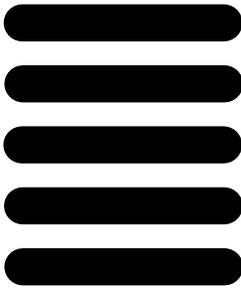




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## Corporate Inversion Reporting

By Robert W. Wood • Wood & Porter • San Francisco

Most of the shine is off corporate inversions. In fact, they are now relegated to a largely historical Dennis Kozlowski–Tyco era. Section (“Code Sec.”) 7874 of Code was enacted as part of the American Jobs Protection Act of 2004 to penalize situations in which a U.S. parent corporation (or partnership) becomes a subsidiary of a foreign corporation having the same shareholders, domestic or foreign. The idea of an inversion transaction is not too far off its name. What might have formerly been a controlled foreign corporation of a domestic parent is inverted, with the foreign company becoming the parent of a domestic subsidiary.

Yet, Code Sec. 7874 is a broad provision and can certainly snare the expatriation of a domestic subsidiary of a U.S. parent. The tax reach of Code Sec. 7874 is twofold.

First, it applies to pure inversions where the foreign corporation becomes the owner of 80 percent or more of the former U.S. parent company. In this case, the foreign corporation is treated as if it is a U.S. corporation for all purposes of the Code. To make matters worse, the use of tax credits are severely limited, and all inversion gain is treated as U.S. source income, effectively eliminating the use of foreign tax credits. This appears to close down the U.S. income tax benefits of pure inversions.

### How Inverted Is an Inversion?

Code Sec. 7874 also applies to lesser inversions, where the foreign corporation owns at least 60 percent (but less than 80 percent) of the vote or value of the former U.S. parent company. Here, the foreign corporation is treated as a foreign corporation. However, for a 10-year period after expatriation, the expatriating company will recognize U.S. income or gain by reason of the transfer. This is a fairly extensive provision, and may include income or gain generated under Code

*(continued on page 2)*

**ALSO IN THIS ISSUE**

“A” Reorganizations Revisited.....	3
All in the Family: NOLs and Other Family Jewels.....	7

Secs. 304, 311(b), 367, 1001 and 1248, as well as any income generated from the license of property by the expatriating company. Again, the use of credits is limited.

Notably, when the foreign corporation becomes the owner of less than 60 percent of the former U.S. parent, Code Sec. 7874 does not apply. Even so, Code Sec. 7874 contains a couple of safe harbors designed to make sure that good transactions don't get tarred with the same brush as bad ones. One of the safe harbors makes Code Sec. 7874 inapplicable if the new home country is where the "expanded affiliated group" had substantial business activities.

The expanded affiliated group is the Code Sec. 1504 definition of an affiliated group, but expanded to include foreign corporations, and using a more-than-50-percent threshold rather than an 80-percent ownership threshold. The reach of Code Sec.

7874 can also be avoided because the stock of a foreign corporation held by members of the "expanded affiliated group" will be ignored. Thus, if all of the foreign corporation's stock is held by other group members, then it is not owned by the former shareholders and Code Sec. 7874 will not apply.

**Regulations**

There's been a good deal of concern about various transactions that do not fit within the two statutory safe harbors. Temporary and proposed regulations try to address this, and they are worth a look. In late December of 2005, the IRS issued temporary regulations that fix (or attempt to fix) several anomalies in the anti-corporate inversion provision that was enacted in October of 2004. [T.D. 9238, Dec. 27, 2005; Reg. §1.7874-1T.]

One rule ignores stock in a foreign corporation owned by members of the expanded affiliated group in determining whether the original owners continued to own certain high percentages of interests in the expatriated entity. This rule ignores stock (of a former foreign subsidiary) that a U.S. parent may continue to own after it expatriates to become a subsidiary of the new foreign holding company. This is sometimes referred to as "hook" stock.

The temporary regulations address certain intra-group restructuring. Evidently, an outbound F reorganization is not effected by these rules. An outbound stock transfer may also not be effected. However, these good results may not follow when there are minority owners. Caution dictates a careful review of the regulations in these circumstances.

The temporary regulations also address situations where no corporation owns more than 50 percent of the stock of the expatriating entity. In other words, what if 50/50 joint venturers want to move outside the United States? Unfortunately, the joint ventures appear to be implicated by the regulations and thus subject to Code Sec. 7874.

**Watch out**

Finally, the temporary regulations address attempts to sidestep Code Sec. 7874. Watch out for more regulations here. Indeed, the preamble to these temporary regulations



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states that the IRS is looking at other expatriation strategies, and that it has the power to issue retroactive regulations. For example, shareholders of a U.S. corporation (or U.S. partnership) may transfer their shares to a newly formed foreign entity that makes the check-the-box election to be treated as a partnership. Although this seemingly doesn't fall within the purview of Code Sec. 7874 (since only transferee corporations are snagged), the IRS believes that the legislative grant to create regulations provides it authority to curtail the benefits of this transaction or other similar transactions which may step side the Code.

**Effective Date**

Code Sec. 7874 was enacted on October 22, 2004. Yet, it is effective for inversions that occur after March 4, 2003. Even worse, Code Sec. 7874 can claw back transactions up to two years further. So much for prospective rule-making. Jumping on this retroactive bandwagon, the regulations are also effective on March 4, 2003.

Code Sec. 7874 is complicated and broad, and practitioners will need to heed its U.S. tax leash. Yet, partial inversions may slip through its yoke, and transactions with sound business purpose may be excepted altogether. Practitioners will have to make a concerted effort to determine its affects upon any transaction.