income of a person that may be liable to U.S. federal income tax on that dividend, even if it is not burdened with tax by reason of that person’s tax attributes at the time of the transaction.
DISCUSSION

I. Introduction

Congress enacted section 7874 as part of the American Jobs Creation Act of 2004 in order to police perceived abuses associated with so-called “inversion” transactions in which a domestic corporation (or partnership) limits its U.S. tax liability by reincorporating in a foreign jurisdiction, or by becoming a subsidiary of a foreign corporation—in each instance without a substantial change in ownership, typically followed by other planning steps. The foreign subsidiaries in the multinational group could then be transferred to FA, thus removing their future earnings from the U.S. tax base as well. Furthermore, FA or its foreign subsidiaries could then make loans or enter into licensing arrangements with U.S. members of the group, thereby further eroding the U.S. tax base. With a view toward curbing these types of transactions, Congress introduced a number of anti-inversion bills in 2002 and 2003, but no legislation was passed until the enactment of section 7874.

Section 7874(a) provides, in pertinent part, that if pursuant to a plan or series of related transactions:

(i) FA acquires, directly or indirectly, substantially all of the properties held directly or indirectly by a domestic corporation, or substantially all the properties constituting a trade or business of a domestic partnership,

(ii) after the acquisition at least 60 percent of the stock (by vote or value) of FA is held by former shareholders or partners of the domestic entity (“DT”) by reason of their former ownership of DT, and

(iii) after the acquisition, FA’s “expanded affiliated group” (“EAG”) fails to meet the so-called substantial business activities test, which works as an overall exception to section 7874,

then FA will be treated as a “surrogate foreign corporation” and consequently any “inversion gain” will be fully taxable from the date the acquisition begins until ten years after its completion, with only limited offset by losses and tax credits.

I.R.C. § 7874.


Section 7874(d)(2) defines “inversion gain” as income or gain recognized by DT during the “applicable period” from any property transfer (other than of inventory) or from a license of DT property—in each case either as part of DT’s acquisition by FA, or afterward if the transfer or license is to a “foreign related person.”
Section 7874(b) further provides that if conditions (i) and (iii) above are met and at least 80 percent of the stock of FA (by vote or value) is held by former owners of DT by reason of such historic ownership, FA will be treated as a domestic corporation for all federal tax purposes. For purposes of this computation, stock issued in a “public offering” is excluded from computation of this ownership fraction.\(^6\) In addition, section 7874(c)(4) provides that “[t]he transfer of properties or liabilities (including by contribution or distribution) shall be disregarded if such transfers are part of a plan a principal purpose of which is to avoid the purposes of [section 7874.]”

Concerned that taxpayers were using private placements as a tool to avoid the “public offering” rule, Treasury and the Service issued Notice 2009-78, which proposed to exclude from the computation any stock issued for “nonqualified property” (including cash and other similar liquid assets, as well as any other property acquired with a principal purpose of avoiding section 7874). This rule was implemented, with some modifications, in proposed and temporary regulations issued in 2014.\(^7\)

Even after issuance of these and other anti-avoidance regulations, Treasury and the Service remained concerned that taxpayers were engaging in transactions that, while technically permitted, avoided the purpose of section 7874. On September 22, 2014, Treasury and the Service issued the Notice, describing regulations that they intend to issue that would have the effect of causing more transactions to be subject to section 7874,\(^8\) and that are intended to limit the opportunity for certain post-inversion tax planning involving the EAG of a surrogate foreign corporation.\(^9\) The Notice states that the regulations, when issued, generally will be effective from the date of the Notice.\(^10\)

The specific provisions of the Notice are discussed in our comments below.

II. Comments Relating to Section 2 of the Notice

A. Exclusion of Certain Foreign Acquiror Stock from the Ownership Fraction

1. Existing rules and proposed revisions

Under temporary and proposed regulations, a foreign corporation cannot increase its size by accepting additional cash contributions.\(^11\) In an expansion of the statutory “public offering

\(^6\) I.R.C. § 7872(c)(2)(B).
\(^9\) Id. § 3.
\(^10\) Id. § 4.
rule,”

stock of a foreign corporation that is issued for “nonqualified property” is excluded from the ownership fraction used to determine whether that corporation constitutes a surrogate foreign corporation under section 7874(a)(2)(B) (the “Ownership Fraction”). Nonqualified property includes, cash, marketable securities, and obligations of certain related persons. To prevent avoidance of the principles of the regulations, nonqualified property also includes any other property acquired in transactions related to the acquisition of the domestic corporation “with a principal purpose of avoiding the purposes of section 7874.”

Even with the existing rules, Treasury and the Service were concerned that certain taxpayers were targeting foreign corporations with substantial passive assets and little in the way of ongoing operations, and using those corporations to facilitate inversion transactions not subject to section 7874. Because the passive assets were already held by the foreign corporation, they would not be subject to the modified public offering rule, and the full value of the foreign corporation, including the value attributable to the passive assets, would be reflected in the denominator of the Ownership Fraction.

The Notice addresses this issue by creating a rule (the “Cash Box Rule”) providing that if more than 50 percent of the gross value of all “foreign group property” is “foreign group nonqualified property,” then a portion of the stock of the foreign acquiring corporation will be excluded from the denominator of the Ownership Fraction. For this purpose, foreign group property means any property held by the EAG, other than (i) property that, at the time of the acquisition, was held, directly or indirectly, by the domestic entity, and (ii) stock or a partnership interest in, or an obligation of, a member of the EAG. Furthermore foreign group nonqualified property means any foreign group property that is described in Temporary Regulation section 1.7874-4T(i)(7), except for property that gives rise to income described in section 1297(b)(2)(A) or sections 954(h) or (i) (determined by substituting the term “foreign corporation” for the term “controlled foreign corporation”). This more-than-50 percent test will be applied after the acquisition and all transactions related to the acquisition, if any, are completed.

When triggered, the Cash Box Rule will skew the Ownership Fraction in the direction of the former shareholders of the domestic acquired corporation. In this regard, the Notice directs that the portion of the stock of the foreign acquiring corporation that will be excluded from the denominator of the Ownership Fraction will be equal to the product of (i) the value of the stock of the foreign acquiring corporation other than (a) stock described in section 7874(a)(2)(B)(ii) (that is, stock held by reason of prior ownership of the US target corporation), and (b) stock excluded from the denominator of the Ownership Fraction under either Regulation

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12 I.R.C. § 7874(c)(2).
16 Id.
17 See id.
section 1.7874-1(b) (because it is held by a member of the EAG) or Temporary Regulation section 1.7874-4T(b) (because it is disqualified stock); and (ii) the “foreign group nonqualified property fraction,” which the Notice describes as the gross value of all foreign group nonqualified property, divided by the gross value of all foreign group property.\textsuperscript{18}

2. Comments

We appreciate the Notice’s inclusion of the 50 percent threshold, which ensures that most companies will not need to apply this section of the Notice to determine if a proposed transaction is an inversion. However, we have concerns about several issues relating to that analysis, and suggest some refinements to the proposed rules to facilitate compliance. We also have significant concerns with respect to the application of the Cash Box Rule to foreign insurers and foreign reinsurers, which are addressed in Part II.A.3., below.

a. Valuation Safe Harbors

We believe that in the context of stock transactions involving a foreign acquirer for which the “good” assets are not easily valued based on public trading of the company’s shares, valuation of individual corporate assets presents a challenge, not to mention a high cost. While it may be easy to determine the value of highly liquid assets, the value of illiquid assets is less easily determined, and companies likely would need to undertake a full asset valuation – possibly including many tiers of subsidiaries in many countries – to ensure that they are not subject to the proposed rules.

We therefore recommend that the regulations include valuation safe harbors to facilitate this computation for privately held companies. For instance, if a company maintains audited consolidated financial statements in accordance with GAAP or IFRS, the company could apply a valuation safe harbor based upon the most recent audited financial statements within the prior 12 months, subject to appropriate adjustments to reflect any asset acquisitions or dispositions, unless it acquired or disposed of a material amount of assets outside the ordinary course of business. Given that financial statements are based on historical cost, we suggest applying an approach similar to that used in the FIRPTA context, and allow a foreign acquirer to be treated as below the 50 percent threshold if no more than 25 percent of the book value of the total foreign group property reflected on the balance sheet is attributable to foreign group nonqualified property.\textsuperscript{19} A “material” acquisition or disposition could be defined as an acquisition or disposition representing 5 percent or more of the combined value of FA’s assets, as reflected on the company’s financial statements.

\textsuperscript{18}See id. at § 2.01(b). The Notice also provides that (i) property received by the foreign acquiring corporation, in a related transfer, that gives rise to disqualified stock that is excluded from the denominator of the Ownership Fraction pursuant to Temp. Reg. § 1.7874-4T(b) will be excluded from both the numerator and the denominator of the foreign group nonqualified property fraction, and (ii) a coordination rule similar to Temp. Reg. § 1.7874-4T(h) (regarding the interaction of the EAG rules with the rule that excludes disqualified stock from the denominator of the Ownership Fraction) will be included in the regulations under development by Treasury and the Service. See id.

