New York State Bar Association

Tax Section

Report on Certain Issues Under Section 7874

May 3, 2010

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Report No. 1211

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I. Introduction

A. Background

This Report[1] provides recommendations for additional guidance with respect to certain issues under Section[2] 7874. Congress enacted Section 7874 in 2004 to address certain perceived abuses associated with "inversion" transactions pursuant to which the domestic parent of a multinational corporate group would be replaced with a foreign parent corporation located in a jurisdiction with which the group had limited business nexus without significant change in the ultimate ownership of the group.[3] Congress was concerned, in particular, that such transactions could be used to remove current and future foreign operations of the group from the U.S. taxing jurisdiction and to reduce U.S. tax on U.S.-source income through earnings stripping and other transactions.[4]

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1 The principal drafter of this Report was Vadim Mahmoudov. Substantial contributions were made by Serge Mezhburd and Munir Zilanawala. Helpful comments were received from Kimberly Blanchard, Peter Blessing, Dennis Caracristi, Stephen Land, Alexey Manasuev, Shane Milam, Richard Reinhold, and Michael Schler.

2 Unless otherwise indicated, all references in this Report to "Section" and "Sections" are to the Internal Revenue Code of 1986, as amended (the "Code"), and all references to "Treas. Reg. §" are to regulations issued thereunder (the "Treasury Regulations" or "Regulations"). References to the "IRS" and the "Service" are to the Internal Revenue Service, and references to "Treasury" are to the United States Department of the Treasury. For our prior comments on Section 7874, *see Report on Temporary Treasury Regulations Section 1.7874-1T*, N.Y. ST. B.A. TAX SECTION, Mar. 22, 2006 [hereinafter *2006 NYSBA Report*].

3 *See generally* H.R. REP. NO. 108-755, at 568 (2004) (Conf. Rep.), *reprinted in* 2004 U.S.C.C.A.N. 1341, 1636.

4 *Id.*; *see also* JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF TAX LEGISLATION ENACTED IN THE 108TH CONGRESS, at 342 (2005); *infra* note 25 and accompanying text.

Section 7874(a) provides, in relevant part, that if, pursuant to a plan or a series of related transactions, (i) a foreign corporation ("FC") directly or indirectly acquires substantially all the properties held directly or indirectly by a domestic corporation, or substantially all the properties constituting a trade or business of a domestic partnership, (ii) after the acquisition at least 60% of the stock (by vote or value) of FC is held by former shareholders or partners of the domestic entity ("DE") by reason of their former ownership of DE,[5] and (iii) after the acquisition the expanded affiliated group that includes FC (the "EAG")[6] does not have substantial business activities in the country of FC's incorporation relative to the total business activities of the EAG,[7] then FC will be treated as a "surrogate foreign corporation" and any "inversion gain"[8] will be fully taxable from the date the acquisition begins to ten years after its completion, with only limited offset by losses or credits.[9] Section 7874(b) provides further that if conditions (i) and (iii) above are met and at least 80% of the stock (by vote or value) of FC is held by former owners of DE by reason of such former ownership, then FC will be treated as a domestic corporation for purposes of the Code.

Section 7874(c)(2) provides that, for purposes of measuring post-acquisition ownership of FC under the Ownership Test, stock held by members of the EAG and stock of FC that is sold in a public offering related to the acquisition of DE is disregarded.

Since the enactment of Section 7874 in 2004, Treasury and the Service have issued four regulatory pronouncements and a Notice to clarify the operation of the statute.

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5 The 60% ownership threshold of Section 7874(a)(2)(B)(ii) and 80% threshold of Section 7874(b), described below, will be collectively referred to as the "Ownership Test"; where a particular threshold is relevant to the discussion, it will be specified. For example, if FC is 90% owned by former owners of DE, then the transaction will be referred to as having met the 80% Ownership Test.

6 The EAG is defined by reference to Section 1504(a), but includes foreign corporations and has a lower common ownership threshold ("more than 50%" rather than "at least 80%").

7 This prong will be referred to as the "Substantial Activities Test"; an EAG that does not have substantial business activities in FC's country of incorporation will be referred to as having failed the Substantial Activities Test.

8 Section 7874(d)(2) defines "inversion gain" as income or gain recognized by DE during the "applicable period" from any property transfer (other than of inventory) or from a license of DE property, in each case either as part of DE's acquisition by FC, or afterwards if the transfer or license is to a "foreign related person."

9 In addition, individuals who are "disqualified individuals" (in general, insiders) with respect to a corporation treated as an expatriated entity under Section 7874(a)(2) are subject to a surtax in respect of certain stock compensation. Section 4985.

The first set of temporary regulations was issued in December 2005 to clarify the operation of the Ownership Test.[10] Following Section 7874(c)(2), these regulations generally excluded stock held by members of the EAG from both the numerator and denominator of the fraction that determines the stock ownership percentage under the Ownership Test. The regulations included such stock in the denominator (but not the numerator) in the case of (i) an "internal group restructuring" in which the common parent of the EAG retains 80% or greater ownership (by vote or value) of DE and (ii) a "loss of control" transaction in which former owners of DE do not own more than 50% of the stock (by vote or value) of any EAG member after DE's acquisition by FC. These regulations also specified that "hook stock," or interests in a parent entity owned by its 50%-or-greater subsidiary, would be disregarded in applying the foregoing rules and the Ownership Test.

A second set of temporary regulations was issued in June 2006 (the "2006 Temporary Regulations").[11] These regulations addressed a number of issues, including: an indirect acquisition of properties held by DE; identifying FC stock held "by reason of" holding an interest in DE; the Substantial Activities Test; the treatment of a publicly traded foreign partnership and of a partnership treated as a surrogate foreign corporation; the treatment of options and similar interests as stock of FC; and the consequences of being treated as a domestic corporation under Section 7874(b). In particular, the 2006 Temporary Regulations provided both a bright-line safe harbor and a facts-and-circumstances test, either of which FC could satisfy to meet the Substantial Activities Test. The safe harbor required the EAG to have in FC's country of incorporation at least (i) 10% of its employees (by headcount and compensation), (ii) 10% of the gross basis (by either tax basis or fair market value) of its tangible active business assets, and (iii) 10% of its gross receipts from sales of goods or services (counting only sales for use, consumption, or disposition in the foreign country). In addition, several examples illustrated the application of the general facts-and-circumstances test. The 2006 Temporary Regulations also provided that options and similar interests held by reason of former ownership of DE stock would be treated as exercised to the extent the effect of such exercise would be to treat FC as a surrogate foreign corporation.

In May 2008, the temporary regulations proposed in December 2005 were finalized.[12] The final regulations were substantially identical to the temporary regulations, except that they slightly altered (i) the operation of the internal group restructuring exception and (ii) the mechanics of excluding hook stock from the Ownership Test analysis. The Preamble stated an intention to issue anti-avoidance

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[10] Temp. Treas. Reg. § 1.7874-1T (as issued by T.D. 9238, 2006-1 C.B. 408).

[11] Temp. Treas. Reg. § 1.7874-2T (as issued by T.D. 9265, 2006-2 C.B. 1).

[12] Treas. Reg. § 1.7874-1 (as finalized by T.D. 9399, 2008-1 C.B. 1157).

regulations regarding the treatment of DE creditors as shareholders, the acquisition of multiple DEs, and the use of intervening partnerships.

Treasury and the Service issued the fourth and most recent set of regulations relating to Section 7874 in June 2009 (the "2009 Temporary Regulations").[13] These regulations withdrew the 2006 Temporary Regulations and proposed in their stead new temporary regulations.[14] One key difference between the withdrawn and newly proposed regulations was that, with respect to the Substantial Activities Test, the latter removed both the safe harbor and the examples under the facts-and-circumstances test.[15] Furthermore, for purposes of the Ownership Test, the 2009 Temporary Regulations treat an option or similar interest as stock solely to the extent the value of stock that may be acquired pursuant to the instrument exceeds the exercise price of the instrument (i.e., the "spread" value of the instrument). Comments were requested on these changes. In addition, the 2009 Temporary Regulations incorporate rules regarding acquisitions by multiple FCs and of multiple DEs, treat creditor claims with respect to an insolvent DE as stock of DE, and address several other issues arising under Section 7874.

Finally, in September 2009, Notice 2009-78 (the "Notice") was issued.[16] The Notice announced the intention to issue regulations providing that stock of FC would not be taken into account for purposes of the Ownership Test if it was issued in exchange for "nonqualified property" (i.e., cash and certain other liquid assets, or any property acquired in a transaction with a principal purpose of avoiding the purposes of Section 7874), even if such stock would not be described in Section 7874(c)(2)(B) because it was not "sold in a public offering." Likewise, the Notice stated the intention to issue regulations that would take certain stock of FC into account for purposes of the Ownership Test notwithstanding Section 7874(c)(2)(B), such as FC stock received by

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[13] Temp. Treas. Reg. § 1.7874-2T (as amended by T.D. 9453, 2009-28 I.R.B. 114).

[14] The June 2009 pronouncement also slightly modified the 1.7874-1 regulations finalized in May 2008 by T.D. 9399.

[15] But for the deleted examples, the facts-and-circumstances test in the 2009 Temporary Regulations is generally similar to the facts-and-circumstances test in the 2006 Temporary Regulations. However, whereas the latter (as well as the safe harbor therein) took into account sales to customers in the relevant foreign country, the former more broadly considers sales of goods to customers (apparently regardless of where the customers are located or where title passes, so long as the sale is booked in the subsidiary or branch located in the relevant foreign country). The 2009 Temporary Regulations also added an anti-stuffing rule to the facts-and-circumstances test. Temp. Treas. Reg. § 1.7874-2T(g)(5)(iii) (2009).

[16] 2009-40 I.R.B. 452.

former shareholders of a publicly traded foreign corporation that, along with DE, becomes wholly owned by FC. These regulations remain forthcoming.

This Report is primarily focused on certain issues arising under the 2009 Temporary Regulations and the Notice.

B. Summary of Recommendations

1. The Preamble to the 2009 Temporary Regulations requested comments on the removal of the safe harbor and examples under the Substantial Activities Test. Our comments are as follows:

- We believe clarity and certainty in the application of tax laws benefit both taxpayers and the government and therefore we recommend providing safe harbors under the Substantial Activities Test.

- However, the safe harbor in the 2006 Temporary Regulations could be viewed as excessively lenient to taxpayers and therefore we recommend splitting the safe harbor into two tests, one for EAGs conducting less than 50% of their business activities in the U.S. (measured by both assets and employee compensation) and one for EAGs conducting 50% or more of their business activities in the U.S. (measured by either assets or employee compensation).

- For EAGs conducting less than 50% of their business activities in the U.S., we propose reinstating the safe harbor with two of the elements taken into account in the 2006 Temporary Regulations safe harbor but requiring that each such element in the relevant country is at least equal to the greater of (i) 15% of the EAG's worldwide activities in respect of such element and (ii) 20% of the EAG's activities in respect of such element outside the U.S.

- For EAGs conducting 50% or more of their business activities in the U.S., we propose reinstating the safe harbor with two of the elements taken into account in the 2006 Temporary Regulations safe harbor but requiring a 25% threshold for each element.

- We recommend eliminating the "gross receipts" element from any safe harbor, although a significant minority of our Executive Committee would retain a modified version of the receipts test. In any event, the receipts test would still be relevant for the facts-and-circumstances test.

2. The Preamble to the 2009 Temporary Regulations requested comments on the rules concerning options. Our comments are as follows:

- We recommend generally ignoring options in conducting the Ownership Test, subject to an anti-abuse rule that treats certain options as stock. This approach is consistent with the approach taken in analogous areas of tax law, is simple and achieves the goal of preventing avoidance. In the alternative, if the determination is made to generally count options as stock for purposes of the Ownership Test (subject to an anti-abuse rule), we would recommend adding an "angel list" of categories of options that would be carved out of the general rule (again, subject to an anti-abuse rule). If final regulations adopt the spread value approach to valuing options, there may be less justification carving out various categories of options, including publicly traded options, but we would still at least carve out customary compensatory options.

- We agree with the Service that the "spread value" approach is generally superior to the "deemed exercise" approach for purposes of calculating the economic value of options. However, it is not clear how the "spread value" approach applies for purposes of testing voting power. We recommend that the regulations clarify the application of the "spread value" approach to voting power or adopt an anti-abuse rule providing that the "deemed exercise" approach may be used to apply the Ownership Test if the spread value approach would give an inappropriate result.

- The 2009 Temporary Regulations contain an asymmetric anti-abuse rule providing that options with respect to FC stock will not be treated as stock in certain circumstances. We recommend extending the anti-abuse rule to cover options and similar interests with respect to DE as well. We also urge the Service to provide guidance on the "substantially all of the properties" requirement of Section 7874(a)(2)(B)(i).

- The 2009 Temporary Regulations provide that the general rule of counting options for purposes of the Ownership Test does not apply to the extent that doing so would duplicate claims on equity. We recommend clarifying this rule to provide that, in circumstances when options are counted, the existing shareholders' ownership percentage for purposes of the Ownership Test is reduced by a corresponding percentage.

3. Our comments regarding the Notice are as follows:

- While expanding the statutory public offering rule of Section 7874(c)(2)(B) to cover certain stock issued in a private offering raises questions regarding the Service's authority, we agree that disparate treatment of public and private offerings makes little sense as a policy matter in most cases.

- However, a blanket rule disregarding stock issued for cash for purposes of the Ownership Test can cause Section 7874 to apply to bona fide business

transactions that are, in substance, sales of a U.S. business for cash. Therefore, we recommend exceptions for sufficiently large primary issuances (whether made in a public or private offering) and other situations where the historical shareholders of DE fail to retain some threshold percentage of their proprietary interest in DE. Any such exceptions should be backstopped with specific anti-abuse rules. In the alternative, we recommend replacing the *per se* rule with a rebuttable presumption that transactions targeted by the Notice are abusive and therefore are subject to the anti-stuffing rule of Section 7874(c)(4).

- We recommend that, in connection with issuing guidance on such transactions, clarification be provided under what circumstances prior distributions "skinnying down" DE would be treated as abusive under the anti-stripping rule of Section 7874(c)(4).

- The Notice (and the statutory exclusion of stock issued in a public offering) overlaps with other rules, particularly the rules for determining whether the relevant entities are part of an EAG, and special rules for conducting the Ownership Test when an EAG exists, to produce odd results. We recommend that the regulations implementing the Notice clarify that any shares excluded from the Ownership Test under the Notice should nevertheless be counted for purposes of the EAG rules. We also recommend an exception to the EAG rules that would apply to FC stock received by historic shareholders of DE other than "by reason of" their proprietary interests in DE.

4. We also address two other issues:

- The Code and the Regulations are not entirely clear regarding when to conduct the Ownership Test in an integrated multi-step transaction. We recommend that the regulations clarify that the test should compare the ownership immediately before the first transaction to the ownership immediately after the last transaction. This approach would be consistent with that taken by analogous Treasury Regulations in other contexts.

- The 2009 Temporary Regulations treat creditor claims with respect to an insolvent DE as stock of DE. We do not believe that a broad rule treating debt as stock is required by the policies behind Section 7874 and recommend a more limited rule targeting lenders who acquire the debt of DE pursuant to a plan to acquire its stock or assets.

II. The Substantial Activities Test

Perhaps the most publicized feature of the 2009 Temporary Regulations has been the removal of the safe harbor and the examples illustrating the facts-and-circumstances test under the Substantial Activities Test. The removal of the safe harbor is particularly

significant because the safe harbor had provided a bright-line test for an ambiguous statutory provision. The Preamble to the 2009 Temporary Regulations states that the safe harbor was removed because it "may apply to certain transactions that are inconsistent with the purposes of Section 7874, which is meant to prevent certain transactions that seek to avoid U.S. tax by merely shifting the place of organization of a domestic corporation (or partnership)."[17] Separately, the Service has announced that it will not provide customized guidance on this issue in the form of private letter rulings.[18]

This Part II the Report considers the advantages and disadvantages of providing a safe harbor under the Substantial Activities Test. We conclude that a safe harbor would be appropriate and offer suggestions for modifying the safe harbor contained in the 2006 Temporary Regulations to address the Service's concerns.

