The Treasury Department has issued final, temporary (TD 9761) and proposed (REG-135734-14) regulations modifying the application of Sections 17874 and 367 to inversion transactions and limiting the US tax benefits of certain post-inversion planning. The temporary regulations adopt with some modifications provisions described in notices issued in 2014 and 2015, and add new provisions not included in the earlier notices.

General scope and applicability of the temporary regulations

The temporary regulations adopt with some modifications rules described in Notices 2014-52 and 2015-79. Notice 2014-52 (the 2014 Notice), issued 22 September 2014, described regulations to be issued under Sections 304, 367, 956, 7701(l) and 7874 to address certain inversion transactions and certain post-inversion transactions. Notice 2015-79 (the 2015 Notice), issued 19 November 2015, announced further regulations to be issued addressing certain additional inversion and post-inversion transactions.

The temporary regulations also add new rules not included in the 2014 and 2015 Notices. The new rules: (1) identify the foreign acquiring corporation when a domestic entity is acquired in multiple steps in the inversion transaction;
disregard stock of the foreign acquiring corporation that is attributable to certain prior domestic entity acquisitions; (3) require a controlled foreign corporation (CFC) to recognize all realized gain upon certain transfers of assets described in Section 351 following an inversion transaction that shifts the ownership of those assets to a related foreign person that is not a CFC; and (4) clarify the definition of “group income” for purposes of the substantial business activities test of Section 7874(a)(2)(B)(iii). The temporary regulations also include a new definitions section to define commonly used terms and incorporate rules described in certain other earlier notices (Notices 88-108, 2008-91, 2009-10 and 2010-12) concerning the short-term obligation exception from US property for purposes of Section 956.

The new rules included in the temporary regulations, as well as the changes to the rules described in the 2014 and 2015 Notices, generally apply to acquisitions or post-inversion transactions completed on or after 4 April 2016. However, the rules described in the 2014 Notice apply to acquisitions completed on or after 22 September 2014, and the rules described in the 2015 Notice apply to acquisitions completed on or after 19 November 2015.

New provisions included in the temporary regulations

The preamble to the temporary regulations divides the rules into three parts: (1) rules addressing certain transactions structured to avoid the purposes of Section 7874; (2) rules addressing post-inversion transactions; and (3) certain miscellaneous provisions. These new rule are summarized below.

Multiple-step acquisition of a domestic entity. The temporary regulations include a new “multiple-step acquisition rule” to address, as explained in the preamble, transactions in which a foreign corporation (initial acquiring corporation) acquires substantially all of the properties held by a domestic entity (the initial acquisition) in a transaction that does not result in the initial acquiring corporation being treated as a domestic corporation under Section 7874(b), and, under a plan that includes the initial acquisition (or a series of related transactions), another foreign corporation (subsequent acquiring corporation) acquires substantially all of the properties of the initial acquiring corporation (the subsequent acquisition). The multiple-step acquisition rule treats the subsequent acquisition as a domestic entity acquisition and the subsequent acquiring corporation as a foreign acquiring corporation, and, importantly, defers testing for inversion status until after the subsequent acquisition. When this rule applies, stock of the subsequent acquiring corporation received in the subsequent acquisition in exchange for stock of the initial acquiring corporation is treated as stock of the subsequent acquiring corporation held by reason of holding stock in the domestic entity. As a result of this rule, Section 7874 may apply to both the initial acquisition and the subsequent acquisition.

Acquisitions of multiple domestic entities. Due to concerns that, in certain circumstances, Section 7874 may not apply in certain cases when a single foreign acquiring corporation acquires multiple domestic entities over a prescribed period, the temporary regulations add a new rule that – for purposes of calculating the ownership percentage under Section 7874(a)(2)(B)(ii), by value, with respect to a domestic entity acquisition – excludes from the denominator of the ownership fraction stock of the foreign acquiring corporation attributable to certain prior domestic entity acquisitions. This new rule applies if, within the 36-month period ending on the signing date with respect to the relevant domestic entity acquisition, the foreign acquiring corporation completed one or more other domestic entity acquisitions that are not excluded under an exception.

Clarification of Treas. Reg. Section 1.7874-4T. The temporary regulations clarify certain changes to Treas. Reg. Section 1.7874-4T described in the 2015 Notice, including the meaning of “avoidance property” with respect to the definition of nonqualified property, and eliminating other terms and phrases in the regulations not considered necessary.

“Cash box” rule. The temporary regulations adopt with modifications the “cash box” rule described in the 2014 Notice, which excludes from the denominator of the ownership fraction certain stock of the foreign acquiring corporation attributable to certain passive assets if, after the domestic entity acquisition and all related transactions are complete, more than 50% of the gross value of all foreign group property constitutes certain passive assets. In response to comments, the temporary regulations modify the cash box rule to: (1) include a de minimis exception; (2) narrow the definition of foreign group property; (3) confirm that, for purposes of the more-than-50%
threshold test, foreign group property includes nonqualified property that gives rise to disqualified stock that is excluded from the denominator of the ownership fraction under Treas. Reg. Section 1.7874-4T(b); and (4) take into account assets held by certain controlled partnerships in determining whether the more-than-50% threshold test is satisfied.

