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In this report, the authors examine the changes to section 7874 proposed by the Senate Finance Committee in connection with the Build Back Better Act from an historical perspective, and they explain how the proposal could be fine-tuned to address the government's underlying policy objectives without producing unintended, counterintuitive results.

Everything's been said, but it needs saying again.
— Ernest Gaines[1]

I. Introduction

As the Build Back Better Act (H.R. 5376) has taken shape in Congress, the international tax community has focused primarily on the country-by-country changes to section 951A (global intangible low-taxed income) and, perhaps to a lesser extent, the proposed interest expense limitations under section 163(n). We believe a less heralded proposal, a proposal by the Senate Finance Committee (Senate proposal) to expand the types of acquisitions to which section 7874 can apply, also deserves attention.[2] Although passage of the Build Back Better Act may be in doubt, the Senate proposal to expand the scope of section 7874 is consistent with prior legislative proposals. The precursor to the Senate proposal can be found in Obama-era green books, and this proposal was most recently revived in the fiscal 2022 green book.[3] Thus, regardless of the fate of the Build Back Better Act, legislative proposals similar to the Senate proposal are likely to be advanced again by Treasury or Congress.

This report reflects more broadly on section 7874's historical and current role and closely examines whether the Senate proposal would properly carry out its intended policy in light of current law. Collectively, as tax advisers, we have observed many everyday transactions that these proposed changes would affect in unexpected and

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[1] For an analysis of similar proposals by Treasury, "General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals" (May 28, 2021) (fiscal 2022 green book), see Gary Scanlon et al., "More Sledgehammers, Fewer Flies: The Green Book's Anti-Inversion Proposals," *Tax Notes Federal*, July 26, 2021, p. 539. Shortly before we submitted this report, Yaron Z. Reich published an excellent piece covering many of the same issues found here. *See* Reich, "How the Senate's Anti-Inversion Proposal Adversely Affects Partnerships," *Tax Notes Federal*, Mar. 7, 2022, p. 1341. We commend Reich for being the Newton to our Leibniz.

[2] The Senate proposal would also reduce the shareholder ownership thresholds required for a transaction to constitute an inversion. We express no opinion here on those proposed changes, because they are beyond the scope of this report. We note, however, that the reduction in the requisite ownership percentages, with or without the expansion of the in-scope acquisitions, would put additional pressure on the ownership adjustments rules in Treasury regulations, many of which are discussed in this report. Therefore, if the Senate proposal is adopted in whole or in part, those regulations should be reevaluated to determine whether they remain "fit for purpose." For example, the scope of the de minimis rules found in reg. section 1.7874-4, -7, and -10 could be expanded to apply to more transactions with little or no ownership continuity.

[3] *See, e.g.*, Treasury, "General Explanations of the Administration's Fiscal Year 2017 Revenue Proposals" (Feb. 2016); and fiscal 2022 green book, *supra* note 1. The Trump administration did not publish a green book. It is anticipated that the Biden administration will release its fiscal 2023 green book between the submission and publication dates for this report. *See* Doug Sword, "Biden to Release Fiscal 2023 Budget Proposal March 28" (Mar. 21, 2022). This report does not consider the provisions of this new green book that relate to section 7874.

counterintuitive ways. This report highlights those unintended results and examines the policy basis for the proposed changes. We conclude by recommending refinements to the proposal to address the government's policy objectives in a more direct and tailored manner.

II. Current Law

Section 7874 has three general requirements that must be satisfied for a transaction (or a series of related transactions) to constitute an inversion. First, a foreign corporation must complete a domestic entity acquisition, which is the direct or indirect acquisition of either (1) substantially all the assets directly or indirectly held by a domestic corporation or (2) substantially all the properties constituting a trade or business of a domestic partnership. Second, former equity holders of the domestic entity must own at least 60 percent of the stock of the foreign acquiring corporation, by vote or value, by reason of their ownership of the domestic entity (that percentage being the ownership percentage, and that requirement being the ownership requirement). Third, the foreign acquiring corporation's expanded affiliated group (EAG)[4] must not have substantial business activities in its country of creation or organization.[5]

How section 7874 applies to a domestic entity acquisition depends on the ownership percentage. If the ownership percentage is at least 80 percent, the transaction results in a complete inversion under section 7874(b), and the foreign acquiring corporation is a surrogate foreign corporation that is treated as a domestic corporation for all purposes of the Internal Revenue Code.

If the ownership percentage is at least 60 percent but less than 80 percent, the transaction results in a partial inversion under section 7874(a). Although the foreign acquiring corporation in a partial inversion is respected as a foreign corporation for U.S. tax purposes, it is a surrogate foreign corporation, and the domestic entity and all U.S. persons related to the domestic entity are expatriated entities.[6] Several adverse U.S. tax consequences apply as a result of a partial inversion, including: (1) an expatriated entity cannot use tax attributes to offset gain or income recognized (inversion gain) with respect to certain transfers or licenses of property;[7] (2) an excise tax is imposed on specified executive compensation when the shareholders of a domestic corporation recognize gain on a partial inversion;[8] (3) dividends from the foreign acquiring corporation are ineligible for qualified dividend rates under section 1(h)(11);[9] (4) deductions of an expatriated entity permitted under section 965(c) for the transition tax included in the Tax Cuts and Jobs Act[10] are immediately recaptured and taxed at 35 percent without offset by credits;[11] and (5) the cost of goods sold exception to section 59A (the base erosion and antiabuse tax) does not apply for payments to the foreign acquiring corporation or any foreign person that is a member of an EAG that includes the foreign acquiring corporation.[12]

The regulations under section 7874 provide rules that adjust the ownership percentage. These rules generally increase the possibility that the

[4] An EAG is defined as an affiliated group within the meaning of section 1504(a), using a lower ownership threshold ("more than 50 percent" rather than "at least 80 percent") and including foreign corporations. Section 7874(c)(1).