A. A Safe Harbor Is Appropriate

As a matter of tax policy, clarity and certainty in the application of tax laws benefit both taxpayers and the government by promoting taxpayer compliance and enhancing the ability of the IRS and the courts to apply and enforce the tax law equitably.[19] Like mechanical rules, safe harbors generally enhance clarity and certainty by providing bright-line rules for taxpayers, though safe harbors operate unilaterally in favor of taxpayers. The government may find a safe harbor approach preferable to a mechanical rule if it is difficult to craft a rule for all cases. In other situations, the government may prefer not to provide taxpayers with any kind of specific guidance (whether a mechanical rule or a safe harbor) because, for example, (i) mechanical rules may be inadministrable[20] or (ii) vague rules may be more likely to deter abusive

[17] T.D. 9453, 2009-28 I.R.B. 114.

[18] Rev. Proc. 2010-7, 2010-1 I.R.B. 231, Section 4.01(30). *See also* T.D. 9453, 2009-28 I.R.B. 114 ("[T]he question of whether the substantial business activities condition is satisfied will continue to be on the list of provisions with respect to which the IRS will not ordinarily issue rulings or determination letters."). An official of the Service explained that "the reasons we refuse to [issue PLR guidance] are consistent with why we don't rule on other things. It would be a very intensive factual analysis." Stephen Joyce, *Merrick Defends Service's Decisions in Final Regulations Under Section 7874*, Daily Tax Rep. (BNA) No. 139, at G-1 (July 23, 2009).

[19] *See, e.g.*, Madden v. Comm'r, 514 F.2d 1149, 1152 (9th Cir. 1975) (concluding that the court's decision enhances "certainty, particularly desirable in tax law"); Chu v. Comm'r, 486 F.2d 696, 701 n.6 (1st Cir. 1973) ("clarity and certainty in the application of tax laws must be maintained").

[20] See, for example, the numerous, ultimately unsuccessful attempts to provide regulatory guidance on the debt/equity distinction under Section 385.

transactions.[21] Although the second argument in particular may have some merit in this case, on balance we do not believe either consideration outweighs the benefits of providing some clarity, in the form of a safe harbor, under the Substantial Activities Test.

First, there is no reason to expect mechanical rules to be unworkable under Section 7874. Mechanical tests broadly similar to the safe harbor in the 2006 Temporary Regulations exist in many U.S. tax treaties[22] as well as the branch profits regulations.[23] Indeed, the statutory language of the Substantial Activities Test, which presupposes that the EAG is engaged in business activities in multiple jurisdictions and compares the level of such activities in FC's jurisdiction, invites arithmetic guidelines.[24]

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[21] Examples of open-ended anti-abuse regulations include Treas. Reg. §§ 1.704-4(f)(1) (relating to partnership distributions of contributed property) and 1.731-2(h) (relating to partnership distributions of marketable securities). A much-discussed example of open-ended regulations are the partnership anti-abuse regulations under Treas. Reg. § 1.701-2, although they contain numerous instructive examples. Similarly, Treas. Reg. § 1.355-2(d), excluding transactions that are viewed as a device for distributing earnings and profits from Section 355, gives the IRS very broad and open-ended authority (albeit somewhat narrowed by clarifications in Treas. Reg. § 1.355-2(d)(5) and the examples in Treas. Reg. § 1.355-2(d)(4)). For articles discussing intentionally open-ended drafting of anti-abuse regulations, see Hal Gann, *The Recent Evolution of Antiabuse Rules*, TAX NOTES, Feb. 20, 1995, at 1189; Richard M. Lipton, *Tax Administration in the 90s: The New "Reign of Terror,"* 74 TAXES 227 (1996) (comparing the test provided by open-ended anti-abuse regulations to Justice Stewart's definition of pornography: the IRS knows an abuse when it sees one); Compendium, *Compendium on Anti-Abuse Rules*, 48 TAX LAW. 799 (1995).

[22] *See, e.g.*, Understanding Regarding the Convention for the Avoidance of Double Taxation, U.S.-Neth., Mar. 8, 2004, S. TREATY DOC. NO. 108-25, at 35 (2004) (at least 7.5% of each of payroll expense, asset value, and gross income, and average of three ratios above 10%); Memorandum of Understanding re Interpretation of the Convention Between the Republic of Austria and the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, re art. 16, May 31, 1996, S. TREATY DOC. NO. 104-31 (1996) (same except must exceed 7.5% threshold); Convention Between the Government of the Grand Duchy of Luxembourg and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, art. 24, ¶ 3, Apr. 3, 1996, S. TREATY DOC. NO. 104-33 (1996) (same as the Netherlands treaty except must meet rather than exceed 10% threshold).

[23] Treas. Reg. § 1.884-5(e)(3).

[24] *Cf.* Treas. Reg. § 1.884-5(e)(3) (containing a "substantial presence" test that compares the activities of a foreign corporation in a particular jurisdiction to all of its activities based on a set of bright-line, mechanical elements similar to the elements in the 2006 Temporary Regulations).

The deterrence argument has merit. As its legislative history illustrates, Section 7874 is an anti-abuse provision: Congress was concerned about the removal of a U.S. parent entity of a multinational corporate group to a tax-haven jurisdiction with the principal purpose of reducing the group's U.S. tax liability.[25] Anti-abuse provisions in the tax law are frequently left open-ended to produce a chilling effect on the purported abuse.[26]

Section 7874, however, is not limited to acquisitions by foreign corporations organized in tax-haven jurisdictions. The Substantial Activities Test can be seen as something of a proxy for identifying inversions motivated to a meaningful extent by business considerations.

> **Example 1**. DE is a domestic corporation owned by U.S. and French individuals and has one wholly owned subsidiary, F1, which is incorporated in France and is engaged in an active trade or business in France.[27] After the acquisition, more than 50% of the EAG's employees are employees of F1 and based in France. More than 50% of the EAG's assets are owned by F1 and located in France. The shareholders of DE contribute their DE stock to a newly formed French corporation, FC, in exchange for all the stock of FC.

No one would believe that Congress intended Section 7874 to cause FC to be treated as a domestic corporation as a result of this transaction, since FC is (indirectly through F1) engaged in an active business in its home country that constitutes the majority of the activities of the EAG. Of course, when more than 50% of the EAG's employees and assets are in France, no safe harbor is necessary because Example 1

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[25] S. REP. NO. 108-192, at 142 (2003) ("The Committee believes that inversion transactions resulting in a minimal presence in a foreign country of incorporation are a means of avoiding U.S. tax and should be curtailed. In particular, these transactions permit corporations and other entities to continue to conduct business in the same manner as they did prior to the inversion, but with the result that the inverted entity avoids U.S. tax on foreign operations and may engage in earnings-stripping techniques to avoid U.S. tax on domestic operations."); OFFICE OF TAX POLICY, DEP'T OF THE TREASURY, CORPORATE INVERSION TRANSACTIONS: TAX POLICY IMPLICATIONS 1-2 (2002) ("An inversion is 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.… U.S.-based companies and their shareholders are making the decision to reincorporate outside the United States largely because of the tax savings available.").

[26] *See supra* note 21.

[27] As used hereinafter in this Report, unless otherwise indicated F1 shall refer to a foreign corporation and D1 shall refer to a domestic corporation.

should easily satisfy the facts-and-circumstances test. However, it becomes less clear how the Substantial Activities Test applies when the percentages above are reduced to still meaningful levels.

> **Example 2**. DE is a publicly traded domestic corporation. FC is a publicly traded Canadian corporation that is engaged in an active trade or business in Canada. FC wishes to acquire the stock of DE in exchange for FC stock. FC wishes to remain the listed entity because of Canadian business and tax considerations. Shareholders of DE receive 65% of the FC stock in exchange for all their DE stock. After the transaction, 35% of the employees and assets of the EAG are attributable to operations in Canada and 65% are attributable to operations outside Canada.

Example 2 illustrates a business-motivated acquisition. However, if not for the Substantial Activities Test, it would be caught by Section 7874 because a foreign corporation indirectly acquires the properties of a domestic corporation and after the transaction at least 60% of FC is held by former owners of DE by reason of such ownership. Without a safe harbor under the Substantial Activities Test, it is not clear whether 35% is a "substantial" portion of the employees, assets, and sales of the EAG. [28] We believe that a safe harbor confirming that the Substantial Activities Test is met in the examples above would be appropriate.

A Substantial Activities Test safe harbor may also be appropriate in light of the breadth of other elements of Section 7874. As discussed later in Part IV, Section 7874(c)(2)(B), which disregards FC stock sold in a public offering for purposes of the Ownership Test, is broad (particularly as expanded by the Notice) and as currently written may apply to legitimate business transactions, such as predominantly cash-driven acquisitions that are in substance sales of a DE by its historic owners to an FC. Since Congress intended the inversion rules to apply to tax-driven reincorporations rather than

[28] Further, absent a safe harbor, it may be unclear whether the tax consequences of a transaction that could be treated as an expatriation constitute an "uncertain tax position" for financial accounting purposes. Financial Accounting Standards Board Interpretation No. 48 ("FIN 48") provides that uncertain tax positions that reduce an enterprise's current or future tax liabilities must be reported on its financial statements in certain circumstances. In addition, FIN 48 generally requires an enterprise to account for the possibility that a position that reduces the enterprise's U.S. tax liability will be disallowed in determining the tax reserves reflected on its books. If the parties to an outbound transaction cannot obtain the necessary level of comfort regarding the application of Section 7874 to their transaction, FC may be required by its accountants to provide a reserve for all U.S. taxes that would be payable if FC were a domestic corporation, a draconian financial reporting result that could well prevent a transaction from going forward. Thus, uncertainty with respect to the application of the Substantial Activities Test has significant practical implications.

bona fide business combinations,[29] a bright-line rule under the Substantial Activities Test could mitigate some presumably unintended consequences of the breadth of the public offering rule.

Accordingly, we recommend that the Substantial Activities Test be clarified with a safe harbor. We recognize, however, that the safe harbor included in the 2006 Temporary Regulations could be viewed as excessively lenient to taxpayers. IRS officials have explained that the Service removed the safe harbor because it "let certain transactions through that were inappropriate,"[30] such as "90-10 structures," whereby corporate groups would base 90% of their operations in the United States and 10% in a single foreign jurisdiction.[31] We recommend adapting the test as discussed below rather than removing the safe harbor altogether.

B. Specific Recommendations for Safe Harbors

1. Proposal #1: Reinstate 2006 Temporary Regulations Safe Harbor for EAGs Conducting Less Than 50% of Their Business Activities in the U.S but Adopt a Higher Threshold

The legislative history suggests that the purpose of Section 7874 is to prevent a predominantly U.S.-based group from reducing its U.S. tax liabilities by moving its parent entity abroad.[32] We believe that a group that conducts less than 50% of its business activities in the United States should not be viewed as a predominantly U.S.-

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[29] *See supra* note 25; T.D. 9265, 2006-2 C.B. 1, Preamble, Background ¶ B.3 ("The IRS and Treasury Department believe that Congress was concerned about transactions where the new foreign parent entity is incorporated in a country in which the EAG does not have a *bona fide* business presence that is meaningful in the context of the group's overall business.") (citing S. REP. NO. 108-192, at 142 (2003)).

[30] Lauren Gardner, *IRS Official Says Section 7874 Safe Harbor Deleted, Did Not Work Well in All Situations*, Daily Tax Rep. (BNA) No. 209, at G-4 (Nov. 2, 2009).

[31] Alison Bennett, *IRS Considering Options After Pulling Inversions Safe Harbor, Official Says*, Daily Tax Rep. (BNA) No. 177, at G-5 (Sept. 16, 2009).

[32] In introducing the Reversing the Expatriation of Profits Offshore (REPO) Act, on which Section 7874 is closely based, Senators Baucus and Grassley each referenced the goal of preventing companies with significant U.S. activities from moving offshore. For instance, Senator Baucus stated, "The companies reincorporating in tax haven countries, and their executives, are still physically located in the United States. Their executives and employees enjoy all the privileges afforded to honest U.S. taxpayers." 148 CONG. REG. S2594 (daily ed. Apr. 11, 2002). Similarly, Senator Grassley stated, "Our bill requires the IRS to look at where a company has its heart and soul, not where it has a filing cabinet and a mail box." 148 CONG. REG. S2592 (daily ed. Apr. 11, 2002).

based group and should be afforded more flexibility to choose the tax jurisdiction of its group parent. If less than 50% of an EAG's total business activities are conducted in the United States (measured by assets and employee compensation), we propose reinstating those two elements, which were both taken into account in the 2006 Temporary Regulations safe harbor,[33] but providing that such elements would be treated as satisfied only if they constitute the greater of (i) 15% of the EAG's worldwide activities and (ii) 20% of the EAG's activities outside the United States. The appropriate threshold in each case, including the 50% test above, should be met separately with respect to each of the two elements of the safe harbor.

> **Example 3.** DE is an operating domestic corporation and has three wholly owned subsidiaries: F1, which is incorporated in France and is engaged in an active trade or business in France, G1, which is incorporated in Germany and is engaged in an active trade or business in Germany, and S1, which is incorporated in Spain and is engaged in an active trade or business in Spain. Each corporation represents the following percentage of the EAG's overall activities (with respect to each of the two elements) in its respective country: DE: 20%; each of F1 and G1: 15.5%; S1: 49%. If the shareholders of DE wished to invert the top-tier entity of the group to one of the jurisdictions where DE's subsidiaries are organized, a move to France or Germany would not qualify for a safe harbor under the Substantial Activities Test because neither France nor Germany represent more than 20% of the EAG's activities outside the United States. However, a move to Spain would qualify.

Under the facts of this example, the safe harbor may be met for more countries when the percentage of the group's U.S. activity increases somewhat. For example, each foreign jurisdiction in this example would satisfy the Substantial Activities Test if DE comprised 30% and S1 comprised 39% of the EAG's worldwide activities. However, we believe that requiring at least 15% of the EAG's worldwide activities to be conducted in the relevant foreign country when the EAG has less than 50% of its worldwide activity in the U.S. acts as a significant check on abusive expatriations.

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[33] For reasons explained in Part II.B.3 below, we do not recommend reinstating the "gross receipts" element. However, a significant minority of our Executive Committee would apply the "gross receipts" element both in respect of this proposal #1 and proposal #2 discussed below, but treat it as satisfied if all of EAG's foreign gross receipts constitute a higher percentage (e.g. 40%) of the EAG's worldwide gross receipts. In any event, gross receipts would still be relevant for the facts-and-circumstances test.

2. Proposal #2: Reinstate 2006 Temporary Regulations Safe Harbor for EAGs Conducting 50% or More of Their Business Activities in the U.S. with a 25% Threshold for Each Element

The policy concerns behind Section 7874 are more likely to be implicated when 50% or more of an EAG's business activities are conducted in the United States.[34] In that case, we believe that the Service can impose a more rigorous threshold. Ultimately, the appropriate threshold for each element of a quantitative Substantial Activities Test safe harbor turns on the meaning of "substantial," a term lacking uniform definition in the Code and Treasury Regulations.

In the context of business activities, rules referring to and defining substantiality include (i) the transitional rules relating to publicly traded partnerships, which state that a partnership will not qualify as an existing partnership if a new line of business is "substantial" (15%),[35] and (ii) the definition of a qualified resident in the branch profits tax regulations, which requires that the foreign corporation have a "substantial" presence in its country of residence as judged by the three elements of the "active trade or business" test in the U.S. tax treaties discussed in note 22 above (payroll expense, asset value, and gross income), with a 20% minimum for each element and a 25% minimum for their average.[36] In other contexts, the Tax Court has found 25% to be "substantial" for purposes of Section 1253(b)(2)(F).[37] The court surveyed numerous definitions of "substantial" in the tax law, ranging from 2% to 33%, and found 25% to be substantial under the "plain meaning" of the term.[38]

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[34] *See supra* note 32.

