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# US Inbound Newsalert\*

## International Tax Services

### In this Issue

#### Tax Consequences of Cross-Border Restructurings of Domestic Corporations and Partnerships Less Certain with New Temporary Regulations under Section 7874

The U.S. federal income tax consequences of many cross-border restructuring transactions involving domestic corporations and domestic partnerships have become much less certain under new temporary regulations issued on June 10, 2009 (T.D. 9453). By withdrawing an objective safe harbor test contained in prior regulations, removing all examples of how a subjective facts-and-circumstances test is to be applied, and reminding taxpayers that the IRS ordinarily will not rule on whether the facts-and-circumstances test is met in a given case, the IRS and Treasury have made it much more difficult for taxpayers to plan their way through the minefield of section 7874.

The temporary regulations continue the trend of expanding the scope of section 7874 by sweeping in transactions involving multiple foreign acquiring corporations or multiple domestic target corporations, as well as insolvent domestic corporations. The preamble indicates that this expansion will continue, with future regulations to cover divisive transactions, potentially with retroactive effect.

The temporary regulations generally apply to acquisitions completed on or after June 9, 2009, and will expire on or before June 8, 2012. Taxpayers may apply the temporary regulations to acquisitions completed prior to June 9, 2009, provided the temporary regulations are applied consistently to all such acquisitions. The new temporary regulations replace the temporary regulations issued on June 6, 2006 (the "2006 temporary regulations"), which expired on June 6, 2009, and include the effective date modifications announced by Notice 2006-70, rendering such notice obsolete as of June 9, 2009. The Treasury and IRS request written or electronic comments and requests for a public hearing by September 10, 2009.

### Background

A foreign corporation is generally treated as a "surrogate foreign corporation" under section 7874(a)(2)(B) if, pursuant to a plan or a series of related transactions, three test tests are satisfied:

1. The foreign corporation completes after March 4, 2003, the direct or indirect acquisition of substantially all of the properties held directly or indirectly by a domestic corporation (the "substantially all" test);

2. After the acquisition, at least 60 percent of the stock (by vote or value) of the foreign corporation is held by former shareholders of the domestic corporation by reason of holding stock in the domestic corporation (the "ownership" test); and
3. After the acquisition, the expanded affiliated group (defined in section 7874(c)(1)) that includes the foreign corporation does not have substantial business activities in the foreign country in which, or under the law of which, the foreign corporation is created or organized, when compared to the total business activities of the expanded affiliated group (the "substantial business activities" test).

If a foreign corporation is treated as a surrogate foreign corporation, the domestic corporation that was, or the assets of which were, acquired by it is treated as an "expatriated entity" and generally is subject to limitations on its ability to use certain tax attributes to reduce its U.S. tax on income from certain transactions with related foreign persons. However, if at least 80 percent (rather than 60 percent) of the stock (by vote or value) after the acquisition is held by the former shareholders of the domestic corporation by reason of holding stock in the domestic corporation, the foreign corporation is treated as a domestic corporation for all purposes of the Internal Revenue Code.

Similar provisions apply to transactions involving the acquisition by a foreign corporation of substantially all of the properties constituting a trade or business of a domestic partnership.

## Summary of Key Provisions in the Temporary Regulations

The temporary regulations modify and amend the 2006 temporary regulations to address several areas of concern to the Treasury and IRS, some of which were identified as areas for potential future guidance in the preamble to final regulations issued in May 2008, as well as to address comments received with respect to the 2006 temporary regulations.

Among the key areas addressed in the temporary regulations are the following:

- Stock held by a partnership,
- Indirect acquisition of properties,
- Acquisitions by or of multiple entities,

- Clarification regarding the "by reason of" standard of the ownership test,
- The substantial business activities test,
- Publicly traded foreign partnerships,
- Options and similar interests,
- Economically equivalent interests,
- Insolvent entities, and
- Modification of the internal restructuring exception.

## Stock Held by a Partnership

Final regulations providing guidance for determining the ownership percentage in the case of expanded affiliated groups were issued on May 20, 2008 (the "2008 final regulations"). These regulations provided that stock held by a partnership is to be considered as held proportionately by the partners of the partnership for all purposes of section 7874. In response to comments received, the temporary regulations modify the scope of Treas. Reg. Sec. 1.7874-1(e) related to affiliate-owned stock held by a partnership, to apply only for purposes of determining whether the ownership test is satisfied.