[5] While the statute couches this "lack of substantial business activities" as a requirement, it is perhaps easier and more accurate to view the existence of substantial business activities as an exception to section 7874. Viewed in that light, there are only two requirements to section 7874: the domestic entity acquisition and ownership percentage requirements. An acquisition that satisfies both will be an inversion, unless the resulting EAG has substantial business activities in the country of creation or organization of the foreign acquiring corporation in which it is tax resident. This articulation of the statute is particularly helpful in light of the unlikelihood of any multinational group — inverted or otherwise — having sufficient activities in any single country outside the United States to satisfy the elevated standards in reg. section 1.7874-3.

[6] Section 7874(a)(2)(A) and (B).

[7] Section 7874(a)(1) and reg. section 1.7874-11. Under regulations issued in 2016, inversion gain includes income inclusions attributable to indirect dispositions of property by a domestic entity, such as a subpart F inclusion resulting from a wholly owned controlled foreign corporation's transfer of property to a related foreign person. *See* reg. section 1.7874-11(e), Example. While this rule is commonly described as restricting the use of net operating losses and foreign tax credits to shelter inversion gain, the deduction under section 250 for foreign-derived intangible income earned by reason of a related-party sale or license might also be disallowed by reason of this provision.

[8] Section 4985.

[9] Section 1(h)(11)(C)(iii)(II).

[10] The TCJA is technically titled "An Act to Provide for Reconciliation Pursuant to Titles II and V of the Concurrent Resolution on the Budget for Fiscal Year 2018," P.L. 115-97.

[11] Section 965(l). This result is potentially catastrophic for taxpayers that had significant foreign earnings as of the enactment of the TCJA, particularly if those earnings have been distributed to shareholders or used to repay debt and are therefore unavailable to satisfy the resulting tax liability.

[12] Section 59A(d)(4).

ownership percentage will be at least 60 percent (and therefore that a domestic entity acquisition will result in an inversion) by either increasing the numerator of the fraction used to compute the ownership percentage (the ownership fraction) or decreasing its denominator.[13] The three regulations most relevant to the examples discussed in this report are the rules pertaining to (1) stock owned by members of the EAG that includes the foreign acquiring corporation under reg. section 1.7874-1, (2) disqualified stock under reg. section 1.7874-4, and (3) non-ordinary course distributions (NOCDs) under reg. section 1.7874-10.

In general, the EAG-owned-stock rules exclude from both the numerator and the denominator of the ownership fraction foreign acquiring corporation stock owned by a member of the EAG that includes the foreign acquiring corporation.[14] However, for a domestic entity acquisition that qualifies as an internal group restructuring, foreign acquiring corporation stock owned by an EAG member is included in the denominator of the ownership fraction, but still excluded from its numerator, even if that stock were received by the EAG member "by reason of" an interest in the domestic entity.[15] A domestic entity acquisition qualifies as an internal group restructuring if two conditions are satisfied: (1) before the acquisition, at least 80 percent of the interests (by vote and value) of the domestic entity is held directly or indirectly by the corporation that is the common parent of the EAG after the acquisition; and (2) after the acquisition, at least 80 percent of the stock (by vote and value) of the foreign acquiring corporation is held directly or indirectly by that common parent.[16]

The disqualified stock rule generally excludes foreign acquiring corporation stock from the denominator of the ownership fraction if it is transferred for specific kinds of property, such as cash or marketable securities, in a transaction that is related to a domestic entity acquisition and increases the net equity value of the foreign acquiring corporation.[17] The disqualified stock rule is intended to prevent a foreign acquiring corporation from "fattening up" in connection with a domestic entity acquisition, thereby reducing the ownership percentage by increasing the denominator of the ownership fraction.[18]

The NOCD rule deems stock of the foreign acquiring corporation to be included in both the numerator and denominator of the ownership fraction if the domestic entity makes disproportionately large distributions (that is, NOCDs) during the 36-month period before a domestic entity acquisition.[19] In effect, these rules treat the former owners of a domestic entity as owning additional domestic entity interests equal to the amount of that entity's NOCDs immediately before the domestic entity acquisition and then exchanging those interests for additional foreign acquiring corporation stock in the acquisition, thus increasing the "by reason of stock" owned by the former equity holders. The purpose of the rule is to prevent domestic entities from "skinnying down" before a domestic entity acquisition, thereby reducing the ownership percentage by reducing the numerator and denominator of the ownership fraction.[20]

Both the NOCD rule and the disqualified stock rule are subject to a de minimis exception,

[13] The NOCD rule, discussed below, can increase the numerator *and* denominator. Also, the internal group restructuring exception and the loss of control exception of the EAG-owned-stock rules, discussed below, can reduce the ownership percentage by decreasing the numerator without changing the denominator.