[35] Treas. Reg. § 1.7704-2(c).

[36] Treas. Reg. § 1.884-5(e)(3).

[37] Nabisco Brands, Inc. v. Comm'r, T.C.M. (RIA) ¶ 95127 (1995). Section 1253(b)(2)(F) provides that a transfer of a franchise, trademark, or trade name shall not be treated as a sale or exchange of a capital asset if, among other things, the transferor retains a right to contingent payments that constitute a "substantial" element under the transfer agreement.

[38] *Id.* at 95-837. The court quoted the taxpayer's argument that 25% is "toward the high end of the accepted range" before holding for the taxpayer. *Id.*

The term "substantial" appears at several other points in the Code and Treasury Regulations. The "substantial" part requirement of the pre-1984 collapsible corporation rules under Section 341 is satisfied when a corporation realizes one-third of its taxable income from property it produced or purchased. Rev. Rul. 72-48, 1972-1 C.B. 102. The continuity of interest requirement for a tax-free reorganization, which requires a "substantial" part of the value of proprietary interests in the target to be preserved, is met by 40% continuity. Treas.

After considering interpretations of "substantial" under other provisions of the Code and Regulations, as well as the policies behind Section 7874, we believe a threshold of 25% for each element to be appropriate for a Substantial Activities Test safe harbor. We recognize that a 25% threshold would be challenging to meet for a widely dispersed multinational group. However, if 50% or more of the EAG's total business activities (measured by either assets or employee compensation) are conducted in the United States, a more rigorous safe harbor should be appropriate.

3. Potential Alternative Approaches

We have considered whether the same three elements used in the safe harbor included in the 2006 Temporary Regulations (employees, assets, and sales) should be used in the safe harbors we have proposed and have concluded that two of those elements are appropriate. The elements focusing on the assets and the employees of the EAG are fundamentally different from the sales element. Specifically, the assets and the employees of an EAG have physical presence in the jurisdiction where they are located. By contrast, a sale is a transaction. It does not necessarily reflect where an asset was produced or where such asset will be used. For instance, a manufacturing company may have its plants and substantially all of its employees in Canada but export a majority of its goods to the United States under a consignment arrangement with the parent in the United States. We think it is clear that this company should be treated as a bona fide Canadian entity regardless of where its holding company is located and if the company's shareholders choose to move the holding company to Canada such a move should be covered by the safe harbor. Moreover, given the global nature of markets, expecting a certain percentage of a group's sales to be in a particular country does not seem appropriate. Further, because parties may choose where to effectuate a sale of personal property without regard to where the asset is produced or used,[39] the sales element is more susceptible to taxpayer manipulation than either the asset element or the employee element of the safe harbor. Therefore, we recommend that the safe harbor be based on assets and employees of the EAG and not include the sales element that was included in the 2006 Temporary Regulations (though in appropriate cases sales may be a relevant element in the facts-and-circumstances inquiry with respect to transactions ineligible for the safe harbor).

Reg. § 1.368-1T(e)(2)(v) Ex. 1. A "substantial" understatement of income tax on a taxpayer's return is the greater of 10% of the tax required to be shown on the return and specified dollar amounts. Section 6662(d).

[39] For instance, closings of aircraft purchases frequently take place while the aircraft is located in a jurisdiction with a favorable tax regime (or is located over international waters), regardless of where the aircraft manufacturer conducts its activities.

Some of our members have suggested that the two-element tests (for purposes of any safe harbor, as well as computing the 50% threshold of U.S. activities) should be done on an averaging basis, rather than conjunctively. For example, if the taxpayer is subject to a safe harbor of 15%, and FC is incorporated in Ireland, it would not qualify for our proposed safe harbor if the EAG has 14% of its employees and 28% of its assets in Ireland. However, if the safe harbor only required an average percentage of 15% for both elements (rather than a minimum of 15% for each element), the safe harbor would be met in this case because the average percentage is 21%.

One concern with a pure averaging approach would be that it treats each element as having equal weight regardless of whether the company is labor-intensive or capital-intensive. This would be an arbitrary approach that creates some possibility for manipulation, for example, by groups that are highly labor-intensive and thus could achieve a large swing in their "assets" percentage by moving relatively few assets to the desired jurisdiction. Similarly, a highly capital-intensive business may be able to easily distort its "employees" percentage in a particular jurisdiction by hiring (or firing) a few employees there. Finally, a group that simply satisfies a sufficiently high percentage under one of the safe harbor elements could get away with a zero or minimal percentage on the other element, which seems problematic as a policy matter. A potential middle ground would be a hybrid test that permits averaging but still requires a "floor" (say, 10%) for each element in the case of a safe harbor, or a "ceiling" (say, 65%) in the case of the test inquiring whether less than 50% of the group's activities are in the U.S., as a backstop against extreme disparities. Such a hybrid approach would be consistent with similar tests under U.S. treaties.[40]

Some of our members have also suggested an additional safe harbor designed for EAGs with significant operations in a number of jurisdictions, none of which meets a 15% threshold. Such a safe harbor could allow for a lower specified threshold in respect of each of the EAG's employees and assets when no jurisdiction meets the 15% threshold for each element. In the alternative, the safe harbor could provide that when there is no jurisdiction where each of the EAG's employees and assets meet the 15% threshold, the Substantial Activities Test would be met in any jurisdiction in which each of the EAG's employees and assets equal at least 75% of the highest amount with respect to each element in any country. For example, if a multinational group has 12% of its employees in France (and France is the jurisdiction with the highest concentration of this group's employees) and 12% of its assets in Germany (and Germany is the jurisdiction with the highest concentration of this group's assets), any jurisdiction with at least 9% of the group's employees and assets would satisfy the Substantial Activities Test.

We have also considered approaches based on non-mechanical factors such as "management and control." A number of jurisdictions, including the United Kingdom,

[40] *See supra* note 22.

sometimes determine corporate residency for tax purposes based on where a corporation is managed and controlled.[41] Recent bills in Congress have similarly proposed that if the "management and control" of a foreign corporation occurs directly or indirectly primarily within the United States, then the corporation shall be treated as a domestic corporation.[42] The proposed legislation directs the Treasury to issue regulations to determine the locus of management and control but provides only general criteria such regulations must take into account.[43]

While the merits of such proposals are beyond the scope of this Report, we do not think "management and control" is an appropriate standard for a Substantial Activities Test safe harbor. Mechanical rules for "management and control," such as the location of board meetings, could easily be manipulated to produce inappropriate results. Indeed, the legislative commentary that accompanied the release of the proposed "Reversing the Expatriation of Profits Offshore Act" of 2002, on which Section 7874 is closely based, suggested that a company should not be "considered to be conducting substantial business activity in the country of reincorporation by merely conducting board meetings in the foreign country or by relocating a limited number of executives to the foreign jurisdiction."[44] On the other hand, adoption of a facts-and-circumstances analysis rather than mechanical rules to determine "management and control" would defeat the very purpose of a safe harbor. A safe harbor based on a non-mechanical factor such as "management and control" is likely to be vague and/or open to manipulation by

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41 Corporation Tax Act, 2009, c. 4, §§ 14, 18 (Eng.).

42 Stop Tax Haven Abuse Act, S. 506, 111th Cong. § 103 (2009) (creating new Section 7701(o)); Stop Tax Haven Abuse Act, H.R. 1265, 111th Cong. § 103 (2009) (same). These proposals are aimed at companies that achieve the same tax benefits sought by inverting U.S. corporations by initially incorporating in a low-tax jurisdiction.

43 The proposed legislation would treat "the management and control of a corporation … as occurring primarily within the United States if substantially all of the executive officers and senior management of the corporation who exercise day-to-day responsibility for making decisions involving strategic, financial, and operational policies of the corporation are located primarily within the United States." *Id.* The term "executive officers and senior management" would include other individuals who exercise the same day-to day responsibilities, even if affiliated with "other corporations in the same chain of corporations as the corporation." *Id.*

44 Press Briefing Memo, Sens. Charles Grassley (R-Iowa) and Max Baucus (D-Mont.), Reversing the Expatriation of Profits Offshore (REPO) Act (Apr. 11, 2002), *reprinted in* Daily Tax Rep. (BNA) No. 71, at L-11 (Apr. 12, 2002).

taxpayers, and may also be inconsistent with the legislative history behind Section 7874.[45]

Finally, we understand that the Treasury is not inclined to include a safe harbor that would exempt inversions to "high-tax" jurisdictions from the application of Section 7874.[46] We agree that the mere fact that a jurisdiction imposes income taxes at rates similar to U.S. rates does not mean FC will pay taxes at such rates and does not necessarily imply the absence of a tax-avoidance motive for expatriation. The jurisdiction may have a territorial regime and accordingly such rates may apply only to local income. FC may be able to erode its tax base in its home jurisdiction through earnings stripping, tax credits and deductions, or special tax regimes applicable to particular industries.[47] The legislative history notwithstanding, Congress did not explicitly limit Section 7874 to inversions to tax-haven jurisdictions, and we agree with the Treasury that a safe harbor based on the tax regime of a foreign jurisdiction would not be appropriate.

III. Treatment of Options and Similar Interests

A. Background

Section 7874(c)(6)(A) directs the Treasury to "prescribe such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations to treat warrants, options, contracts to acquire stock, convertible debt interests, and other similar interests as stock." In the 2006 NYSBA Report, we suggested that "absent an anti-avoidance purpose, stock rights should not be treated as stock for purposes of Section 7874," and that safe harbors modeled on safe harbors in other areas of the tax law would be appropriate in determining whether stock rights were

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[45] *Id. See also* H.R. 2937, 110th Cong. (2007) (proposing new Section 7874(a)(4) pursuant to which "management or administrative activities (including the location of any corporate headquarters) in the foreign country in which, or under the law of which, the entity is created or organized shall not be taken into account as business activities"). No further action was taken on H.R. 2397 after it was proposed.

[46] Alison Bennett, *Government Looking at New Safe Harbor for Section 7874 Inversions, Officials Say*, Daily Tax Rep. (BNA) No. 191, at G-1 (Oct. 6, 2009).

[47] See, for example, the tax-favored treatment Ireland affords to securitization vehicles. Taxes Consolidation Act, 1997 § 110 (Act. No. 39/1997) (Ir.) *available at* http://www.revenue.ie/en/practitioner/law/taxes-consolidation-act-1997.html (last visited February 19, 2010).

issued with an avoidance purpose.[48] However, our suggestion was not adopted by the Service.

The 2006 Temporary Regulations treated options and similar interests held by reason of holding stock or a partnership interest in a DE as exercised to the extent the effect of such exercise would be to treat FC as a surrogate foreign corporation.[49] An "interest that is similar to an option" included a warrant, a convertible debt instrument, a non-debt instrument convertible into stock, a put, a stock interest subject to risk of forfeiture, and a contract to acquire or sell stock.[50] The one example in the 2006 Temporary Regulations provided that FC convertible bonds issued to former DE shareholders would be treated as converted into FC stock for purposes of the Ownership Test.

The 2009 Temporary Regulations substantially revised the approach to options. The Preamble to the 2009 Temporary Regulations stated that "treating options … as exercised may, in certain cases, lead to inappropriate results. For example, treating options as exercised may distort the ownership of the foreign corporation for purposes of [the Ownership Test]."[51] Consequently, the 2009 Temporary Regulations specify that options and similar interests will be considered claims on equity with a value equal to their spread value, i.e., the value of the stock or partnership interest that may be acquired pursuant to the instrument less the exercise price under the instrument. In other words, options are only considered stock to the extent they are "in the money." Furthermore, in computing the denominator of the option holder's ownership fraction, the equity value of the entity does not include the exercise price under the option. The definition of an "interest similar to an option" includes every instrument specified in the 2006 Temporary Regulations as well as a non-debt instrument convertible into a partnership interest, a partnership interest subject to risk of forfeiture, a contract to acquire or sell a partnership interest, and an exchangeable share or partnership interest. Finally, the general rule for treating in-the-money options and similar interests as equity does not apply to the extent that doing so would create duplicate claims on equity (the "Anti-Duplication Rule"). For instance, a call option to purchase shares held by an existing shareholder would not be

[48] *2006 NYSBA Report*, *supra* note 2, at 12.

[49] Temp. Treas. Reg. § 1.7874-2T(f)(1) (2006).

[50] Temp. Treas. Reg. § 1.7874-2T(f)(2) (2006).

[51] T.D. 9453, 2009-28 I.R.B. 114, Preamble, ¶ H.

treated as stock.[52] The foregoing rules apply to options and similar interests with respect to both DEs and FCs.[53]

The spread value of an option is tested immediately before (in the case of DE) or after (in the case of FC) FC's acquisition of DE. An anti-abuse rule applies to FC (but not DE), pursuant to which an option or similar interest is not treated as stock of FC if a principal purpose of the issuance or acquisition of the instrument is to avoid the treatment of FC as a surrogate foreign corporation.[54]

The Service requested comments regarding the treatment of options and similar interests in the 2009 Temporary Regulations.[55] In particular, comments were requested as to whether certain options, such as publicly traded options or compensatory options, should be excluded from the general rule and whether the amount of stock treated as being held by reason of holding options should be determined based on the option's spread value, as opposed to on an as-exercised basis, and the effect of the latter approach on the Ownership Test.

In light of the foregoing, this Part III of the Report focuses on three issues. First, is the treatment of options as stock (with possible carve-outs for certain categories of options) appropriate? Second, assuming options and similar interests are treated as stock, should the value of such stock be determined by the spread value of the instrument or by treating the instrument as exercised? Third, is an anti-abuse rule appropriate only for FC options?

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[52] *See* Temp. Treas. Reg. § 1.7874-2T(j)(4), -2T(n)(2) Ex. (15) (2009). Although the Anti-Duplication Rule seems focused on ignoring an option holder's notional equity interest, we believe the same principle should apply to reduce an existing shareholder's ownership percentage for purposes of Ownership Test analysis to the extent an option holder is treated as having a corresponding percentage. For example, if FC has a sole shareholder who owns stock worth $80 and an option holder who owns in-the-money options worth $20, the shareholder's ownership percentage should be treated as 80%, not 100%, if the option holder is treated as owning 20%, in order to avoid duplicate claims on FC's equity. We recommend that the Anti-Duplication Rule be clarified in this regard.

[53] Temp. Treas. Reg. § 1.7874-2T(j) (2009).

[54] Temp. Treas. Reg. § 1.7874-2T(j)(2)(ii) (2009).

[55] T.D. 9453, 2009-28 I.R.B. 114, Preamble, ¶ H.4.

B. Treatment of Options as Stock

1. Potential Approaches to Treatment of Options

The 2009 Temporary Regulations treat all in-the-money options as stock with a value equal to the holder's claim on the equity of the issuer. We believe that when considering the effect of options on provisions of Section 7874 that require calculations of equity ownership, there are three basic alternatives: (1) ignore all options in determining equity ownership of an entity, subject to an anti-abuse rule that treats certain options as stock[56]; (2) treat all options as stock for such purposes, subject to an anti-abuse rule that does not treat certain options as stock; or (3) generally treat options as stock, subject to an anti-abuse rule, but carve out certain categories of options (an "angel list") that may be presumed to be non-abusive or not conveying a determinate equity interest, such as publicly traded options or certain compensatory options. Of course, an angel list can also accompany the first regime, excluding certain categories of options from the scope of the anti-abuse rule. For the reasons set forth below, we recommend that options and similar instruments not be treated as stock, subject to an anti-abuse rule that would treat an option as stock if the option is reasonably certain to be exercised.[57] In the alternative, we recommend that options generally be treated as stock, subject to an anti-abuse rule (with certain categories of options that are presumed non-abusive specified on an angel list).