\textsuperscript{19}Cf. Reg. § 1.897-2(b)(2).
Similarly, if a company obtained a comprehensive third-party valuation of its assets for non-tax reasons within the 12 months prior to the transaction at issue and there were no material acquisitions or dispositions outside the ordinary course of business since the valuation date, we recommend that the valuation be presumed valid. A safe harbor for “reasonability” of the valuation could be established in a manner analogous to the standard for reasonability of stock valuation for purposes of section 409A.\textsuperscript{20} We recognize that approaches to asset valuation can differ, so we propose that if a company chooses to rely upon an external valuation and that valuation is deemed not to be reasonable, any challenge to that valuation must be made based on the value of the company’s assets as of the valuation date (assuming no material asset dispositions after the valuation date).

b. Effect of potential sunset of statutory provisions

As noted above, the Notice provides that for purposes of the Cash Box Rule, property that gives rise to income described in sections 954(h) or 954(i) (determined by substituting the term “foreign corporation” for the term “controlled foreign corporation”) will be excluded from the definition of foreign group nonqualified property (the “Section 954(h) Exclusion” and the “Section 954(i) Exclusion,” respectively).\textsuperscript{21} Sections 954(h) and 954(i) apply only to taxable years of foreign corporations beginning before 2015 (and taxable years of U.S. shareholders with or within which any such taxable year of any such foreign corporation ends).\textsuperscript{22}

We assume, therefore, that the drafters of the Notice intended that the sunset of sections 954(h) and 954(i), and 953(e) (which also sunsets, and on which section 954(i) depends for certain definitions) not be critical for purposes of determining the operation of either the Section 954(h) Exclusion or the Section 954(i) Exclusion. For the avoidance of doubt, we recommend that, in the regulations implementing the Cash Box Rule, the exclusions from foreign group nonqualified property either explicitly incorporate the relevant language of sections 954(h) and 954(i) (and, in the latter regard, section 953(e)) or clarify that the Section 954(h) Exclusion and the Section 954(i) Exclusion will apply regardless of the sunset of sections 954(h), 954(i), and 953(e).

c. Exclusion of certain domestic property of the EAG from “foreign group nonqualified property”

Sections 954(h) and 954(i) apply only to foreign corporations. Similarly, section 1297(b)(2)(A), which excludes certain banking income of foreign corporations from the PFIC rules, applies only to foreign corporations. Because the Cash Box Rule targets foreign corporations, it is understandable that the Section 954(h) Exclusion, the Section 954(i) Exclusion, and the exclusion from foreign group nonqualified property for property that gives rise to income described in section 1297(b)(2)(A) (the “Section 1297(b)(2)(A) Exclusion”) are based on provisions of the Code that focus on foreign corporations. However, foreign-controlled

\textsuperscript{20} See Reg. § 1.409A-1(b)(5)(iv).


\textsuperscript{22} See I.R.C. §§ 953(e)(10), 954(h)(9).
groups often include domestic subsidiaries, and it seems inconsistent with the policy goals of the Cash Box Rule to preclude the property of those domestic subsidiaries from potentially being eligible for the exclusions from foreign group nonqualified property.

We therefore recommend that the regulations implementing the Cash Box Rule clarify that the exclusions from foreign group nonqualified property apply to the property held by the foreign acquiring corporation and its pre-acquisition foreign and domestic subsidiaries that are members of the EAG.

3. Special issues for foreign insurers and reinsurers

Recognizing that insurers and reinsurers typically hold substantial amounts of property that is described in Temporary Regulation section 1.7874-4T(i)(7) (“Liquid Assets”) in the ordinary conduct of their insurance businesses, the Notice offers a limited exclusion from the definition of foreign group nonqualified property for property that gives rise to income described in section 954(i) (determined by substituting the term “foreign corporation” for the term “controlled foreign corporation”), i.e., the Section 954(i) Exclusion. As discussed below, we believe that the cross-reference to section 954(i) (and, presumably, although indirectly, section 953(e))\(^{23}\) causes the determination of whether the property of a foreign insurer or a foreign reinsurer may be excluded from foreign group nonqualified property to be more complex and restrictive than is necessary or appropriate.

a. Background of the Section 954(i) Exclusion

Section 954(i) provides the active insurance exception to the foreign personal holding company income rules of Subpart F. Specifically, section 954(i)(1) excludes from foreign personal holding company income the “qualified insurance income” of a “qualifying insurance company.” Thus, for purposes of the Section 954(i) Exclusion, it is necessary to determine whether the relevant property (i) is held by a qualified insurance company (determined by substituting the term “foreign corporation” for the term “controlled foreign corporation”) and (ii) gives rise to qualifying insurance income.

A foreign corporation will constitute a qualifying insurance company for purposes of the Section 954(i) Exclusion only if it satisfies the following requirements:

- It is subject to regulation as an insurance (or reinsurance) company by its home country (i.e., the country in which such corporation is created or organized);
- It is authorized by the insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to unrelated persons in that country;
- It is engaged in the insurance business;
- It would be subject to tax under Subchapter L of the Code, i.e., the insurance company provisions set forth in sections 801-848, if it were a domestic corporation; and

\(^{23}\) See I.R.C. § 954(i)(6) (providing that, for purposes of section 954(i), the definitions provided in section 953(e) apply).
• It derives more than 50 percent of its net written premiums from the issuance or reinsurance of contracts covering “applicable home country risks” and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person.  

Importantly, for purposes of the last requirement, (i) the net written premiums of any “qualifying insurance company branch” of the foreign corporation must be aggregated with those of the rest of the corporation, and (ii) the term “applicable home country risks” means risks in connection with property in, liability arising out of activity in, or the lives or health of residents of the home country of the foreign corporation or qualifying insurance company branch, as the case may be, issuing or reinsuring the contract covering the risks.

In order for income to constitute qualified insurance income for purposes of the Section 954(i) Exclusion, it will be necessary for that income to be received from an unrelated person and be derived from the investments made by a qualifying insurance company (or its qualifying insurance company branch) of:

• Its reserves allocable to “exempt contracts” or of 80 percent of its unearned premiums from exempt contracts; or
• An amount of its assets allocable to exempt contracts equal to one-third of its premiums earned on property, casualty, or health insurance contracts during the taxable year and 10 percent of its reserves for life insurance or annuity contracts.

For purposes of the qualified insurance income determination, the term “exempt contract” apparently will mean an insurance or annuity contract issued or reinsured by a qualifying insurance company (or its qualifying insurance company branch) in connection with property in, liability arising out of activity in, or the lives or health of residents of a country other than the United States. Moreover, two other special limits apparently will apply:

• No contract of a qualifying insurance company (or its qualifying insurance company branch) will be an exempt contract unless the company (or branch) derives more than

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24 See I.R.C. § 953(e)(3); see also I.R.C. §§ 953(e)(6) (defining the term “home country”), 954(i)(6) (providing that, for purposes of section 954(i), the definitions provided in section 953(e) apply).

25 See I.R.C. § 953(e)(3)(B); see also I.R.C. § 953(e)(4) (defining the term “qualifying insurance company branch” to mean a qualified business unit (within the meaning of section 989(a)) of a foreign corporation if such unit is licensed, authorized, or regulated by the applicable insurance regulatory body for its home country to sell insurance, reinsurance, or annuity contracts to persons other than related persons in such home country, and such foreign corporation is a qualifying insurance company, determined under section 953(e)(3) as if such unit were a qualifying insurance company branch).


27 See I.R.C. § 954(i)(2); see also I.R.C. §§ 953(e)(5) (providing rules for determining whether a contract issued by a foreign corporation is a life insurance or annuity contract), 954(i)(4)-(5) (providing methods for determining unearned premiums and reserves).

28 See I.R.C. § 953(e)(2)(A); see also I.R.C. § 954(i)(6) (providing that, for purposes of section 954(i), the definitions provided in section 953(e) apply).
30 percent of its net written premiums from exempt contracts (determined without regard to this rule) that cover applicable home country risks and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person.  

- A contract issued by a qualifying insurance company (or its qualifying insurance company branch) that covers risks other than applicable home country risks will not be an exempt contract unless the company or branch, as the case may be, conducts substantial activity with respect to an insurance business in its home country and performs in its home country substantially all of the activities necessary to give rise to the income generated by such contract. 

In view of the preceding discussion, it seems that the Liquid Assets held by a foreign corporation and its insurance branches will be excluded from foreign group nonqualified property under the Section 954(i) Exclusion only if all of the following requirements are satisfied:

1. The foreign corporation is regulated as an insurance (or reinsurance) company in its home country;
2. The foreign corporation and each of the insurance branches are authorized to sell insurance, reinsurance, or annuity contracts to unrelated persons in their respective home countries;
3. The foreign corporation is engaged in an insurance business;
4. The foreign corporation and each of the insurance branches conduct in their respective home countries substantial activity with respect to that business;
5. The foreign corporation and each of the insurance branches perform in their respective home countries substantially all of the activities necessary to give rise to the income generated by a contract issued by such corporation or such branch;
6. The foreign corporation would be subject to tax as an insurance company if it were a domestic corporation;
7. The foreign corporation and the insurance branches derive more than 50 percent of their aggregate net written premiums from the issuance or reinsurance of contracts covering applicable home country risks and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person;
8. The foreign corporation and each of the insurance branches derive more than 30 percent of their net written premiums (as separately determined for each) from

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29 See I.R.C. § 953(e)(2)(B); see also I.R.C. § 953(e)(1)(C) (providing that determinations related to exempt contracts are made separately for the qualifying insurance company and its qualifying insurance company branches).

30 See I.R.C. § 953(e)(2)(C).
the issuance or reinsurance of contracts covering applicable home country risks and with respect to which no policyholder, insured, annuitant, or beneficiary is a related person;

9. The assets give rise to income from unrelated persons; and

10. The assets are held as investments by the foreign corporation or the insurance branches in support of their exempt contracts or required surplus.

b. Observations on the exclusions from foreign group nonqualified property

The Notice treats foreign insurers and foreign reinsurers very differently from foreign banks and foreign finance companies. Specifically, the incorporation of the more restrictive and complex rules of section 954(i) for foreign insurers and foreign reinsurers versus the more lenient rules of sections 1297(b)(2)(A) and 954(h) for foreign banks and foreign finance companies suggests that a strategic decision was made on the part of Treasury and the Service to impose much stricter limits on the ability of foreign insurers and foreign reinsurers to acquire domestic corporations.\(^{31}\) Unfortunately, the policy justification underpinning that decision is not described in the Notice.