## Indirect Acquisition of Properties

The 2006 temporary regulations identified certain acquisitions that constitute indirect acquisitions of properties held by a domestic corporation. The temporary regulations retain and expand these rules.

First, the temporary regulations provide that the acquisition of an interest in a partnership is an indirect acquisition of a proportionate amount of the properties of the partnership for purposes of the substantially all test.

Second, the temporary regulations expand the rule of the 2006 temporary regulations relating to triangular acquisitions, where a corporation ("acquiring corporation") acquires stock or assets of a domestic corporation in exchange for stock of a foreign corporation ("foreign issuing corporation") that directly or indirectly owns more than 50 percent of the stock (by vote or value) of the acquiring corporation after the acquisition. In such cases, the foreign issuing corporation is treated as acquiring a proportionate amount of the stock or assets of the domestic corporation. Under the temporary regulations, the rule is modified to apply under the following circumstances:

1. If the acquiring corporation and the foreign issuing corporation are members

- of the same expanded affiliated group after the acquisition;
2. In the case of an acquisition of properties of a partnership; or
  3. If a partnership acquires properties of a domestic corporation (or partnership) in exchange for stock of a foreign issuing corporation, but only if the foreign issuing corporation and the partnership would be members of the same expanded affiliated group after the acquisition if the partnership were a corporation.

Lastly, the temporary regulations indicate that the identified transactions do not represent an exclusive list of transactions that constitute "indirect acquisitions."

**PwC Observation:** By making the definition of "indirect acquisition" open-ended, the IRS and Treasury have made the scope of section 7874 still more uncertain. Moreover, this open-ended definition is styled as a clarification of the existing rule, thereby casting uncertainty upon prior transactions as well.

## Acquisitions by or of Multiple Entities

**Acquisitions by Multiple Foreign Corporations.** The Treasury and IRS believe that taxpayers have been seeking to avoid the rules of section 7874 by engaging in transactions under which, pursuant to a plan or a series of related transactions, multiple foreign corporations would collectively acquire substantially all of the properties held by a domestic corporation. In such cases, taxpayers may take the position that neither foreign corporation is a surrogate foreign corporation because no foreign corporation separately acquires substantially all of the properties held by the domestic corporation. To address such transactions, the temporary regulations provide that, in such cases, each foreign corporation shall be treated as completing the acquisition for purposes of determining whether such foreign corporation is treated as a surrogate foreign corporation.

**Acquisition of Multiple Domestic Corporations or Partnerships.** The Treasury and IRS also believe that taxpayers have been seeking to avoid the rules of section 7874 by engaging in transactions under which, pursuant to a plan or a series of related transactions, a single foreign corporation acquires more than one domestic entity. In such cases, taxpayers may take the position that the ownership test is determined separately with respect to each domestic corporation or partnership. To address such transactions, the temporary regulations

provide that, if a foreign corporation completes more than one such acquisition pursuant to a plan or a series of related transactions, for purposes of determining the ownership of the foreign corporation by the former shareholders/partners of a domestic corporation/partnership, the acquisitions are to be treated as a single acquisition, and the domestic corporations/partnerships as a single entity. This rule applies to acquisitions of multiple corporations, multiple partnerships, or multiple corporations and partnerships.

**PwC Observation:** Treasury's authority for this expansive reading of the statute is questionable. Moreover, this expansion of the rules is styled as a clarification and not a change from current law, thereby putting at risk taxpayers who undertook transactions in reliance on the literal words of the statute. Lastly, the temporary regulations provide no guidance on what constitutes a plan and how a series of related transactions would be determined.

## The "By Reason of" Standard

The ownership test requires a determination of whether at least 60 percent of the stock by vote or value of the foreign corporation is held by former shareholders of the domestic corporation "by reason of" holding stock in the domestic corporation (or, as the case may be, by former partners of the domestic partnership "by reason of" holding a capital or profits interest in the domestic partnership). The temporary regulations address this "by reason of" standard in the context of distributions and other transactions, and acquisitions involving other property.