The Code and Regulations do not take a uniform view of the effect of options on equity ownership determinations. There are two basic approaches. The first approach generally does not treat options as stock unless it is likely the option will be exercised, there is a tax avoidance purpose, or certain anti-abuse tests are met.[58] In conjunction with

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[56] However, options should be treated as stock if they would be so treated under general principles of law. *See, e.g.*, Treas. Reg. §§ 1.1504-4(a)(1) ("The fact that an instrument may be treated as an option under these regulations does not prevent such instrument from being treated as stock under general principles of law."); 1.355-6(c)(3)(i) (equivalent); 1.382-4(d)(9)(iv) (equivalent); 1.1361-1(*l*)(4)(ii)(A)(1) (equivalent).

[57] *See infra* notes 94-95 and accompanying text for a discussion of approaches to anti-abuse rules.

[58] *See, e.g.*, Treas. Reg. §§ 1.354-1(e) ("a right to acquire stock has no principal amount"); 1.355-1(c) (same); 1.355-6(c)(3) (option not treated as exercised unless its exercise would trigger the application of Section 355(d) and immediately after the distribution it is reasonably certain that the option will be exercised); 1.355-7(e)(1)(i) (ignoring option unless exercised, and then treating option as an agreement, understanding, or arrangement to acquire stock only if it was "more likely than not to be exercised" as of the relevant date, subject to a "principal purpose" anti-abuse rule); 1.356-3(b) (equivalent to 1.354-1(e)); 1.367(a)-3(c)(4)(ii) ("one or more options (or an interest similar to an option) will be treated as exercised and thus will be counted as stock … if a principal purpose of the issuance or the

this approach, regulations usually include safe harbors, pursuant to which options are not treated as stock, for options that are considered non-abusive or otherwise issued for a valid business purpose.[59] The second approach, which treats options as stock, is typically taken by various constructive ownership rules.[60]

2. Potential Rationales for Treatment of Options

In evaluating the alternatives for the treatment of options, we believe at least three policy goals should be kept in mind: (i) preventing avoidance of Section 7874 by taxpayers using options to avoid meeting the Ownership Test; (ii) properly reflecting an option holder's economic interest in an entity; and (iii) providing a simple rule that is easy for the Service to administer and for taxpayers to comply with.

To achieve the first goal, preventing abuse, it would seem appropriate to craft a rule that treats an option as stock for purposes of the Ownership Test only if the option implicates a risk of tax avoidance. Consequently, there is a case for not treating options

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acquisition of the option (or other interest) was the avoidance of the general rule contained in section 367(a)(1)"); 1.382-4(d) (option not treated as exercised unless one of three anti-abuse tests is met); 1.1361-1(*l*)(4)(ii), (iii) (any instrument, obligation, or arrangement issued by a corporation treated as a second class of stock if it constitutes equity or otherwise results in the holder being treated as the owner of stock under general tax principles, a principal purpose is to circumvent the one-class-of-stock rule for S corporations, and it is not described in a safe harbor); 1.1504-4(b)(2)(i) (option treated as exercised only if treatment as non-stock "would result in the elimination of a substantial amount of federal income tax liability … and [i]t is reasonably certain that the option will be exercised").

59 *See, e.g.*, Treas. Reg. §§ 1.355-6(c)(3)(vi); 1.355-7(e)(4); 1.382-4(d)(7); 1.1361-1(*l*)(4)(iii)(B), (C); 1.1504-4(d)(2). Regulations under Section 367 (which treat options as stock only if a "principal purpose" test is met) are the only ones examined here under the first approach that do not provide a safe harbor.

60 *See, e.g.*, Section 318(a)(4) (person holding option to acquire stock treated as owning stock); Treas. Reg. § 1.318-3(c) (applying option attribution even if such attribution would duplicate claims on equity, in contrast to the Anti-Duplication Rule); Treas. Reg. § 1.280G-1, Q&A (17)(b) (same as Section 318(a) except carve-out for unvested options and options exercisable for stock that is not substantially vested within the meaning of Treas. Reg. § 1.83-3(b), -3(j)); Treas. Reg. § 1.414(c)-4(b)(1) (same as Section 318(a)(4)); Section 544(a)(3) (same as Section 318(a)(4)); Treas. Reg. § 1.958-2(e) (same as Section 318(a)(4)); Section 1563(e)(1) (same as Section 318(a)(4)); *but see* Section 267(c) (not attributing stock ownership to option holders). The only instance (besides the Section 7874 regulations) to our knowledge of options being treated as stock outside an attribution rule context is for purposes of determining whether a person has disposed of PFIC stock. Prop. Treas. Reg. § 1.1291-1(d), 57 Fed. Reg. 11024, 11035 (Apr. 1, 1992) (option to acquire PFIC stock treated as stock, unless PFIC is pedigreed QEF, for purposes of Section 1291(a)(2)).

as stock unless such an anti-abuse rule applies, or at least for creating an angel list of options presumed to be non-abusive.

We believe a second, potentially competing, policy goal should be to ensure a clear reflection of an option holder's economic interest in an entity. This "economic interest" rationale seems appropriate in light of the very nature of the Ownership Test, which considers what, if any, change has taken place in the ownership of DE. One can infer from the Service's stated reason for shifting from the deemed exercise to the spread value approach from the 2006 to the 2009 Temporary Regulations ("treating options (or similar interests) as exercised may distort the ownership of [FC] for purposes of [the Ownership Test]"[61]) that the Service's current approach is primarily based on an "economic interest" theory, because counting in-the-money options is generally the better method for gauging an option holder's economic interest.

If accurately reflecting economic interest should be the primary policy goal governing the treatment of options, then arguably one should count all options as stock to the extent they are in the money (or otherwise have some economic value), which militates against creation of any "angel list."[62] However, as discussed below, it is debatable to what extent an option represents an "economic interest" in an entity if it is nontransferable and subject to a substantial risk of forfeiture.[63] More generally, in order for an "economic interest" to be counted as stock, should its holder have the unilateral ability to exercise the interest, and possibly to sell for cash the stock obtained, subject only to a few, if any, reasonable conditions?[64] If so, then there may be circumstances in which an "angel list" (or simply a more precise definition of what constitutes an "option

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[61] T.D. 9453, 2009-28 I.R.B. 114, Preamble, ¶ H.

[62] This rule is fair if it applies generally and cuts both ways, including with respect to not counting "underwater" options. For example, while excluding historic FC options that are out of the money from the Ownership Test analysis may hurt the taxpayer (because DE owners would be considered to own a larger share of FC), excluding such options issued to historic owners of DE on the same basis could produce a taxpayer-friendly result.

[63] *See infra* notes 89-93 and accompanying text.

[64] *See infra* note 79. Notably, Section 318(a)(4), which deems all option holders to own the underlying stock, applies only if the option holder "has a unilateral right to acquire stock"; "situations where there is a bilateral contract" do not fall within the scope of Section 318(a)(4). Rev. Rul. 89-64, 1989-1 C.B. 91. *See also* Rev. Rul. 68-601, 1968-2 C.B. 124; F.S.A. 199915007 (Dec. 21, 1998) ("Contingencies that remove the election from the optionee's unilateral control generally prevent attribution."; if "there are serious conditions precedent which could result in a substantial risk of forfeiture of Purchaser's right to exercise the option, … he cannot be said to have the right to obtain the underlying stock *at his election*").

or similar interest" for purposes of Section 7874) is consistent with the economic interest rationale.

Furthermore, an option that is at the money or even slightly out of the money may still be worth more than $0 because of the time-value component of an option.[65] Such an option arguably should also be considered to convey an economic interest in the entity because the likelihood the option will have a spread value accompanies the mere passage of time, especially if the underlying equity is volatile or the option has a distant expiration date. However, the only methodology capable of addressing this issue would be a requirement to treat an option as stock to the extent of the option's fair market value, rather than spread value. As described below in Part III.C.2, spread- and time-value calculations for certain instruments treated as options can be complex, which brings us to the third policy goal we believe should inform the treatment of options: simplicity.

For reasons of administrative convenience and reducing taxpayer compliance burdens, an approach at either extreme may be most appropriate—treat no options as stock, or treat all options as stock, subject in both cases to an anti-abuse rule that should be designed to minimize departures from the simple general rule. The approach taken in the 2009 Temporary Regulations (i.e., treating all in-the-money options as stock) appears to take administrability into account but does not make it an overarching priority. On the one hand, the automatic treatment of in-the-money options as stock obviates the difficult judgments necessary to preserve the integrity of an "angel list" against abuse, such as whether an option on DE stock is described on the angel list, was issued with an avoidance purpose, or is reasonably certain to be exercised.[66] On the other hand, the requirement that options have spread value to be counted as stock requires potentially

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[65] A similar point arises under Section 4985, the companion provision to Section 7874 that imposes a surtax on (among other things) the stock option compensation of top management of expatriated corporations, and its legislative history. Section 4985(b)(1)(A) requires such options to be valued at "fair value," which the legislative history states can differ from spread value. "For purposes of the tax, the fair value of an option (or a warrant or other similar right to acquire stock) or a stock appreciation right is determined using an appropriate option-pricing model … that takes into account (1) the stock price at the valuation date; (2) the exercise price under the option; (3) the remaining term of the option; (4) the volatility of the underlying stock and the expected dividends on it; and (5) the risk-free interest rate over the remaining term of the option. *Options that have no intrinsic value (or "spread") because the exercise price under the option equals or exceeds the fair market value of the stock at valuation nevertheless have a fair value and are subject to tax under the provision.*" H.R. REP. NO. 108-755, at 578 (2004) (Conf. Rep.), *reprinted in* 2004 U.S.C.C.A.N. 1341, 1645 (emphasis added).

[66] Even if the current approach is retained, circumstances requiring inquiry into the purposes of the issuance or acquisition of an option would still expand if the anti-abuse rule that currently covers only FC options is extended to DE options, as we recommend in Part III.D.

complex calculations of equity value and (for some types of instruments) implicit exercise price.[67] On balance, a rule that generally excludes options from the Ownership Test analysis would seem to advance the goal of simplicity, and the backstop of an anti-abuse rule should be sufficient to deter manipulative use of options by taxpayers seeking to avoid Section 7874.

3. Recommendations

Ignoring options in the Ownership Test analysis would be consistent with the treatment of options in similar contexts in other provisions of the Code and Treasury Regulations, many of which appear to have been influenced by the same goals outlined above. We would particularly point to Section 382. Apart from drafting similarities, Sections 382 and 7874 are similar in that both are anti-abuse measures: Section 382 aims to prevent tax-motivated trafficking in corporate attributes;[68] Section 7874 aims to prevent tax-motivated changes in corporate jurisdiction.[69]

In Section 382, Congress provided that options would be deemed exercised only if such exercise would result in an "ownership change" (one of the requirements for the application of Section 382), and that regulations could narrow the rule further.[70] Treasury and the Service have accordingly issued regulations pertaining to Section 382(k)(6)(B), whose language is nearly identical to that of Section 7874(c)(6). Such regulations do not treat options as exercised unless one of three anti-abuse tests is met, and treat certain options as ordinarily not meeting such tests.[71] The history of these regulations is instructive.

The first set of regulations under Section 382 followed the statutory suggestion and considered an option exercised if an ownership change would result. However, Treasury and the Service reconsidered this approach "in response to numerous comments regarding the practical difficulties of applying the option rules in the [first set of]

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[67] *See infra* note 100 and accompanying text.

[68] S. REP. NO. 94-938, at 201 (1976), *reprinted in* 1976 U.S.C.C.A.N. 2897, 3632 ("the limitations contained in sections 382 and 269 represent an attempt to distinguish between normal changes in the ownership of a going business, where tax attributes such as a net operating loss carryover are incidental, and an acquisition chiefly for the sake of loss carryovers themselves").

[69] *See supra* note 25 and accompanying text.

[70] Section 382(*l*)(3)(A)(iv).

[71] Treas. Reg. § 1.382-4(d).

regulations."[72] They then issued a second set of regulations that "were intended to reduce these practical difficulties by narrowing the scope of the option rules and simplifying their application."[73] The third and final set of Section 382 option regulations clarified and expanded the anti-abuse tests present in the second set, and added safe harbors (in response to commentators' requests) to exempt several categories of options from the application of the anti-abuse tests—nearly the opposite of the initial approach. The Preamble stated that over the course of drafting the Section 382 regulations its approach toward options changed to such a degree that "many of the options that were treated as exercised under the [first set of] regulations (and thus resulted in ownership changes) would not be treated as exercised under the rules of the [second set of] regulations."[74]

Consistent with our recommendations in the 2006 NYSBA Report, we believe that the experience with Section 382 demonstrates that the goals of preventing abuse and ensuring simplicity can be achieved with a rule that does not treat options as stock except in limited circumstances (e.g., if the option is stock under common law principles, was issued with a principal purpose of avoiding section 7874, or is reasonably certain to be exercised). However, we recognize that this approach comes at the expense of fully reflecting economic interest. If an approach generally excluding options is not adopted, we believe an "angel list" of options is appropriate, though such a list should be relatively narrow if the main goal is to accurately count, for purposes of the Ownership Test, all options that represent an economic interest in DE or FC.

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[72] T.D. 8531, 1994-1 C.B. 121, Background.

[73] *Id.*

[74] *Id.* at ¶ F. Treasury Regulations under Section 355(e) underwent a similar evolution. Regulations proposed in 1999 treated an exercised option as an agreement indicating the existence of a plan under Section 355(e)(2)(A)(ii) "unless the distributing corporation establishes by clear and convincing evidence that, on the [relevant date], the option was not more likely than not to be exercised." 64 Fed. Reg. 46155, 46159-60 (Aug. 24, 1999). The second round of proposed regulations eliminated the "clear and convincing evidence" requirement. 66 Fed. Reg. 66, 69 (Jan. 2, 2001). These were adopted as temporary regulations later in 2001, 66 Fed. Reg. 40590 (Aug. 3, 2001), but revised temporary regulations issued in 2002 adopted the opposite default rule, apparently in response to comments. An exercised option would now be treated as an agreement only if it was "more likely than not to be exercised" on the relevant date, subject to an anti-abuse rule incorporating a "principal purpose" avoidance test. T.D. 8988, 2002-1 C.B. 929. Final regulations issued in 2005 confirmed this approach. Treas. Reg. § 1.355-7(e) (as finalized by T.D. 9198, 2005-1 C.B. 972).

4. Angel List

There are ample regulatory examples of angel lists, pursuant to which certain categories of options will ordinarily not be treated as stock. We believe the Service may consider the following categories for inclusion on an angel list under Section 7874:

(i) publicly traded options[75];

(ii) compensatory options with customary terms and conditions that (a) are provided to an employee, director, or independent contractor in connection with the performance of services for the issuing entity or a related person, (b) are not excessive by reference to the services performed, (c) are not transferable (within the meaning of Treas. Reg. § 1.83-3(d)), and (d) lack a readily ascertainable fair market value (as defined in Treas. Reg. § 1.83-7(b)) at the time the options are issued[76];

(iii) typical commercial agreements for holding stock in escrow (or under a pledge or other security agreement) that are subject to customary commercial conditions[77];

(iv) options exercisable only upon death, disability, mental incompetence, or separation from service[78];

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[75] *See* Treas. Reg. § 1.1504-4(d)(2)(ii) (unless issued, transferred, or listed with a principal purpose of avoiding the application of Section 1504, such as if the option's exercise price or term is materially different from what is customary, or if a large percentage of the issuance is placed with one investor or a group of investors and a very small percentage is traded).

