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Client Alert

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Treasury Issues Temporary Regulations on Inversions

On April 4, 2016, the US Department of Treasury issued extensive temporary regulations (the "Temporary Regulations") addressing inversion transactions and post-inversion planning. The Temporary Regulations finalize the rules announced in Notice 2014-52 (the "2014 Notice") and Notice 2015-79 (the "2015 Notice"), with a few modifications. The Temporary Regulations also introduce new limitations on inversions, including limitations on multiple-step acquisitions and "serial" acquisitions. As discussed in a prior Client Alert, the 2014 Notice and the 2015 Notice left many questions unanswered, were based on broad assumptions, and raised concerns regarding the scope of Treasury's regulatory authority. For more information, see our previous North America Tax Client Alert: *Treasury Takes Another Shot at Inversions*, distributed on November 23, 2015 and available under publications at www.bakermckenzie.com/tax/. The Temporary Regulations continue to raise many of the same issues.

The portions of the Temporary Regulations that relate to rules announced in the 2014 Notice are generally effective as of September 22, 2014 (the date of the 2014 Notice), while the portions relating to rules announced in the 2015 Notice are generally effective as of November 19, 2015 (the date of the 2015 Notice). New rules and modifications announced for the first time in these Temporary Regulations are generally effective as of April 4, 2016, though in many cases taxpayers may elect to apply the provisions to earlier transactions.

At the same time as the Temporary Regulations, Treasury also issued a sweeping package of proposed regulations under section 385 addressing related-party debt instruments (the "Proposed Regulations"). While some of the provisions of the Proposed Regulations target inversions, the Proposed Regulations apply much more broadly to US and foreign-based multinationals, and, if finalized in their current form, would dramatically change the manner in which debt instruments are characterized for US federal income tax purposes. While the Proposed Regulations are not yet in effect, given their broad scope, taxpayers would be well advised to review the provisions closely. The Proposed Regulations are the subject of a separate Client Alert. For more information, see our previous North America Tax Client Alert: *Proposed Regulations Under Code Section 385*, distributed on April 19, 2016 and available under publications at www.bakermckenzie.com/tax/.

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New Provisions Limiting the Ability to Invert

The Temporary Regulations include two new rules, not described in either the 2014 Notice or the 2015 Notice, that make it more difficult for companies to invert under section 7874.

Multiple-Step Acquisition Rule

The Temporary Regulations amend Treas. Reg. § 1.7874-2T to add a "multiple-step acquisition" rule intended to prevent taxpayers from structuring their transactions in a way that avoids the substantial business activities test or the "third-country" rule (discussed below).

The multiple-step acquisition rule applies when (i) a foreign corporation (the initial acquiring corporation) acquires substantially all of the properties of a domestic target in a transaction that does not result in the initial acquiring corporation being treated as a domestic corporation under section 7874(b) (the initial acquisition), and (ii) as part of a plan or a series of related transactions, another foreign corporation (the subsequent acquiring corporation) acquires substantially all of the properties of the initial acquiring corporation (the subsequent acquisition). As revised, Treas. Reg. § 1.7874-2T now effectively treats the initial acquiring corporation as a domestic corporation whose shareholders consist solely of the former domestic target shareholders (or partners) for purposes of applying section 7874 to the subsequent acquisition. In other words, the subsequent acquisition may be subject to section 7874, even though the subsequent acquirer has not, in form, acquired a domestic target.

If another foreign corporation acquires substantially all the properties of the subsequent acquiring corporation, the principles of the multiple-step acquisition rule also apply to the third acquisition.

Section 7874(a)(2)(B)(i) provides that a foreign acquiring corporation is not subject to section 7874 unless it acquires, directly or indirectly, substantially all the properties of a domestic corporation or substantially all the properties constituting a trade or business of a domestic partnership (a "domestic entity acquisition"). Under former regulations, a foreign acquiring corporation that acquired stock in a foreign target was not subject to section 7874, even if the foreign target had a domestic subsidiary. Thus, in the transaction described above, the subsequent foreign acquirer would not be subject to section 7874 (in the absence of the step-transaction doctrine or another anti-abuse doctrine applying). The Temporary Regulations modify this rule. If an initial acquisition and subsequent acquisition occur pursuant to a plan or a series of related transactions, the subsequent acquisition will be treated as a domestic entity acquisition.