**Distributions and Other Transactions.** Based on comments received with respect to the 2006 temporary regulations, the temporary regulations indicate that the "by reason of" standard does not require stock of the foreign corporation to be received in exchange for stock of the domestic corporation (or an interest in the domestic partnership). Rather, it can also be satisfied if stock of a foreign corporation is received with respect to stock in a domestic corporation (or an interest in a domestic partnership), such as in a taxable or nontaxable distribution. The temporary regulations also indicate that the "by reason of" standard may be satisfied other than through exchanges or distributions.

**PwC Observation:** By making the "by reason of" standard open-ended, the IRS and Treasury have made the scope of section 7874 still more uncertain. Moreover, the modifications to the regulations are styled as clarifications of existing

law, thereby casting uncertainty upon prior transactions as well.

**Acquisitions Involving Other Property.** In response to another comment, the temporary regulations clarify that, subject to the anti-avoidance provision of section 7874(c)(4) and general tax principles, the "by reason of" standard applies based on the amount of stock of the foreign corporation received in exchange for, or with respect to, the stock of the domestic corporation (or interest in the domestic partnership). This determination is based on the relative values of the stock of the domestic corporation (or interest in a domestic partnership) and any other property exchanged for the stock of the foreign corporation. Thus, the "by reason of" standard is not affected by a relationship between stock of the domestic corporation (or interest in the domestic partnership) and such other property.

## The Substantial Business Activities Test

The temporary regulations address several aspects of the substantial business activities test, most notably by removing the safe harbor that was provided in the 2006 temporary regulations.

**Removal of Safe Harbor and Examples.** When the 2006 temporary regulations were issued, the preamble indicated that the Treasury and IRS believed that a dual approach involving an all-facts-and-circumstances test and a bright-line safe harbor test appropriately provided taxpayers with the certainty of an objective, clear safe harbor, while preserving the ability of a taxpayer to conclude that section 7874 is not applicable to a foreign entity's acquisition where the group has a meaningful and bona fide business presence in the relevant foreign country. Since that time, however, the Treasury and IRS have concluded that the safe harbor provided by the 2006 temporary regulations may apply to certain transactions that are inconsistent with the purposes of section 7874 (i.e., to prevent certain transactions that seek to avoid U.S. tax by shifting the place of organization of a domestic corporation or partnership). For this reason, the temporary regulations eliminate the safe harbor test. The temporary regulations also remove the examples illustrating the general rule provided by the 2006 temporary regulations. The Treasury and IRS have requested comments with respect to these changes. The question of whether the substantial business activities test 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.

**PwC Observation:** The lack of a safe harbor test and any examples illustrating the general rule will make the analysis regarding the substantial business activities test difficult in many cases. The inability for a taxpayer to obtain a ruling on whether the substantial business activities test applies makes certainty even more elusive.

**Sales and Services between Expanded Affiliated Group Members.** In response to comments on the 2006 temporary regulations, the preamble to the temporary regulations indicates that, subject to the anti-avoidance rule of section 7874(c)(4) and general tax principles, in appropriate circumstances, sales or the performance of services between members of the expanded affiliated group may be taken into account under the general rule in determining the applicability of the substantial business activities test.

**Items Not to Be Considered.** The 2006 temporary regulations identify certain assets, activities, and income not to be taken into account in determining whether the substantial business activities test is satisfied. The temporary regulations add to these items any assets, business activities, or employees located in the foreign country in which, or under the law of which, the foreign acquiring corporation is created or organized if such assets, business activities or employees are transferred to another country pursuant to a plan in existence at the time of the acquisition.

**Partnership Items.** The temporary regulations retain and modify a provision in the 2006 temporary regulations to provide that, for purposes of the substantial business activities test, a member of the expanded affiliated group that holds at least a 10 percent capital and profits interest in a partnership shall take into account its proportionate share of the items of the partnership, including business activities, employees, assets, income, and sales.