[76] *See* Treas. Reg. §§ 1.382-4(d)(7)(iii); 1.355-6(c)(3)(vi)(B)(1) (exception ceases to apply if option becomes transferable); 1.1361-1(*l*)(4)(iii)(B)(2) (options issued to directors not covered; exception ceases to apply if option becomes transferable); 1.1504-4(d)(2)(v) (options includes stock appreciation rights, phantom stock, "or other similar instruments"; exception does not apply to options issued or transferred with a principal purpose of avoiding the application of Section 1504; exception ceases to apply if option becomes transferable); *see also* Treas. Reg. § 1.355-7(d)(8) (providing safe harbor from Section 355(e) for non-excessive stock acquisitions pursuant to Sections 83 or 421(a) or (b) in connection with the performance of services as an employee, director, or independent contractor for any enumerated entity; rule does not apply to controlling or 10% shareholder of acquired corporation).

[77] *See* Treas. Reg. §§ 1.355-6(c)(3)(vi)(A); 1.355-7(e)(4)(i); 1.382-4(d)(7)(ii); 1.1504-4(d)(2)(iv).

[78] *See* Treas. Reg. §§ 1.355-6(c)(3)(vi)(D); 1.355-7(e)(4)(ii); 1.382-4(d)(7)(iv).

(v) bona fide rights of first refusal with customary terms, entered into between owners of the entity (or between the entity and one of its owners), regarding its ownership interests[79];

(vi) contracts or similar arrangements to acquire stock (a) that have commercially reasonable terms, (b) in which the parties' obligations are subject only to reasonable closing conditions, (c) that close within one year, and (d) that are not entered into with FC or a member of its EAG[80];

(vii) options granted in connection with commercially reasonable loans from active, regular lenders that are not subsequently transferred without a corresponding portion of the loan[81];

(viii) options created pursuant to a title 11 or similar case (within the meaning of Section 368(a)(3)(A))[82];

(ix) call (or put) options expiring within 24 months with an exercise price at least 90% (or no more than 110%) of the underlying stock on the relevant date[83]; and

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[79] *See* Treas. Reg. §§ 1.355-6(c)(3)(vi)(E); 1.355-7(e)(4)(iii); 1.382-4(d)(7)(v). Mid-America Indus. v. United States, 341 F. Supp. 597 (W.D. Ark. 1972), *rev'd on other grounds*, 477 F.2d 1029 (8th Cir. 1973), held that a right of first refusal did not constitute an option where none of the contingencies necessary to permit the acquisition of stock had occurred and the option holder had no control over their occurrence. "[T]o constitute an option to purchase stock, the rights in question must enable the holder to purchase the stock 'presently at his election'" (citation omitted). *Id*. at 609.

[80] *See* Treas. Reg. §§ 1.382-4(d)(7)(i); 1.1504-4(d)(2)(iii) (no requirement to close within one year). We note that such contracts, to the extent they represent an interest similar to an option and permit the acquisition of shares owned by an existing shareholder, may already be carved out by the Anti-Duplication Rule.

[81] *See* Treas. Reg. §§ 1.1361-1(*l*)(4)(iii)(B)(1); 1.1504-4(d)(2)(vi); *see also* Treas. Reg. § 1.355-7(e)(4)(i) ("An option that is part of a security arrangement in a typical lending transaction … includes … an option to acquire stock contingent upon a default under a loan."; such instrument not treated as an option unless principal purpose of avoidance).

[82] *See* Treas. Reg. § 1.1504-4(d)(2)(vii).

[83] *See* Treas. Reg. §§ 1.1361-1(*l*)(4)(iii)(C) (applies only to call options; no 24-month requirement; option meeting requirements not treated as second class of stock); 1.1504-4(g)(3) (option meeting requirements not considered reasonably certain to be exercised; subject to special anti-abuse rule).

(x) any other instruments specified by the Service in regulations, a revenue ruling, or a revenue procedure.[84]

As a general matter, we note that the Preamble to a proposed version of regulations under Section 355(d) (also an anti-abuse measure[85]) highlighted option types (ii) through (iv), stating, "The proposed regulations generally except certain instruments not ordinarily having an abuse potential from treatment as options, such as escrow, pledge, or other security agreements, compensatory options, and options exercisable only upon death, disability, mental incompetency, or retirement."[86] It is also notable that the Preamble to the Section 1504 regulations states that certain "[o]ptions … do not have an abuse potential, such as publicly traded options, employee stock options, and options granted in connection with a bona fide loan agreement,"[87] and therefore are generally not treated as options, subject to an anti-abuse rule.[88] Such Preamble further states that "[s]afe harbors … for other options, which based on their terms, do not evidence an abuse potential," including in this category the call/put options described in (ix) above.

Treasury and the Service have in particular requested comments on whether publicly traded options or compensatory options should be excluded from the general rule that treats in-the-money options as stock. With regard to publicly traded options, we agree with the statement quoted above that they do not present an abuse potential absent a principal purpose of avoidance. The parties to an inversion transaction typically will not have control over the exercise or pricing of publicly traded options. However, to the extent the main objective is to count for purposes of the Ownership Test all options that represent an economic interest in DE or FC, there appears to be little reason to treat publicly traded options differently from other options. Further, such options, especially

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84 *See* Treas. Reg. §§ 1.355-6(c)(3)(vi)(F); 1.355-7(e)(4)(iv); 1.382-4(d)(7)(vi); 1.1361-1(*l*)(4)(iii)(B)(3); 1.1504-4(d)(2)(ix).

85 H.R. REP. NO. 101-881, at 341 (1990).

86 Prop. Treas. Reg. § 1.355-6(c)(3), 64 Fed. Reg. 23556 (May 3, 1999). Both proposed and final regulations under Section 355(d) included these three categories, as well as rights of first refusal ((v) on the angel list above), in the class of instruments generally not treated as options absent a principal avoidance purpose. *Id.* at 23562-63; Treas. Reg. § 1.355-6(c)(3)(vi).

87 T.D. 8462, 1993-1 C.B. 192, Overview.

88 Other instruments not treated as options under Section 1504 are options on plain-vanilla preferred stock; stock purchase agreements ((vi) above); escrow, pledge, and other security agreements ((iii) above); options created pursuant to a title 11 or similar case ((viii) above); and convertible preferred stock. Treas. Reg. § 1.1504-4(d)(2).

when traded in large numbers on liquid markets, will likely be easy to value. Thus, treating them as stock would not offend the goal of simplicity.

With regard to compensatory options, we believe they should ordinarily not be treated as stock because, if the rather stringent requirements outlined in clause (ii) above are met, their treatment as nonstock would achieve all three goals we believe should influence the treatment of options. First, we believe the conditions a compensatory option must meet to avoid being treated as stock are sufficiently rigorous as to minimize the risk of abuse. Options meeting these conditions are typically used to attract and retain skilled employees rather than to avoid the application of Section 7874. If more stringent requirements are desired, the Service could specify that instead of (or in addition to) the vague "excessive" standard of clause (ii)(b) above, compensatory options eligible for inclusion on an angel list may not represent more than [x]% of the equity of the entity by vote or value. In addition, a presumption might be established that compensatory options do not qualify for treatment as non-stock if issued within two years preceding FC's acquisition of DE (or earlier if as part of the same plan as the acquisition) unless the facts and circumstances demonstrate the absence of an avoidance purpose. Although we do not think these changes are necessary because the customary provisions addressing compensatory options appear to function well in other Regulations, we offer them for consideration.

Second, ignoring an option that is subject to vesting as an ownership interest is consistent with the treatment of such options (and other similar compensatory equity interests) in other areas of the tax law. For example, property interests that are nontransferable and subject to a substantial risk of forfeiture[89] are considered "substantially nonvested"[90] for purposes of determining the income of the property's recipient.[91] Until such property interests become substantially vested, their holder is not considered their owner; i.e., the economic interest in the relevant entity is owned by someone other than the holder.[92] Thus, there does not appear to be a compelling

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[89] A condition of future performance of services—a common element of compensatory options—usually subjects property to a substantial risk of forfeiture. *See, e.g.*, Sections 83(c)(1), 409A(d)(4), 457(f)(3)(B), 457A(d)(1)(A).

[90] Treas. Reg. § 1.83-3(b).

[91] Furthermore, options are not even considered "property" for purposes of Section 83 unless they have a "readily ascertainable fair market value." Section 83(e)(3); Treas. Reg. §1.83-7.

[92] Treas. Reg. §§ 1.83-1(a) ("Until such property becomes substantially vested the transferor shall be regarded as the owner of such property, and any income from such property received by the employee … constitutes additional compensation…."); 1.83-1(f) Ex. (1); 1.280G-1, Q&A (17)(b) ("stock underlying an unvested option is not considered owned by the individual who holds the unvested option"). *See also* Rev. Proc. 80-11, 1980-1 C.B. 616 (advising taxpayers to report dividends on restricted stock that is not substantially vested

argument for treating compensatory options (or, for that matter, restricted stock issued to employees) as stock on the basis of an "economic interest" theory. Third, the goal of simplicity would be served by carving out compensatory options without a readily ascertainable fair market value, thus avoiding potentially complex valuations. Indeed, compensatory options are one of only two categories of instruments on the angel list we have suggested for consideration that appear on angel lists under all other comprehensive regulatory models for the treatment of options.[93]

Any angel list should be subject to a general anti-abuse rule; in other words, options on an angel list should enjoy only a rebuttable presumption of being non-abusive. For example, an option should be treated as stock, even if otherwise described on the angel list, if it is reasonably certain that the option will be exercised. Alternatively, an option could be treated as stock if it was issued, created, modified, transferred, or listed with a principal purpose of avoiding the application of Section 7874. However, we prefer the "reasonably certain" approach to an anti-abuse rule over the "principal purpose" approach because the term "reasonably certain" is more objective and more amenable to

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within the meaning of Section 83 as compensation income on their tax returns). This treatment does not apply if a Section 83(b) election is made with respect to the restricted stock. Rev. Rul. 83-22, 1983-1 C.B. 17.

93 The other is (x) (other instruments specified by administrative guidance). Although we do not consider regulations under Section 355(e), Treas. Reg. § 1.355-7, to offer a comprehensive model for the treatment of options, we note that they ignore all options until exercised. The 2002 temporary regulations under Section 355(e) excepted nontransferable compensatory options without a readily ascertainable fair market value from the special rules that treated an option as an agreement, understanding, or arrangement to acquire the stock subject to the option on the earliest of the date the option was written, transferred, or modified, if on that date the option was more likely than not to be exercised. Temp. Treas. Reg. § 1.355-7T(e) (as amended by T.D. 8988, 2002-1 C.B. 929). Final regulations issued in 2005 removed this exception because "arrangements using compensatory options have been structured to prevent an acquisition of stock from being treated as part of a plan that includes a distribution in avoidance of section 355(e)." T.D. 9198, 2005-1 C.B. 972, Preamble ¶ H. Nevertheless, final regulations maintain the safe harbor for stock acquisitions that are part of customary compensation arrangements qualifying under Sections 83 or 421(a) or (b). Treas. Reg. § 1.355-7(d)(8); *see also supra* note 76.

mechanical rules.[94] Nevertheless, the "reasonably certain" approach should take into account all the facts and circumstances.[95]

C. Measuring an Option Holder's Equity Ownership

While the 2006 Temporary Regulations treated an option as exercised (the "deemed exercise approach"), the 2009 Temporary Regulations treat an option as stock only to the extent of the difference between the value of stock to be received by exercising the option and the option's exercise price (the "spread value approach"). For this purpose, any amount the option holder must pay DE or FC to exercise the option is ignored in determining the entity's value and therefore the value of stock to be received.[96]

We believe the policy goals of preventing abuse, properly reflecting economic interest, and providing simple, administrable rules should affect the choice of approach to measuring an option holder's equity ownership, just as they affect the more general issue of whether and to what extent options should be treated as stock. Below is a brief summary of our views, followed by a more in-depth discussion.

- Economic Interest: The spread value approach is clearly superior to the deemed exercise approach. All options covered by the spread value approach convey to the option holder an economic interest in the entity in which stock may be obtained by exercising the option, while the deemed exercise approach treats as stock some options that do not convey such an interest.[97]

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94 Regulations under Section 355(d) use the "reasonably certain" approach on the ground that it is more "objective" than the "principal purpose" approach. T.D. 8913, 2001-1 C.B. 300, Preamble, ¶ 4.b. Treas. Reg. § 1.1361-1(*l*)(4)(iii)(A) uses the stricter "substantially certain to be exercised" test for call options and also requires such options to have a strike price "substantially below" the fair market value of the underlying stock on the relevant date.

95 *See, e.g.*, Treas. Reg. § 1.355-6(c)(3)(vii)(A) (taking control premiums and minority and blockage discounts into account in determining the fair market value of stock underlying an option); 1.355-7(e)(1)(i) (same).

96 Temp. Treas. Reg. § 1.7874-2T(j)(1) & (2)(i) (2009). Temporary regulations under Section 382 take the same approach for purposes of valuing the "loss corporation" and computing its Section 382 limitation. Temp. Treas. Reg. § 1.382-2T(h)(4)(vii)(C) (1987).

97 Of course, the spread value approach remains underinclusive because it ignores the time value of an option, which arguably conveys a separate economic interest, as discussed above at part III.A.2.

- Anti-abuse: Because of its superior ability to reflect economic interests, on balance the spread value approach should also be a superior tool for catching most of the abusive transactions. However, as shown below, the spread value approach imperfectly prevents abuse because it does not seem to attribute all potential voting power inherent in an option to the option holder. The Service could address this issue by reserving the right (in abusive situations only) to use either the deemed exercise or spread value approach—whichever will result in meeting the Ownership Test. However, such an anti-abuse measure would come at the cost of simplicity.

- Simplicity: This goal is better served by the deemed exercise approach. The spread value of certain instruments, such as convertible bonds or options on non-publicly traded stock, can be difficult to determine.

1. The Spread Value Approach Works Well for Value, but Not Vote, Computations

The Preamble to the 2009 Temporary Regulations correctly points out that generally treating options as exercised can distort the ownership of FC for purposes of the Ownership Test. This is particularly true in the case of a holder of a large number of options that are barely in the money (or even underwater). Treating such options as stock only to the extent of their spread value is less likely to exaggerate the holder's claim on the equity of FC, and therefore more accurately reflects ownership by value.

> **Example 4**. DE has 800 shares and FC has 200 shares outstanding. All shares are worth $1 each. FC also has a historic warrant holder who owns no stock but has the right to purchase 400 shares of FC for $1.50 each. (FC shares had been worth $2 each when the warrants were issued.) The warrants were not issued with a principal purpose of avoiding the treatment of FC as a surrogate foreign corporation. FC acquires all the outstanding stock of DE, and DE shareholders receive 800 newly issued shares of FC stock in exchange. FC does not satisfy the Substantial Activities Test.

Under the deemed exercise approach, the warrants may be treated as exercised even though they are out of the money, in which case former DE shareholders own 57.1% of FC shares [800 / (800 + 200 + 400)] and Section 7874 does not apply. Under the spread value approach, former DE shareholders own 80% of FC shares [800 / (800 + 200)], and Section 7874(b) applies to treat FC as a domestic corporation.

However, the spread value approach has its drawbacks when the voting power of some shares is disproportionately large.

Example 5. (i) Facts. DE is worth $40. A, the chief executive officer of DE, owns all the DE common stock, which is worth $10 and carries 90% of the voting power in DE. B, a passive investor, owns all the DE preferred stock, which is worth $30 and carries the remaining 10% of the vote. FC is worth $30. FC is willing to acquire DE in a transaction that would give DE's owners 67% of the voting power in FC and effective control over the combined business, but the parties wish to avoid the application of Section 7874.