If, and to the extent that, this decision reflects a concern on the part of Treasury and the Service regarding “overcapitalized” insurance companies,\(^{32}\) we believe that the considerations outlined below demonstrate that any such concern would be more appropriately addressed outside the scope of section 7874 and the exclusions from foreign group nonqualified property.\(^{33}\) In this regard, we urge Treasury and the Service to consider the following points when assessing our recommendations:

- Although a significant portion of the assets held by an insurer or a reinsurer in the ordinary conduct of its insurance business may be liquid in character, those assets are not “passive” from the perspective of the company’s business. Rather, those assets

\(^{31}\) As noted above, satisfaction of section 954(i) depends on, \textit{inter alia}, the location of the risks being insured or reinsured by the foreign corporation, the nature of the business activities within the foreign corporation’s home country, the status of the foreign corporation as a bona fide insurance company engaged in an insurance business, and the use of the relevant property within the foreign corporation’s insurance business, whereas the authorities under section 1297(b)(2)(A) direct their attention narrowly to the determination of whether the foreign corporation is a bona fide bank engaged in the active conduct of a banking business. See Notice 89-81, 1989-2 C.B. 399; see also Prop. Reg. § 1.1296-4 (1995); Notice of Proposed Rulemaking, Exceptions to Passive Income Characterization for Certain Foreign Banks and Securities Dealers, 60 Fed. Reg. 20922 (Apr. 28, 1995).

\(^{32}\) See, e.g., Notice 2003-34, 2003-1 C.B. 990.

are held by such companies in order to ensure that they will have adequate funds on hand to pay claims when losses arise and to meet the requirements and expectations of insurance regulators, rating agencies, and the insurance market. Thus, those assets are not held to facilitate the types of transactions that the Cash Box Rule aims to curb.34

- Acquisitions made by insurance and reinsurance companies often include equity consideration on account of regulatory, rating agency, and other business concerns associated with all-cash acquisitions. Thus, while the potentially adverse impact of the Cash Box Rule and, more generally, section 7874 may be able to be navigated if a foreign corporation uses only cash consideration to acquire a domestic target, that avenue often is not practical, available, or otherwise permitted for a foreign insurer or a foreign reinsurer. Instead, foreign insurers and foreign reinsurers will have to be cognizant of the potential impact of the Cash Box Rule on any acquisition of a domestic corporation – even a much smaller domestic corporation – to the extent equity consideration is used to complete the transaction.

- It is unlikely that many foreign insurers and foreign reinsurers – especially those that have no prior tax connection with the United States – have the infrastructure necessary for purposes of determining whether they can satisfy the many requirements of the Section 954(i) Exclusion. Stated differently, insurers and reinsurers operating in other parts of the world have not tended to incorporate into their business models the need to determine their levels of “home country” risk insured or reinsured, the U.S. tax character of the insurance they have underwritten or reinsured, the U.S. tax equivalent of their insurance reserves, whether their business activities in their respective home countries are sufficiently “substantial,” or whether they have satisfied the various other requirements of the Section 954(i) Exclusion. For example, in the European Union, an insurer or reinsurer operates across borders through a “single passport” regime. Furthermore, in Asia, a headquarters company typically will complete all or most of the underwriting and investment functions for the branches and subsidiaries that it establishes in other countries.

- Foreign reinsurers typically reinsure risks arising around the globe, thus making it extremely difficult, if not impossible, for those companies to reach the more-than-50-percent threshold of net written premiums from reinsurance contracts covering risks in their home country for purposes of the Section 954(i) Exclusion. Thus, depending on the mix and relative values of the foreign reinsurer’s assets, even a small amount of equity consideration issued by a foreign reinsurer in an acquisition of a domestic target might cause the foreign reinsurer to become a domestic corporation for U.S. federal tax purposes on account of the operation of the Cash Box Rule and section 7874(b).

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34 Cf. Fact Sheet: Treasury Actions to Rein in Corporate Tax Inversions (Sept. 22, 2014) (explaining that the purpose of the Cash Box Rule is to “[l]imit the ability of companies to count passive assets that are not part of the entity’s daily business functions in order to inflate the new foreign parent’s size and therefore evade the 80 percent rule” (emphasis added)), available at http://www.treasury.gov/press-center/press-releases/Pages/jl2645.aspx.
In sum, in the absence of further clarification from Treasury and the Service, the disparate treatment afforded foreign insurers and foreign reinsurers in the Notice has had, and will continue to have, an unwarranted chilling effect on business combinations involving those companies and domestic corporations (whether insurance companies or otherwise).

c. Recommendations

Considering all of the issues discussed above, we strongly recommend that Treasury and the Service issue an announcement stating that an exclusion from foreign group nonqualified property for property that gives rise to income described in section 1297(b)(2)(B) will be included in the regulations implementing the Cash Box Rule. Correspondingly, we recommend that those regulations include the aforementioned exclusion for property that gives rise to income described in section 1297(b)(2)(B), along with the Section 1297(b)(2)(A) Exclusion, the Section 954(h) Exclusion, and the Section 954(i) Exclusion. Also, we reiterate our recommendation in Part II.A.2.c above that the regulations implementing the Cash Box Rule clarify that each of these exclusions from foreign group nonqualified property can apply to the property held by the foreign acquiring corporation and its pre-acquisition foreign and domestic subsidiaries that are members of the EAG.

Similar in operation to section 1297(b)(2)(A), section 1297(b)(2)(B) excludes from passive income any income “derived in the active conduct of an insurance business by a corporation which is predominantly engaged in an insurance business and which would be subject to tax under subchapter L if it were a domestic corporation.” Although the scope of section 1297(b)(2)(B), like that of section 1297(b)(2)(A), continues to be refined, including in recently proposed regulations, an exclusion incorporating section 1297(b)(2)(B) would focus on the status of the foreign corporation as an insurance company for U.S. federal tax purposes engaged in the active conduct of an insurance business. Such an exclusion from foreign group nonqualified property would offer a far more practical alternative than the Section 954(i) Exclusion and would be on par with the Section 1297(b)(2)(A) Exclusion. Moreover, as more guidance is developed under section 1297(b)(2)(B), we would expect that such guidance would have a corresponding impact on the scope of property excluded from foreign group nonqualified property.

In addition, we recommend that, in the regulations implementing the Cash Box Rule, Treasury and the Service explain the intended interaction of the rules of sections 954(i) and 953(e) for purposes of the Section 954(i) Exclusion.

B. Disregard of Certain Pre-transaction Distributions by Domestic Target

1. Existing rules and proposed changes

As discussed above, the current regulations focus on contributions to the foreign acquirer to increase its size relative to the domestic target, but include no similar rules for reducing the size of the domestic target. The “anti-skinning rule” of the proposed regulations would

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35 REG-108214-15, released April 23, 2015, in reaction to concerns regarding reinsurance operations of hedge funds.
disregard any “non-ordinary course distributions” made by the domestic entity during the 36-month period ending on the acquisition date (the “relevant period”). For this purpose, a “non-ordinary course distribution” is any distribution within a taxable year in excess of 110 percent of the average of the 36-month period immediately preceding that taxable year. This rule applies to all distributions, regardless of whether they are treated as dividends for tax purposes. Thus, for instance, a spin-off described in section 355 would be a distribution subject to the anti-skinnying rule, if it occurred during the relevant period.

Very significantly, a similar rule would apply to determine the fair market value of the domestic target for purposes of the “substantiality” test of Regulation section 1.367(a)-3(c)(3)(iii).

2. Comments

a. Dividends and stock repurchases

While we recognize that the 110 percent rule looks very similar to the PFIC “excess distribution” rules, we believe that in this case the 36-month look-back rule may go farther than necessary to carry out the purpose of section 7874. For instance, a corporation that, prior to the release of the Notice, announced a policy of steady increases of dividends and share repurchases, and carried out that policy over a multi-year period. Such a corporation could be subject to the anti-skinnying rule even though the increasing dividends or share repurchases may have had nothing to do with a potential transaction. Similarly, a corporation that commits to distribute a percentage of its prior year profits annually, and in fact does so, could be penalized if its profits grow significantly.

We view a situation like this as fundamentally different from a situation where dividends are increased specifically with an eye to potential inversion transactions. We therefore recommend that rather than an irrebuttable rule, the 110 percent rule create a rebuttable presumption that distributions were made for the purpose of facilitating an inversion. This presumption could be rebutted by evidence that at the time the distributions were made, there was no plan or intention to enter an inversion transaction. Similarly, to the extent a corporation has a stated policy of increasing cash distributions, and has carried out that policy during the entire 36-month period preceding the start of the relevant period and during the relevant period (without making distributions during the relevant period outside that policy), we recommend that cash distributions made during the relevant period not be subject to the anti-skinnying rule (though they could be subject to scrutiny under the statutory purpose rule in section 7874(c)(4)).

37 Id.
38 Id.
39 I.R.C. § 1291(b)(2) (applying a 125% average standard).
We understand that Treasury and the Service are considering whether special rules should be applied to redemptions of “pure preferred” stock. In our view, if preferred stock is redeemed by its terms upon maturity, it should be outside the scope of the anti-skinnying rule, unless that stock itself was issued as a distribution to shareholders during the relevant period. We believe there are other circumstances where redemptions of preferred stock should be excluded from the anti-skinnying rule. For instance, if a company is able to borrow money at a low interest rate to redeem preferred stock at a higher dividend rate, that borrowing and redemption should not be subject to the anti-skinnying rule, as the company is substituting low-cost financing for higher cost financing. This decision would seem not to have as a “principal purpose” avoidance of the purposes of section 7874, and thus should not cause a transaction to become subject to section 7874.40

b. Spin-offs and other distributions of controlled entities

Even if the anti-skinnying rule applies to most distributions, we have concerns about applying it broadly to distributions described in section 355, as well as to taxable distributions of controlled entities primarily engaged in an active business, particularly in the context of publicly traded entities. The often transformative effect of major distributions, the five year active business, business purpose, device and other requirements of section 355 and the regulations thereunder, and the discipline of the public markets significantly reduce the likelihood that a spin-off could be undertaken as planning for an inversion in the absence of meaningful discussions with a potential foreign acquirer. We recommend that the anti-skinnying rule not apply to such distributions and that the statutory purpose test be the governor for such transactions.