Third-country rule. The temporary regulations generally adopt the “third-country rule” included in the 2015 Notice, but clarify the application of the rule’s tax residency requirement and replace the gross value requirement with a continuity of interest requirement.

Non-ordinary course distributions (NOCD) rule. The regulations adopt with certain modifications the NOCD rule, which disregards certain distributions made by a domestic entity during the 36-month period preceding its acquisition by a foreign acquiring corporation for purposes of determining the ownership fraction under Section 7874(a)(2)(B)(ii). In response to comments, the temporary regulations provide that the amount of a distribution is determined based on the value of the property at the time of the distribution and also provide that a corporation or partnership is treated as having made any distributions made by a predecessor entity (the predecessor rule). This predecessor rule aims to prevent potential avoidance of the NOCD rule and increase the accuracy of NOCD calculations. Under this rule, the former owners of the domestic entity are treated as receiving stock of the foreign acquiring corporation with a fair market value equal to the amount of the NOCDs for purposes of determining the ownership percentage by value (but not vote).

Subsequent transfers of stock of the foreign acquiring corporation. The temporary regulations adopt with some modifications a rule set forth in the 2014 Notice concerning the interaction of Treas. Reg. Section 1.7874-5T and the foreign acquiring corporation rules. Changes in the regulations include: (1) providing that a pro rata portion of the subsequently transferred stock is treated as consisting of “by-reason-of stock” and (2) modifying the internal group restructuring exception.

Substantial business activities test. The temporary regulations implement the 2015 Notice’s “subject-to-tax rule” without substantive change. They also include a new rule clarifying “group income” for purposes of the substantial business activities test.

Regulations addressing certain post-inversion transactions

US property rule. The temporary regulations adopt with modifications the US property rule included in the 2014 Notice, under which, solely for purposes of Section 956, any obligation or stock of a non-CFC foreign related person is treated as US property within the meaning of Section 956(c)(1) to the extent such obligation or stock is acquired by an expatriated foreign subsidiary during the applicable period. The temporary regulations clarify that stock or obligations that otherwise meet the requirements of the US property rule but that were issued prior to the applicable period, in a transaction related to the inversion transaction, constitute US property - provided they are acquired on or after 4 April 2016. The temporary regulations also add rules providing that obligations of non-CFC foreign related persons are excluded from the definition of US property to the same extent that obligations of US persons are excluded from the definition of US property under Section 956(c)(2)(C) and (J). The temporary regulations also exclude from the definition of US property obligations of non-CFC foreign related persons that arise in connection with the provision of services by a CFC, based on the principles of the exception in Treas. Reg. Section 1.956-2T(d)(2)(ii).

Section 7701(l) recharacterization rule. The temporary regulations adopt with some modifications the Section 7701(l) recharacterization rule described in the 2014 and 2015 Notices. The temporary regulations includes three exceptions to the rules to recharacterize a transaction - two of which are consistent with the earlier Notices (the exceptions for fast-pay arrangements described in Treas. Reg. 1.7701(l)-3(b) and transactions in which an appropriate amount of gain is recognized). The third exception in the temporary regulations (the de minimis exception) modifies an exception in the 2014 Notice and applies when the expatriated foreign subsidiary is a CFC immediately after the specified transaction and any related transaction and there is only a de minimis shift of ownership of the stock of the expatriated foreign subsidiary or any lower-tier expatriated foreign subsidiary to non-CFC foreign related persons. The temporary regulations also include rules for unwinding the recharacterization as a result of certain subsequent transactions that affect the ownership of the expatriated foreign subsidiary.
**Section 367(b) stock dilution rule.** The temporary regulations implement, with some changes, the Section 367(b) stock dilution rule described in the 2014 and 2015 Notices. The temporary regulations include two new exceptions to the rule. The first exception applies when the exchanging shareholder is neither an expatriated entity nor an expatriated foreign subsidiary. The second exception applies when the expatriated foreign subsidiary is a CFC immediately after the specified exchange and there is only a de minimis shift of ownership of the stock of the acquired expatriated foreign subsidiary to non-CFC foreign related persons.

**Section 367(b) asset dilution rule.** The temporary regulations include a new “Section 367(b) asset dilution rule,” which applies when an expatriated foreign subsidiary transfers specified property to a foreign transferee corporation in an exchange described in Section 351 that occurs within the applicable period. When this rule applies, the expatriated foreign subsidiary generally must recognize all realized gain (but not loss) with respect to the transferred specified property.

**Section 304(b)(5)(B) rules.** The temporary regulations adopt, without change, the Section 304(b)(5)(B) rules described in the 2014 Notice.

**Inversion gain rule.** The temporary regulations adopt the inversion gain rule included in the 2015 Notice providing that inversion gain includes income inclusions (e.g., subpart F income inclusions) attributable to indirect transfers of property by an expatriated entity, including through a partnership in which the expatriated entity is a partner or a CFC.

**Endnotes**

1. All “Section” references are to the Internal Revenue Code of 1986, and the regulations promulgated thereunder.


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