## Publicly Traded Foreign Partnerships

The 2006 temporary regulations treat as a foreign corporation any foreign partnership that would, but for the exception for partnerships with passive income under section 7704(c), be treated as a corporation under section 7704 at any time during the two-year period following the completion by the foreign partnership of an acquisition that otherwise falls under the rules of section 7874. Out of a concern that taxpayers

may be taking the position that the rule does not apply to a foreign partnership whose interests become publicly traded outside this two-year period, even if the public trading occurs pursuant to a plan that existed at the time of the acquisition, the temporary regulations modify the rule to apply to such transactions as well. Under the temporary regulations, a plan is deemed to exist at the time of the acquisition if the foreign partnership would, but for the section 7704(c) exception, be treated as a corporation under section 7704(a) at any time during the two-year period following the acquisition. The temporary regulations also clarify that a publicly traded foreign partnership treated as foreign corporation under the rule is treated as a foreign corporation for all purposes of section 7874.

The temporary regulations also modify an example in the 2006 temporary regulations to eliminate a perceived implication regarding the public offering rule of section 7874(c)(2)(B). The public offering rule provides that, for purposes of the ownership test, stock of the acquiring foreign corporation that is sold in a public offering related to the acquisition is not taken into account. In the example (Section 1.7874-2T(e)(5), Example 3 of the 2006 temporary regulations), a publicly traded foreign partnership is treated as a surrogate foreign corporation but not as a domestic corporation. The publicly traded foreign partnership acquires the stock of a domestic corporation in exchange for 75 percent of its outstanding interests. At the same time as the acquisition, an unrelated person acquires the remaining 25 percent interest in exchange for stock of a foreign corporation. The example concludes that the former shareholders of the domestic corporation hold 75 percent of the interests in the publicly traded foreign partnership by reason of holding stock of the domestic corporation. Implicit in this conclusion is that the 25 percent interest received by the unrelated person in exchange for the stock of the foreign corporation is not subject to the public offering rule. The temporary regulations modify the example to eliminate the implication. The Treasury and IRS are considering issuing guidance concerning the public offering rule and request comments in this regard.

## Options and Similar Interests

The 2006 temporary regulations provide that options and similar interests held by reason of holding stock in a domestic corporation or an interest in a domestic partnership are treated as exercised. The 2006 temporary regulations do not address the treatment of options or similar interests, or stock in a foreign corporation held by

reason of holding options or similar interests, in a domestic corporation or a domestic or foreign partnership (e.g., where the holder of a warrant to acquire stock of the domestic corporation exchanges the warrant for a warrant to acquire stock of the foreign acquiring corporation). The 2006 regulations also do not address the treatment of options or similar interests in a foreign corporation not held by reason of holding stock in a domestic corporation or an interest in a domestic partnership. The temporary regulations make the following changes to the 2006 temporary regulations in order to address these points.

**Domestic Corporations or Partnerships.** The temporary regulations provide that an option or similar interest in a domestic corporation or a domestic or foreign partnership are treated as stock of the domestic corporation or an interest in the partnership with a value equal to the holder's claim on the equity of the domestic corporation or partnership immediately before the acquisition. For example, if the holder of an option in a domestic corporation receives stock of a foreign corporation by reason of holding the option, the holder is treated as holding the stock of the foreign corporation by reason of holding stock in the domestic corporation.

**Foreign Corporations.** The temporary regulations further provide that an option or similar interest in a foreign corporation is generally treated as stock of the foreign corporation with a value equal to the holder's claim on the equity of the foreign corporation immediately after the acquisition. This rule does not apply if a principal purpose of the issuance or acquisition of an option or similar interest is to avoid the foreign corporation being treated as a surrogate foreign corporation.

**Multiple Claims on Equity.** The rules of the temporary regulations concerning options or similar interests do not apply to the extent treating an option or similar interest as stock of a corporation or an interest in a partnership would duplicate, in whole or in part, a shareholder's or partner's claim on the equity of the corporation or partnership. Except to the extent otherwise provided, stock of a corporation held by a shareholder, or an interest in a partnership held by a partner, shall in all cases be taken into account for purposes of section 7874.