[14] Reg. section 1.7874-1(b). The EAG rule has its origins in section 7874(c)(2)(A), which disregards stock held by members of the EAG that includes the foreign acquiring corporation.

[15] Reg. section 1.7874-1(c)(1). Another exception exists if the transaction results in a loss of control, that is, if former owners of the domestic entity do not hold, in the aggregate, directly or indirectly, more than 50 percent of the stock (by vote or value) of any member of the EAG of the foreign acquiring corporation. *See* reg. section 1.7874-1(c)(1) and (3).

[16] Reg. section 1.7874-1(c)(2).

[17] Reg. section 1.7874-4(b) and (c).

[18] The disqualified stock rule has its origins in section 7874(c)(2)(B), which disregards some publicly offered stock in determining the ownership fraction.

[19] Reg. section 1.7874-10.

[20] The NOCD rule was issued under the antiabuse authority of section 7874(c)(4). It is very broad and can apply in counterintuitive ways, particularly when combined with the disqualified stock rule. For example, the concurrent application of the NOCD and disqualified stock rules can cause an all-cash purchase of the assets of a domestic entity by a foreign corporation to qualify as a partial or complete inversion, unless the de minimis exception, discussed below, applies. Further, an example in the preamble to the NOCD rule implies that the rule can even treat historical equity holders of a domestic entity that do not actually own equity in the domestic entity at the time of the domestic entity acquisition as former equity holders for purposes of the ownership test if those persons received NOCDs within the 36-month period preceding the domestic entity acquisition. *See* preamble to T.D. 9834, 83 F.R. 32524, 32528 (July 12, 2018).

but in practice this exception is difficult to meet. The exception requires both (1) the ownership percentage (determined without regard to the NOCD rule, the disqualified stock rule, and the excessive passive asset rule in reg. section 1.7874-7) to be less than 5 percent, and (2) each 5 percent former equity holder of the domestic entity to own less than 5 percent (by vote and value) of each member of the foreign acquiring corporation's EAG.[21] The constructive attribution rules of section 318 are applied to determine whether a former equity holder is a 5 percent owner of a domestic entity before the acquisition and to determine a 5 percent former equity holder's ownership of EAG members after the acquisition. Because of the breadth of the constructive ownership rules of section 318, taxpayers often lack the information necessary to accurately determine whether the de minimis rule is satisfied.[22]

III. The Senate Proposal

The Senate proposal would significantly expand the reach of section 7874. First, the Senate proposal would reduce the ownership percentage thresholds (to "more than 50 percent" for partial inversions and to "at least 65 percent" for complete inversions). Second, it would broaden the definition of a domestic entity acquisition to include, in addition to the acquisitions described above, the direct or indirect acquisition of (1) substantially all the properties held directly or indirectly by a domestic corporation and constituting a trade or business; (2) substantially all the properties held directly or indirectly by a domestic partnership and constituting a trade or business; (3) substantially all the properties held directly or indirectly by a domestic partnership; and (4) substantially all the properties held directly or indirectly by a foreign partnership and constituting a U.S. trade or business. In short, the Senate proposal would conform the treatment of domestic partnerships and domestic corporations for purposes of section 7874 and expand the application of section 7874 to foreign partnerships with U.S. trades or businesses.

There are two important changes to highlight regarding these new acquisition categories. First, the trade or business acquisition appears to apply to the acquisition of *any* trade or business, regardless of its size relative to the overall entity.[23] Second, the new acquisition categories apply to the acquisition of properties, including properties constituting a trade or business, owned directly or *indirectly* by an in-scope entity, including a partnership.

The House version of the Build Back Better Act contained no proposals to amend section 7874, and as of this writing, there is neither a Joint Committee on Taxation explanation nor a Senate report for the Senate proposal. Thus, there is no explanation for this proposal. However, as discussed earlier, this is not a new proposal; similar proposals have been made in Treasury green books, including most recently in the fiscal 2022 green book. The green books mention the "significant policy concerns" that inversions raise (for example, the ability to erode the U.S. tax base, as discussed later) but do not address how the expanded domestic entity acquisition categories implicate those concerns. Importantly, the fiscal 2022 green book reiterates those policy concerns without addressing the provisions of the TCJA, the anti-inversion regulations issued in 2016,[24] or the regulations under section 385,[25] all of which significantly deter partial inversions.

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[21] Reg. section 1.7874-4(d)(1) and -10(d). *See also* reg. section 1.7874-7(c) (de minimis exception to the application of the excessive passive asset rule).

[22] *Cf.* LTR 202141005 (describing a complex method used by a taxpayer in determining whether the shareholders of a target corporation in a public acquisition controlled the acquiring corporation within the meaning of section 304(c), which cross-references section 318); Mark R. Hoffenberg, Stephen M. Marencik, and Adam Murphy, "Determining Control in Public M&A Transactions," *Tax Notes Federal*, Dec. 13, 2021, p. 1487 (analyzing LTR 202141005 and describing the challenges of determining overlap in public deals); *see also* New York State Bar Association Tax Section, "Report on Section 304 in Public M&A Transactions," Rep. No. 1445 (Nov. 19, 2020).