Section 7874(a)(2)(B)(ii) provides that a foreign acquiring corporation is not subject to section 7874 unless the former shareholders or partners of the domestic target hold, "by reason of" holding stock or a partnership interest in the domestic target, at least 60 percent of the stock (by vote or value) of the foreign acquiring corporation after the acquisition. This stock is sometimes referred to as "by reason of" stock. The Temporary Regulations clarify how to apply the ownership test to multiple-step acquisitions. In applying the ownership test to the subsequent acquisition, "by reason of" stock includes subsequent acquiring corporation stock held by former shareholders or partners of the domestic target who (i) in the initial acquisition, received stock of the initial acquiring corporation by reason of holding

interests in the domestic target, and (ii) in the subsequent acquisition, received stock of the subsequent acquiring corporation in exchange for, or with respect to, this initial acquiring corporation stock.

Treasury was concerned that, without the multiple-step acquisition rule, taxpayers could avoid the purposes of section 7874 by taking the position that the acquisition of foreign stock is not, even if pursuant to the same plan, treated as an acquisition of substantially all of the assets of a domestic entity for purposes of applying section 7874.

The multiple-step acquisition rule applies to domestic entity acquisitions completed on or after April 4, 2016.

"Serial" or Multiple Domestic Acquisitions Rule

The Temporary Regulations introduce a "multiple domestic acquisitions" rule that generally disregards stock in the foreign acquiring corporation that is attributable to prior domestic entity acquisitions, regardless of whether the transactions factually are engaged in as part of the same plan.

New Treas. Reg. § 1.7874-8T applies if a foreign acquiring corporation in a domestic entity acquisition (the relevant domestic entity acquisition) completed one or more earlier domestic entity acquisitions (prior domestic entity acquisitions) within 36 months of the binding contract for the relevant domestic entity acquisition. Stated simply, the new rule applies when a foreign company acquires multiple domestic entities (or substantially all of the assets thereof) within a prescribed period of time, regardless of whether there is any plan or intent linking the two transactions. Moreover, the new rule appears to apply even if the prior domestic entity acquisition fell outside the scope of section 7874 because, for example, the acquisition satisfied the substantial business activities test.

When the rule applies, the denominator of the section 7874 ownership fraction, by value (but not vote), must be reduced by an amount intended to represent the stock issued to the target shareholders in the prior domestic entity acquisition. Specifically, the excluded amount is generally the product of (i) the number of foreign acquiring corporation shares issued to former owners of a domestic target in a prior domestic entity acquisition (prior acquisition shares), adjusted for share splits (and similar changes to the foreign acquirer's capital structure) and redemptions and (ii) the fair market value of a single share of stock of the foreign acquiring corporation when the relevant domestic entity acquisition is completed. Treas. Reg. § 1.7874-8T includes a de minimis exception for certain all cash or nearly all cash transactions. Under this exception, a domestic entity acquisition is not a prior domestic entity acquisition if (i) the ownership fraction with respect to the earlier domestic entity acquisition was less than five percent (by vote and value), and (ii) the fair market value of foreign acquiring corporation stock that former owners of the domestic target received in the earlier acquisition did not exceed $50 million.

The serial acquisitions rule applies to acquisitions completed on or after April 4, 2016, regardless of when a prior domestic entity acquisition was completed.

Limitations on the Ability to Invert Announced in the 2014 Notice and the 2015 Notice

The Temporary Regulations also formalize the guidance announced in the 2014 Notice and the 2015 Notice under section 7874, subject to a few modifications described below. While Treasury responded to some taxpayer comments (including rejecting a number of comments because of administrative complexity or other reasons), the Temporary Regulations do not make major changes to the Notices, and demonstrate that Treasury continues to take an aggressive approach to inversion transactions.

