IRS Clarifies and Tightens New "Anti-Inversion" Regulations

June 13, 2012

On June 7, 2012, the US Treasury Department (the "IRS") issued new regulations interpreting the US tax rules that apply to "expatriated entities." An expatriated entity, sometimes referred to as an "inverted company," is a US company (usually the parent company of a group of US and foreign affiliates) that seeks to become a lower-taxed foreign company rather than a higher-taxed US company. In 2009, the IRS issued temporary regulations that were scheduled to expire on June 8, 2012 (the "2009 temporary regulations"), and the regulations released on June 7 were issued shortly before the 2009 temporary regulations lapsed.

Background on US Anti-Inversion Rules

Internal Revenue Code section 7874, enacted as part of the American Jobs Creation Act of 2004, subjects expatriated entities (and their affiliates) to adverse US tax consequences. Generally, if a US company transfers its properties to a foreign corporation and at least 80 percent of the stock (by vote or value) of the new foreign parent company is held by former shareholders of the US company, then the new foreign parent company (the "surrogate foreign corporation") will be subject to US tax as though it were a US corporation, notwithstanding its foreign incorporation. If at least 60 percent (but less than 80 percent) of the stock (by vote or value) of the new foreign parent company is held by former shareholders of the US company, then the foreign status of the surrogate foreign corporation is respected for US tax purposes, but any gain on the inversion transaction is generally subject to US income tax, notwithstanding any exclusions, exemptions and credits (other than the foreign tax credit) that would otherwise reduce the US tax on the inversion gain. These anti-inversion rules apply only if, after the acquisition, the surrogate foreign corporation and its subsidiaries (the "expanded affiliated group") do not have "substantial business activities" in the surrogate foreign corporation's home country, compared to the total business activities of the expanded affiliated group.

The IRS has issued guidance on several aspects of section 7874, including when a foreign company will be considered a "surrogate foreign corporation" and therefore subject to the adverse tax rules of section 7874. The first regulations defining surrogate foreign corporation were temporary regulations issued in 2006. These regulations included a safe-harbor, in which the substantial business activities exception would be met if at least 10 percent of the expanded affiliated group's employees, assets, and sales were in the surrogate foreign corporation's country of formation (the "relevant foreign country"). In 2009, the IRS issued new temporary regulations that eliminated the safe harbor, forcing companies to rely entirely on a general facts-and-circumstances test. In response to criticism about the lack of guidance in applying the general facts-and-circumstances test in the 2009 temporary regulations, the temporary regulations released on June 7, 2012 (the "2012 temporary regulations") replace the facts-and-circumstances test with a bright-line test.

2012 Temporary Regulations

Under the 2012 temporary regulations, an expanded affiliated group will be considered to have substantial business activities in the relevant foreign country only if at least 25 percent of the group employees, group assets, and group income are located or derived in the relevant foreign country.

- For purposes of determining whether the group employee test is satisfied, the number of employees and amount of employee compensation must each meet the 25% threshold. In both cases, one calculates whether the threshold is met by dividing the number of group employees (or amount of group compensation) in the relevant foreign country by the total number of group employees (or amount of group compensation). Importantly, a group employee is considered to be based in the relevant foreign country only if the employee spent more time providing services in that country than in any other single country during the testing period.
- For the group assets test, one takes the total amount of tangible personal property or real property used or held for use in the active conduct of a trade or business in the relevant foreign country and divides it by the total amount of such assets held by the group. Solely for this purpose, in the case of tangible personal property or real property that is rented by a member of the group, the value of the rented property is deemed to be eight times the net annual rent paid. Note that intangible property is ignored for purposes of this determination, and a group asset is considered to be located in the relevant foreign country only if the asset was physically present in that country at the close of the acquisition date and for more time than in any other country during the testing period.
- For purposes of the group income test, group income is determined by taking into account only transactions occurring in the ordinary course of business with customers that are not related persons. Importantly, group income is considered to be derived in the relevant foreign country only if the customer is located in the relevant foreign country.

In light of the difficulty in making these calculations under definitions in 2009 temporary regulations, the 2012 temporary regulations provide guidance in determining the "applicable date." The 2012 temporary regulations also eliminate the "look-through" rule in the 2009 temporary regulations that applied the substantial business activities test in the context of partnerships. The 2012 temporary regulations replace it with an all-or-nothing rule, the application of which depends on whether the members of the expanded affiliated group hold more than 50 percent (by value) of the partnership at issue. The 2012 temporary regulations also request comments on the extent to which partners of a partnership should be treated as if they were employees solely for purposes of the group employee test.

The new substantial business activities test in the 2012 temporary regulations is significant on two levels. First, by replacing the imprecise facts-and-circumstances test of the 2009 temporary regulations, the 2012 temporary regulations provide clear guidance to taxpayers as to whether they qualify for the substantial business activities exception. In the preamble to the 2012 temporary regulations, the IRS states that it made the change in response to comments and that it believes that the new rule "will provide more certainty in applying section 7874 to particular transactions than the 2009 temporary regulations and will improve the administrability of this provision."

Second, while clear, the new bright-line test will be extremely difficult for many companies to meet, increasing the likelihood that transactions that meet the 60-percent or 80-percent threshold will be subject to the adverse rules of section 7874. By setting both a relatively high bar (25%) and requiring the expanded affiliated group to meet the 25% threshold in multiple ways, the 2012 temporary regulations effectively require the expanded affiliated group to conduct much more than a quarter of its activity in the relevant foreign country. Because multiple tests each require involvement of at least 25% in the relevant foreign country, the new substantial business activities test will be very hard to meet in low-cost countries and small countries, and probably will be impossible to meet in a group that is truly global. Indeed, the new regulations appear to be in the spirit of the recent Obama Administration proposals to adopt US tax rules that punish companies that create jobs outside the United States and reward companies that create jobs in the United States.

The Rest of the Regulations

In addition to including the 2012 temporary regulations (described above), the package of regulations released by the

IRS includes final regulations that generally adopt the remaining portions of the 2009 temporary regulations (i.e., the portions that did not relate to the substantial business activities test). Nonetheless, the final regulations in the package make several minor technical changes to the rules of the 2009 temporary regulations. These include guidance on the treatment of options (such as measuring voting power for purposes of determining whether the 60-percent or 80-percent thresholds have been met, the proper valuation of options, and broadening the application of an anti-abuse rule), clarification of the treatment of "downstream" mergers, and certain changes in wording intended to provide greater clarity. The IRS also requests comments on the proper determination of ownership, in light of the interaction of various rules of section 7874.

Effective Date

The final regulations and the 2012 temporary regulations apply to acquisitions completed on or after June 7, 2012. For acquisitions completed before June 7, 2012, the 2009 temporary regulations (or the preceding 2006 temporary regulations, as applicable) continue to apply. The 2012 temporary regulations do include binding contract relief: In the case of an acquisition completed on or after June 7, 2012, that is either (a) described in a document filed with the SEC on or before June 7 or (b) subject to a written agreement that was binding on June 7, the taxpayer may choose to apply the 2012 temporary regulations or the facts-and-circumstances test in the 2009 temporary regulations.

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