Pursuant to a plan, A and B contribute their DE stock to FC. A is appointed as chief executive officer of FC and receives options on FC common stock with a spread value of $10 (exercise price of $50 for 60 shares worth $1 each). If the options were fully exercised, the 60 shares would give A 67% of the fully diluted voting power in FC. B receives nonvoting FC preferred stock worth $30. Historic owners of FC hold 30 shares of FC common stock worth $30, which carry 100% of the vote until A exercises the options and would carry 33% of the vote if A fully exercised the options.

(ii) Analysis. (A) Spread value approach. A's options on FC stock are treated as FC stock with a value of $10, while B owns FC preferred stock worth $30. Thus, former shareholders of DE own 57.1% of FC by value [(10 + 30) / (10 + 30 + 30)]. Because the spread value approach, as drafted in the 2009 Temporary Regulations, makes no reference to the voting power of stock that is deemed held by a shareholder by reason of option ownership, it is not clear how much voting power A should be deemed to have with respect to FC. Possibly A is treated as owning only 10 common shares, which would give A voting power of 25% (10/40). The Ownership Test is not met.

(B) Deemed exercise approach. A's options on FC stock are treated as fully exercised and A is treated as owning 60 common shares and 67% of FC by vote. The 60% Ownership Test is met.

In this example, two-thirds of FC's voting power is potentially within A's grasp, and, as a practical matter, it is possible for A to exercise significant control over FC even without exercising the options. As a policy matter, it would seem appropriate to take into account all the voting power of A's to-be-issued shares. However, Temp. Treas. Reg. § 1.7874-2T(j), the one example thereto illustrating spread value numerically,[98] and the Preamble to the 2009 Temporary Regulations refer solely to "value" in explaining the spread value approach; they do not address vote.

If Treasury and the Service believe it appropriate to attribute voting power to option holders, the regulations should be clarified accordingly. There are regulatory

[98] Temp. Treas. Reg. § 1.7874-2T(n)(2) Ex. (14) (2009).

models for both approaches of attributing and not attributing voting power to options that are treated as stock.[99] If the spread value approach toward measuring an option holder's equity ownership is retained, regulations should specify whether a holder of an in-the-money option (i) is not deemed to have any voting power, (ii) is deemed to have voting power corresponding to the number of shares whose value equals the spread value of the option, or (iii) is deemed to have voting power corresponding to the number of shares that may be obtained by exercising the option.

2. The Spread Value Approach Is More Complex

The deemed exercise approach has the advantage of computational simplicity, whereas the spread value approach requires valuing the spread of every option. In some cases, the option element will be difficult to value because the exercise price is not explicitly stated. This may occur with convertible bonds, for example.[100] In other cases, the value of the equity interest that can be acquired by exercising an option will be difficult to determine. This is likely to occur when either DE or FC is privately held and

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[99] *Compare* Treas. Reg. § 1.355-6(c)(3)(iv)(A) ("For purposes of section 355(d), an option that is treated as exercised … is treated as exercised both for purposes of determining the percentage of the voting power of stock owned by the holder and for purposes of determining the percentage of the value of stock owned by the holder."), *with* Treas. Reg. § 1.1504-4(b)(2)(iii)(A) ("An option that is treated as exercised is treated as exercised for purposes of determining the percentage of the value of stock owned by the holder and other parties, but is not treated as exercised for purposes of determining the percentage of the voting power of stock owned by the holder and other parties."). Rather, for purposes of Section 1504 "the determination of the voting power owned is made under other applicable principles of law." T.D. 8462, 1993-1 C.B. 192.

[100] The equity value of a convertible bond is generally measured by first separating it into two components: a straight bond and the conversion option. Valuing a straight bond, which is a plain-vanilla debt instrument, requires estimating the interest rate the issuer would have had to pay on the bond absent the conversion option, which implies a need to determine the value of such option. Valuing the conversion option requires using an option-pricing model, which incorporates the price and volatility of the underlying stock, the conversion ratio, the term of the bond, and interest rates. Conversion options are nevertheless difficult to value using option-pricing models because of (i) the reliance of such models on long-term assumptions; (ii) the stock dilution resulting from exercise of the conversion option; (iii) changes in the conversion ratio over time; (iv) dividends paid on the stock; and (v) the ability given to most holders (and issuers) of conversion options to exercise the options (or repurchase the bonds) before expiration. Assuming these challenges are overcome, to calculate the spread value of a convertible bond as contemplated by the 2009 Temporary Regulations one would subtract the strike price (determined from the conversion ratio and current stock price) from the conversion value. ZVI BODIE, ALEX KANE & ALAN J. MARCUS, INVESTMENTS 723-25, 758-60 (6th ed. 2005); ASWATH DAMODARAN, INVESTMENT VALUATION 906-914 (2d ed. 2002).

there is little or no trading of its shares. A banker's valuation may be expensive to obtain, while an inference of value from the pricing agreement between the option buyer and seller may not be reliable if negotiations are not at arm's length and is usually inapplicable in compensatory situations. Accordingly, the deemed exercise approach, which merely counts the vote and value of the shares that may be acquired pursuant to an option, is easier when the option element or the underlying stock itself is difficult to value.

3. Recommendations

Accordingly, while we believe the spread value approach is generally superior for purposes of the value component of the Ownership Test, as shown by Example 4, the deemed exercise approach may be more appropriate in particular situations involving potential voting power, as shown by Example 5. We believe that, on balance, the spread value approach is preferable because it better serves the goals of accurately reflecting an option holder's economic interest and preventing abuse. Its chief drawback is computational complexity, although this arises only with certain instruments.

We therefore recommend that the final regulations retain the spread value approach and either clarify it to address voting power or adopt an anti-abuse rule to deal with such situations. Such a rule could provide that the deemed exercise approach may be used to apply the Ownership Test if the spread value approach would give an inappropriate result.

D. Anti-Abuse Rule

The 2009 Temporary Regulations contain an anti-abuse rule providing that options with respect to FC stock will not be treated as stock if "a principal purpose of the issuance or acquisition of the option (or similar interest) is to avoid the foreign corporation being treated as a surrogate foreign corporation."[101] This anti-abuse rule prevents FC from issuing a large number of warrants on FC stock to a third party in an attempt to reduce the ownership share of former DE owners below 60% (or 80%). However, the 2009 Temporary Regulations do not contain a similar rule for options with respect to DE stock.

We do not see a compelling reason for an asymmetric anti-abuse rule in this context, and believe that it should be extended to cover options and similar interests with respect to DE.

> **Example 6**. The stock of DE is worth \$810. The stock of foreign entity FA is worth \$190. The owners of DE and FA wish to combine these entities under a

[101] Temp. Treas. Reg. § 1.7874-2T(j)(2)(ii) (2009).

> non-U.S. parent, FC, without having FC be treated as a domestic corporation under Section 7874(b). Pursuant to an integrated plan, DE issues a significant amount of in-the-money options to employees, including some to historic owners of DE, which reduces the value of its outstanding shares to $680. Immediately thereafter, stockholders of DE and FA contribute their shares to FC. Stockholders of DE receive 78.2% of FC shares [680 / (680 + 190)]. The DE option holders retain their options on DE stock.

Unless an anti-abuse rule applies to this transaction, the owners of DE have avoided the 80% Ownership Test by issuing, and leaving outstanding, options at the DE level. The "economically equivalent interest" rule in Temp. Treas. Reg. § 1.7874-2T(k)(1), as currently drafted, does not seem to apply in this case to treat the options on DE stock as FC stock, assuming distribution rights on DE stock are not substantially similar to distribution rights on FC stock.

> **Example 7**. DE is a domestic partnership that wholly owns D1. DE has a fair market value of $600 and is equally owned by three partners. The stock of unrelated FC is worth $240. Two partners of DE wish to sell DE to FC in exchange for FC stock; the other partner is opposed. To obtain the recalcitrant partner's agreement, his partnership interest in DE worth $200 is retired in exchange for in-the-money options in respect of DE worth $250, reducing the combined value of the other partners' interests to $350. Immediately thereafter, the two remaining partners contribute their DE interests to FC, receiving 59.3% of FC shares [350 / (350 + 240)].

In this example, the partners of DE have avoided the application of Section 7874 altogether, reducing the Ownership Test percentage from 71.4% [600 / (600 + 240)] to below 60%. Although the economically equivalent interest rule may apply to treat the holdout partner's options on DE partnership interests as stock of FC, especially if FC's distributions to its shareholders are substantially similar to distributions received from DE, an anti-abuse rule would likely deal more effectively and directly with this situation.

One might question whether either example is indeed abusive. In each case, FC acquires significantly less than 100% of the economic interest in DE in a very real sense. This is particularly true where the options are received by an investor in exchange for an equity interest (as in Example 7) and are measured by reference to their in-the-money value. Where the options are issued to employees of DE and not issued for an existing equity interest, as in Example 6, however, a greater potential for abuse could exist.

One might also question whether either example meets the "substantially all of the properties" requirement of Section 7874(a)(2)(B)(i). In Example 6, the options that may be treated as stock of DE represent a claim on 16% (130/810) of DE's equity value, so the owners of DE might argue that FC has failed to acquire "substantially all" of DE, causing the transaction to fall outside the scope of Section 7874. In Example 7, it appears

that FC has not acquired "substantially all" the properties of D1 through its acquisition of DE because over 40% of DE (on an as-converted basis) continues to be held by a historic partner of DE.[102] On the other hand, Section 7874(c)(4) could apply to the transactions in these examples to ignore the pre-inversion conversion of DE interests into options. Ultimately, we do not think it appropriate or necessary to limit the option anti-abuse rule to interests in FC.

IV. Issues Raised by Notice 2009-78

A. Background

As discussed above, Section 7874(c)(2)(B) excludes from the Ownership Test analysis any stock of FC "sold in a public offering related to the acquisition" of DE. The Notice goes a step further and states that any stock of FC "issued in exchange for 'nonqualified property' in a transaction related to the acquisition" shall be so excluded.[103] The Notice thus expands the scope of the exclusion of FC stock (Section 7874(c)(2)(B), as expanded by the Notice, the "Exclusion Rule") to cover certain stock issued in a private offering.[104] Although the Notice states that this rule remains to be finalized in the form of Treasury Regulations, it also states that such regulations shall apply to acquisitions completed on or after September 17, 2009, and that taxpayers may apply this rule to such acquisitions prior to the publication of such regulations. Accordingly, the interpretation of the Exclusion Rule proposed in the Notice was effective immediately upon issuance of the Notice.

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[102] There is currently no guidance on the meaning of "substantially all" for purposes of Section 7874. The legislative history indicates that Congress "expect[s] that the [Service] 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." H.R. REP. NO. 108-755, at 570 n.429 (2004) (Conf. Rep.), *reprinted in* 2004 U.S.C.C.A.N. 1341, 1638. 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, July 2006. We urge the Service to issue guidance on this issue.

[103] Notice 2009-78, I.R.B. 2009-40 (Sept. 17, 2009). The Notice further states, "Subject to certain exceptions, 'nonqualified property' shall generally mean: (1) cash or cash equivalents; (2) marketable securities as defined in section 453(f)(2); and (3) any other property acquired in a transaction with a principal purpose of avoiding the purposes of section 7874."

[104] On the other hand, the Notice also exempts from the Exclusion Rule certain stock that is issued in a "public offering" and therefore may be described in Section 7874(c)(2)(B).

In the 2006 NYSBA Report, we pointed out that, at one point during the legislative process, the Senate version of Section 7874 explicitly disregarded FC stock issued in private placements. However, the enacted provision followed the House bill, where the Exclusion Rule was limited to public offerings. In light of this legislative history, we suggested that any application of the Exclusion Rule to privately placed stock would seem to require a statutory amendment.[105] The Notice cites the broad regulatory authority granted to the Treasury in several provisions under Section 7874 as support for the Service's authority to expand the Exclusion Rule.

We believe that the authority of the Treasury and the Service to adopt such a sweeping rule is not free from doubt, and consideration should be given to narrowing the scope of the regulations contemplated in the Notice.[106] Opponents of the Notice can point to the legislative history as support for the proposition that Congress had specifically considered, and rejected, an Exclusion Rule that would have covered both private placements and public offerings. They may also argue that, while there most likely is authority to challenge certain abusive transactions involving private placements, that authority does not extend so far as to permit the issuance of a *per se* rule that automatically treats as abusive all private issuances of stock for cash in a transaction related to FC's acquisition of DE.

Several arguments may be made by Treasury and the Service in response to such an authority challenge. First, it may be contended that the statute is simply silent on the issue of private placements; it merely defines the minimum universe of stock issuances that are definitely subject to the Exclusion Rule (i.e., public offerings related to the acquisition of DE) but does not limit the ability to expand that universe by regulation. Second, the legislative history offers no explanation as to why solely public offerings were listed in the final version of the Exclusion Rule, or any policy rationale suggesting that public offerings are more susceptible to abuse than private placements, and therefore does not demonstrate any unambiguous legislative intent.[107] Third, Treasury and the Service can point to four separate statutory provisions, each of which arguably gives

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[105] *See 2006 NYSBA Report*, *supra* note 2, at 16 n.47.

[106] As a separate matter, taxpayers may fairly object to the fact that the Notice was effective immediately, even with respect to transactions that were not yet consummated but had already been the subject of a binding commitment or public announcement. In light of the broad scope of the Notice and its surprising departure from the statutory language, some transition relief for such transactions would be appropriate.

[107] One might also point to cases such as Am. Trucking Ass'ns v. United States, 344 U.S. 298 (1953), in which the Supreme Court upheld an agency's expansive use of its general authority to "prescribe rules, regulations and procedure" to address leasing practices, which were mentioned in the original draft of the relevant bill but omitted in the enacted version.

them the authority to ignore any FC stock issued for cash in any offering (public or private) related to the acquisition:

- Section 7874(c)(4) anti-stuffing rule, which mandates that any "transfer of properties…(including by contribution…) shall be disregarded" if it is "part of a plan the principal purpose of which is to avoid the purposes of [Section 7874]"

- Section 7874(c)(6)(B) authority to prescribe "such regulations as may be appropriate to determine whether a corporation is a surrogate foreign corporation, including regulations … to treat stock as not stock"

- Section 7874(g) catch-all grant of regulatory authority to "provide such regulations as are necessary to carry out [Section 7874], including regulations providing for such adjustments to the application of this section as are necessary to prevent the avoidance of the purposes of this section…"

- Section 7805(a) general authority to "prescribe all needful rules and regulations for the enforcement of" the Code.

In light of the broad Congressional delegation of authority under Section 7874, a court must uphold the rule (once it is finalized in Treasury Regulations) unless it is "arbitrary, capricious, or manifestly contrary to the statute,"[108] setting a very high bar for opponents of such a rule to challenge it on authority grounds. Accordingly, Treasury and the Service may argue that, while they could have addressed abusive private placements with a narrow intent-based anti-abuse rule, they were not required to do so. Rather, for reasons of simplicity and administrative convenience, a bright-line rule was adopted, treating all issuances of FC shares for cash in connection with the acquisition of DE as inherently abusive "stuffing" that mandates eliminating such shares from Ownership Test calculations. One can point to the fact that the expanded rule also narrows the universe of publicly issued stock caught by the Exclusion Rule, by exempting non-abusive joint ventures of public companies, in arguing that the new rule is even-handed and rational.

Regardless of whether there is authority to adopt such a broad rule, we believe that expansive application of the Exclusion Rule can produce anomalous results that do not further the policy objectives underlying Section 7874, as demonstrated by certain examples below. Accordingly, if Treasury and the Service believe they have broad regulatory authority in this field, they should exercise that authority to address such anomalies, in the context of both private and public offerings. Furthermore, we continue to believe that disparate treatment of public and private offerings for purposes of the

[108] Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc., 467 U.S. 837, 843-44 (1984).

Exclusion Rule makes little sense as a policy matter in most cases.[109] Accordingly, the approach in the Notice can be justified on policy grounds (putting aside the question of authority) to the extent it attempts to harmonize the treatment of FC stock issued for cash in connection with certain inversion transactions, regardless of the nature of the offering. Accordingly, our comments below are equally applicable to both public and private sales of stock that may be subject to the Exclusion Rule.