[23] We say "appears to" because the drafting of the proposed changes is not crystal clear. One might be tempted to read these rules as creating two requirements: (1) substantially all of an entity's properties must be acquired, and (2) those acquired properties must constitute a trade or business. This reading would, however, render the existing rule for domestic corporations superfluous. Therefore, we believe the better reading of the proposed rule is that it applies to the acquisition of substantially all the properties of a trade or business owned directly or indirectly by an entity, regardless of whether those properties represent substantially all of the entity's properties.

[24] T.D. 9761.

[25] T.D. 9790.

IV. The Purpose of Section 7874

A. In General

Section 7874 was added to the code in 2004 to address concerns about tax inversions, which typically involve the replacement of a domestic corporation with a foreign corporation as the parent of a multinational group with minimal changes to the group's shareholders and operations. Before the enactment of section 7874, the media and Congress focused on three U.S. tax benefits that inversions provided taxpayers.[26] First, multinationals could avoid U.S. corporate tax on existing and future foreign earnings by causing the U.S. company to sell its foreign subsidiaries "out from under" the U.S. tax net to the new foreign parent, as well as have the new foreign parent acquire any additional foreign operations. Second, multinationals could reduce tax on U.S. corporate earnings by issuing intercompany debt or making other deductible payments, such as royalties, to the foreign parent or other foreign affiliates. Third, a foreign parent could access cash held offshore by the U.S. company's foreign subsidiaries at the time of the transaction without incurring the U.S. tax cost that would arise if that cash were repatriated directly to the United States.

B. Partnership Inversions

Section 7874 also applies to acquisitions of properties constituting a trade or business of a domestic *partnership*. While the legislative history to section 7874 is replete with references to tax avoidance associated with corporate inversions, it mentions partnership inversions barely at all, almost as an aside. This suggests that Congress viewed partnership inversions as implicating the same tax avoidance concerns as corporate inversions — that is, the erosion of the U.S. tax base. But partnerships, whether domestic or foreign, do not pay entity-level U.S. tax. Therefore, the income of a partnership, unlike that of a corporation, is not included in the U.S. tax base merely by reason of its organization in the United States. Rather, the income of a partnership — again, whether domestic or foreign — is included in the U.S. tax base only to the extent the income is subject to U.S. tax in the hands of its partners.

The New York State Bar Association Tax Section, in a report issued shortly before the enactment of section 7874, described the primary benefit of a partnership inversion as obtaining foreign corporate status *ab initio*.[27] In other words, partnership inversions could avoid the detriments of being exposed to the U.S. corporate tax system.[28] But if that were the primary benefit of a partnership inversion, it is unclear why domestic partnerships were made subject to section 7874, but not foreign partnerships or even individuals, neither of which is subject to entity-level U.S. corporate tax.[29]

In any case, because partnerships do not pay entity-level U.S. tax, Congress's concerns about partnership inversions must necessarily have centered on the avoidance (or deferral) of partner-level tax. U.S. partners[30] of a partnership, whether domestic or foreign, are typically subject to U.S. tax on their distributive shares of all the earnings of the partnership, as well as (if their level of ownership is sufficient) their pro rata shares of specified earnings of foreign subsidiaries owned by the partnership. In contrast, foreign partners[31] are typically subject to tax only on a partnership's

[26] For a detailed analysis of these tax benefits, see NYSBA Tax Section, "Report on Outbound Inversion Transactions," Rep. No. 1014 (May 24, 2002).

[27] *Id*. at 19.

[28] As Boris I. Bittker and James S. Eustice famously wrote, "A corporation is like a lobster pot: it is easy to enter, difficult to live in, and painful to get out of." Bittker and Eustice, *Federal Income Taxation of Corporations and Shareholders*, para. 2.01[3] (1997). Because of the anti-inversion rules of sections 367 and 7874, this sentiment is particularly apt as a description of a *domestic* corporation.

[29] *See* NYSBA, *supra* note 26, at 53 ("Given the fact that there is virtually no difference under current U.S. tax law between the treatment of foreign and domestic partnerships, it is not clear why the foreign partnership should be exempt from the potential application of the new inversion rules."). For the reasons stated below, we do not believe this observation counsels in favor of expanding the application of section 7874 to, for example, a sole proprietor's incorporation of a foreign business. Rather, we believe it calls for a closer examination of the justification of including domestic partnerships within the provision's ambit in the first place and whether other provisions, such as sections 367, 482, 951, and 951A, are better suited to police potential owner-level tax avoidance than section 7874.

[30] The term "U.S. partners" is a simplification for purposes of illustration. Many U.S. persons are partners of partnerships that generally do not pay U.S. tax (*e.g.*, domestic partnerships and some tax-exempt corporations). Because the focus of this discussion is on potential U.S. tax avoidance by U.S. partners, those types of U.S. persons are ignored.

[31] The term "foreign partners" is also a simplification for purposes of illustration, because many types of non-U.S. persons would not owe U.S. tax on ECI earned by a partnership.

U.S.-source fixed or determinable annual or periodic income or income that is effectively connected with a U.S. trade or business (ECI) or deemed to be ECI under the 1980 Foreign Investment in Real Property Tax Act rules of section 897. Each profile is addressed separately in the following discussion.