Third-Country Rule

New Temp. Reg. § 1.7874-9T adopts the "third-country" rule announced in the 2015 Notice, with some modifications. The third-country rule, if applicable, disregards a portion of the foreign parent's stock for purposes of the ownership test to the extent that the stock relates to a related acquisition of a foreign entity that is a tax resident of a different jurisdiction than the foreign parent. The rule reflects an implicit (but often incorrect) assumption by Treasury that the decision to form a new foreign parent in a third jurisdiction is motivated by tax avoidance, rather than valid business purposes, such as corporate law concerns, location of management or board meetings, or foreign planning.

Consistent with the 2015 Notice, the third-country rule as set forth in the Temporary Regulations can apply if the foreign acquirer has acquired, directly or indirectly, and whether through an asset acquisition or a stock acquisition, an existing foreign target corporation in a transaction related to the inversion, and the foreign acquirer and the foreign target are subject to tax as residents in different jurisdictions. Under the 2015 Notice, the third-country rule would have applied only if the foreign target's assets represented at least 60 percent of the gross value of all of the EAG's assets, excluding property that the US company and its subsidiary held before the inversion. The Temporary Regulations replace this gross asset value test with an ownership test. More specifically, under the Temporary Regulations, the third-country rule applies only if 60 percent of the shares in the foreign acquirer (before taking into account the domestic entity acquisition) are attributable to the acquisition of the foreign target.

Consistent with the 2015 Notice, the Temporary Regulations limit the third-country rule to transactions in which, absent the third-country rule, the ownership percentage under section 7874 would be at least 60 percent. In other words, the third-country rule should not bring a transaction within the scope of section 7874, but may cause a transaction that would otherwise have been subject to section 7874(a) to fall into section 7874(b), which treats the parent as a US corporation.

The Temporary Regulations clarify that, in determining the tax residency of the foreign acquirer and the foreign target, the taxpayer must take into account all related transactions. As a result, the parties cannot avoid the third-country rule by redomiciling either the foreign target or the foreign acquirer in a related transaction.

Modifications to Substantial Business Activities Test

Consistent with the 2015 Notice, the Temporary Regulations add a tax residency requirement to the "substantial business activities" test under section 7874.

Section 7874(a)(2)(B)(iii) provides that a foreign acquiring corporation is not subject to section 7874 if the foreign acquirer's "expanded affiliated group" ("EAG") has "substantial business activities in the foreign country in which, or under the laws of which, the entity is created or organized." Under final regulations issued in June 2015, an EAG will satisfy the substantial business activities requirement if at least 25 percent of its employees (by both headcount and compensation), tangible personal or real property, and gross income are located or derived in the relevant foreign country. As revised, Treas. Reg. § 1.7874-3T further requires that the foreign acquirer must be subject to tax as a resident of the relevant foreign country – a requirement that does not appear in the statute.

The Temporary Regulations do not appear to change the rule in the statute requiring substantial business activities in the country of incorporation. Thus, a company that has substantial business activities in the jurisdiction of tax residence may not satisfy the substantial business activities requirement if it is incorporated in a different jurisdiction.

The Temporary Regulations also clarify how financial statements may be used to determine group income for purposes of the substantial business activities test. In response to taxpayer comments, Treasury explained that financial reporting principles are relevant in determining the amount of items of income to be taken into account, but not in determining which EAG members are taken into account. Accordingly, Treas. Reg. § 1.7874-3T provides that the relevant financial statements used to determine group income must take into account all items of income generated by all members of the EAG for the testing period. The Temporary Regulations do not, however, provide further clarification with regard to group income determinations when relying on financial statements as the starting point for such determinations.