We understand that there is a concern that advisers may be actively marketing spin-offs in order to make companies more attractive for inversions. While this is a legitimate concern, simply treating any spinoff per se as a distribution for purposes of the anti-skinnying rules could unduly restrict legitimate business transactions. The concern instead might be better addressed by relying on the statutory test, or if that were not considered sufficient, possibly a rebuttable presumption that the anti-skinnying rules apply to a spin-off followed by an acquisition of distributing by a foreign corporation. In the latter case, to provide clear guidance for taxpayers regarding such a rebuttable presumption, we would recommend that safe harbors analogous to Regulation section 1.355-7(d) be established (considering whether an inversion transaction was negotiated or discussed prior to the spin-off or within a certain period after the spin-off).

Second, we note that, subject to whether a distributed entity may be considered a “successor” of a distributing company, the anti-skinnying rules would apply to distributions only for purposes of sizing the distributing company. While it may seem arbitrary that a corporate group could achieve a better result in the context of these rules by distributing an entity or entities that might invert rather than distributing the unwanted assets, that result may follow from the statute. In any event, we would note that the fact that the rule would apply only in the one case and not the other is, we believe, an additional reason that the anti-skinnying rule may not be

40 See I.R.C. § 7874(c)(4).
appropriate for distributions of active businesses. Guidance is of course needed in regard to the meaning of “successor” in this context.

We also are concerned about how the skinnyning down rule will apply to in-kind distributions. Assume, for instance, that UST spun off a business two years prior to its acquisition by FA. If that distribution were truly ignored for purposes of section 7874, it is not at all clear how one would one add back the value of the business. One could treat the spun-off business as if it had continued as a subsidiary of FA, such that one would include its assets and income on the relevant testing dates as part of the substantial business activities analysis. This could be difficult, if not impossible, for a taxpayer to obtain. Moreover, if the spun-off business later combined with another business, it could be difficult – even were the taxpayer to be able to obtain the data – to separate the distributed assets from the other assets for purposes of the add-back.

A far preferable approach would be to add back the distributed business assets and income based on the value of those businesses as of the date of the spin-off, and ignore any possible changes in the business that might have occurred since the spin-off date. Given the look-back period, those changes could be significant, and while this could create distortions, it would vastly simplify the add-back computation.

c. Partnerships

Section 7874 treats partnerships differently than corporations, providing that an inversion can occur when a foreign corporation acquires “substantially all of the properties constituting a trade or business of a domestic partnership.” 41 There is no requirement that the corporation acquire substantially all the properties of that partnership. 42 In other words, if a partnership operated two trades or businesses, but only transferred one of them into a foreign corporation in exchange for corporate stock, that transaction could be an inversion. Implicit is that the business that was not transferred is not included in the analysis, and remains a business within a domestic partnership that is operated outside the inversion. Given that section 7874 is to apply separately to each trade or business of a partnership, it follows that a distribution of a trade or business from a partnership would not implicate the “skinning down” rules. We therefore recommend that in determining the Ownership Fraction, in the case of the acquisition of assets constituting the trade or business of a partnership, there should be no add back of the value of distributed assets constituting a separate trade or business of the partnership.

On the other hand, distributions from the acquired trade or business are relevant for the anti-skinning rule. Issues particular to partnerships may apply here. For instance, if a partnership has multiple trades or businesses, it becomes necessary to determine from which trade or business a distribution is made, which may not be obvious where funds are commingled or assets shared.


42 This feature can raise difficult issues regarding what is a separate trade or business versus, e.g., an expansion.
Third, we believe that the proposed rules in the Notice do not account for significant fluctuations in tax distributions. Many partnership agreements require tax distributions to the extent of available cash, determined based on the taxable income of the partnership multiplied by an assumed tax rate. If a partnership has little taxable income for several years, and then significantly more taxable income in a later year, the tax distribution made to the members would be subject to the proposed “skinnying down” rules of the Notice. Although the computations generally are not exact, tax distributions typically approximate the taxes payable to the government by the partners, and thus, in this analysis at least, are more analogous to a domestic corporation’s payment of taxes than to a distribution. In any event, tax distributions clearly are motivated by valid business considerations and not by a desire to avoid the purposes of section 7874. We therefore further recommend that in determining the Ownership Fraction, a partnership not be required to add back tax distributions made in the ordinary course of a partnership’s operations, based on a formula reasonably expected to approximate the partners’ incremental tax liability attributable to their investment in the partnership.

Similarly, a partnership should not be required to add back amounts withheld under section 1441, 1445 and 1446 or similar provisions of state and local law and remitted to the applicable taxing authority, and which are treated for purposes of section 731 as distributed to the applicable partner. In these cases, the partner in question never received the funds. To the extent the Service has concerns about potential manipulation of tax distribution formulas (which in any event we believe can be addressed through anti-abuse rules), that same concern should not apply here, because taxes withheld and remitted are computed pursuant to formulae set forth in the applicable statutes and regulations.

d. Effect on substantial business activities determination

The Notice states that a “skinnying down” distribution will be disregarded “for purposes of section 7874.” We believe that this rule should be limited in scope to a determination of the Ownership Fraction, and should not apply to determine whether the expanded affiliated group has substantial business activities in the country of FP’s incorporation. We have noted above the conceptual and computational difficulties that a different scope would entail. We acknowledge that the statutory purpose test of section 7874(c)(4) would continue to apply.

Moreover, it may be that a spin-off occurs because of differences between businesses in different locations, such that, for instance, after the spin-off the distributing corporation’s EAG has substantial business activities in Country X, where before the spin-off it did not. In our view, if that distributing corporation were to be acquired by another Country X corporation, for valid business reasons, it would be appropriate to apply the “substantial business activities” safe harbor without adding back the spun-off business unless a principal purpose of avoiding the purposes of section 7874 were present.

e. Vote vs. value

Where a distribution is of equity subsidiaries, the distribution may sometimes be of less than 100 percent of the subsidiary. Sometimes, for instance, high-value equity may be distributed

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to the shareholders but high-vote shares may be retained by FT. In such a case, we believe that it is more appropriate to look only to the value of the distribution. We believe this is implied in the calculation of “non-ordinary course distributions” but would recommend clarification of that point in the regulations to be issued.

f. Substantiability test

As noted above, the anti-skinnying rule also applies for purposes of the substantiability test in Regulation section 1.367(a)-3(c)(3)(iii). The substantiability test is one of the tests that must be met in order for shareholders to avoid taxation under section 367(a)(1) in an otherwise tax-free transaction on receipt of shares of a non-U.S. corporation in exchange for shares of a U.S. corporation (shareholder inversion rules).

Unlike the section 7874 tests, the substantiability test is a 50-50 test and thus can apply to transactions that are intended as mergers of equals. Adding back distributions under the anti-skinnying rule can produce unfair and inappropriate results where, for example, a small isolated distribution was made during the relevant period. We recommend that a de minimis exception should be applicable for this purpose, which could include exceptions for a fixed dollar amount as well as for a percent of the total value of the U.S. company at the time of the transaction. If considered necessary, such a de minimis exception could be conditioned on a requirement that the distribution not have been motivated by the substantiability test.

C. Rules Regarding Subsequent Transfers of FA Stock

Our comments below focus on the rules regarding transfers of FA stock in the case of foreign-parented groups, where the proposed rules are intended to avoid “accidental inversions” as a result of restructurings and ownership shifts of foreign-parented groups. We appreciate the expansion of existing rules, which we believe will significantly reduce the incidence of “accidental inversions.” However, we remain concerned that the limitations of the rules could create problems in certain internal restructurings of foreign-parented groups, resulting in deemed inversions – even where the only U.S. corporation in question is one that had for years been owned by the foreign-parented group.

1. Existing rules

Even prior to the Notice, the Service had indicated that in some circumstances, F reorganizations of foreign companies did not necessarily trigger an inversion. Taxpayers had been concerned that even a foreign-to-foreign F reorganization could be viewed as an inversion based the construct of a deemed transfer of the assets of “Old FA” to “New FA” followed by liquidation of “Old FA.”

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44 Id. § 2.02(b).
45 See, e.g., Reg. § 1.367(b)-2(f)
Private Letter Ruling 201432002 involved an F reorganization of a foreign corporation that directly owned a U.S. corporation, with the intent of offering shares of the reorganized company to the public. Importantly, the foreign corporation was a subsidiary within an EAG, and less than 50 percent of the stock of the reorganized foreign corporation would be offered to the public, so that the foreign corporation would remain within the EAG after the public offering. This allowed the Service to apply the EAG rule to exclude the shares issued in the F reorganization from both the numerator and the denominator of the Ownership Fraction, with the result that the transaction was not an inversion.

This ruling was largely limited in effect to restructurings of subsidiaries within an EAG, and did not address the effects of an F reorganization where the parent corporation of an EAG is the reorganized entity, or where as a result of transactions related to the F reorganization, the reorganized foreign corporation leaves the EAG.

2. Proposed revisions

The Notice expands the EAG rule by treating transferred stock as held by a member of the EAG if (i) before the transaction, the transferring corporation and the domestic entity are members of the same foreign-parented group, and (ii) after the transaction, the transferring corporation remains a member of the EAG or would be a member of the EAG but for the subsequent transfer of any stock of FA by a member of the group in a related transaction (taking into account all other related transactions). Where this expanded rule applies, the transferred stock would be excluded from the numerator and may be excluded from the denominator of the Ownership Fraction. The practical effect is that where the expanded EAG rule applies, an inversion is extremely unlikely.

The Notice gives two examples of the application of this rule. In the first example, an individual owns all the stock of FT, which as part of an F reorganization transfers all DT stock to FA in exchange for 100 shares of FA stock and distributes the FA stock in liquidation. In this example, the FA stock would be treated as held by a member of the EAG because, prior to the acquisition, FT and DT are members of the same foreign-parented EAG, and but for the distribution of the FA stock to the individual owner, FT would be a member of the same EAG after the transaction.

