*Accidental Inversions*

# When Intended Estate Planning Results in an Accidental Inversion

*The transfer of shares by non-U.S. individuals of an existing U.S. corporation owning U.S. real estate to a newly formed foreign corporation in exchange for shares of the foreign corporation can have disastrous U.S. estate tax consequences for the non-U.S. domiciliary on death.*

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For many years, the most common structure for non-U.S. individuals [1] to hold U.S. business assets, such

as U.S. real estate, has been to hold such assets directly under a U.S. corporation and then to have the shares of the U.S. corporation owned by a foreign corporation. If implemented properly, this structure protects the non-U.S. individual from U.S. federal estate and gift tax, and also allows the non-U.S. individual to control the timing of shareholder-level tax on dividend distributions. Since the introduction of Section 7874 in 2004, however, if not implemented properly, this structure could result in an "inversion" that would result in the foreign corporation being treated as a U.S. corporation, for all purposes of the Code. In that case, the non-U.S. individual would not be protected from U.S. federal estate tax. Given that non-U.S. domiciliaries [2] have only a $60,000 exemption on the value of their U.S.-situs assets includable in their gross estate, structures such as the one described above, if they result in an inversion, would have disastrous U.S. federal estate tax consequences to the non-U.S. domiciliary on death.

This article will discuss one variation of the "inversion" transaction, which involves the transfer of shares by non-U.S. individuals of an existing U.S. Subchapter C corporation owning U.S. real estate to a newly formed foreign corporation in exchange for shares of the foreign corporation ("Share Inversion"). It then describes the effect of the Share Inversion and associated anti-inversion rules on the recipient foreign corporation and its non-U.S. individual owners. This transaction will be referred to as the "Base Transaction" throughout this article.

## Summary of U.S. Federal Tax Rules

To fully appreciate the inversion rules' impact on the Base Transaction, following is a brief description of certain terms used throughout this article and the basic U.S. federal income, estate, and gift tax rules that apply to individuals.

For U.S. federal *income* tax purposes, "U.S. person" includes U.S. corporations [3] and individuals who are either U.S. citizens, U.S. green card holders, or considered to be substantially present in the United States. [4] Nonresident aliens and foreign corporations ("foreign persons") are not considered U.S. persons. [5] U.S. persons are subject to U.S. federal income taxation on their entire worldwide income, regardless of the source of the income. In contrast, foreign persons are subject to U.S. federal income tax on only certain types of "U.S.-source" income. For these purposes, U.S.-source income generally includes (1) income effectively connected to a U.S. trade or business, including gains from the sale of U.S. real property (ECI) [6]; and (2) certain types of passive income from U.S. sources that are not derived from a U.S. trade or business, such as dividends, rents, and interest ("FDAP (fixed or determinable annual or periodical) income"). [7]

Unlike the U.S. federal income tax, the U.S. federal estate and gift taxes are applied based on an individual's citizenship or domicile (instead of residence). U.S. citizens and U.S. domiciliaries [8] are subject to the U.S. federal estate and gift tax on the fair market value (FMV) of their worldwide assets (wherever located throughout the world) that they transfer during life or at death. [9] On the other hand, individuals who are neither U.S. citizens nor considered domiciled in the United States are subject to U.S. federal estate or gift tax only on the FMV of their ownership interest in certain U.S.-situs assets transferred during life or on death. U.S. citizens and U.S. domiciliaries are currently entitled to a $5,450,000 million lifetime exemption (adjusted for inflation); [10] however, a non-U.S. domiciliary is permitted to generally exclude only the first $60,000 of his taxable U.S.-situs property from the calculation of his U.S. federal estate tax. No similar exemption from U.S. federal gift tax exists for non-U.S. domiciliaries.

Noncitizens who are not considered domiciled in the United States are subject to U.S. federal estate or gift tax only on the value of their ownership interests in certain U.S.-situs assets transferred during their lifetime or on death. Property that is considered U.S.-situs property for estate and gift tax purposes varies depending on the type of property transferred. Some assets are considered U.S. situs for U.S. federal estate tax purposes but not for U.S. federal gift tax purposes, whereas other assets are considered U.S. situs for both estate and gift tax purposes. Shares of stock in U.S. corporations are U.S.-situs property for U.S. federal estate tax, but not for U.S. federal gift tax purposes. [11] In contrast, certain assets are considered U.S. situs for both U.S. federal estate *and* gift tax purposes. These assets include interests in real property located in the United States. [12] On the other hand, a non-U.S. domiciliary is not subject to U.S. federal estate or gift tax on his interests in foreign situs property. Shares of stock in foreign corporations are considered foreign-situs property, and thus, not subject to U.S. federal estate or gift tax. [13]

For many foreign individual investors, the most important U.S. tax consideration when considering an investment in the United States is how to avoid the U.S. federal estate and gift taxes. This is primarily because non-U.S. domiciliaries are allowed to exclude only the first $60,000 in value of U.S.-situs assets from their U.S. estates. Thus, most non-U.S. domciliaries seek to hold their U.S.-situs assets, such as U.S. real estate, under a foreign corporation, [14] as shares in a foreign corporation are explicitly excluded from the definition of U.S.-situs assets. Further, foreign individuals often prefer to have their U.S. investments held directly by domestic entities, such as U.S. corporations, as domestic entities typically have an easier time conducting business in the United States and, where the U.S. branch profits tax might apply to a foreign corporation engaged in business in the United States, holding U.S. business assets under a domestic corporation also allows a non-U.S. investor to control the timing of shareholder-level taxation that applies to dividend distributions.

## Base Transaction

A non-U.S. individual owns stock in a U.S. corporation, which primarily owns interests in real estate located in the United States. In this case, the U.S. corporation qualifies as a U.S. real property holding corporation (USRPHC) for purposes of the Foreign Investment in Real Property Tax Act of 1980 [15] (FIRPTA), which is discussed below.