1. Domestic Partners

Before the enactment of section 7874, a partnership inversion's primary benefit to U.S. partners would have been deferral of U.S. taxation on income from the partnership's foreign operations. U.S.-source FDAP income or ECI would have been subject to current U.S. tax at the level of the foreign corporation under section 881 or 882, respectively, rather than at the partner level. To the extent that the U.S. corporate tax rate was less than the partner's individual tax rate, a partnership inversion could have produced a current U.S. tax benefit.[32] But in general, the price of that partial deferral was subjecting the income to two layers of tax — at the corporate level currently and at the shareholder level upon distribution — as opposed to a single layer of partner-level tax.[33]

Although the legislative history is silent in this regard, perhaps Congress, in applying section 7874 to domestic partnerships but only to acquisitions of a trade or business of those partnerships, recognized that both deferral and a single layer of U.S. tax could be achieved for the foreign incorporation of U.S. trade or business assets. For example, immediately after the foreign incorporation, the new foreign corporation could contribute the U.S. trade or business assets to a new domestic corporate subsidiary and then leverage that domestic corporate subsidiary with related-party debt. If the foreign corporation retained the intangible property related to the business, the resulting related-party royalty payments from the domestic subsidiary could further reduce U.S. taxable income. Assuming that the foreign parent is a tax resident of a low- (or no-) tax jurisdiction, this strategy could eliminate some or all of the entity-level U.S. tax.[34] Further, assuming that the foreign parent is not a controlled foreign corporation as defined in section 957(a), U.S. investors would not be taxed on any of the earnings from the U.S. trade or business until distributed.[35]

Deferral for U.S. partners was potentially even more potent in the context of foreign earnings in 2004. As long as the foreign corporation's earnings were not subject to either the subpart F regime[36] or the passive foreign investment company rules,[37] the earnings would not be taxed currently in the partner's hands but rather would be subject to U.S. tax only upon their distribution.[38] In this regard, it is significant that as of 2004, the position of Treasury and the IRS was that a domestic partnership that was a U.S. shareholder under section 951(b) (generally, 10 percent ownership by vote or value) (U.S. shareholder) of a CFC had the subpart F inclusion for that CFC's subpart F income under section 951(a), and that all U.S. partners — even "small" U.S. partners (that is, U.S. partners that are not themselves U.S. shareholders) — were required to include their distributive shares of the partnership's subpart F

[32] Foreign corporations are not unique in this regard; the same temporary tax savings could be obtained by incorporating partnership assets in a domestic corporation. Indeed, this phenomenon was widely observed after the enactment of the TCJA, when corporate income tax rates dropped to 21 percent, and various S corporations and asset management companies converted to C corporations, in part because of the lower corporate tax rates. In our view, this phenomenon should not have given rise to special rules under section 7874 for foreign corporations. Rather, these concerns historically have been, and continue to be, policed through the accumulated earnings tax and the personal holding company rules.

[33] This double taxation is ameliorated, but not eliminated, if the dividends from the foreign acquiring corporation qualify for the lower qualified dividend rate under section 1(h)(11). Moreover, absent treaty benefits, the application of the branch profits tax under section 884 results in a worse outcome relative to a domestic corporation for U.S. partners.

[34] Note, however, that this strategy would result in taxation of any appreciation in the transferred assets under section 367 (discussed below). *See, e.g.*, reg. section 1.367(a)-3(d). Also, the subpart F rules (discussed below) could offset any base erosion achieved by the U.S. subsidiary by taxing specific U.S. owners of the foreign acquiring corporation.

[35] The same deferral could be achieved even if the foreign parent were a CFC for U.S. persons that are not U.S. shareholders of the foreign parent within the meaning of section 951(b). On the other hand, if the foreign parent were a CFC, U.S. shareholders within the meaning of section 951(b) would have to include interest or royalties paid by the domestic subsidiary to the foreign parent as subpart F income under section 951(a), thus eliminating the deferral benefit.

[36] This could be the case if U.S. partners were not U.S. shareholders, the foreign corporation was not a CFC, or the income of the foreign corporation was not subpart F income. *See* section 951 et seq.

[37] *See* section 1291 et seq.

[38] This was the issue presented in *Siegel v. Commissioner*, 45 T.C. 566 (1966), in which the taxpayer practically admitted that the business rationale for incorporating his foreign farming business was to achieve the benefit of deferral.

inclusion in income.[39] Thus, for U.S. partners that were not U.S. shareholders in their own right, the foreign incorporation of a domestic partnership with CFCs could permit them to avoid including the CFCs' subpart F income, provided that the partnership liquidated or shed its domestic status as part of the transaction.[40]

Some readers might point out that the deferral benefits of a partnership inversion could be accomplished only by successfully navigating the proverbial Scylla and Charybdis of sections 367 and 482, but those provisions were far less daunting then than they are today. For example, section 367(a), which imposes a toll charge on outbound transfers of specified stock or tangible property, provided an exception for the transfer of assets used in an active trade or business outside the United States, and the regulations under section 367(d), which treats outbound transfers of intangible property as contingent sales, did not apply to transfers of foreign goodwill and going concern value.[41]

Since 2004, however, Congress has significantly tightened the rules policing outbound transfers. First, the TCJA removed the foreign active trade or business exception from section 367(a) and expanded section 367(d) to apply to the outbound transfer of all intangible property, including goodwill and going concern value.[42] The TCJA also amended section 482 to permit the commissioner to value transfers of intangible property based on aggregate values or realistic alternatives.[43] When viewed in conjunction with the recent trend of IRS transfer pricing victories in the courts, section 482 is now a much more powerful tool for the government.[44]