Clarifying the Definition of Nonqualified Property

Consistent with the 2015 Notice, the Temporary Regulations modify the existing rules in Treas. Reg. § 1.7874-4T, which provide that certain stock in the foreign acquirer that is issued in exchange for "nonqualified property" may be disregarded for purposes of the ownership test under section 7874.

Under prior temporary regulations, nonqualified property includes (i) cash or cash equivalents, (ii) marketable securities, (iii) obligations of a member of the EAG, a former shareholder or partner of the inverting US company, or an owner of or person related to one of the foregoing, and (iv) any other property acquired in a transaction related to the acquisition, with a principal purpose of avoiding the purposes of section 7874 ("avoidance property"). An example in the prior temporary regulations provides that, if a person transfers nonqualified property to a corporation in exchange for stock in a transaction with an avoidance purpose, the newly issued stock is avoidance property. The Temporary Regulations modify the definition of avoidance property to mean any property acquired with a principal purpose of avoiding the purposes of section 7874. Specifically, the Temporary Regulations clarify that avoidance property is not limited to property acquired in exchange for nonqualified property.

The Temporary Regulations also clarify the existing de minimis exception under Treas. Reg. § 1.7874-4T, to reflect the addition of the "cash box" and "non-ordinary course distributions" rules described below. Under this exception, the nonqualified property rules do not apply to a transaction in which, before applying

the nonqualified property rules, the former shareholders of the domestic entity hold less than five percent of the stock of the acquirer and satisfy certain other ownership requirements. The Temporary Regulations provide that this five percent threshold is calculated without regard to the "cash box" rule in Treas. Reg. § 1.7874-7T and the "non-ordinary course distributions" rule in Treas. Reg. § 1.7874-10T, both of which are discussed in more detail below.

Transferred Stock ("Spinversion") Rule

The Temporary Regulations adopt, with some modifications, the rule announced in the 2014 Notice to treat stock that is transferred by a member of the EAG in a related transaction as not being held by a member of the EAG.

Under section 7874(c)(2), stock held by a member of the EAG is not taken into account for purposes of the ownership test. This exception generally allows restructurings within an EAG to take place without triggering section 7874. New Treas. Reg. § 1.7874-6T provides that this rule will not apply where a member of the EAG receives stock but subsequently transfers the stock in a related transaction. More generally, the Temporary Regulations amend the rules on stock held by a member of the EAG to take into account all related transactions.

Treas. Reg. § 1.7874-6T prevents so-called "spinversion" transactions from falling under the section 7874(c)(2) exception. For instance, if a parent contributes the stock of a US subsidiary to a foreign holding company that is a member of the EAG, but then distributes the foreign holding company to its shareholders in a spin-off, the initial contribution may be treated as an inversion subject to section 7874.

The 2014 Notice included two exceptions to this rule, with different requirements depending on whether the transaction involved a US-parented group or involved a foreign-parented group. The Temporary Regulations adopt these two exceptions, but broaden the exception for US-parented groups, so that the exception applies even where the group has a different US parent before and after the transaction.

The Temporary Regulations treat partnerships that are 50 percent owned by members of the EAG as members of the EAG. Moreover, the Temporary Regulations include a special rule addressing situations where a member of the EAG holds both "old and cold" stock in a domestic entity and stock that it received as part of the inversion (fungible stock). In such a case, the holder is deemed to transfer the "old and cold" and newly acquired stock on a pro rata basis.

Passive Asset or "Cash Box" Rules

The Temporary Regulations adopt, with some modifications, the passive asset or "cash box" rule announced in the 2014 Notice and modified in the 2015 Notice. New Treas. Reg. § 1.7874-7T disregards a portion of the foreign parent's stock for purposes of the ownership test if more than 50 percent of the foreign group's property consists of "foreign group nonqualified property."