The optimal U.S. tax structure to hold this U.S. real estate should avoid U.S. transfer tax exposure (gift, estate, and generation skipping transfer tax) for the non-U.S. individual and his future estate. Thus, the non-U.S. domiciliary may form a foreign corporation to hold the USRPHC stock (and possibly other U.S. assets) because stock in a foreign corporation is not included in the non-U.S. domiciliary's U.S. gross estate and is not subject to U.S. federal estate or gift tax. [16] To accomplish the estate and gift tax planning goal, the non-U.S. domiciliary would then contribute the shares of the USRPHC to the foreign corporation. This "Base Transaction" is permitted under FIRPTA and, until 2004, successfully converted what otherwise was a U.S.-situs asset (stock in the USRPHC) to a foreign-situs asset (stock in the foreign corporation). [17] Section 7874 , however, causes the Base Transaction to result in potentially disastrous U.S. estate and gift tax exposures, as discussed below. [18]

## Overview of FIRPTA

This section reviews the legislative history of FIRPTA and analyzes the operation of the FIRPTA rules that are primarily in Sections 897 and 1445 . It is clear that FIRPTA was intended to address only U.S. federal "income" tax consequences of real property gains, rather than U.S. federal estate or gift tax consequences associated with owning U.S. real property.

## Legislative history.

Before the enactment of FIRPTA, a foreign person's U.S.-source real estate gains were generally not taxable in the United States unless the real property was held in connection with a U.S. trade or business. [19] Sometimes, even when the real property was connected to a U.S. trade or business, the foreign person would circumvent U.S. federal tax exposures by putting the U.S. real property in a holding corporation. Then, when the foreign person wanted to sell its interest in the underlying real property, rather than having the holding corporation sell the real property directly, the foreign person would sell its shares in the holding

corporation, and the resulting gain from the sale was not taxable in the United States. [20] Foreign persons were also able to avoid U.S. tax on U.S.-source real estate gains by using the Section 453 installment sale method rules, which enabled them to defer principal payments into years when the foreign person was not engaged in a U.S. trade or business, and thereby not subject the payment to tax in the United States. [21] Aside from the potential tax abuses, the unfair advantage of foreign persons over U.S. persons in the U.S. real estate market also had a significant effect on the U.S. agriculture industry. Specifically, foreign investment [22] was causing the price of U.S. farm land to soar, which put smaller U.S. farmers out of business because they could no longer compete with rising market prices. [23]

In response to these abuses and because it was essential to establish equity of tax treatment in U.S. real property between foreign and U.S. persons [24], Congress enacted FIRPTA, [25] as modified by the Economic Recovery Tax Act of 1981 and the Tax Reform Act of 1984, which made a foreign person's U.S. real estate gains taxable, as if automatically effectively connected to a U.S. trade or business of the foreign investor. [26] FIRPTA added Section 897 , which contains detailed rules on the taxation of a foreign person's investment in U.S. real property interests. The Tax Reform Act of 1984 added Section 1445 , which created a withholding mechanism to enforce the tax owed under Section 897 and resolve collection and filing issues under prior law. [27]

## Application of FIRPTA rules.

FIRPTA, as codified principally in Sections 897 and 1445 , governs the taxation of dispositions of United States real property interests (USRPIs) by foreign persons. Section 897(a) generally requires gain or loss from the disposition of a USRPI by a foreign person to be taken into account as if (1) the foreign person were engaged in a trade or business within the United States during the tax year, and (2) the gain or loss were effectively connected with that trade or business. [28] As a result, recognized net gains generally are subject to U.S. federal income tax at graduated rates. [29]

"USRPI" generally means an interest (other than an interest solely as a creditor) (1) in real property located in the United States or the Virgin Islands, or (2) in a U.S. corporation that is (or, during the five-year period preceding the disposition of the interest, was) a USRPHC. [30] In general, a U.S. corporation is a USRPHC if the FMV of the corporation's USRPIs is at least 50% of the aggregate FMV of its (1) USRPIs, (2) interests in real property located outside the United States, and (3) other assets used or held for use in a trade or business. [31]

To enforce the substantive tax rules in Section 897 , Section 1445 imposes on a transferee (i.e., the buyer) the obligation to withhold when (1) the transferor of the property is a foreign person, and (2) the property transferred is a USRPI. [32] When withholding is required, the transferee of the USRPI generally must deduct and withhold 15% of the amount realized by the transferor; [33] however, special withholding rules may apply in certain situations. [34] In addition, an exception to the withholding requirement may apply when a taxpayer disposes of a USRPI in an exchange that qualifies for nonrecognition treatment. [35]

If a USRPI is disposed of in a transaction that otherwise would be governed by a nonrecognition provision, Section 897(e) says that the nonrecognition provision will apply for purposes of Section 897 only if the USRPI is exchanged for an interest, the sale of which would be subject to U.S. federal income tax. [36] For purposes of this rule, a nonrecognition provision is any Code provision under which gain or loss will not be recognized if the requirements of that provision are met (e.g., Section 351 ). [37]

The Regulations restate the general rule in Section 897(e) using slightly different terminology. [38] They say that in a transaction in which gain is realized, a nonrecognition provision will apply only to the extent that the transferred USRPI is exchanged for another USRPI, which, immediately after the exchange, would be subject to U.S. taxation on its disposition ("USRPI for USRPI exception"). [39]

The Regulations add that, to qualify for nonrecognition treatment, the transferor of the USRPI generally must file a U.S. federal income tax return for the year in which the transfer occurs and attach a statement that includes certain required information. [40] For example, if a foreign person contributed a USRPI to a U.S. corporation, which qualified as a USRPHC immediately thereafter, and received shares in the U.S. corporation in the exchange, the transfer generally would qualify for nonrecognition treatment if certain reporting obligations are satisfied.