Further, even if a taxpayer can shift earnings to a foreign corporation without incurring an upfront cost under sections 367 and 482 that is commensurate with the assets' future earnings,[45] changes since 2004 have reduced many of the historical advantages of U.S. persons operating through a foreign corporation rather than a domestic partnership. First, the enactment of GILTI regime in the TCJA has effectively eliminated deferral for U.S. shareholders of CFCs. GILTI ensures that most foreign earnings of a CFC will be subject to current U.S. tax in the hands of a U.S. shareholder, either as subpart F income or as tested income, the latter with the exception of a deemed return on some tangible assets and limited categories of excluded income (for example, foreign oil and gas extraction income or income subject to high rates of foreign tax).[46]

Further, for small U.S. partners, recent changes to the taxation of domestic partnerships mean that those partners will not have a subpart F or GILTI inclusion for CFCs owned by a domestic partnership.[47] Although generally a foreign corporation owned by a domestic partnership will qualify as a CFC,[48] only those partners that themselves qualify as U.S. shareholders will be subject to current U.S. tax under section 951 or

[39] *See* preamble to REG-101828-19, 84 F.R. 29114, 29116 (June 21, 2019) (preamble to the proposed regulations under section 958, describing prior-law treatment of domestic partnerships for purposes of subpart F).

[40] Although, if the resulting foreign corporation were a PFIC, those U.S. persons could then be subject to the PFIC regime.

[41] Before the issuance of regulations in 2016, regulations provided that foreign goodwill and going concern value were not subject to section 367(d), which resulted in significant controversy with the IRS. *See* T.D. 9803. Similar disputes arose under section 482 concerning questions about whether particular intangibles were "compensable." *Amazon.com Inc. v. Commissioner*, 148 T.C. 108 (2017), *aff'd*, 934 F.3d 976, n.1 (9th Cir. 2019).

[42] *Amazon.com*, 934 F.3d at 979, n.1 ("In 2017, Congress amended the definition of 'intangible property.' . . . If this case were governed by . . . the 2017 statutory amendment, there is no doubt the Commissioner's position would be correct.").

[43] *Cf. Id.* at 976.

[44] Additional provisions have increased the potential costs of transferring assets to a foreign corporation, including the enhanced branch loss recapture rule in section 91, which was also added to the code by the TCJA.

[45] This could occur, for example, as the result of depressed asset prices or better-than-expected returns from the property. Regarding the latter situation, risky assets, such as pharmaceuticals under development, may turn out to be highly profitable, even though that information may not be knowable when the asset is transferred, and if the transfer is not subject to section 367(d), that future income generally would not be captured. For the commensurate with income rules, see generally sections 367(d) and 482 and reg. section 1.482-4.

[46] The policy rationale for not taxing foreign oil and gas extraction income is that the income reflects "location specific rents" and therefore is not susceptible to income shifting like other categories of income. Whether one views the high-tax exception in section 951A(c)(2)(a)(i)(III) as providing a deferral benefit depends on one's point of comparison. If those assets were incorporated in a domestic corporation, little or no U.S. tax would result because of the FTC under section 901. Finally, corporate partners may achieve a tax rate benefit when a partnership transfers assets to a foreign corporation because of the deduction under section 250(a)(1)(B) for GILTI. The benefit may be offset to some extent by the loss of section 250(a)(1)(A) deductions for FDII and could also be achieved by the corporate partner on its own (*e.g.*, by transferring its partnership interest to a foreign corporation).

[47] *See* T.D. 9960.

[48] *See* reg. section 1.958-1(d)(2)(i) and (ii).

951A on the foreign corporation's earnings.[49] Effectively, for purposes of subpart F and GILTI, a domestic partnership is now treated as an aggregate of its partners, in the same manner as a foreign partnership. Thus, incorporating a domestic partnership into a foreign corporation and liquidating the partnership no longer offers the potential benefit of avoiding subpart F (or GILTI) for small U.S. partners, because those small U.S. partners are already not subject to these inclusion regimes.[50]

Also, regulations issued in 2016 under section 385 have significantly reduced the ability of a partnership inversion to achieve both deferral and a single layer of U.S. tax in the manner described above.[51] The section 385 regulations generally recharacterize a debt instrument of a domestic corporation as equity for U.S. tax purposes if it is distributed to a foreign parent or otherwise transferred to the foreign parent or a foreign affiliate in a transaction that has the same economic effect as a distribution.[52] Interest payments on a debt instrument recharacterized as equity under the section 385 regulations are treated as nondeductible dividends for U.S. tax purposes. Importantly, although these regulations address the tax benefits from partial inversions, the section 385 regulations apply to all foreign-parented groups, not just groups that have completed a partial inversion. Several other changes since 2004 have also limited the ability of foreign-parented groups to earnings strip U.S. profits, such as the BEAT and sections 163(j) (interest deduction limitations)[53] and 267A (the anti-hybrid rules), in addition to an overall compression of worldwide corporate tax rates after 2017.