In a variation of that transaction, immediately after the restructuring, FA subsequently issues 200 new shares to a new shareholder (Individual B) in exchange for qualified property. In that case, the EAG exception would not apply because FT would not be a member of the EAG.

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46 August 8, 2014.

47 See I.R.C. § 7874(c)(2)(A); Reg. § 1.7874-1(b).


49 Id. § 2.03(b), Ex. 2.

50 Id. § 2.03(b), Ex. 2(ii).
after the new share issuance. The example concluded that this transaction would not constitute an inversion because the property was qualified property, so the Ownership Fraction was 100/300.\(^{51}\)

3. Comments

We appreciate that the proposed revisions to the rules regarding subsequent transfers would prevent many post-closing restructurings from triggering an inversion. However, we remain concerned that a narrow but entirely plausible set of circumstances could trigger an “accidental inversion” by a foreign-controlled group.

The specific circumstance of concern is a variation of the alternative facts of Example 2 in the Notice. As we interpret the Notice, the transaction would have been an inversion if Individual B had contributed nonqualified property for FT stock, which would have resulted in FT ceasing to be a member of the EAG, and an Ownership Fraction of 100/100. We see no policy reason why the result should be any different in the case of qualified property versus nonqualified property. If the F reorganization had not occurred, Individual B could have transferred nonqualified property to FT for stock without triggering an inversion even though FT would leave the EAG. In our view, the result should be no different immediately after a foreign-to-foreign F reorganization.

An F reorganization is a “mere change in identity, form, or place of organization of one corporation, however effected.\(^{52}\) The taxable year does not close as the result of for a domestic to domestic or foreign to foreign F reorganization,\(^{53}\) and the acquiring corporation generally is treated as a continuation of the transferor. As such, we see no policy reason that a foreign-to-foreign F reorganization should result in any different treatment for the reorganized corporation than if the corporation had not reorganized. The Service has acknowledged that unique considerations apply to F reorganizations and that they should be analyzed separately from other transactions, even where the other transactions are effected as part of the same plan.\(^{54}\) This same logic applies here.

We understand that at least certain types of F reorganizations\(^{55}\) may be considered to involve assets transfers and so literally could be described in section 7874(a)(2)(B) unless excluded by regulation, such as by the internal restructuring exception. We believe that there is ample regulatory authority to exclude foreign-to-foreign F reorganizations.

We recommend, therefore, that the forthcoming regulations completely exclude foreign-to-foreign F reorganizations from determinations of whether an inversion has occurred, and look

\(^{51}\) Id. § 2.03(b), Ex. 2(iii).

\(^{52}\) I.R.C. § 368(a)(1)(F).

\(^{53}\) See IRC § 381(b)(1). Compare Reg. § 1.367(a)-1T(e) and § 1.367(b)-2(f)(4).

\(^{54}\) Rev. Rul. 96-29, 1996-1 C.B. 50.

\(^{55}\) In particular, F reorganizations that cross country lines and F reorganizations that are within the scope of section 367(b) and hence section 1.367(b)-2(f).
only at all other steps, taken as a whole, as if FA (the foreign corporation immediately after the F reorganization) was merely a continuation of FT (the foreign corporation immediately prior to the F reorganization).

D. Interaction of the Notice with the Substantial Business Activities Rule

Section 7874 provides that a foreign corporation is a surrogate foreign corporation, and thus a domestic corporation is an expatriated entity, only if after the foreign corporation acquires the domestic corporation, the EAG including the foreign corporation does not have “substantial business activities” in the country of incorporation of the foreign corporation, relative to the group as a whole. Under temporary regulations, this “substantial business activities” test is satisfied if, and only if, at least 25 percent of the EAG’s employees are based in the relevant foreign country, at least 25 percent of the total employee compensation expense is in that foreign country, at least 25 percent of the total value of all group tangible assets is in that country; and at least 25 percent of the group’s income from third-party transactions is in that country.

It appears that the Notice is not intended to cover a transaction that escapes classification as an inversion transaction subject to 7874 because the EAG satisfies the “substantial business activities” test. However, that is not made explicit in the Notice. We recommend that for avoidance of doubt, regulations adopting provisions of the Notice specifically provide that they do not apply to a corporation that would be an inverted domestic corporation but for satisfying the “substantial business activities” test.

III. Comments Relating to Section 3 of the Notice

A. Application of Section 956

1. Existing rules and proposed changes

In the Notice, Treasury and the Service expressed their concern that an inverted domestic corporation could effectively divert earnings from the U.S. group by having its foreign subsidiaries make loans to, or acquire stock of, a foreign affiliate outside the U.S.-parented chain. To prevent this, the Notice states that if an “expatriated foreign subsidiary” (a CFC subsidiary of an expatriated domestic corporation) acquires an obligation or stock of a non-CFC related foreign corporation during the applicable period of section 7874(d)(1) (i.e., the period beginning with the first date of acquisition of UST property by FA as part of the transaction, and ending 10 years after the last date of property acquisition), that property shall be treated as United States property for purposes of section 956. This proposed rule is referred to as the “anti-hopscotch” rule.

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57 Temp. Reg. § 1.7874-3T.
2. Comments - Service Request for Advice

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

a. Specific carve-outs for which advice was requested

In 1962, Congress adopted the Subpart F inclusion and Section 956. The House of Representatives first used the terms “non-qualified property” and “qualified property” under their suggested version of Section 956, and required income inclusion for investments in non-qualified property. The final bill replaced those terms with “investment in U.S. property” and many carve-outs that are still in the Code. In 1962, the House of Representatives recognized that carve outs were appropriate where the property was acquired in the ordinary course of a business:

> Your committee in determining what constitutes qualified property concluded that for competitive reasons the foreign corporation should be able to expand its investments in the same trade or business (or substantially the same trade or business) wherever it was located. Thus, money or other property located outside of the United States which is ordinary and necessary to the active conduct of a qualified trade or business of the controlled corporation is considered qualified property.\(^{59}\)

This rationale has not been altered by Congress and the carve-outs then adopted still exist in the Code.

Some of the current carve-outs in the Code to the definition of U.S. property generally are not relevant to hopscotch situations.\(^{60}\) However, the following carve-outs generally relate to ordinary business transactions and in view of the anti-abuse considerations underlying the Notice, seem equally appropriate in the context of the Notice:

1. Section 956(c)(2)(C) provides for an exception to the definition of U.S. property for “certain obligations arising out of the sale or processing of property.” This exception will apply if the CFC sells property to its U.S. parent and takes back a note rather than cash. The note that the CFC holds will not be U.S. property. Such an exception would seem appropriate to apply to a hopscotch situation where an expatriated foreign subsidiary has

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\(^{58}\) 1988-2 C.B. 446.


\(^{60}\) For example, section 956(c)(2)(A) excludes bank deposits and government obligations, which would not apply to hopscotch situations unless the Foreign Parent is a bank or government. Section 956(c)(2)(B) excludes property located in the United States that is used for export, which is also not involved. Section 956(c)(2)(D) excludes aircraft and rolling stock, which is also not relevant.
sold property to a foreign affiliate. This exception could be extended to cases relating to the furnishing of services. For example, the CFC provides services to a foreign affiliate and receives a note rather than cash. This Note would also get caught by this new rule unless an exception is added.

2. Section 956(c)(2)(H) provides an exception to U.S. property status for assets equal to the earnings of the CFC that have been taxed as effectively connected with the conduct of a U.S. trade or business. The actual language refers to section 952(b), which is the general rule that Subpart F income does not include income that is ECI. This special ECI exception is incorporated in section 956. For example, if the CFC had a $1,000 of ECI then the CFC could lend that $1,000 to its U.S. parent for a note and the note would not be U.S. property. While this exception does not necessarily relate to ordinary business transactions, this exception also seems appropriate to apply.

3. Section 956(c)(2)(I) provides for an exception for “deposits of cash or securities as collateral … which are made or received on commercial terms in the ordinary course of a U.S. or foreign person's business as a dealer in securities or commodities, but only to the extent such deposits are made or received as collateral or margin for a securities loan, notional principal contract, options contract, forward contract, futures contract, or any other financial transaction in which the Secretary determines it is customary to post collateral or margin.” This narrow exception seems appropriate to apply because this situation occurs in the ordinary course of a business.

4. Section 956(c)(2)(J) provides for an exception for “obligations of a U.S. person to the extent the principal amount thereof does not exceed the fair market value of readily marketable securities sold or repurchased pursuant to a sale and repurchase agreement or otherwise posted or received as collateral for the obligation in the ordinary course of a U.S. or foreign person's business as a securities or commodities dealer.” Such an exception seems appropriate to apply, but with substituting the words “any person” for “U.S. person.”

b. Carve-out if CFC regularly engaged in a third-party lending business

If the expatriated foreign subsidiary is regularly engaged in the business of making loans to unrelated parties, we recommend that loans made to related parties in the ordinary course of its business, consistent with past practice, to related parties not be treated as U.S. property. This view is consistent with the legislative history of section 956 cited earlier. In the alternative, if this rule is viewed as too broad, we recommend that loans made pursuant to a binding commitment that predated the inversion transaction, or negotiations leading to it (e.g., loans made under a revolving line of credit that was established several years prior to the first negotiations leading to the inversion transaction), not be treated as U.S. property.
c. **Short term loan carve-out of Notice 88-108**

In the Notice, Treasury and the Service stated that the exception to the definition of obligation provided by Notice 88-108\(^{61}\) will not apply. We respectfully recommend that the Service reconsider this position.

Notice 88-108 was adopted because the Treasury was aware that in order to improve their quarter-end balance sheets, many U.S. companies with revolving lines of credit with outside lenders will pay down a portion of the outside debt through intercompany loans just before quarter-end, only to renew the line of credit and pay down the intercompany loan after the quarter-end closing. A special 30-day relief rule, contained in Notice 88-108, was issued to accommodate companies that engage in this practice.\(^{62}\)

Consideration of adopting this rule under the Notice would seem appropriate because foreign-parented groups may also face these same financial needs. The short-term nature of these loans and the business motivation undercuts the concern that the structure is being used as a device to avoid the purposes of section 956. As the rule is not considered inconsistent with the purpose of section 956 in other contexts, there does not seem to be a valid rationale for treating it as such solely in an inversion context.