As discussed above, to prevent potential abuses, FIRPTA generally denies the application of nonrecognition provisions except in limited cases. For example, a foreign person may make a tax-free exchange of a USRPI only if a taxable USRPI is received in exchange. [41]

Notwithstanding the USRPI-for-USRPI exception, the Temporary Regulations under Section 897(e) provide an exception that allows for nonrecognition treatment in certain foreign-to-foreign exchanges of USRPIs. Specifically, this exception provides for nonrecognition treatment if a foreign person exchanges stock in a USRPHC in three types of transactions:

(1) A Type D or Type F reorganization exchange between foreign corporations (and their foreign

shareholders).[42]

(2) A Type C reorganization between foreign corporations if the transferor's shareholders also own more than 50% of the transferee.[43]

(3) A Section 351 transfer (or a Type B reorganization exchange) of USRPHC stock to a foreign corporation and immediately after the exchange all of the outstanding stock of the transferee corporation is owned by the same nonresident alien individuals and foreign corporations that immediately before the exchange owned the stock of the USRPHC.[44]

The exception under the Temporary Regulations further requires that (1) the transferee's subsequent disposition of the transferred USPRI be subject to U.S. federal income tax;[45] (2) certain filing requirements are satisfied;[46] and (3) one of "five conditions" in Temp. Reg. 1.897-6T(b)(2) exists.[47]

## Notice 2006-46 .

In Notice 2006-46, 2006-1 CB 1044 , the IRS and Treasury determined that the five conditions in Temp. Reg. 1.897-6T(b)(2) were no longer necessary and declared that final Regulations would eliminate these conditions. Taxpayers may rely on the guidance in Notice 2006-46 until final Regulations are issued and, therefore, do not have to satisfy one of the five conditions in Temp. Reg. 1.897-6T(b)(2) .

## Overview of Anti-Inversion Rules

The U.S. government[48] has recognized that inversions provide tax savings in two significant ways. First, an inversion may reduce U.S. tax on foreign-source income by effectively shifting income away from a U.S. corporation to its related foreign corporations ("income shifting"). In turn, this potentially achieves pure territorial tax treatment for the group, rather than worldwide income treatment.[49] Second, an inversion may reduce U.S. tax through earnings stripping with foreign related-party debt (or similar transactions), where a U.S. subsidiary pays interest to its foreign parent and the interest may then be deductible for U.S. federal tax purposes ("earnings stripping").[50] In light of these abuses, the U.S. government has issued numerous anti-inversion rules over the past 20 years to prevent U.S. multinational corporations from relocating their domicile to foreign jurisdictions.

## Legislative history.

The history of the inversion transaction dates back to two notable corporate inversions that took place over 20 years ago.[51] The first was the 1982 inversion of McDermott Inc., a Delaware corporation ("McDermott"), where McDermott Inc. shareholders transferred their shares to its wholly owned foreign subsidiary, McDermott International, Inc. ("McDermott International") in exchange for cash and shares in McDermott International pursuant to a reorganization plan. The IRS argued that the former McDermott shareholders were taxable under Section 304 [52] on the transfers of their McDermott stock in exchange for stock in McDermott International. However, the courts disagreed with the IRS and found that because "stock" did not constitute "property" within the meaning of Section 317 , Section 304 did not apply to their stock-for-stock exchange. In response to the inversion, the IRS issued Section 1248(i) , which requires a U.S. corporate parent of a controlled foreign corporation to recognize gain equal to the Section 1248 [53] dividend amount if a shareholder of the U.S. corporate parent exchanges stock of the U.S. corporate parent for stock of a foreign corporation.[54]

The second inversion involved the 1994 inversion of Helen of Troy Limited, a U.S. cosmetic company that redomiciled in Bermuda in a transaction that was tax free for its shareholders.[55] In response to this inversion, the IRS said in Notice 94-93, 1994-2 CB 563 , that in alliance with Treasury, it would introduce guidance on the consequences of inversion transactions because they were concerned that, depending on the facts and circumstances, an inversion transaction may create losses improperly or permit the avoidance of income or gain in circumvention of the repeal of the General Utilities [56] doctrine or other applicable rules. The IRS soon enacted new Regulations under Section 367 .[57]

In 2002, Treasury released a preliminary report on the issues that arise from the reincorporation of U.S. multinational companies in foreign countries ("Preliminary Report").[58] In a statement accompanying the Preliminary Report, then Treasury Secretary Paul O'Neill said:

> When we have a tax code that allows companies to cut their taxes on their U.S. business by nominally moving their headquarters offshore, then we need to do something to fix the tax code. In addition, if the tax code disadvantages U.S. companies competing in the global marketplace, then we should address the anti-competitive provisions of the code. I don't think anyone wants to wake up one morning to find every U.S. company headquartered offshore because our tax code drove them away and no one did anything about it. This is about competitiveness and complications in the tax code that put U.S.-based companies out of step with their foreign competitors. We will work with Congress to address these important issues quickly.

The Preliminary Report defined an inversion as "a transaction through which the corporate structure of a U.S.-based multinational group is altered so that a new foreign corporation, typically located in a low or no tax country, replaces the existing U.S. parent corporation as the parent of the corporate group." The Preliminary Report said that inversion transactions "implicate fundamental issues of tax policy," recognizing that:

> The U.S. tax system can operate to provide a cost advantage to foreign-based multinational companies over U.S.-based multinational companies. Inversions demonstrate this cost advantage in its purest form. By reorganizing to create an offshore parent corporation in a no-tax jurisdiction, a U.S.-based group can reduce its tax liability significantly without any real changes in its business operations and without negatively affecting its access to capital markets.