## Economically Equivalent Interests

In order to address a perceived abuse where taxpayers intend to avoid the consequences of section 7874 by using interests, such as stock or

partnership interests, that, although not in form exchangeable or convertible into stock of a foreign corporation, are structured to be substantially equivalent to an equity interest in the foreign corporation. As a result, the temporary regulations provide that any interest, including stock or a partnership interest, which is not otherwise treated as stock of a foreign corporation, including under the rules concerning options or similar interests, is treated as stock of the foreign corporation if the following two conditions are satisfied:

1. the interest entitles the holder to distribution rights that are substantially similar in all material respects to the distribution rights entitled to a shareholder of the foreign corporation by reason of holding stock in the foreign corporation; and
2. treating the interest as stock of the foreign corporation has the effect of treating the foreign corporation as a surrogate foreign corporation.

## Insolvent Entities

The temporary regulations provide that, if immediately prior to the first date properties are acquired as part of an acquisition that satisfies the substantially all test, a domestic corporation is in a title 11 or similar case, or the liabilities of the domestic corporation exceed the value of its assets, any claim by a creditor against the domestic corporation is treated as stock of the domestic corporation. As a result, stock of a foreign corporation held by a creditor of the domestic corporation by reason of its claim against the domestic corporation would be considered held by a former shareholder of the domestic corporation by reason of holding stock in the domestic corporation. A similar rule applies with respect to a domestic or foreign partnership.

**PwC Observation:** Treasury's authority for this expansive reading of the statute is questionable. Moreover, this expansion of the rules is styled as a clarification and not a change from current law, thereby putting at risk taxpayers who undertook transactions in reliance on the literal words of the statute.

In response to comments received, the temporary regulations provide that a creditor that is treated as a shareholder of a domestic corporation, or as a partner in a partnership, is treated as a shareholder, or partner, for all purposes of section 7874. Thus, for example, subject to the anti-avoidance rule of section 7874(c)(4) and general tax principles, stock of

the foreign corporation received by a creditor in exchange for other property would not be taken into account in determining former shareholder or former partner ownership.

## Modification to Internal Restructuring Exception

Under the general rule regarding affiliate-owned stock, for purposes of the ownership test, stock held by one or more members of the expanded affiliated group is not included in either the numerator or the denominator of the fraction that determines the ownership percentage ("ownership fraction"). The 2008 final regulations provide an internal group restructuring exception, under which an acquisition is an internal group restructuring if:

1. before the acquisition, 80 percent or more of the stock (by vote and value) or the capital and profits interest, as applicable, of the domestic entity was held directly or indirectly by the corporation that is the common parent of the expanded affiliated group after the acquisition; and
2. after the acquisition, 80 percent or more of the stock (by vote and value) of the acquiring foreign corporation is held directly or indirectly by such common parent.

If the exception applies, stock held by the expanded affiliated group member is included in the denominator, but not in the numerator, of the ownership fraction (i.e., making it less likely for the rules of section 7874 to apply). The preamble to the temporary regulations indicates that the IRS and Treasury are concerned about certain divisive transactions in which taxpayers take the position that the ownership test is not satisfied because of the internal group restructuring exception, with the result that the foreign corporation is not a surrogate foreign corporation. Believing this result to be inappropriate, the IRS and Treasury will issue regulations that determine former shareholder ownership when, pursuant to the same plan or a series of related transactions that includes the acquisition, all or part of the stock of the foreign corporation is transferred outside the expanded affiliated group that includes the foreign corporation after the acquisition. The regulations will provide that the internal group restructuring exception does not apply to such transactions and will also modify the application of the general rule to such transactions. The preamble indicates that such regulations may

apply to acquisitions completed on or after June 9, 2009.

**PwC Observation:** The new rules announced in the preamble are difficult to reconcile with the language of the statute and could apply to some restructuring transactions involving foreign groups with U.S. subsidiaries (e.g., where an existing foreign parent contributes a U.S. company to a foreign company and distributes the foreign company shares to its shareholders).

### Summary: Continued Emphasis on Perceived Abuses and Potential Future Guidance

The temporary regulations reflect a greater focus by the IRS and Treasury on perceived efforts to

avoid the application of section 7874, for example, through the use of multiple entities and partnerships or through a perceived inappropriate application of certain exceptions. The preamble announces future guidance that would continue this trend. With the removal of the safe harbor test and of the examples illustrating the general rule, and the reminder that the Treasury and IRS will not ordinarily issue rulings or determination letters on the substantial business activities test, taxpayers face greater uncertainty regarding the application of these broad-reaching rules.

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