**B. Comments regarding Section 3.02(e) of the Notice**

1. **Description of proposals under the Notice**

   Following an inversion, the inverted group may engage in certain internal restructurings that, if effective, would cause an expatriated foreign subsidiary to cease to be a CFC, thereby deferring or possibly avoiding the imposition of U.S. federal income tax on the expatriated foreign subsidiary’s pre-inversion earnings and profits. To limit the availability of these transactions, Treasury and the Service intend to issue regulations addressing “specified transactions” and “specified exchanges” under section 7701(l) and section 367(b), respectively.

   a. **“Specified transactions” and recharacterization under section 7701(l)**

   The Notice states that Treasury and the Service intend to adopt regulations under section 7701(l) that will recharacterize certain “specified transactions” completed during the ten-year

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\(^{61}\) 1988-2 C.B. 446.

\(^{62}\) The exclusion may not be claimed, however, if the CFC holds “for 60 or more calendar days during such taxable year … obligations which, without regard to the 30-day rule … would constitute an investment in U.S. property if held at the end of the CFC’s taxable year.” This means that the CFC must actually collect the debt which is on its books at quarter-end within 30 days after the debt was incurred, and that the aggregate holding period of any and all obligations of the CFC that would constitute investments in U.S. property (disregarding for this purpose the 30-day rule) does not exceed 59 days. This limitation puts a premium on properly identifying all obligations held by a CFC that constitute investments in U.S. property, because any inadvertent obligation (no matter how insignificant) could prevent a taxpayer from relying on the 30-day rule.
applicable period set forth in section 7874(d)(1). A specified transaction is defined as any
transaction in which stock of an expatriated foreign subsidiary (“specified stock”) is issued or
transferred to a non-CFC related foreign person or a domestic partnership or trust that has one or
more non-CFC related foreign partners or beneficiaries (a “specified related person”). With
respect to the issuance of specified stock, the specified transaction will be recharacterized as a
deemed issuance of stock by the section 958(a) U.S. shareholder(s) to the specified related
person in exchange for the property that was actually transferred to the expatriated foreign
subsidiary, on the same terms (with matching distributions) as the actual stock that was issued by
the expatriated foreign subsidiary, followed by an exchange of such property for the deemed
issuance of stock to the section 958(a) U.S. shareholder(s) by the expatriated foreign subsidiary.
An effect of this recharacterization is to swell the balance sheet of the U.S. shareholder and the
CFC (i.e., deem the decontrol contribution to increase the U.S. tax base).

Similar principles will apply when specified stock is transferred to a specified related
person (though if the specified related person is a corporation, the transfer generally will be
taxable if not excepted under the rules discussed in part III.B.1.b below and so generally will not
be subject to section 7701(l) recharacterization).

If a specified transaction is recharacterized under section 7701(l), the recharacterization,
including the deemed instrument, will be treated as outstanding for all purposes of the Code.
Consequently, if a distribution is made with respect to specified stock, the expatriated foreign
subsidiary will be treated as having made the distribution to the U.S. shareholder(s), which, in
turn, will be treated as having made a matching distribution to the specified related person under
the deemed instrument. The expatriated foreign subsidiary, having actually distributed the funds
to the specified related person, will be treated as the paying agent of the U.S. shareholder(s) with
respect to the deemed instrument. The Notice further provides that rules similar to the rules
regarding transactions affecting benefitted stock under the fast-pay stock rules would apply to
transactions involving specified stock.

Specified transactions are not subject to recharacterization under these proposed rules if
any of three exceptions applies. The first exception is very broad and has the effect of
eliminating from section 7701(l) most transactions involving the transfer of stock of an
expatriated foreign subsidiary. It applies if the specified stock is transferred in a fully taxable

63 See Notice 2014-52, 2014-42 I.R.B. 712, § 3.02(e)(i)(B); see also Reg. § 1.7701(l)-3(c)(2)(i) (requiring that
the timing and amount of any distributions on the fast-pay stock match the timing and amount of the
payments made on the financing instrument).

64 Notice 2014-52, 2014-42 I.R.B. 712, § 3.02(e)(i)(A)-(B), (e)(iii) Ex. 1. If there are multiple U.S.
shareholders (within the meaning of section 951(b)) that own (within the meaning of section 958(a)) stock
in the expatriated foreign subsidiary, and that are related to or under common control with the specified
related person, then the deemed transactions will be with each of the U.S. shareholders.

65 We believe these consequences, which may involve carryover basis and other complications, would be
better avoided and in the context of the partnership example below we have suggested an alternative
approach.

66 Id. § 3.02(e)(i)(B); see Reg. § 1.7701(l)-3(b)(3)(iii).
transaction, including taxable transfers under existing U.S. tax rules as well as transfers that would be taxable under the expanded section 367(b) rules discussed below with respect to “specified exchanges” (i.e., subject to a de minimis rule, transfers by an exchanging shareholder described in section 1.367(b)-4(b)(i)(A) of expatriated foreign subsidiary stock for stock of another foreign corporation). For this purpose, any deemed dividend resulting from a specified transaction will not be excluded from foreign personal holding company income under section 954(c)(6). 67

The second exception applies if the expatriated foreign subsidiary remains a CFC following the specified transaction, and the section 958(a) U.S. shareholders’ aggregate direct or indirect ownership of the expatriated foreign subsidiary decreases by no more than 10 percent.

The third exception applies if the specified transaction would be subject to the fast-pay stock rules of Regulation section 1.7701(l)-3, in which case those rules will apply instead of these proposed rules. 68

b. “Specified exchanges” under section 367

The Notice states that Treasury and the Service intend to amend the regulations under section 367(b) to require the exchanging shareholder to include the section 1248 amount with respect to any “specified exchange,” regardless of whether the transaction results in a decontrolling event, the exchanging shareholder retains its section 1248 shareholder status, and/or the foreign acquiring corporation is a CFC immediately after the exchange. A specified exchange is any exchange of stock in an expatriated foreign subsidiary for stock in a foreign corporation under sections 351 or 368(a)(1). 69 An exception will apply, similar to the second exception noted above for specified transactions, if the section 958(a) U.S. shareholders’ ownership interest in the expatriated foreign subsidiary does not decrease by more than 10 percent.

2. Subchapter K Implications of Section 3.02(e) of the Notice

We recognize the policy concerns that led to the proposed rules in the Notice. However, we are concerned that the proposed rules are more complex than necessary to deter such transactions and may result in uncertain and unintended consequences, particularly with respect to specified transactions involving partnerships. Such difficulties are best illustrated by examining in some detail the various issues associated with the examples in section 3.02(e)(iii) of the Notice and Example 2 in particular, which involves the transfer of specified stock to a partnership. As noted above, most transfers to a corporation will not be within the scope of the section 7701(l) recharacterization.

67  Id. § 3.02(e)(i).
68  Id. § 3.02(e)(i)(A).
69  Id. § 3.02(e)(ii); see also Reg. § 1.367(b)-4(b)(1).
a. Example 2 and Proposed Recast

In each of the examples in Section 3.02(e) of the Notice, FA, a foreign corporation, wholly owns DT, a domestic corporation, which, in turn, wholly owns FT, a foreign corporation that is a CFC. FA also wholly owns FS, a foreign corporation. FA acquired the shares of DT in an inversion transaction that was completed on January 1, 2015. The examples assume that FA is not treated as a domestic corporation as a result of its acquisition of DT. Accordingly, DT is a domestic entity, FT is an expatriated foreign subsidiary, and FA and FS are specified related persons with respect to FT.

Example 2 involves a decontrolling transaction using a foreign partnership. Following an inversion, FA and DT contribute property to a foreign partnership, FPRS. DT contributes FT in exchange for a 40 percent interest in FPRS, and FA contributes unspecified property in exchange for the remaining 60 percent interest in FPRS. According to the Notice, this specified transaction will be treated as though DT issued a deemed instrument (“DT Deemed Stock”) to FPRS in exchange for the issuance to FA of a 40 percent interest in FPRS. DT is deemed to continue to wholly own FT rather than transfer it to FPRS and therefore FT will continue to be treated as a CFC. The Notice concludes that any distributions from FT to FPRS will be treated as having been distributed from FT to DT, and then from DT to FPRS via the DT Deemed Stock.

The Notice requests comments on Example 2 and potential alternative recharacterizations that could result when specified stock is transferred to a partnership.70

The recast in Example 2 raises a number of challenging issues, principally as the result of the issuance of the DT Deemed Stock, which is hook stock, and the indefinite looping effect of such stock. The Notice does not spell out the partner inclusions from FPRS and so does not address the issues that would be created by this construct. We first propose an alternative, simpler way to approach this transaction.

b. Alternative approach

It appears that the drafters of the Notice believed that any recast should not disturb the commercial aspect of the arrangement to any greater degree than necessary to retain treatment of FT as a CFC and continued treatment of FT dividends as passing through DT. On that basis, it appears that the drafters retained the commercially agreed 40% interest in the capital and profits of FPRS, including a share of the property contributed by FA. The effect of this approach, however, is to increase the balance sheet and income statement of DT by having it hold and earn the income from not only all of FT but also a share of FPRS.

We believe that a much simpler approach would not be a more difficult fit with the statutory authority invoked, section 7701(l), than that selected,71 and would eliminate the

70 Notice 2014-52, § 3.02(e)(i)(A).

71 Both would have the issue of deeming an instrument issued by DT. The alternative proposal also may require a deemed intercompany transfer of some DT shares to FA and would treat FPRS as a conduit to with respect to the contribution of FT (and collateral consequences), but the latter at least would fit comfortably within the conduit principles of section 7701(l).
difficult conceptual problems of the approach selected. An alternative would be to allow taxpayers to elect to apply the simpler approach.