The Temporary Regulations add a de minimis exception, similar to the de minimis exception under Treas. Reg. § 1.7874-4T, for transactions in which the domestic entity's shareholders receive less than five percent of the stock of the foreign parent and satisfy certain other ownership requirements. The Temporary Regulations also provide that only assets held at the level of the foreign acquirer or

its subsidiaries are taken into account. Assets held within the same EAG but "upstream" from the foreign acquirer are excluded from the analysis. Finally, the Temporary Regulations provides a special rule treating certain controlled partnerships as members of the EAG, similar to the rule under Treas. Reg. § 1.7874-4T.

Non-ordinary Course Distributions Rule

New Treas. Reg. § 1.7874-10T provides that, where a domestic entity has made "non-ordinary course distributions" during a 36 month look-back period, the former owners of the domestic entity are treated as receiving stock of the foreign acquirer with a fair market value equal to the amount of the distributions. (The rule applies only for purposes of the value test, and not the vote test.) In addition, consistent with the 2014 Notice, new regulations under section 367(a) apply similar principles for purposes of determining the fair market value of the US target company under the exception for transfers of stock or securities of a domestic corporation in Treas. Reg. § 1.367(a)-3(c).

At a high level, the Temporary Regulations are similar to the rules announced in the 2014 Notice (as modified by the 2015 Notice), but provide more concrete guidance on several issues that were ambiguous in the 2014 Notice. The Temporary Regulations also retain the de minimis exception proposed in the 2015 Notice, which is similar to the exception under the nonqualified property rules in Treas. Reg. § 1.7874-4T as described above.

The non-ordinary course distributions rule is a bright-line test that applies regardless of whether the distribution had an avoidance purpose. The 2014 Notice adopted this approach notwithstanding the language in section 7874(c)(4), which looks to the principal purpose of a transaction. Despite comments from the public to the effect that the non-ordinary course distributions rule should create only a rebuttable presumption, Treasury stood its ground in the Temporary Regulations and retained the bright-line rule. Moreover, Treasury confirmed that the non-ordinary course distributions rule is not a safe harbor, and that a distribution not captured by the bright-line rule may nevertheless be disregarded under the general anti-abuse rule of section 7874(c)(4).

The 2014 Notice provided that non-ordinary course distributions would be disregarded, but did not further explain the effect on the ownership test. The Temporary Regulations confirm that the foreign entity is deemed to issue additional stock in the amount of the non-ordinary course distributions. Treasury rejected a comment suggesting that, where the consideration paid to the domestic entity's owners includes a mix of cash and stock, the additional stock deemed issued should take into account this mix. Treasury expressed concern that this mix of consideration could have been different absent the non-ordinary course distributions, and that an approach taking the mix into account would be too complex.

The Temporary Regulations clarify that the amount of stock deemed issued is based on the value of the non-ordinary course distributions at the time of distribution. Thus, fluctuations in the value of the domestic entity's stock, or of the property distributed, should have no effect. The 2014 Notice did not address this point.

The Temporary Regulations include new provisions defining a "distribution" for purposes of the non-ordinary course distributions test. The Temporary Regulations generally carve out certain types of distributions that do not reduce the domestic entity's value, such as distributions under section 305 and section 304(a)(1), as well as distributions under section 361(c)(1). Consistent with the 2014 Notice, distributions by a predecessor to its former owners are taken into account. The Temporary Regulations define a predecessor as a corporation or partnership that was acquired (including an acquisition of assets, stock, or partnership interests), but only if the former owners received at least 10 percent of the stock in the acquirer.

The Temporary Regulations also introduce a new rule addressing spin-off transactions. Spin-offs are generally treated as distributions for purposes of the non-ordinary course distributions rule. Under prior guidance, divisive spin-offs could result in different consequences depending on how the acquisition was structured. For example, suppose a domestic parent owned two businesses, A and B, and a foreign acquirer wished to acquire business A (the larger of the two) in exchange for FA stock. To separate the two businesses, the domestic parent could contribute business B to a newly formed domestic holding company and then distribute the stock of the holding company to its shareholders. If the foreign company then acquired the domestic parent, the non-ordinary course distributions rule would take into account the value of business B. Alternatively, the domestic parent could contribute business A to a newly formed domestic holding company and then distribute the stock of the holding company to its shareholders. If the foreign company then acquired the new holding company, the non-ordinary course distributions rule would not come into play because the holding company had not made a distribution. The Temporary Regulations change the result in the second scenario. Under the Temporary Regulations, if the value of the distributed holding company represents more than 50 percent of the value of the original domestic parent, then for purposes of the non-ordinary course distributions rule, the direction of the spin-off is reversed. In other words, the distributed holding company is deemed to have distributed the stock of the domestic parent.