In 2004, Congress introduced important statutory legislation ( Section 7874 ) that would diminish a U.S. corporation's ability to reincorporate in a foreign jurisdiction to obtain tax benefits. In a 2004 Committee Report,[59] the House said:

> The Committee believes that corporate inversion transactions are a symptom of larger problems with our current uncompetitive system for taxing U.S.-based global businesses and are also indicative of the unfair advantages that our tax laws convey to foreign ownership. The bill addresses the underlying problems with the U.S. system of taxing U.S.-based global businesses and contains provisions to remove the incentives for entering into inversion transactions. Imposing full U.S. tax on gains of companies undertaking an inversion transaction is one such provision that helps to remove the incentive to enter into an inversion transaction.[60]

The 2004 Committee Report reiterated that the inversion rules were targeted at "U.S. based global businesses."

Since 2004, there have been numerous Regulations, Rulings, and Notices on inversions.[61] Notice 2014-52, 2014-42 IRB 712 , which essentially broadened the reach of Section 7874 , said that Treasury

and the IRS would issue Regulations to address certain transactions that are structured to avoid the purposes of Sections 7874 and 367 and certain post-inversion tax avoidance transactions. Notice 2014-52 also said that Treasury and the IRS planned to issue additional guidance to further limit (1) inversion transactions that are contrary to the purposes of Section 7874 ; and (2) the benefits of post-inversion tax avoidance transactions. In Notice 2015-79, 2015-49 IRB 775 , issued further guidance-much more aggressive rules-to address transactions that are structured to avoid Section 7874 . [62] At the time of writing this article, IRS and Treasury had issued Proposed and Temporary Regulations that further limit inversions. [63] Notwithstanding the numerous attempts by the IRS and Treasury to curtail inversions, under the right set of facts, inversion transactions continue. Further guidance, or even congressional action, is expected.

## Section 7874

An inversion will typically occur when (1) a foreign corporation directly or indirectly acquires substantially all of the properties held directly or indirectly by a U.S. corporation; [64] (2) following the acquisition, the former shareholders of the U.S. corporation own at least 60% of the stock (by vote or value) of the foreign corporation by reason of holding stock in the U.S. corporation; [65] and (3) following the acquisition, neither the foreign corporation nor its expanded affiliated group has substantial business activities [66] in the foreign corporation's country of incorporation, compared with the total worldwide business activities of the foreign corporation's expanded affiliated group (collectively, "Three Requirements"). [67] If an inversion occurs, for a ten-year period the expatriated entity will be subject to tax on its "inversion gain." [68] Generally, this gain relates to certain transfers of stock or property of the expatriated entity and income from licenses of property by the expatriated entity. [69]

A foreign corporation will *forever* be classified as a U.S. corporation after the acquisition if at least 80% of the stock (by vote or value) of the foreign corporation is held by former stockholders of the U.S. corporation by reason of holding stock in the U.S. corporation. [70] The foreign corporation will also be treated as a U.S. corporation for all purposes of the Code (notwithstanding Sections 7701(a)(4) and (5)). [71] However, the inversion gain will not apply in this instance. [72]

Section 7874(a)(2)(B)(i) requires the acquisition of "substantially all" of the properties held by the domestic corporation. Under Treasury Regulations, the acquisition of stock in a domestic corporation is treated as the acquisition of assets of the domestic corporation proportionate to the percentage of stock acquired. [73] In contrast, the acquisition of stock of a foreign corporation that owns, directly or indirectly, domestic

corporation stock is not an acquisition of the properties held by a domestic corporation. [74] No guidance has been provided in Section 7874 or the corresponding Regulations to determine whether "substantially all" of the assets of a U.S. target corporation have been acquired. [75]

Although there are many variations of inversions, the Base Transaction is included within the type of inversion when, pursuant to a plan (or a series of related transactions), a U.S. corporation becomes a subsidiary of a foreign corporation and the former shareholders of the U.S. corporation hold at least 80% (by vote or value) of the foreign corporation by reason of holding stock in the U.S. corporation. While the Base Transaction will not trigger recognition of the inversion gain, it will deny the intended tax benefit by treating the foreign parent corporation as a domestic corporation for all purposes of the Code. [76]

## Unintended Effect of Section 7874

As discussed above, the Base Transaction involves a transfer by a non-U.S. domiciliary of stock in a USRPHC to a foreign corporation in exchange for stock in the foreign corporation. If structured and implemented properly, the Base Transaction qualifies for nonrecognition treatment under Section 351 . Moreover, Regulations under Section 897 specifically allow for nonrecognition in this type of Section 351 exchange. Thus, if certain reporting requirements are met, the Base Transaction is not taxable under Section 351 and FIRPTA.

Notwithstanding these otherwise favorable results, Section 7874 potentially causes adverse U.S. federal estate and gift tax consequences because the Base Transaction satisfies the Three Requirements described above. More specifically, the foreign corporation indirectly acquires all of the properties held by the U.S. corporation; the nonresident alien who directly owned the shares in the U.S. corporation now owns all of the shares of the foreign corporation, which holds the stock of the U.S. corporation; and, finally, neither the foreign corporation nor any of its affiliated members satisfy the substantial business activities exception because they do not meet the Group Assets Test [77] since the majority of their assets consist of U.S. real property interests. Because the Base Transaction triggers the inversion rules, and the ownership threshold requirement is met, the foreign corporation will be treated as a U.S. corporation for all U.S. federal tax purposes. As a result, the non-U.S. domiciliary is treated as owning stock in a U.S. corporation (a U.S.-situs asset) rather than stock in a foreign corporation (a foreign-situs asset).

In light of these results, the exception to taxation under the Section 897 Temporary Regulations and withholding under Section 1445 for certain Section 351 transactions is practically useless if the goal is to

achieve the U.S. estate and gift tax protection that comes from holding shares in a foreign corporation. [78]

The IRS dealt with the Base Transaction in Ltr. Rul. 201032016 but it did not address the applicability of the Section 7874 inversion rules. The ruling involved a nonresident alien's transfer of shares in two U.S. corporations that qualified as USRPHCs to a U.S. parent corporation, which were then transferred to a foreign corporation. The IRS ruled that both transfers qualified for Section 351 nonrecognition treatment and were not taxable under Section 897 . However, the IRS did not address whether Section 7874 applied to the second transaction.