Under that approach, FPRS would in effect be treated as a conduit to the extent of its ownership of FT and items attributable to it (and as a consequence, also with respect to the corresponding property contributed by FA and related items). FT either could be viewed as continued to be owned directly by DT (in effect, ignore FPRS, under principles such as embodied in section 1.701-2(e)) or could be considered contributed to FRPS but tracked solely to DT. The corresponding FA assets necessarily would be considered tracked solely to FA. The DT Deemed Stock relating to 60 percent of FT would be deemed issued in recapitalization of existing shares held by FA or, if FA does not hold DT shares, of DT shares deemed transferred to it by the affiliated holder. This would permit replication of the matching distribution in the analogous case illustrated in the Notice for decontrol via the issuance of shares (though without the collateral consequence of swelling the balance sheet of DT).

c. Brief Discussion of Issues Associated with Proposed Recast

The alternative approach would eliminate difficult issues arising from hook stock. These include valuation issues, excessive inclusions, possibly May Department Store regulation issues, and various issues including zero basis on an unwind. For example, the recast illustrated in Example 2 may produce value shifting concerns similar to those raised in Notice 94-93. To address the cascading valuation issues raised in Notice 94-93, FPRS should be deemed to have received no greater percent of DT’s outstanding shares than would preserve the value of FA’s shares in DT.

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72 An alternative approach that is closer to the treatment in the case of decontrol via the issuance of shares could be to treat FA as contributing assets equal to the value of FT to DT for the DT Deemed Stock, and DT as contributing them to FPRS, with FA respected as contributing directly to FPRS the balance of the assets contributed by it. This, however, would have the inappropriate consequence of swelling the balance sheet of DT, involve carryover basis consequences and involve even more complicated compliance questions.

73 Not all issues would be eliminated. The recharacterization illustrated in Example 2 could produce a deconsolidating event under slightly different facts. For example, if DT was a member of a consolidated group, the deemed acquisition by FPRS of more than 20 percent of the common stock of DT may terminate DT’s affiliation status, resulting in the restoration of gains and losses deferred in intercompany transactions among other consequences.

74 Notice 89-37, 1989-1 C.B. 679. If adopted in their current form with their current stated effective date, these regulations will apply to any transaction or distribution occurring after March 9, 1989. See Prop. Reg. § 1.337(d)-3(g).


76 While the DT Deemed Stock (hook stock) remains outstanding, the value of the interests in DT and FPRS would be artificially increased. This additional “value” would result from the indefinite looping effect of the DT hook stock. For example, the value of DT’s 40 percent interest in FPRS would reflect its interest in (i) 40 percent of the $100 of FPRS property (i.e., the $60 of property FA contributed plus the $40 of FT stock deemed owned by DT), plus (ii) 16 percent of the $100 of FPRS property, plus (iii) 6.4 percent of the $100 of FPRS property, and so on ad infinitum. A similar approach would apply with respect to FA’s 60
When DT is deemed to receive a dividend from FT, FA’s distributive share of this dividend would be subject to the 30 percent gross basis tax under section 881 (unless reduced under an applicable U.S. tax treaty). A $100 dividend actually paid by FT thus would result in a minimum of $160 of income subject to U.S. federal income tax (i.e., $100 DT would be deemed to have received from FT plus FA’s $60 distributive share of FPRS’s actual dividend received from FT). It is not clear under the Notice whether DT is deemed to be allocated a share of the dividend income from FPRS, or whether it would be allocated other income instead. It would already have reported the entire amount of the dividend from FT. As regards any distribution on the DT hook stock held by FPRS, the IRS has ruled that a domestic corporation should not have income from a dividend on its own shares held by a partnership in which it is a partner.

Additional issues relate to how the recast is to be unwound. The Notice provides that the recast will be respected for all purposes of the Code. Taken literally, the recast would remain in place following a sale of the expatriated foreign subsidiary or a sale by a section 958(a) U.S. shareholder of its interest in the specified related person that owns the stock of the expatriated foreign subsidiary. This could produce perverse results if the recast is not unwound, yet unwinding the recast may implicate difficult zero-basis issues (among other issues), neither of which we believe were intended.

In the event FPRS sells the FT stock to an unrelated party, DT presumably would be treated as having sold the FT stock. It is not clear what happens to the rest of the arrangement. Would the matching DT Deemed Stock simply disappear, which would be the simplest solution? Moreover, if DT is deemed to have sold the FT stock when FPRS actually sells the FT stock, additional fictional steps will be required to transfer the sales proceeds to FPRS.

percent interest in FPRS; however, taken together, DT’s and FA’s combined interest cannot exceed the value of the underlying assets (i.e., $100).

Presumably, such dividends would be eligible for indirect foreign tax credits, even if DT would not have been eligible without the recast under section 902(c)(7).

Assuming DT has sufficient earnings and profits, it is not clear whether the deemed distribution from DT will be treated as a dividend if the underlying distribution from FT was not a dividend under section 301(c)(1). Moreover, it is unclear what, if any, effect the subpart F basis and PTI adjustments will have on any deemed distributions to FPRS.

PLR 8022010 (March. 5, 1980).

If DT is treated as having sold the FT stock when FPRS actually sells the FT stock, DT would recognize any built-in gain in the FT shares with respect to the deemed sale, and such gain would be recharacterized as a dividend to the extent of FT’s earnings and profits, which may carry foreign tax credits. See I.R.C. §§ 902, 1001, 1248. However, this fictional transaction would not explain how FPRS received the proceeds from the sale. There are a number of possibilities. DT could be treated as having distributed the sales proceeds to FPRS with respect to the DT Deemed Stock. DT could be treated as having redeemed the DT Deemed stock with the sales proceeds. Lastly, DT could be treated as having contributed the sales proceeds to FPRS. Each of these scenarios creates follow-on, and likely unintended, tax consequences for which guidance in any forthcoming regulations would be warranted.
d. **Recommendations Regarding Subchapter K Implications of Section 3.02(e) of the Notice**

When specified stock is transferred to a partnership, the recast proposed in the Notice may implicate difficult collateral issues, uncertainty, and additional complexity. While we recognize the policy concerns underlying the proposed rules, we believe that, in the partnership context, the proposed cure is worse than the disease. For this reason, we would suggest the simplified approach we note above at part III.B.2.b.

Alternatively, we believe that anti-abuse rules and judicial doctrines may be adequate to remedy the specific concerns arising from specified transactions involving partnerships.\(^{81}\)

If, however, the approach suggested in the Notice is retained, we would recommend that the forthcoming regulations provide guidance on the various technical issues discussed above, in particular explaining the determination of shares issued, avoiding the perverse effects of cascading income, clarifying that the dividend deemed received by the paying corporation is not income to the paying corporation, and addressing what happens to the deemed instrument on a disposition of FT by FPRS.

### 3. **Business Restructuring Exception to Section 3.02(e) of the Notice**

The Treasury and the Service have requested comments on whether an exception to the proposed rules set forth in Section 3.02(e) of the Notice should apply when a specified transaction or a specified exchange results in the integration of similar or complementary businesses and the taxpayer does not exploit the group’s inverted structure to avoid U.S. taxation on the expatriated foreign subsidiary's pre-inversion earnings and profits.\(^{82}\) For example, the Notice provides that such an exception may apply when the expatriated foreign subsidiary does not, during the applicable ten-year period, acquire U.S. property, pay extraordinary dividends out of pre-inversion earnings and profits, and engage in non-pro rata redemptions as a way of bailing out pre-inversion earnings and profits.

Foreign-parented multinationals frequently engage in internal restructurings for bona fide and substantial business reasons. Such business objectives, however, are not limited to aligning

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\(^{81}\) E.g. Notice 2004-31, 2004-17 I.R.B. 830 (Apr. 1, 2004), in which the Service designated as a “listed transaction” a transaction in which a partnership acquired preferred stock in a member of a partner’s consolidated group and issued a guaranteed payment instrument to the foreign parent of the group. In this notice, the Service announced its intention to challenge such transactions on various grounds, including treating the partnership as a sham entity, the partnership anti-abuse regulations, and lack of substantial economic effect.

\(^{82}\) Notice 2014-52, 2014-42 I.R.B. 712, § 3.02(e)(iv). It is unclear whether Treasury and the Service intend to limit this exception to specified transactions. This uncertainty turns on the fact that section 3.02(e)(2)(iv) references the rules described in section 3.02(e) of Notice, covering specified transactions and specified exchanges, but then offers up two suggested conditions for the exception, one of which is limited to specified transactions. We recommend that any such exception apply to both specified transactions and specified exchanges as there appears to be no principled reason for limiting the exception to specified transactions. In fact, as Example 3 of the Notice illustrates, a transaction can be both a specified transaction and a specified exchange.
and integrating similar or complementary businesses, but may also include exploiting business synergies by integrating distribution networks; developing complementary brands; enhancing manufacturing and development systems; capitalizing on cost savings; eliminating redundant back office functions; and simplifying and rationalizing the organizational structure. Thus, we fully support an internal restructuring business exception to Section 3.02(e) of the Notice.

We also recommend that the gain recognition regime under section 367(a) serve as a model for enforcing the strictures of this business restructuring exception, with annual certifications as discussed below.

The application of this business restructuring exception may be illustrated by Example 3 of section 3.02(e)(iii) of the Notice, which involves a specified exchange that falls within the Notice’s proposed rules under section 367(b).

In this example, DT exchanges all of the stock of FT for 60 percent of the stock of FS pursuant to a reorganization described in section 368(a)(1)(B). FT is a CFC immediately before and immediately after the reorganization, and DT retains its section 1248 shareholder status. Were it not for the Notice, this transaction would not be subject to section 367(b) and, as such, DT would not be required to include in income the section 1248 amount attributable to the FT stock. This is because immediately after the exchange, FT and FS are CFCs and DT is a section 1248 shareholder with respect to FT and FS. However, because DT’s ownership interest has decreased by more than 10 percent (presumably by value), the example concludes that DT must include in income the section 1248 amount with respect to the FT stock transferred to FS.