Finally, the Temporary Regulations provide more specific guidance regarding the timing for calculating non-ordinary course distributions. Under the 2014 Notice, once distributions within the 36 month look-back period had been identified, distributions within each taxable year were tested to determine whether the distributions exceeded a benchmark amount determined based on the prior three years. This mismatch between the 36 month look-back period and the taxable year approach for benchmarking created uncertainties in applying the rules to transactions in the middle of a taxable year. The Temporary Regulations eliminate this discrepancy. Under the Temporary Regulations, the 36 month look-back period is divided into 12 month "look-back years," and distributions occurring within each 12 month look-back year are tested against distributions in the prior 36 months. The Temporary Regulations provide specific rules for applying the look-back rules where an entity has existed for less than 36 months, and for testing a particular look-back year if the entity does not have a full 36 months of history prior to that look-back year. Some comments proposed Treasury should shorten the 36 month look-back period. Treasury justified this position on the grounds that transactions can take a long time to close, and that companies considering an inversion, but without a particular foreign target in mind, may use non-ordinary course distributions to reduce their size and thus expand the pool of potential targets.

Inversion Gain

The Temporary Regulations adopt the expanded definition of "inversion gain" proposed in the 2015 Notice. New Treas. Reg. § 1.7874-11T defines inversion gain to include income or gain recognized by an expatriated entity in a taxable year that includes any portion of the applicable period, by reason of a direct or indirect transfer of stock or other properties, or the license of any property, either as part of the domestic entity acquisition, or after such acquisition if the transfer or license is to a related person. Thus, for instance, inversion gain includes subpart F income resulting from a transfer or license by a controlled foreign subsidiary of the expatriated entity. The Temporary Regulations further expand the definition to include any amounts treated as a dividend under section 78.

Limitations on Post-Inversion Planning

Many US multinationals with profitable foreign operations have significant amounts of cash offshore that they would like to access for various corporate purposes. To access that foreign cash, US multinationals typically must pay US tax on those earnings. The specter of this US tax often "traps" the cash offshore indefinitely. Inverted companies historically have been in a better position to utilize this foreign cash without US taxation. As announced in the 2014 Notice and the 2015 Notice, Treasury has targeted a number of transactions that access the trapped cash in the Temporary Regulations.

Section 956: Treating Obligations of Non-CFC Foreign Related Persons as US Property

Before the 2014 Notice, inverted companies could access their trapped cash by having the foreign subsidiaries of the former US parent lend to the inverted group's new foreign parent. These obligations were not obligations of US persons and therefore did not implicate section 956.

Consistent with the 2014 Notice, Treas. Reg. § 1.956-2T expands the definition of "United States property" to include an obligation or stock of a non-CFC foreign related person if the obligation or stock is (i) held by a controlled foreign subsidiary of the former US parent or of a related US person (an "expatriated foreign subsidiary") and (ii) the expatriated foreign subsidiary acquired the obligation in anticipation of, or within 10 years of, the inversion. This change extends section 956 well beyond the statutory definition of US property, which includes only obligations or stock of a US person. Notably, these rules apply only to inverted groups that are subject to section 7874. An inverted group that satisfies the section 7874 substantial business activities test or the ownership test, or a foreign-parented group that did not engage in an inversion, is outside the scope of the rule.