2. Foreign Partners

For foreign partners, the benefit of a partnership inversion is not deferral but rather possible elimination of U.S. tax on U.S.-source income. As noted above, foreign partners are not subject to tax on their distributive shares of foreign-source, non-ECI but are subject to tax on their distributive shares of ECI and U.S.-source FDAP income. In general, if a domestic partnership were to transfer assets that produce U.S.-source FDAP income or ECI to a foreign corporation, this transaction would generally just change who is subject to U.S. tax on that income, not how much income is subject to U.S. tax.[54] However, as discussed earlier, a partnership inversion could facilitate the erosion of the U.S. tax base through, for example, further incorporating U.S. trade or business assets into a domestic subsidiary capitalized with related-party debt. But, as discussed below, the promulgation of the section 385 regulations and other anti-base-erosion measures limits the ability to use related-party leverage to erode the U.S. tax base.

Recent changes in the tax law have bolstered the conclusion that foreign partners cannot eliminate U.S. tax by incorporating a partnership. For example, under prior law, foreign partners could sell their interests in a partnership with a U.S. trade or business to a foreign corporation without being subjected to U.S. tax on their gain.[55] Assuming a section 754 election is made for the partnership, that transaction could result in a basis step-up for ECI-generating assets, thus reducing future U.S. tax revenue. That changed, however, with the enactment of section 864(c)(8) in the TCJA, which ensures that any asset step-up resulting from the sale of a partnership interest is taxable to the extent that gain is attributable to the partnership's ECI assets.

[49] *See* reg. section 1.958-1(d)(1).

[50] Note that the foreign incorporation of a domestic partnership could still have a benefit for U.S. shareholders of the CFCs of the domestic partnership. As discussed above, a foreign corporation wholly owned by a domestic partnership is still a CFC. *See* reg. section 1.958-1(d)(2)(ii). Thus, a U.S. shareholder of a foreign subsidiary of a domestic partnership includes that foreign corporation's income under subpart F or GILTI. If the domestic partnership incorporates into a foreign corporation and liquidates, the U.S. shareholder will no longer be subject to the inclusion rules for the foreign parent unless U.S. shareholders, in the aggregate, own more than 50 percent (by vote or value) of the foreign parent after the transaction.

[51] *See* T.D. 9790.

[52] *See* reg. section 1.385-3.

[53] The worldwide interest limitation of section 163(n), proposed in the Build Back Better Act, would further limit the ability to earnings strip through interest payments.

[54] Like a domestic corporation, a foreign corporation may be eligible for lower rates of tax under section 11 than individual partners would pay under section 1. The foreign corporation may also be subject to branch profits tax (potentially at a 30 percent rate) on its effectively connected earnings and profits under section 884.

[55] *See Grecian Magnesite Mining, Industrial and Shipping Co. SA v. Commissioner*, 149 T.C. 63 (2017).

3. Takeaways for Partnership Inversions

In sum, changes in law since 2004 have substantially limited the ability to reduce taxes through an inversion of a domestic partnership. In our view, these observations counsel a reconsideration of the inclusion of domestic partnerships in the rules of section 7874, not an expansion of the section 7874 rules applicable to partnerships. If the primary policy rationale underlying the Senate proposal is to create parity between domestic and foreign partnerships, we would support that goal.[56] But in light of the policy discussion above, coupled with the results illustrated in the examples below, we believe this parity is better achieved by instead removing partnerships entirely from the scope of a domestic entity acquisition and adopting an aggregate approach to partnerships for purposes of section 7874. This approach would be consistent with the recent trend in Treasury guidance on the subpart F, GILTI, and PFIC regimes, as well as some changes proposed elsewhere in the Build Back Better Act (for example, the treatment of partnerships as aggregates of their partners for purposes of section 163(j)(4)).[57]

If the government believes that even after these recent developments, partnership inversions can still facilitate the erosion of the U.S. tax base, based on our examination above, that potential is generally limited to the deferral (for U.S. partners) or erosion (for foreign partners) of income attributable to a U.S. trade or business. Any concerns in this regard should be addressed through targeted legislative changes, such as amendments to the BEAT, instead of an overbroad application of section 7874.

In addition to the policy questions discussed above, we believe the partnership proposals could have adverse practical effects for the United States. For example, foreign partnerships will be used whenever possible to avoid the risk of a future foot fault under section 7874. This shift will result in decreased information reporting on Form 1065, "U.S. Return of Partnership Income," because foreign partnerships generally do not have to file a return absent U.S.-source FDAP income or ECI.[58] Moreover, the proposed expansion of section 7874 to foreign partnerships raises questions about how the U.S. government would be able to enforce those rules when, for example, a foreign corporation with minimal U.S. nexus and predominant foreign ownership is deemed to be a domestic entity.

C. Corporate Trade or Business Acquisitions

In contrast to the discussion above regarding partnerships, we better understand the policy rationale for the expansion of section 7874 to a foreign corporation's direct or indirect acquisition of substantially all the properties directly held by a domestic corporation and constituting a trade or business.[59] Specifically, some spinoff transactions described under section 355 may have the effect of removing foreign earnings from the U.S. corporate tax base while not giving rise to an acquisition of "substantially all" of the domestic corporation's properties. Although this policy rationale may be understandable, we believe that it does not justify the expansion of the domestic entity acquisition concept.

For example, suppose that a domestic corporation (USD) operates domestic Business A, worth $70x, and foreign Business B, worth $30x. If USD were to contribute Business B to a newly formed foreign corporation (FC) and distribute that stock to its shareholders, that transaction may qualify as a spinoff under sections 368(a)(1)(D) and 355 without resulting in an acquisition of substantially all of USD's assets by FC (which would be subject to section 7874 under current law). After the spinoff, USD no longer owns the stock of FC, so FC's future earnings would no longer be subject to U.S. tax under section 951 or 951A.