## Overrides of estate tax situs rules for stock in foreign corporations.

As discussed above, only the portion of a non-U.S. domiciliary decedent's gross estate situated in the United States at the time of his death is subject to U.S. federal *estate* tax. [79] Section 2104(a) says that stock owned and held by a nonresident alien of the United States is deemed to be property within the United States if issued by a U.S. corporation. [80]

Prior to the issuance of Section 7874 , in the Base Transaction, when the nonresident alien non-U.S. domiciliary contributed his shares in the USRPHC to the foreign (parent) corporation in exchange for stock, these newly received shares were not part of his U.S. gross estate because they qualified as a foreign-situs asset. [81] Section 7874 now modifies this result by treating the foreign parent corporation a U.S. corporation for all purposes of the Code. This causes the share in the U.S. corporation to be treated as a U.S.-situs asset and may cause the shares to be subject to U.S. federal estate tax. [82] Therefore, Section 7874 effectively overrides the estate tax rules on situs categorization.

## No exception to Section 7874 .

Unfortunately, no exception to Section 7874 exists for the Base Transaction. For example, certain internal group restructurings do not result in an inversion that is subject to the rules of Section 7874 that could result in the transferee foreign corporation being treated as a U.S. corporation.

There are two requirements to qualify as an internal group restructuring under the Regulations: (1) before the acquisition, 80% or more of the stock (by vote and value) or the capital and profits interest, of the domestic entity must have been held directly or indirectly by the *corporation* that is the common parent of the expanded affiliated group ("EAG") after the acquisition; and (2) after the acquisition, 80% or more of

the stock (by vote and value) of the acquiring foreign corporation must be held directly or indirectly by such common parent.[83] In the Base Transaction, because the transferring shareholder is an individual (or certain trusts), the internal group restructuring exception does not apply and the Base Transaction results in the stock of the foreign corporation received in the transaction being treated as a stock in a domestic corporation for all purposes of the Code.

## Solutions to Exempt Base Transaction From Anti-Inversion Rules

The legislative history of Section 7874 indicates clearly that the anti-inversion rules were intended to apply to multinational companies with global operations looking to redomicile in a more income tax-efficient jurisdiction. Nowhere does the legislative history indicate that the anti-inversion rules were meant to apply to the Base Transaction. After all, the anti-inversion rules focus primarily on abuses at the U.S. corporate level, not the shareholder level. When the Section 7874 rules deprive an individual of an intended U.S. federal estate tax benefit,[84] they clearly violate the underlying intent of the inversion rules.[85]

To preserve the intended purpose of the inversion rules, Congress, Treasury, or the IRS should create a special carve-out in the inversion rules that would exempt transactions like the Base Transaction from Section 7874 . Section 7874(g) gives the Secretary of the Treasury the ability to "provide such regulations as are necessary to carry out [ Section 7874 ]." While this subsection appears to have been designed to prevent the avoidance of the inversion rules by granting the Treasury the ability to enforce the inversion rules through regulatory authority, it should also allow Treasury to issue Regulations to ensure that certain transactions that are outside the intended scope of Section 7874 are not caught by the inversion rules. The phrase "[t]he Secretary shall provide such regulations as are necessary to carry out this section" should be construed to mean that Treasury must ensure that Section 7874 is carried out properly by not applying to transactions that are outside the intended scope of Section 7874 .

Finally, as mentioned above, one of the key reasons for the anti-inversion rules was to prevent "income shifting" by large corporations.[86] This type of abuse is virtually impossible in the Base Transaction scenario because any income generated by the underlying U.S. real estate would be U.S.-source income and subject to U.S. federal income tax, regardless of the overlying ownership. "Earnings stripping" was the other motivating factor behind the anti-inversion rules.[87] The act of a non-U.S. individual transferring shares of an existing domestic corporation owning U.S. real estate to a newly formed foreign corporation in exchange for shares of the foreign corporation does not, in itself, result in earnings stripping. It would require additional transactions to rise to such a level of abuse.

## Limit application of Section 7874 to U.S. federal income tax.

The simplest solution to the accidental inversion would be to clarify that the inversion rules apply only for U.S. federal income tax purposes. If Section 7874 truly was intended to prevent abuse by multinational corporations and U.S.-based global businesses, Section 7874(b) should be narrowed to only U.S. federal income tax and not include U.S. federal estate and gift taxes. While a statutory change is unlikely, Regulations could clarify that Section 7874(b) was not intended to cause foreign corporations to be treated as U.S. corporations for purposes of U.S. federal estate and gift taxes.

Assuming that the Base Transaction results in an inversion, clarifying Regulations would provide that the foreign corporation that now owns the U.S. corporation will be treated as a U.S. corporation for U.S. federal tax income purposes only. Thus, while the foreign corporation would be viewed as a U.S. corporation for U.S. federal income tax purposes, it would still be viewed as a foreign corporation for U.S. federal gift and estate tax purposes. Further, the shares of the foreign corporation received in the Base Transaction would be treated as a foreign-situs asset for U.S. federal estate and gift tax purposes. Finally, if the Base Transaction results in the foreign corporation being treated as a U.S. corporation for federal income tax purposes, no coordinating Regulations would be necessary under FIRPTA, as Temp. Reg. 1.897-6T(a)(1) already covers a foreign person's transfer of a USRPI to a U.S. corporation in an exchange that otherwise qualifies for nonrecognition under Section 351 .[88]

## Closely held business exception.

The legislative history of Section 7874 says that the inversion rules were designed to combat the expatriations of "U.S.-based multinational groups" that relocate their headquarters offshore. Specifically, the inversion rules originated out of the relocations of several large multinational businesses (such as McDermott and Helen of Troy, discussed above) that manufactured goods or provided technical, managerial, or skilled services. The legislative history of Section 7874 does not show that the inversion rules were intended to apply to closely held family businesses. Thus, another proposal would be to provide a carve-out exception under the inversion rules for closely held corporations. Under such an exception, if the acquiring foreign corporation in a transaction that otherwise qualifies as an inversion is closely held, the foreign corporation would continue to be treated as a foreign corporation and not subject to Section 7874(b) or otherwise treated as an expatriated entity under Section 7874(a) .