B. The Exclusion Rule Should Not Apply to Predominantly Sale Transactions

1. Discussion

The wording of the Exclusion Rule can cause Section 7874 to apply to bona fide business transactions that are, in substance, sales of a U.S. business for cash with little continuity of ownership by the historic owners of DE. We believe that appropriate limitations should be imposed on the application of the Exclusion Rule to prevent Section 7874 from having a chilling effect on such transactions.

> **Example 8**. Shareholders of DE contribute their DE stock to FC in exchange for 79% of FC stock. Simultaneously, unrelated Investor contributes cash to FC in exchange for 21% of FC stock.

This is the classic example of a transaction targeted by the Notice. The Notice's case appears strong here, since the transaction involves the issuance of a rather small minority interest akin to that of a public group of shareholders following an IPO, so as a policy matter it should make little difference whether Investor acquired its shares in a public or private offering. It is also not clear why placing DE underneath FC was necessary merely to raise capital of 21%. Applying the Notice, the ownership ratio of DE's historic shareholders in FC is 79/79 = 100%, and FC is treated as a domestic corporation if it fails the Substantial Activities Test.

We note that this result likely could be achieved even without the Notice by relying on the anti-stuffing rule in Section 7874(c)(4). However, the Notice obviously makes the Service's job easier by eliminating the need to prove an avoidance purpose. As a middle ground, Treasury and the Service could promulgate a more lenient (albeit still more subjective and more difficult to administer) rule that treats this transaction as

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[109] *See 2006 NYSBA Report*, *supra* note 2 at 15-16. One possible policy distinction may be that a public offering typically would not involve a loss of control by historic owners of DE, while a private investor (e.g., a contributor to a joint venture) is more likely to demand a significant voice in the enterprise. However, this argument becomes less persuasive where the private investor is a friendly accommodation party brought in to make a transitory minority investment to help FC avoid meeting the Ownership Test.

presumptively abusive but gives the taxpayer an opportunity to rebut the presumption by showing, for example, that the cash was truly needed in the business and the structure it adopted had a valid non-tax business purpose.[110]

Even if Treasury and the Service are not inclined to abandon a *per se* rule, relief should be considered for other transactions discussed below, which appear far less indicative of abuse than Example 8 and where the argument in favor of applying anti-abuse regulatory authority would be weaker if the stock issuance in question is done via private placement.

> **Example 9**. Same as Example 8, except that the relative values of the parties' contributions are reversed: shareholders of DE receive only 21% of FC stock and Investor receives 79%. Investor's cash is used to fund an expansion of the existing business through acquisitions and capital expenditures and for other valid business purposes.

For reasons discussed in greater detail in our 2006 NYSBA Report, we believe that this example is fundamentally different due to the much smaller equity stake retained by DE's historic shareholders. We believe that a cash offering of such magnitude should not be viewed as a transaction "related to" the acquisition of DE, but rather as the primary transaction itself that has independent economic significance and should not cause FC to be treated as a domestic corporation.[111] Stated differently, at some point the magnitude of the change in share ownership means that the predominant effect of the transaction is not that of an expatriation but rather that of a sale or joint venture. Attacking this transaction under the Notice (if the cash investment involved a private placement) would severely test the limits of the authority issue. And, if this transaction involves a public offering, we remain convinced that this is not the kind of "public offering related to the acquisition" that Congress had in mind in Section 7874(c)(2)(B).

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[110] The Service on numerous occasions has granted relief from a similar anti-stuffing regime under Section 382(*l*)(1)(B) by issuing favorable private letter rulings, and has recently proposed several safe harbors, which would identify certain categories of "good" capital contributions that would not be caught by the anti-stuffing rule. Notice 2008-78, 2008-41 I.R.B. 851 (Oct. 14, 2008).

[111] *See 2006 NYSBA Report, supra note 2* at 13-16. By deeming the issuance not to be a "related" transaction, the Service could remove this transaction from the purview of Section 7874(c)(2)(B) even if the issuance involved a public offering. Furthermore, by exempting certain public stock issuances in the Notice, the Service has shown that it believes it has the authority to scale back the Exclusion Rule when doing so is appropriate in light of the purposes of Section 7874.

A few additional examples involving transactions that are, in whole or in part, "secondary" rather than primary acquisitions of stock may help bring this point into sharper focus.

> **Example 10**. Same as Example 9, except that, immediately following the contributions to FC and pursuant to an integrated plan, historic shareholders of DE receive a cash payment from FC in complete redemption of their stock. As a result, Investor owns 100% of FC (and, indirectly, DE) after all transactions are complete.

> **Example 11**. Same as Example 10, but the redemption payment does not completely eliminate the historic shareholders of DE. Instead, they retain 1% of FC stock.

In Example 10, it seems clear that Section 7874 should not apply, even if one believes that it should apply in the preceding Example 9. The substance of the entire transaction in Example 10 is a purchase of DE by FC in which the historic owners of DE are completely cashed out, and the transaction presumably could have been structured as such but the form chosen by the parties may have offered some non-tax advantages.[112]

Proceeding further along these lines in Example 11, it is hard to articulate a policy reason for the retention of a 1% interest by the historic owners of DE making the difference between FC being respected as a foreign corporation and becoming taxed as a domestic corporation. Here, the historic owners of DE have disposed of 95.2% of their equity interest in DE for cash, and their retained stake in FC is equal to 4.8% (1/21) of the value of DE.

Therefore, we believe that it would be appropriate to limit the application of the Exclusion Rule to transactions in which the historic shareholders of DE retain some threshold percentage of equity ownership in the pre-transaction enterprise value of DE. We believe that such an approach would be consistent with the policy objectives behind Section 7874: as evidenced by the very existence of the Ownership Test, the inversion rules were meant to target transactions that resulted in relatively small changes in the ownership of the inverted U.S. business.

However, additional nuances and policy arguments must be considered prior to adopting a simplistic continuity-based test.

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[112] However, there may be a technical problem with the form and sequence of the steps actually chosen by the parties in Example 10, if (i) the Ownership Test is conducted immediately following the contributions but prior to the redemption and (ii) the FC shares acquired by Investor for cash are ignored. As discussed in Part V.A below, we believe that applying the Ownership Test in the middle of an integrated multi-step transaction is inappropriate.

> **Example 12**. DE is worth $90. FC is worth $21 and all of its outstanding 21 shares are owned by Investor. Pursuant to a plan, Investor contributes $60 of cash to FC for an additional 60 shares and shareholders of DE contribute the stock of DE to FC in exchange for an additional 90 shares, representing 52.6% of all FC stock (90/171).

Applying the Notice, the 60 shares acquired by Investor for cash are ignored. The "old and cold" 21 shares of FC should still count for purposes of the Ownership Test. The ownership ratio of DE's historic owners in FC is thus 81% (90/111) and FC is treated as a domestic corporation if it fails the Substantial Activities Test. However, consider the following variations.

> **Example 13**. Same as Example 12, except immediately following these transactions the former shareholders of DE sell all of their 90 shares of FC to an unrelated third party, or to Investor, pursuant to a preexisting plan.

Should the result now differ from the outcome in the preceding Example 12, since the historic shareholders never intended to retain their ownership stake and, in fact, only owned their 90 FC shares for a few hours? If so, how long after a transaction should a continuity-based test extend? Is the substance of this transaction abusive, regardless of whether DE's owners retain any equity interest in FC, because they were able to invert DE and then reap the benefits by receiving a purchase price that presumably reflected some value attributable to future tax savings of the inverted structure? Note that the same could be said of any owner of a DE who simply sells it entirely for cash held or borrowed by an existing FC, and Section 7874 clearly would not apply to such a sale. On balance, we believe that a continuity-based test should not extend following the completion of the acquisition, and accordingly this is not a sympathetic case for the taxpayer.[113]

> **Example 14**. DE is worth $90. FC is worth $21 and all of its outstanding 21 shares are owned by Investor. Pursuant to a plan, Investor contributes $60 of cash to FC for an additional 60 shares. This cash is used by FC to purchase 2/3 of the equity interest in DE from its historic owners. Thereafter, DE shareholders contribute their remaining 1/3 interest in DE, worth $30, to FC in exchange for 30 shares representing 27% of all FC stock (30/111).

Even after applying the Notice to ignore the 60 newly issued shares of FC, the ownership ratio of former DE shareholders, at 58.8% (30/51), falls short of meeting the Ownership Test. Accordingly, the inversion rules that applied in Example 12 now appear to have been avoided by restructuring the transaction as a partial secondary purchase,

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113 *Cf*. Treas. Reg. § 1.368-1(e)(1)(i), (e)(8) Ex. 1(i) (ignoring target shareholders' post-reorganization sales of issuer stock to persons unrelated to issuer for purposes of continuity of interest analysis, even if pursuant to a preexisting binding contract).

rather than an entirely primary investment. Of course, Example 14 presents a different business deal—the historic owners of DE have now cashed out the majority of their ownership interest, and the end result is a much "skinnier" FC, albeit one in which the historic business of DE now represents a greater percentage of the overall assets than in Example 12.

> **Example 15**. Same as Example 14, except instead of $60 being funded with a capital contribution by Investor to FC, $60 is borrowed by DE from an unrelated bank and used to redeem 2/3 of DE's existing shares before the remaining 1/3 interest in DE is contributed to FC in exchange for 30 FC shares.

When the dust settles, DE's former shareholders again have received $60 in cash and own 30 shares in FC, while Investor owns 21 "old and cold" shares. Once again, the transaction on its face seems to fall short of meeting the Ownership Test because DE's former shareholders own merely 58.8% of FC. There was no cash infusion by Investor, so the Exclusion Rule is irrelevant. However, due to leverage FC is now even skinnier than in Example 14. The Service has indicated that it believes the anti-stripping provisions of Section 7874(c)(4) may apply to disregard such pre-closing "skinnying down" of DE.[114]

As a policy matter, it is not clear why the source or timing of cash consideration payments – such as whether cash originates within DE or FC – should be a factor in the analysis. In either case, the historic owners of DE sell down their position in DE such that their rollover equity stake in FC is below the Ownership Test threshold. If a sale to FC for cash works, so should a cash redemption by DE. One possible issue mentioned by the Service with respect to debt-financed distributions is that the new debt could be used to strip earnings from DE,[115] and one of the concerns that led Congress to pass Section 7874 was that taxpayers were using inversion structures to siphon off earnings from domestic corporations to their foreign affiliates.[116] However, we do not believe that this

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[114] Lee A. Sheppard, *Taking the Good With the Bad In the Anti-Inversion Rule*, TAX NOTES, Feb. 22, 2010, at 915 (quoting an official of the Service as suggesting that "section 7874(c)(4) would apply to any cash distributions made by the target to its shareholders before the acquisition"). For the same reasons that we believe the Notice's rule may be pushing the limits of Treasury's and the Service's authority on the "stuffing" side, we would caution against adopting such a *per se* rule on the "stripping" side.

[115] *Id.*

[116] For legislative history discussing earnings stripping, see *supra* note 25 and H.R. REP. NO. 108-393, at 162 (2003). Of course, this transaction can be restructured to make FC, rather than DE, the borrower of the funds and to have FC make the payment to DE's shareholders as purchase price rather than redemption proceeds, making the transaction structure more similar to Example 14. This variation should eliminate the earnings stripping concern.

concern should justify a broad rule that treats all distributions (or even all debt-financed distributions) to DE's shareholders as abusive for purposes of Section 7874.

Unless a foreign person related to DE holds DE's obligation, we believe there is simply no abusive earnings stripping. It is beyond cavil that DE could have borrowed and paid a dividend in the ordinary course without engaging in any other transactions, and generally would have been entitled to claim interest deductions in that case. The fact that such borrowing is coupled with an acquisition of DE does not make the deductibility of interest on the external debt any more or less abusive than it already was in the absence of such acquisition, so it is not clear why the tax treatment of the acquisition should be affected.[117] We also note that pre-acquisition "skinnying down" of target has been a commonly accepted technique in other contexts in which the relative values of acquirer and target and/or post-acquisition ownership of acquirer by historic shareholders of target can be a relevant factor, including in the anti-inversion regulations under Section 367.[118]

2. Recommendations

In sum, we believe that an exception to the Exclusion Rule should be created to carve out transactions whose predominant nature is that of a sale, rather than an inversion. As we suggested in the 2006 NYSBA Report, one relatively simple exception could be a threshold above which newly purchased shares of FC (whether issued in a public or private offering, for cash or non-cash consideration) would represent too great a percentage (say, 80%) of the post-transaction pool of FC shares to be ignored and thus would count in the denominator for purposes of the Ownership Test analysis (the "Large Primary Issuance Exception").

In addition to the Large Primary Issuance Exception, another exception could focus on the proportion of the ownership interest in DE retained by DE's former owners

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117 The earnings stripping argument may have more merit if the cash is being lent by FC or its related party. Accordingly, an anti-abuse rule targeting obligations held by foreign persons related to DE that are used to "skinny down" DE may be appropriate.

118 *See*, *e.g.*, Lee A. Sheppard, *Last Corporate Taxpayer Out the Door, Please Turn Out the Lights*, WORLDWIDE TAX DAILY, Feb. 17, 1999, at 31-3 (describing the proposed structure for the AirTouch/Vodafone merger, in which AirTouch was contemplating paying a pre-closing dividend to make itself smaller than its foreign acquirer if no ruling could be obtained from the Service with respect to the substantiality test of Treas. Reg. § 1.367(a)-3(c)(3)(iii)(A)). *See also* Treas. Reg. § 1.368-2(j)(3)(i), -2(j)(6) Exs. (2), (3) (stock of target redeemed with target's funds not treated as outstanding in determining whether control of target was acquired in exchange for voting stock). Admittedly, these analogies are distinguishable by the fact that Congress specifically added an anti-stripping provision in Section 7874.

in combination with some amount (that is less than 80%) acquired by new investors. This second exception could "turn off" the Exclusion Rule in cases where the owners of DE fail to retain some threshold percentage (say, 40%)[119] of their proprietary interest in DE after its acquisition by FC and other investors acquire a sufficiently large (say, 50%) interest in DE (the "Large Secondary Sale Exception"). The Large Secondary Sale Exception would have some support in the statutory framework, to some extent serving as the conceptual mirror of the Ownership Test. Issues to be considered under the Large Secondary Sale Exception would include (i) whether post-transaction dispositions by historic shareholders should count as non-retained equity and (ii) whether pre-transaction distributions or redemptions should be added back in computing the overall enterprise value of DE in which a proprietary interest needs to be retained, and if so under what circumstances such an add-back may be appropriate.

Any such exceptions to the Exclusion Rule should be backstopped with specific anti-abuse rules. For example, a transitory cash investment should be ignored, regardless of its size. A disposition of DE shares by historic owners, followed by their prompt acquisition of an equivalent amount of FC shares, should not be entitled to the Large Secondary Sale Exception. An anti-abuse rule targeting debt obligations held by foreign persons related to DE that are used to "skinny down" DE may also be appropriate. However, we also urge the Service to clarify that other pre-sale distributions would not be treated as "stripping" subject to Section 7874(c)(4), because they do not present a potential for abuse.

C. Coordination Between the Exclusion Rule and Other Ownership Test Rules

The Notice and the Exclusion Rule operate mechanically by adjusting the numerator and denominator of the Ownership Test fraction. However, other rules, particularly rules applicable to EAGs, also adjust this fraction. The potential overlap of these multiple adjustments may produce odd results, suggesting a need for coordination rules.

> **Example 16**. D1 owns 81% and Managers own the other 19% of DE. Pursuant to a prearranged plan, D1 and Managers contribute all of their equity in DE to FC in exchange for 61% of FC and unrelated Investor contributes cash to FC in exchange for 39% of FC.

