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September 5, 2014

The Honorable Mark Mazur
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1500 Pennsylvania Avenue, NW
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The Honorable John Koskinen
Commissioner
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

The Honorable William J. Wilkins
Chief Counsel
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Re: **Report on Temporary Regulations Under Section 7874**

Dear Messrs. Mazur, Koskinen and Wilkins:

I am pleased to submit the attached report (the "Report") of the Tax Section of the New York State Bar Association. The Report comments on temporary regulations issued on January 17, 2014, that disregard, for purposes of Section 7874 of the Code, certain stock issued by a foreign corporation in a transaction related to its acquisition of a domestic entity.

Section 7874 seeks to deter "inversion" transactions, in which domestic entities expatriate to a foreign jurisdiction. A prerequisite for the application of Section 7874 is that at least 60% of the stock of the foreign corporation that acquires the domestic entity must be held, after the acquisition, by former owners of the domestic entity by reason of their ownership of shares or interests in the domestic entity. The regulations under Section 7874 refer to the percentage of stock of the foreign acquiring corporation so held by former owners of the domestic entity as the "ownership fraction". If Section 7874 applies and the ownership fraction is between 60% and 80%, certain adverse tax consequences arise. If Section 7874 applies and the ownership fraction is 80% or greater, the foreign acquiring corporation is treated as a domestic corporation.

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Mr. Mazur
Mr. Koskinen
Mr. Wilkins
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Inversions have received a great deal of attention recently. Secretary of the Treasury Jacob J. Lew, in a letter to Dave Camp, Chairman of the House Ways and Means Committee, called for immediate retroactive legislation to stem inversions. Earlier this year, draft legislation was introduced in both the Senate and the House proposing, among other things, to reduce the 80% test to 50%, again with retroactive effect. The Report does not discuss the larger policy questions relating to inversions (many of which have been discussed in our prior reports)¹ or any legislative proposals. Rather, our comments in the Report focus on mechanical issues within the existing Section 7874 framework (primarily within the temporary regulations). We note, however, that many of the comments made in the Report would be equally applicable if the proposed legislation were enacted.

A central theme of the Report is that certain changes should be made to the current regulations to allow for more consistent treatment under Section 7874 among transactions that are economically equivalent (or at least very similar). While we recognize that tax laws sometimes depart from this ideal, discrepancies in the tax treatment of two transactions that arrive at the same economic result lead to traps for the unwary and have a distortionary effect on taxpayer decisions.

The temporary regulations address situations in which a foreign acquiring corporation issues stock in exchange for cash (or other “nonqualified property”) in a transaction that is related to the acquisition of the domestic entity. The temporary regulations require that any stock so issued be excluded from the denominator of the ownership fraction. A de minimis exception applies under the temporary regulations if, absent the exclusion rule, the ownership fraction would be less than 5%. We believe that the de minimis exception is too narrow. The temporary regulations capture an acquisition of a domestic entity that is almost all for cash, a transaction that we believe is outside the intended scope of Section 7874. Accordingly, we believe the de minimis exception should be increased from 5% to 20%.

In some cases, a foreign corporation may be established to acquire both the domestic entity and a foreign target corporation. The temporary regulations distinguish between acquisitions of stock and acquisitions of assets of the foreign target. In the case of a publicly traded foreign target, we believe asset acquisitions (by way of a forward merger, for example) should be treated the same as stock acquisitions, in that, absent an abusive principal purpose, stock issued by the foreign acquiring corporation in exchange for any nonqualified property held by the foreign target should not be excluded from the ownership fraction.

The preamble to the temporary regulations requested comments on the application of Section 7874 to scenarios in which the parent corporation of a domestic entity contributes the domestic entity to a foreign corporation and then, pursuant to a plan, disposes of stock of the foreign corporation. If the parent corporation in such a scenario is foreign, we generally believe that Section 7874 should not apply, because no “inversion” has occurred. The domestic entity was already owned by a foreign corporation. If, however, the parent corporation is domestic, the transaction is an appropriate candidate for Section 7874. But the regulations under Section 7874 seem to reach anomalous results in certain cases. If the domestic parent retains, say, 70% of the stock of the foreign corporation, such that the foreign corporation remains within the domestic parent’s expanded affiliated group (“EAG”), an EAG exclusion rule generally applies that would exclude such stock from the numerator and denominator of the ownership fraction. We believe that the EAG exclusion rule generally should not apply in such cases.

¹ This is our eighth report on inversion related issues. See *Report on Substantial Business Activities Test Under Temporary Section 7874 Regulations*, N.Y. St. B.A. Tax Section, Nov. 20, 2012; *Report on the Management and Control Provisions of the “International Tax Competitiveness Act of 2011”*, N.Y. St. B.A. Tax Section, January 21, 2011; *Report on Certain Issues Under Section 7874*, N.Y. St. B.A. Tax Section, May 3, 2010; *Report on Temporary Treasury Regulations Section 1.7874-1T*, N.Y. St. B.A. Tax Section, March 22, 2006; *Report with Respect to Regs. § 1.367(a)-3(c)*, N.Y. St. B.A. Tax Section, April 26, 2005; *Report on Outbound Inversion Transactions*, N.Y. St. B.A. Tax Section, May 24, 2002; *Report on Notice 94-93 (“Inversion Transactions”) and Rev. Proc. 94-76 (“Downstream Reorganizations”)*, N.Y. St. B.A. Tax Section, January 31, 1995.

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Finally, the Report includes recommendations pertaining to (1) the treatment of obligations, (2) a request for comments regarding a publicly traded domestic corporation becoming a publicly traded foreign corporation over time, and (3) certain mechanical aspects of the temporary regulations.

We appreciate your consideration of the Report. If you have any questions or comments, please feel free to contact us. We would be glad to discuss or assist in any way.

Respectfully submitted,



David H. Schnabel
Chair

Enclosure

cc:

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Mr. Mazur
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September 5, 2014

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