This exception should provide several safeguards to prevent abuse. First, the exception could provide a

cap on the number of shareholders who own the acquiring foreign corporation, similar to the limitation on the number of shareholders that can own a "small business corporation" (S corporation).[89] For example, the exception could provide that Section 7874 does not apply to a foreign corporation's acquisition of stock in a U.S. corporation (or U.S. partnership) if, immediately after the transaction, the foreign corporation is owned by 100 or fewer individuals (or certain trusts). This type of exception clearly would not apply to most U.S.-based multinational groups, and certainly would not apply to U.S. publicly traded corporations seeking to invert. Thus, such a regulatory exception would be within the intended scope of Section 7874 . This exception could be administered by having the closely held corporation file an annual form with the IRS listing its total shareholders. Alternatively, the closely held corporation could be required to check a box on its U.S. tax return representing that it is under the requisite shareholder limit, or simply list the total number of shareholders on its tax return, which is akin to line I of Form 1120S (U.S. Income Tax Return for an S Corporation).

Second, the exception could provide a dollar threshold based on the FMV of the acquiring foreign corporation (and related persons of such corporation) immediately after the transfer. Even at reasonably high dollar thresholds, this type of exception would not apply to large U.S. multinational corporations seeking to invert. Also, this rule would prevent a situation where a multi-billion dollar corporation owned by a small number of individuals attempted to use the closely held exception to invert. To determine an appropriate dollar threshold and overall comfort level, Treasury could review historical market values of companies that have inverted and compare the projected revenue streams from enforcing and imposing the anti-inversion rules on closely held corporations against the interests of administrative convenience.

Finally, this exception could contain an anti-abuse safeguard, similar to the rule in Reg. 1.701-2(b) in the context of partnerships, which allows the IRS to recast a transaction if the intent of the exception was abused. For instance, an anti-abuse rule would apply when an acquiring corporation uses nominees to avoid the shareholder limit discussed above or to circumvent the dollar threshold requirement.

## IRS consent (private letter ruling).

Another solution would be for Treasury to issue Regulations that give the IRS discretion to exempt certain transfers from Section 7874 if, on the taxpayers' request, they can prove that the transaction is outside the intended scope of Section 7874 . For example, if the shareholders of the acquiring foreign corporation that otherwise is subject to Section 7874(b) can prove that the principal purpose of the inversion is U.S. estate tax planning, the IRS could exempt the transaction from the application of Section 7874 through

case-by-case letter rulings. The letter ruling route, as opposed to issuing additional guidance, might also be preferable because it would allow Treasury to avoid creating rules that lead to results that sometimes are inappropriate or unintended. [90]

## Conclusion

Congress likely never considered U.S. federal estate and gift tax planning when adopting Section 7874 . The Base Transaction is simply not the type of transaction that Congress sought to prevent with Section 7874 . Thus, the simplest way to prevent the Base Transaction from being caught within the overly broad language of Section 7874(b) would be to clarify that the foreign corporation will be treated as a U.S. corporation for U.S. federal income tax purposes only. Finally, under Section 7874(g) , Treasury should have the authority to exempt certain transactions, much like it has with respect to certain internal group restructurings. Such regulatory guidance could be structured in several ways, as discussed above, provided any regulations issued are within the intended scope of Section 7874 .

[1] Section 7701(b)(1)(B) .

[2] Reg. 25.2501-1(b) ; see also *Estate of Jack*, 54 Fed. Cl. Ct. 590 (2002).

[3] Section 7701(a)(4) .

[4] Sections 7701(a)(30) , (b)(1)(A).

[5] Sections 7701(a)(5) , 7701(b)(1)(B).

[6] Section 871 .

[7] See Section 871(a)(1)(A) . FDAP income typically is subject to a flat 30% withholding tax rate (absent an applicable U.S. income tax treaty), without allocable deductions, depending on the type of U.S.-source income.

[8] See note 2, *supra*.

[9] See Sections 2501 (gift tax) and 2001 (estate tax).

[10] See Rev. Proc. 2015-53, 2015-44 IRB 615 .

[11] See Section 2104 (estate), Reg. 20.2104-1(a)(1) .

[12] See Reg. 20.2104-1(a)(1) .

[13] Section 2104(a) ; Regs. 20.2104-1(a)(5) , 20.2105-1(f) .

[14] See Reg. 20.2105-1(f) .

[15] Omnibus Reconciliation Act of 1980, P.L. 96-499, 94 Stat. 2599, 2682 (December 5, 1980).

[16] However, the foreign corporation may be disregarded if it appears that it is merely acting as a holding company for the nonresident alien's shares in the USRPHC, or its corporate formalities are ignored. See

*Swan Est.*, 247 F.2d 144 (CA-2, 1957); *Fillman*, 355 F.2d 632 (Ct. Cl., 1966).

[17] See Notice 2006-46, 2006-1 CB 1044 .

[18] The same issue can arise if an interest in a domestic partnership is transferred to a foreign corporation. However, we will only address the transfer of stock in a U.S. corporation for purposes of this article.

[19] H. Rep't No. 96-1167 at 530, reprinted in 1980-2 CB 530, 534.