The proposed rules should not impede internal restructurings that are animated by bona fide and substantial business reasons, provided the taxpayer has not exploited the group’s inverted structure to avoid U.S. taxation on an expatriated foreign subsidiary’s pre-inversion untaxed earnings and profits. In this example, the inverted group has done nothing to exploit the structure in order to avoid U.S. taxation on FT’s pre-inversion untaxed earnings and profits, and DT has maintained its section 1248 shareholder status with respect to FT. In fact, the transaction in this example actually created a CFC, namely FS. If the FS shares were subsequently sold to an unrelated party, DT would be required to include in income its share of FT’s pre-inversion untaxed earnings and profits under section 1248, just as if it had sold the FT shares to an unrelated party before the inversion. Hence, assuming there were real and substantial business reasons for effecting the transaction in Example 3, there is no apparent reason why DT should be taxed on FT’s pre-inversion untaxed earnings and profits.

To ensure that FT’s pre-inversion untaxed earnings and profits are not subsequently avoided during the applicable period, DT should be required to (i) disclose the specified

83 See Reg. § 1.367(b)-4(b). Under Reg. § 1.367(b)-2(c)(1), the term “section 1248 amount” means the net positive earnings and profits (if any) that would have been attributable to stock of a foreign corporation and includible in income as a dividend under section 1248 and the regulations thereunder if the stock were sold by the shareholder.

84 See Notice 2014-52, 2014-42 I.R.B. 712, § 3.02(e)(ii)(C) (excepting specified transactions in which CFC status is retained and the section 958(a) U.S. shareholders’ aggregate value interest in the expatriated foreign subsidiary is not decreased by more than 10 percent).
exchange and the business reasons for the transaction; (ii) identify the pre-inversion untaxed earnings and profits of FT; (iii) extend the statute of limitations with respect to the U.S. tax consequences of the specified exchange; (iv) certify annually that there have been no transactions to avoid U.S. taxation on FT’s pre-inversion untaxed earnings and profits for the taxable year (including by subsequent loss of CFC status); and (v) maintain sufficient documentation that tracks the pre-inversion untaxed earnings and profits of FT and the extent to which such earnings and profits have been reduced during the applicable period.

C. Revision of Section 304(b)(5)(B)

In contrast to the other provisions discussed above, Section 3.03 of the Notice proposes changes to the rules under section 304 that would apply regardless of whether an inversion transaction has occurred. These proposed rule changes seek to limit a foreign multinational corporation’s ability to source dividends out of the earnings and profits (“E&P”) of certain CFCs through section 304 transactions.

1. Current law and proposed revisions

Under section 304, if one corporation (the “acquiring corporation”) acquires the stock of a related corporation (the “issuing corporation”) in exchange for property, the transaction generally is characterized as a redemption rather than a sale. In addition, such a redemption may be treated as a section 301 distribution of property pursuant to the redemption rules of section 302. When this occurs, special rules under section 304(b) apply in order to determine the amount, if any, of the section 301 distribution that constitutes a dividend and the source from which such dividend arises. Pursuant to section 304(b)(2), the amount of this dividend (and the source thereof) is determined by treating the property as having been distributed first by the acquiring corporation, to the extent of its E&P, and then by the issuing corporation to the extent of its E&P.

Where a foreign multinational corporation owns a CFC through a U.S. subsidiary or consolidated group (a so-called “sandwich structure”), the structure can often result in multiple levels of tax if the foreign parent wishes to access the CFC’s earnings. After the CFC has paid local country taxes, dividends may be subject to local withholding tax and U.S. income tax. Limitations imposed on the availability of U.S. foreign tax credits may result in an overall effective tax rate in excess of the U.S. statutory rate, even before the dividends are distributed from the U.S. group. The remaining net earnings may be subject to further withholding and income tax as such amounts are distributed from the U.S. group to the foreign parent corporation. To address the business and tax inefficiencies associated with sandwich structures, foreign multinational corporations historically have engaged in section 304 transactions to remove the CFC from the U.S. group.

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85 I.R.C. § 304(b)(1).
In response to one form of those transactions structured to come under section 304(a)(2), Congress enacted section 304(b)(5)(B) as part of the Education Jobs and Medicaid Assistance Act of 2010, to reduce the likelihood that a CFC with undistributed E&P could be removed from the U.S. group without the U.S. parent paying tax on the transaction. Section 304(b)(5)(B) provides that where the acquiring corporation in a section 304 transaction is a foreign corporation, its E&P will not be taken into account for purposes of section 304(b)(2)(A) if more than 50 percent of the dividends arising from such acquisition (determined without regard to section 304(b)(5)(B)) would neither be “subject to tax” under Chapter 1 of the Code for the taxable year in which the dividends arise nor included in the E&P of a CFC. In other words, in a section 304 transaction with a foreign acquiring corporation, if less than 50 percent of the dividends would be subject to tax under Chapter 1 of the Code or included in the E&P of a CFC, the dividend will be sourced solely out of the issuing corporation’s E&P. The legislative history contemplates that regulations will be issued to prevent the avoidance of the limitations imposed under section 304(b)(5)(B).

Seeking to further limit the ability to access the untaxed E&P of a CFC acquiring corporation through a section 304 transaction, the Notice states that Treasury and the Service intend to issue regulations providing that, for purposes of applying section 304(b)(5)(B), the determination of whether more than 50 percent of the dividends in a section 304 transaction is subject to tax or includible in the E&P of a CFC will be made by taking into account only the E&P of the foreign acquiring corporation (i.e., the E&P of the issuing corporation will be ignored). Accordingly, in order to access the foreign acquiring corporation’s E&P in a section 304 transaction, the Notice requires that more than 50 percent of the foreign acquiring corporation’s dividend must be subject to U.S. tax under Chapter 1 of the Code or included in the E&P of a CFC. Given that the in the typical transaction targeted by Congress in section 305(b)(5)(B) the seller has been a non-U.S. corporation that was not a CFC, and given that there is no U.S. withholding tax on dividends from a non-U.S. corporation paid to another non-U.S. corporation, the subject to tax test could never be met in the targeted case. In effect, the Notice articulates an anti-abuse rule that eliminates the narrow planning room that remained following the enactment of section 304(b)(5)(B).

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86 Congress had previously enacted section 304(b)(5) (now 304(b)(5)(A)) to address certain transactions that utilized section 304(a)(1). As Example 2 in section 3.03(b) of the Notice indicates, the section 304(b)(5)(B) rule potentially also can apply in a section 304(a)(1) transaction.


88 In this regard, section 304(b)(5)(B) expands the instances in which the dividend will not be sourced out of the foreign acquiring corporation’s E&P. See I.R.C. § 304(b)(5)(A) (excluding the E&P accumulated while the foreign acquiring corporation was not a CFC).

89 Staff of the Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the Senate Amendment to the House Amendment to the Senate Amendment to H.R. 1586, Scheduled for Consideration by the House of Representatives on August 10, 2010, at 28 (JCX-46-10) (August 10, 2010).

90 In a typical transaction, a CFC subsidiary of a U.S. target corporation might purchase previously outstanding shares of the parent company of the U.S. group from the non-U.S. (non-CFC) owner of that company, and so seek to eliminate the E&P of the CFC, which therefore could hold the acquired stock without a section 956 inclusion.
Example 1 of the section 3.30(b) of the Notice illustrates the proposed rule in the context of the targeted type of transaction.

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

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

Under section 304(b)(5)(B) as in effect without regard to the Notice, the transaction might have fallen outside of the rule, depending on whether the deemed dividend out of DT’s E&P (representing more than 50 percent of the relevant E&P) was subject to tax (which it presumably was if it was subject to, e.g., 5 percent U.S. withholding tax. As Example 1 illustrates, the subject to tax test will be applied by looking solely to the $49 of E&P of the CFC acquiring corporation (FS1) and because that E&P would not be subject to tax in any sense, it is ignored pursuant to the proposed rule in the Notice in applying section 304 and only the E&P of DT is taken into account as a dividend.

Although not discussed in the Notice, FS1’s ownership of the DT shares would constitute an investment in U.S. property under section 956. Consequently, by sourcing the dividend solely out of the E&P of DT, this example may result in DT including FS1’s $49 E&P under section 951(a)(1)(B).

2. Authority for change

While we normally do not question the authority for proposed regulations, we do wonder whether the regulatory grant under section 304(b)(5)(C) to “prescribe such regulations as

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91 Some taxpayers apparently took the position a deemed dividend was subject to tax even if the applicable rate under an income tax treaty was 0 percent. The Notice announces regulations that would sidestep this issue in the targeted case.

92 The authority for certain portions of the Notice has been questioned by certain practitioners, including in published articles.
are appropriate to carry out the purposes of this paragraph” is adequate to adopt a rule that so thoroughly changes the meaning of the statutory language.

3. **General recommendation regarding “subject to tax” standard**

   As noted above, although under the Notice the typical, targeted case no longer raises the issue, section 304(b)(5)(B) may potentially apply in other transactions where the meaning of subject to tax may be relevant. While “subject to tax” is not defined under section 304, based on Example 2 in the Notice, it appears that a section 304 dividend will be considered “subject to tax” if the dividend is included in the gross income of a person that may be liable to U.S. federal income tax on such dividend under Chapter 1 of the Code (i.e., DT in the example). However, it is unclear whether such a dividend would be considered “subject to tax” if sheltered by a net operating loss. The beneficial owner of the dividend would not owe, at least currently, U.S. federal income tax on the dividend, though it may nevertheless be “subject” to U.S. federal income tax in the sense that the dividend would enter into the computation of a potential tax liability.

   We therefore recommend that the regulations clarify that a dividend is “subject to tax” if it is reportable in the income of a U.S. person, even if that income is not currently burdened with tax because of the U.S. person’s tax attributes.