For the most part, this new category of US property is treated like any other US property under section 956. For instance, pledging assets in support of or guaranteeing an obligation of a related, non-CFC foreign affiliate is treated in the same way as holding the obligation itself. The exceptions in the Temporary Regulations also correspond to those in the existing section 956 regulations. Specifically, the Temporary Regulations include exceptions for (i) obligations arising in connection with sale or processing of property, (ii) obligations in connection with sale and repurchase agreement or posted or received as collateral by a dealer, and (iii) obligations arising in connection with provision of services.

The preamble to the Temporary Regulations also confirms that exceptions contained in section 956 itself apply to this new category of US property without need for additional regulatory language.

In revising the prior regulations under section 956, Treasury took the opportunity to incorporate the exceptions for short-term obligations provided under Notice 88-108 (the 30/60 day exception) and Notice 2008-91 (the 60/180 day exception). The new Temporary Regulations, however, specifically provide that these obligations apply only to obligations of a US person, and not to obligations of a foreign person. As a result, inverted groups cannot rely on these exceptions for loans to non-CFC foreign affiliates.

Section 7701(l) Recharacterization Rule

Consistent with the 2014 Notice, the Temporary Regulations target transactions to decontrol the CFCs of the inverted US group. Before the 2014 Notice, inverted groups could decontrol CFCs by causing the new foreign parent, or another non-CFC foreign affiliate, to acquire sufficient stock in the CFC to dilute the US shareholders' ownership to 50 percent or less, by vote and value. A decontrolled CFC was, for the most part, no longer subject to Subpart F and related rules, reducing the likelihood that its US shareholders would ever be subject to US tax on the CFC's pre-inversion, untaxed earnings and profits.

As announced in the 2014 Notice, the Temporary Regulations at Treas. Reg. § 1.7701(l)-4T recharacterize any transaction within the 10 year period following the inversion in which stock of an expatriated foreign subsidiary is issued or transferred to a non-CFC foreign affiliate, subject to limited exceptions. Once again, these rules apply only to inverted groups that are subject to section 7874. An inverted group that satisfies the section 7874 substantial business activities test or the ownership test is outside the scope of these rules.

According to Treas. Reg. § 1.7701(l)-4T, any property that was transferred to the CFC is deemed transferred to the CFC's "section 958(a) US shareholders," which in turn are deemed to issue their own instruments to the non-CFC foreign affiliate and contribute the property they just received to the CFC in exchange for additional deemed shares in the CFC. As a result of the recharacterization, the non-CFC foreign affiliate is deemed to have invested in the section 958(a) US shareholders, and the section 958(a) US shareholders are deemed to have increased their investment in the CFC while maintaining the same proportional ownership in the CFC. Stock in the CFC actually held by the non-CFC foreign affiliate is simply ignored for US federal income tax purposes. For purposes of this general recharacterization rule, the Temporary Regulations narrow the definition of a "section 958(a) US shareholder" that was used in the 2014 Notice. The Temporary Regulations limit the meaning of that term to only the US shareholders that participated in the inversion, rather than all US shareholders.

The Temporary Regulations adopt the exceptions to the recharacterization that were described in the 2014 Notice for (i) fast-pay arrangements, (ii) transactions that resulted in an appropriate amount of US taxable income (which can be triggered by the application of new Temporary Regulations under section 367(b) discussed below), and (iii) de minimis ownership shifts (though the Temporary Regulations revise the de minimis exception to calculate the ownership shift by reference to overall ownership percentage, rather than value). Treasury expressly

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declined to incorporate an exception for business integrations, as suggested in a comment to the 2014 Notice.

Treasury determined that the fiction resulting from the recharacterization should last only as long as the perceived abusive structure does. Accordingly, while the 2014 Notice did not address the issue, the Temporary Regulations provide that the fiction is unwound if (i) the CFC ceases to be related to the inverted group, (ii) the CFC's disregarded stock is transferred outside of the inverted group, or (iii) the CFC actually redeems the disregarded stock. Transfers by the non-CFC foreign affiliate of the CFCs disregarded stock that do not fall in one of these three categories are treated as transfers of the instruments that were deemed to be issued by the section 958(a) US shareholders.