[20] *Id.* at 534, 571.

[21] See Petkun, "The Foreign Investment in Real Property Act of 1980," 1 Penn St. Int'l L. Rev. 11, 12-13 (1982).

[22] See Reiner, "Foreign Investment in U.S. Real Estate: Proposals for Taxing Gains," 6 Int'l. Tax J. 138, 138-39 (1979).

[23] See Jimmy Carter, "Agricultural Foreign Investment Disclosure Act of 1978 Statement on Signing S. 3384 Into Law," American Presidency Project (October 14, 1978), www.presidency.ucsb.edu/ws/?pid=29989.

[24] A separate piece of legislation passed to specifically address the unfair treatment and economic risks to U.S. farmers was the Agricultural Foreign Investment Disclosure Act of 1978, which required disclose of transfers by foreign persons of U.S. agricultural real property. 7 U.S.C. sections 3501-35087 U.S.C.

sections 3501-3508.

[25] See note 13, *supra*.

[26] See Staff of the Joint Committee on Taxation, 98th Cong., 2d Sess., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, 406 (Committee Print 1984); Senate Finance Committee Print No. 96-37, 96th Cong. at 8 (1980), accompanying S. 2939, Revenue Reconciliation Act of 1980.

[27] See Committee Print 1984, *supra* note 26.

[28] Section 897(a)(1) . Gain or loss from the disposition of a USRPI is determined under the general rules in Section 1001 . Reg. 1.897-1(h) .

[29] See Sections 871(b) , 882(a)(1).

[30] Section 897(c)(1)(A) ; Reg. 1.897-1(c)(1) . See also Regs. 1.897-1(b) , 1.897-1(d) ; Section 897(c)(1)(A)(ii) .

[31] Section 897(c)(2) ; Reg. 1.897-2(b)(1) .

[32] Section 1445(a) .

[33] *Id.* See also Reg. 1.1445-1(g)(5) . On December 18, 2015, Congress passed the Protecting

Americans from Tax Hikes Act of 2015 ("PATH Act"), which increased the FIRPTA withholding tax to 15%, effective for dispositions occurring 60 days after the date of enactment of the Act.

[34] See Sections 1445(e) , 1446.

[35] See Regs. 1.1445-2(d)(2) , 1.1445-5(b)(2) . See also Section 897(e) and Temp. Reg. 1.897-6T .

[36] Section 897(e)(1) .

[37] Section 897(e)(3) ; Temp. Reg. 1.897-6T(a)(2) .

[38] Temp. Reg. 1.897-6T(a)(1) . See also Section 897(e)(2)(A) .

[39] Temp. Reg. 1.897-6T(a)(1) .

[40] See Temp. Regs. 1.897-6T(a)(1) , 1.897-5T(d)(1)(iii) . This requirement is suspended when (1) the transfer otherwise qualifies in its entirety for nonrecognition treatment under Temp. Reg. 1.897-6T ; (2) the transferor does not have any other ECI for the year in which the transfer occurs; and (3) a notice of nonrecognition is filed for the transfer pursuant to Reg. 1.1445-2(d)(2) . Notice 89-57, 1989-1 CB 698 .

[41] Temp. Reg. 1.897-6T .

[42] Temp. Reg. 1.897-6T(b)(1)(i) .

[43] Temp. Reg. 1.897-6T(b)(1)(ii) .

[44] Temp. Reg. 1.897-6T(b)(1)(iii) .

[45] See also Temp. Reg. 1.897-5T(d)(1) .

[46] See also Temp. Reg. 1.897-5T(d)(1)(iii) .

[47] See Temp. Reg. 1.897-6T(b)(1) .

[48] Congressional Research Service, "Firms That Incorporate Abroad for Tax Purposes: Corporate Inversions and Expatriation (updated March 5, 2010).

[49] Joint Committee on Taxation, *Background and Description of Present-Law Rules and Proposals Relating to Corporate Inversion Transactions* (JCX-52-02, June 5, 2002), pages 3-4.

[50] Office of Tax Policy, Department of the Treasury, *Corporate Inversion Transactions: Tax Policy Implications* 11-14 (2002).

[51] *Bhada*, 892 F.2d 39 (CA-6, 1990), *aff'g* 89 TC 959 (1987); *Caamano*, 879 F.2d 156 (CA-5, 1990), *aff'g* 89 TC 959 (1987); see also Congressional Research Service, Ways and Means Committee Democrats, "A Spike in Corporate Inversions" (undated), www.bloombergview.com/quicktake/tax-inversion.

[52] Under Section 304(a)(1) , if one or more persons are in control of each of two corporations and one of the corporations acquires stock in the other from a controlling person in return for property, the property paid for the stock is treated as a distribution in redemption of the acquiring corporation's stock. The tax treatment of the redemption is subject to Section 302 to determine whether it is treated as an exchange or as a distribution of property under Section 301 .

[53] Section 1248 recharacterizes gains from the sale of stock as dividends to the extent of the earnings and profits attributable to the stock.

[54] H. Rep't No. 104-586, 104th Cong., 2d Sess. 156 (P.L. 104-188, August 20, 1996).

[55] See Helen of Troy Ltd., Prospectus/Proxy Statement (January 5 1994); Joint Committee on Taxation, *Present Law and Selected Policy Issues in the U.S. Taxation of Cross-Border Income* (JCX-51-15, March 16, 2015); Mohan, "The Erosion of the States' Tax Base-A Whopper of a Problem? An Examination of Possible Solutions to Corporate Inversions," Weekly State Tax Rep't: News Archive (Bloomberg BNA), October 10, 2014).

[56] The General Utilities doctrine permitted a corporation to distribute appreciated assets to its shareholders without recognizing gain under certain circumstances. See *General Utilities and Operating Co.*, 296 U.S. 200 (1935). After its repeal, a corporation ordinarily must be required to recognize taxable gain when it distributes an appreciated asset to its shareholder.