If Investor's shares are counted in the denominator of the Ownership Test for purposes of determining whether FC is in D1's EAG, then D1 is treated as owning

[119] Treasury Regulations now confirm the long-standing practice that 40% continuity is sufficient for the "continuity of interest" requirement for reorganizations pursuant to Section 368. Temp. Treas. Reg. § 1.368-1T(e)(2)(v) Ex. 1 (2007).

49.41% (i.e. 81% of 61%) of FC for such purposes, which is not sufficient to treat FC as part of D1's EAG. Applying the Exclusion Rule results in D1 and Managers being treated as holding 100% of FC and meeting the 80% Ownership Test.

However, if Investor's shares are ignored for purposes of determining whether FC is in D1's EAG, D1 is treated as exchanging its 81% interest in DE for an 81% interest in FC and FC is part of D1's EAG. Under this analysis, the transaction seems eligible for the "internal group restructuring" exception[120] because D1 is treated as owning more than 80% of FC immediately after the transaction for purposes of applying the EAG rules. If so, then the Ownership Test is not met because D1's shares are included in the numerator but not the denominator, resulting in an ownership fraction of 19% (19/100).

Presumably, the final regulations will clarify that this is not the correct result, and the 80% Ownership Test is met (and the internal group restructuring exception does not apply), based on the following statement in the Notice: "The rules described in this notice are not intended to affect the application of section 7874(c)(2)(A), §1.7874-1, or section 7874(c)(4)." The rationale for this is that disregarding certain newly issued stock to protect against a perceived abuse operates independently of the EAG rules, including the internal group restructuring exception.

We believe that counting Investor's shares for purposes of applying the EAG rules is clearly the correct analysis. Regardless of whether the Service believes Example 16 demonstrates the kind of abuse meant to be shut down by the Exclusion Rule or whether Investor has contributed a sufficient amount to be respected, treating FC as being affiliated with D1 is counterfactual, and reaching a taxpayer-friendly result on the theory that D1 preserves control over FC within the meaning of the internal group restructuring exception is not sensible.

Note, further, that the question of how the "internal group restructuring" exception interacts with the Exclusion Rule may arise even when FC would be treated as a member of the EAG of DE's historic shareholder regardless of whether one takes a new investor's cash contribution into account.

> **Example 17**. D1 owns 82.3% of DE, a member of its EAG, and Managers own the remaining 17.7%. D1 and Managers contribute DE to FC in exchange for 960 shares of FC (790 shares to EAG Parent and 170 shares to Managers). Investor contributes cash for 40 shares of FC. Thus, after the transaction, the ownership of FC is as follows: D1 = 79%, Managers = 17%, and Investor = 4%.

Absent the Notice, this transaction would not qualify for the "internal group restructuring" exception because D1 owns less than 80% of FC after the transaction.

[120] Treas. Reg. § 1.7874-1(c)(2).

D1's 790 shares would be ignored in both the numerator and denominator of the Ownership Test, and the transaction would meet the 80% Ownership Test because Managers own 81% (170/210) of the shares counted in the analysis.

However, under the Notice, and assuming the Notice is applied for purposes of the EAG rules, the 4% interest issued to Investor would generally be ignored. In that case, D1's ownership interest would be treated as being equal to 82.3% (790/960), making the transaction eligible for the internal group restructuring exception. Once again, this is clearly the wrong answer.

The question of how the Exclusion Rule interacts with the EAG rules also arises with respect to the "loss of control" exception of Treas. Reg. § 1.7874-1(c)(3). Consider the following example, where counting Investor's shares could help the taxpayer.

> **Example 18**. Taxpayer, an individual, owns 100% of DE. Taxpayer contributes his equity interest in DE to FC in exchange for 49 shares of FC. Investor Corp contributes cash in exchange for the remaining 51 shares of FC, which cash is invested in the business.

If Investor Corp's shares are counted in the denominator of the Ownership Test for purposes of the "loss of control" exception, then that exception applies. On the other hand, ignoring Investor Corp's shares results in the 80% Ownership Test being met. In fact, even if only 20 shares of FC were purchased by Investor Corp for cash and ignored, and the other 31 shares were received in exchange for a contribution of an operating business, the 60% Ownership Test would be met: Taxpayer would be treated as owning 61.25% (49/80) of FC.

We do not see a compelling rationale for treating this transaction, where the economic reality is a joint venture diluting DE's owner to a 49% minority interest, differently for purposes of the EAG rules depending on whether or not the mix of Investor Corp's consideration includes cash. The transaction complies with the policy behind the "loss of control" exception. In the initial preamble to the proposed Ownership Test regulations, the Service had stated the following:

> [T]he IRS and Treasury Department believe that the affiliate-owned stock rule was not intended to cause section 7874 to apply to certain acquisitive business transactions, such as the acquisition of stock or assets of a domestic corporation by an unrelated foreign corporation where after the acquisition the former owners of the domestic entity do not own more than 50 percent (by vote or value) of the stock of any member of the expanded affiliate group. For example, the contribution of a domestic entity or its assets to a foreign joint venture corporation in exchange for a minority interest in the joint venture corporation should not result in the joint venture corporation's being treated, for purposes of the ownership percentage test, as wholly owned by the former owners of the domestic entity…. Congress intended the section to apply to transactions … that effectively

> replace a domestic corporation or partnership with a foreign corporation at least 60 percent of which is held by former owners of the domestic entity.[121]

Although one may argue that the Preamble probably envisioned a combination of two operating businesses as opposed to a cash-rich "mixing bowl" when it describes the "joint venture," this distinction is not apparent from the language quoted above, nor do we think it should govern. In other words, a contributor that after the contribution is an EAG member is properly viewed qualitatively differently than noncontrolling contributors for which the Exclusion Rule was designed. Thus, although we propose a threshold for aggregate contributions to override the Exclusion Rule generally under the Large Primary Issuance Exception, we do not believe that a threshold is needed or appropriate for purposes of applying the loss of control exception (beyond that applicable under that exception itself).

We recommend that the regulations implementing the Notice adopt a uniform approach for FC shares that are subject to the Notice for the purpose of the "internal group restructuring" and "loss of control" exceptions to the EAG rule, and for purposes of determining whether an EAG exists. Based on the examples above, we believe that the most sensible approach would be to count such shares for these purposes because the purpose of the Exclusion Rule (preventing abusive manipulation of the Ownership Test by contributions by noncontrolling persons) is not furthered by applying it in these circumstances.

D. Exception to the EAG Rule Where Non-U.S. Operating Assets Are Contributed (Directly or as Shares of an Operating Subsidiary)

The EAG rule can be inappropriate in contexts beyond just those protected by the internal group restructuring exception and the loss of control exception. We believe a third exception is needed to address situations such as those described below. In brief, such an exception would include in the denominator of the Ownership Test shares that are issued to an EAG member in exchange for contributions of non-U.S. operating assets.

> **Example 19**. DE is owned 1% by F1 and 99% by D1. F1 contributes foreign operating assets (worth substantially more than DE), and both F1 and D1 contribute their DE stock, to FC in exchange for 960 shares of FC (720 shares are issued to F1 (of which 2.42 shares are issued for the 1% of DE) and 240 shares to D1). Investor contributes cash for 840 shares of FC. Thus, after the transaction, FC has a total of 1700 shares outstanding, and the ownership of FC is as follows: F1 = 40%, D1 = 13.3%, and Investor = 46.7%.

[121] T.D. 9238, 2006-1 C.B. 408.

If Investor's shares are not ignored under the Exclusion Rule in determining whether FC is a member of F1's EAG, then FC is not a member of any EAG, the denominator of the Ownership Test fraction is 1700, and former shareholders of DE hold 14.3% of FC by reason of holding DE. Thus, the Ownership Test is not met. However, ignoring Investor's shares would appear to cause FC to be included in F1's EAG because F1 would now be treated as holding 75% (720/960) of FC shares. Because this transaction is not eligible for either the loss of control or the internal group restructuring exception, Section 7874(c)(2)(A) automatically disregards *all* FC stock owned by EAG members. F1's shares are thus disregarded under Section 7874(c)(2)(A) and the Ownership Test fraction is 100% (240/240).

This problem could be cured in this case by not applying the Exclusion Rule for purposes of determining whether an EAG exists, as we have already recommended above. However, this solution (while proper) would not solve the bigger underlying glitch: the absence of some tracing rule that distinguishes FC stock received by an EAG member "by reason of" having owned DE stock, as opposed to some unrelated other assets that the EAG member contributed to FC along with DE stock. As discussed in connection with Example 20 below, this bigger problem can be cured by creating a third exception to the EAG rule.

The problem caused by the absence of a tracing rule can also arise as a result of the application of the "multiple target rule"[122] in conjunction with Section 7874(c)(2)(A).

> **Example 20**. EAG Parent contributes stock of domestic corporation DE-1 to FC in exchange for 10 shares. Another EAG member wholly owned by EAG Parent, EAG Sub, contributes stock of F1 to FC in exchange for 60 shares. A third party, TP, contributes stock of a second domestic corporation, DE-2, to FC in exchange for 30 shares. Assume all these contributions are pursuant to a single plan, and thus the transfers of DE-1 and DE-2 are treated as a transfer of a single DE.

Under Section 7874(c)(2)(A) and the general rule of Treas. Reg. § 1.7874-1(c)(1), stock of FC owned by EAG Parent and EAG Sub is ignored in both the numerator and denominator of the Ownership Test fraction. The "loss of control" exception is unavailable here because a former shareholder of DE-1 (EAG Parent) owns more than 50% of an EAG member, EAG Sub. Thus, the ownership fraction of former DE shareholders depends solely on the shares held by TP and equals 100% (30/30).

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[122] The 2009 Temporary Regulations added the "multiple target rule," which treats acquisitions of multiple DEs by a single FC pursuant to a plan as an acquisition of a single DE. Temp. Treas. Reg. § 1.7874-2T(e) and (n)(2) Ex. 7 (2009). This rule shuts down a potential abuse whereby several DEs could be combined in a "mixing bowl" FC by their owners and no set of owners of a particular DE, viewed in isolation, would have met the Ownership Test with respect to FC.

Accordingly, the Ownership Test is met, even though FC stock issued in exchange for DE-1 and DE-2 amounts to only 40% of all FC stock.

On the other hand, if EAG Parent contributes stock of a foreign corporation instead of DE-1, the results are drastically different. Stock held by EAG Parent and EAG Sub can now be included in the denominator under the "loss of control" exception, resulting in TP's ownership ratio of 30% and rendering Section 7874 inapplicable. Thus, even a tiny contribution of a single domestic corporation by EAG Parent can swing the outcome of the Ownership Test, even though in both cases the contributions of domestic corporations constitute only a minority of the overall economic transaction. This does not seem to be an appropriate result.

One potential solution would be to count the 60 FC shares issued in exchange for a foreign corporation in the denominator (causing the ownership fraction in this example to be 30/90) by adopting a tracing rule similar to Treas. Reg. § 1.7874-2T(f). Such a rule would partially turn off the application of Section 7874(c)(2)(A) to the extent FC shares were not received by the EAG member "by reason of" transferring an interest in DE (or cash or other liquid assets, to the extent the Service believes transfers of cash in this example should not be treated as "good" consideration and wishes to apply the Exclusion Rule). Put another way, FC stock issued to an EAG member in exchange for qualifying non-U.S. assets should count in the denominator for Ownership Test purposes.

V. Other Issues Raised by the Section 7874 Regulations

A. Timing Issues in Multi-Step Transactions

As noted above in connection with Example 10, in the case of a multi-step transaction, conducting the Ownership Test before all related steps are completed may produce inappropriate results. The most obvious case is where DE is contributed to FC prior to other related contributions, acquisitions, or redemptions that would dilute the equity interest of DE's historic shareholders in FC. We believe that the Ownership Test should not be affected by the order of steps in a multi-step plan, but rather should focus on the "final picture."

We note that Example 3 in the Notice addresses a combination of two entities, DT (domestic) and FT (foreign) under a newly formed foreign parent, FA. In that Example, the acquisition of FT precedes the acquisition of DT. Assuming this is a merger of equals, FA should not be a surrogate foreign corporation. The answer should not be different if the parties in this Example had chosen a different sequence, whereby DT is acquired first and, for a brief moment, former shareholders of DT own 100% of FA.

We recommend that the final regulations clarify that, in the case of a series of related transactions, the applicable calculations of ownership interests must be done either immediately before the earliest such transaction or immediately after the last such

transaction. This approach would be consistent with that taken by analogous Treasury Regulations under other Code provisions.[123]

B. Treatment of Creditors of DE as Shareholders of DE

The 2009 Temporary Regulations also added a rule (the "Insolvent DE Rule") that treats the creditors of DE as its equity owners if, immediately prior to its acquisition by FC, the DE is in a title 11 or similar case or is insolvent. While we believe that such treatment may be appropriate in certain abusive cases, it is not clear that it is always warranted. One potential drawback of the Insolvent DE Rule is that it could reduce the potential pool of acquirers that could make competitive bids for an insolvent DE's business, and might even discourage lenders from extending credit to a multinational corporate group whose parent is a DE.

> **Example 21**. In 2007, a group of banks and other financial institutions extend a 5-year term loan to DE, a domestic corporation. Over 80% of DE's employees, assets, and sales are attributable to subsidiaries located outside the United States. In 2011, DE defaults on the loan. As part of a bankruptcy reorganization, the lenders cause DE to be liquidated and to transfer all of its subsidiaries and other assets to FC. The lenders receive 100% of the stock in FC as a result of the reorganization.

FC has acquired substantially all the assets of DE. Since the lenders are treated as DE shareholders under the Insolvent DE Rule, the Ownership Test is met. Even though its activities are predominantly offshore, FC would be treated as a domestic corporation if it fails the Substantial Activities Test.

We do not believe the policies of Section 7874 require this outcome, although it is a close call. On one hand, DE's business was already trapped under a domestic parent, and one can argue that bankruptcy should not be an appropriate occasion for enabling DE's foreign subsidiaries to escape the U.S. tax system. Under this view, creditors of DE should not be able to achieve a better result than DE's shareholders could have achieved. On the other hand, the lenders here could be viewed as reluctant purchasers of DE's assets, and we believe this is the better analogy. The lenders in this example presumably did not intend to become shareholders of DE when they funded the loan four years prior to DE's bankruptcy, nor did they contemplate the creation of FC. And it is clear that a third-party purchaser paying cash could have plucked DE's foreign subsidiaries out from under DE and arranged them under a foreign parent without triggering Section 7874. Accordingly, why should an acquisition by DE's creditors be treated differently than a purchase by a third party? The practical effect of the Insolvent DE Rule in this case may be simply to give an advantage in a bankruptcy auction to any third-party bidder for DE's

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[123] *See, e.g.*, Treas. Reg. §§ 1.197-2(h)(6)(ii); 1.338-3(b)(3)(ii)(C).

assets, since an acquisition by an outsider would not be subject to Section 7874 and would result in a more tax-efficient structure, for which the outsider may be willing to pay a higher price.

We believe the purposes of Section 7874 would be better served if the Insolvent DE Rule were limited to lenders who acquired DE's debt pursuant to a plan to acquire its stock or assets. A more limited rule targeting planned acquisitions of debt could adopt a minimum holding period requirement. For example, the Insolvent DE Rule could incorporate presumptions that (i) debt acquired within a certain time period (say, two years) preceding the bankruptcy or insolvency of DE was acquired as part of an abusive plan and/or (ii) debt acquired prior to that time period was not acquired as part of such plan. For example, Section 382(*l*)(5), which essentially treats "old and cold" creditors as historic "good" owners of a bankrupt loss corporation who did not acquire their debt for purposes of loss trafficking, requires that such creditors have held their debt for at least 18 months before the filing of the bankruptcy petition or have continuously held ordinary course debt since it was incurred.