Stock and Asset Dilution Rules

The Temporary Regulations also promulgate new rules under section 367(b), some of which were described in the 2014 Notice and the 2015 Notice. These new rules operate alongside the recharacterization rules under Treas. Reg. § 1.7701(l)-4T described above to discourage inverted US corporations from diluting their ownership in their CFCs. The new rules under section 367(b) apply to transfers of a expatriated foreign subsidiary's stock or assets in exchange for stock in a foreign corporation. These rules apply only to inverted groups that are subject to section 7874.

Under the Temporary Regulations, if in the 10 year period following an inversion, an inverted US corporation transfers stock in one of its CFCs, or one of its CFCs transfers stock in a lower tier CFC, in a section 351 contribution or a section 368(a)(1) reorganization and in exchange receives stock in a foreign corporation, the transferring entity must (i) include in its income the section 1248 amount (as defined in the section 367(b) regulations) attributable to the stock that it exchanges and (ii) recognize any gain in the transferred stock after taking into account any increase to its tax basis in such stock as a result of the including the section 1248 amount in its income. This rule is slightly narrower than the rule described in the 2014 Notice and the 2015 Notice, reflecting Treasury's decision that this rule should only apply if the transferor is a inverted US corporation (or a related US person) or one of its CFCs. Treasury Reg. § 1.367(b)-4T provides an exception for de minimis ownership shifts of 10 percent or less if the transferee is a CFC (again, the Temporary Regulations calculate the ownership shift by reference to overall ownership percentage rather than value).

The Temporary Regulations add a similar rule for asset transfers, which was not included in the 2014 Notice or the 2015 Notice. If, during the 10 year period following an inversion, a CFC of an inverted domestic company transfers its assets (other than assets in a lower-tier CFC) to a foreign corporation in a section 351 contribution, the transferring CFC must recognize all realized gain (but not loss) on the transferred assets. There is a de minimis (10 percent or less) exception to this rule as well if the transferee is a CFC after the transfer. Treasury appears to be particularly concerned about section 351 contributions in which a CFC contributes appreciated intangible property to a foreign affiliate, while a non-CFC foreign related person transfers other assets. These transfers can dilute the inverted US group's indirect interest in the CFC's appreciated assets and reduce or eliminate US tax on the built-in gain, particularly if the transferee foreign affiliate is not itself a CFC.

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Section 304 Rules

Consistent with the 2014 Notice, the Temporary Regulations modify the application of section 304(b)(5)(B) such that only the earnings and profits of the foreign acquiring company (and not the issuing company) are taken into account. As a result, section 304(b)(5)(B) will exclude the earnings and profits of the acquiring company from the calculation of the deemed 304 dividend unless 50 percent or more of the dividends are subject to US federal tax or includible in the earnings and profits of a CFC. If this threshold is not reached, none of the acquiring company's earnings and profits are taken into account for purposes of the section 304 dividend. Unlike the new Temporary Regulations under section 956, section 7701(l) and section 367(b), the rules under Treas. Reg. § 1.304-7T apply to all taxpayers, regardless of whether they are part of an inversion.

The Temporary Regulations also adopt the anti-abuse rule described in the 2014 Notice, which allows the Service to disregard a partnership, option, or other arrangement used with a principal purpose of avoiding application of these new rules. These rules also are not limited to inversion transactions.

Concluding Remarks

Aside from the multiple-step acquisition rule and the "serial" acquisitions rule, the Treasury Regulations contain few surprises. The Treasury Regulations demonstrate that Treasury continues to be aggressive in using its regulatory authority to combat inversions and post-inversion planning. Many of these rules are based on broad assumptions regarding taxpayers' intent in structuring transactions in a particular way. Others seemingly depart from the statutory language. Moreover, in addressing post-inversion planning, Treasury has in effect created a separate set of rules for inverted companies, which would not apply to non-inverted multinationals.

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