[57] These were proposed in 1995 and made final in 1996. TD 8638, 1996-1 CB 85 ; TD 8702, 1997-1 CB 92 .

[58] Note 50, *supra*.

[59] H. Rep't No. 108-548, 108th Cong., 2d Sess., part 1, at 1 (2004) ("2004 Committee Report").

[60] H. Rep't No. 108-755, 108th Cong., 2d Sess. 561 (2004) ("Conference Report") (P.L. 108-357, October 22, 2004 ).

[61] In June 2006, Temporary Regulations under Section 7874 were issued on the treatment of a foreign corporation as a surrogate foreign corporation. TD 9265, 2006-2 CB 1 . In July 2006, Notice 2006-70, 2006-2 CB 252 , modified the effective date in the 2006 Temporary Regulations. Reg. 601.601(d)(2)(ii)(b) . In June 2009, the 2006 Temporary Regulations were withdrawn and replaced with new Temporary Regulations, which generally applied to acquisitions completed on or after June 9, 2009. TD 9453 , 74 Fed. Reg. 27920, 2009-2 CB 114. In June 2012, the IRS issued final Regulations on whether a foreign corporation was treated as a surrogate foreign corporation. TD 959, June 7, 2012. Notice 2014-52, 2014-42 IRB 712 , strives to make inversions more difficult by strengthening the rules under Section 7874 and limiting the ability of companies to repatriate offshore earnings tax free. See "Treasury and IRS Respond to Inversions," *PwC In & Out*, 25 JOIT 11 (December 2014).

[62] See PwC, " Notice 2015-79 Provides Further Inversion Limitation," 27 JOIT 44 (February 2016). 0242

[63] TD 9761 , REG-135734-14, April 4, 2016. See PwC, "Temp. Regs. Further Restrict Inversions," 27 JOIT xx (June 2016) .

[64] This rule does not apply to acquisitions that were completed before March 4, 2003. Section 7874(a)(2)(B)(i) .

[65] Section 7874(a)(2)(B)(ii) .

[66] See Reg. 1.7874-3(b) . The expanded affiliated group will be considered to have substantial business activities in the relevant foreign country after the acquisition when compared to the total business activities of the expanded affiliated group only if, subject to the disregarded items detailed below, each of the following three tests is satisfied: (1) the number of group employees based in the relevant foreign country is at least 25% of the total number of group employees on the applicable date, and (ii) the employee compensation incurred with respect to group employees based in the relevant foreign country is at least 25% of the total employee compensation incurred with respect to all group employees during the testing period (the "Group Employees Test"); (2) the value of the group assets located in the relevant foreign country is at least 25% of the total value of all group assets on the applicable date (the "Group Assets Test"); and (3) the group income derived in the relevant foreign country is at least 25% of the total group income during the testing period (the "Group Income Test").

[67] Section 7874(a) .

[68] Section 7874(d) .

[69] Id.

[70] Section 7874(b) .

[71] See Conf. Rept. No. 108-755 (PL 108-357) p. 346-47 (The provision denies the intended tax benefits of this type of inversion by deeming the top-tier foreign corporation to be a domestic corporation for all purposes of the Code.).

[72] Section 7874(a)(3) .

[73] Treas. Reg. § 1.7874-2(c) .

[74] Treas. Reg. § 1.7874-2(c)(2) .

[75] H.R. Rep. No. 108-755, 108th Cong., 2d Sess., n.429 (2004) ("It is expected that the Treasury Secretary will issue regulations applying the term 'substantially all' in this context and will not be bound in this regard by interpretations of the term in other contexts under the Code."). Several commentators have noted the numerous open questions resulting from a lack of guidance on the meaning of "substantially all." See, e.g., Peter H. Blessing, Targeting Business Entity Inversions: Surrogation and Domestication, 34 Tax Mgm't Int'l J. 3 (2005); Carl Dubert, Section 7874 Temporary Regulations: Treasury and IRS Wave Taxpayers Through the Stoplight, J. Int'l Tax'n (2006).

[76] Joint Comm. on Tax'n, DESCRIPTION OF THE "TAX TECHNICAL CORRECTIONS ACT OF 2005" 10 (July 21, 2005) (The provision clarifies that the inversion gain rule of Section 7874(a)(1) does not apply to an entity that is an expatriated entity with respect to an entity that is treated as a domestic corporation under Code section 7874(b).).

[77] Note 66, *supra*.

[78] From a FIRPTA perspective, the Base Transaction should continue to qualify for nonrecognition under Sections 351 and 897(e) , as an exchange of stock in a USRPHC for stock in a USRPHC should meet the "USRPI-for-USRPI" requirement.

[79] Section 2103 .

[80] See also Reg. 20.2104-1(a)(5) .

[81] See Reg. 20.2105-1(f) .

[82] It is possible, however, that a estate tax treaty may alter this result. In TAM 9128001 , Treasury cited Article 9 of the U.S.-Germany estate tax treaty: "Germany has the primary right to tax shares of stock in a U.S. corporation which forms part of the estate of a decedent domiciled in...Germany."

[83] Reg. 1.7874-1(c) .

[84] Notwithstanding the application of Section 7874 to cause foreign corporation stock to be treated as U.S. corporation stock, it appears that a decedent may still be entitled to exclude such stock from his estate if he qualifies for benefits of an applicable U.S. estate tax treaty. See note 82, *supra*.

[85] See generally Preliminary Report, *supra* note 50.

[86] See note 49, *supra*.

[87] See note 50, *supra*.

[88] See Section 897(e) ; Temp. Reg. 1.897-6T(a)(1) .

[89] See Section 1361(b)(1) .

[90] See, e.g., Notices 2014-52 and 2015-79 (both addressing non-ordinary course distributions in relation to a potential inversion transaction).

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