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[56] Another potential policy goal underlying the Senate proposal is to create parity between domestic corporations and partnerships, which — for the reasons discussed above — may be inappropriate.

[57] For an argument that partnerships should be treated as aggregates of their partners for purposes of section 7874, see Scanlon et al., *supra* note 1.

[58] Section 6031(e)(2).

[59] The rationale for the expansion of the definition of domestic entity acquisition to include a foreign corporation's direct or indirect acquisition of substantially all the properties *indirectly* held by a domestic corporation or a domestic partnership and constituting a trade or business is more difficult to understand. *See, e.g.*, *Hamrick v. Commissioner*, T.C. Memo. 1979-72 ("It is a well settled principle that a shareholder has a separate identity from the corporation and that the business of a corporation is not the business of its shareholders or officers.") (citing *Dalton v. Bowers*, 287 U.S. 404 (1932); and *Burnet v. Clark*, 287 U.S. 410 (1932)).

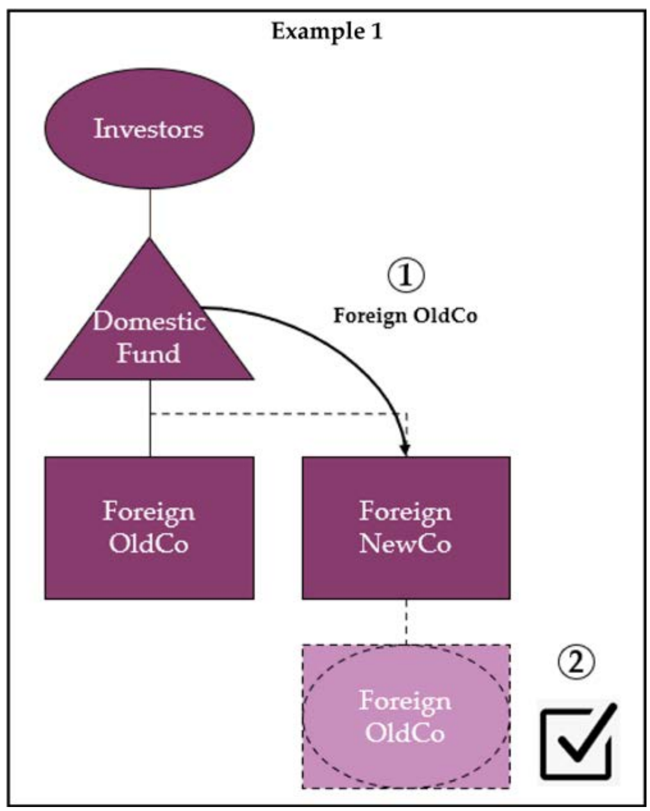
However, the potential for tax avoidance in this transaction does not seem significant. Under current law, the pre-spinoff transfer of the Business B assets to FC would be fully taxable to USD under section 367, and the gain recognized by USD economically should equal the net present value of the future net earnings of Business B.[60] In effect, section 367 would tax USD as if it had sold the Business B assets to a foreign acquirer. Thus, any U.S. tax benefit obtained by USD/FC as a result of this transaction would likely be outweighed by the upfront tax cost.

V. Examples

In addition to the policy concerns discussed above, the Senate proposal, in conjunction with the existing regulatory framework under section 7874, can produce counterintuitive and inappropriate results. We discuss four examples below.[61] For each example, assume that after the relevant domestic entity acquisition, the EAG does not have substantial business activities in the foreign acquiring corporation's country of organization.[62]

These examples illustrate three basic concerns with the Senate proposal as they would interact with existing regulations. First, the regulations do not include rules that apply the EAG-owned-stock rules, including the internal group restructuring exception, to foreign acquiring corporation stock owned by partnerships. Second, they do not exclude foreign acquiring corporation stock received for cash (and other nonqualified property) from the numerator of the ownership fraction as they do from the denominator. Third, for an acquisition of substantially all of a trade or business of a domestic corporation or partnership, the regulations would treat all the foreign acquiring corporation stock directly or indirectly received — or deemed received under regulations (for example, under the NOCD rule) — by the owners of the domestic corporation or partnership by reason of their interest in that domestic corporation or partnership as "by reason of stock." It would thus be included in the numerator of the ownership fraction, even if only a fraction of the entity's assets acquired by the foreign acquiring corporation consisted of those trade or business assets.

Example 1: Indirect acquisition of the assets of a domestic partnership. A group of investors holds all the outstanding interests of Domestic Fund, a domestic partnership for U.S. tax purposes. Domestic Fund owns 100 percent of the stock of Foreign OldCo, a foreign corporation for U.S. tax purposes organized in Country X. The stock of Foreign OldCo is the sole asset of Domestic Fund. For valid business reasons (and unrelated to any U.S. tax considerations), the management of Foreign OldCo decides to form a holding company to hold the stock of Foreign OldCo. To set up this new structure, Domestic Fund contributes all its Foreign OldCo stock to Foreign NewCo, a foreign corporation also organized in Country X, in exchange for all the stock of Foreign NewCo. Immediately after the contribution, Foreign OldCo files a valid and timely entity classification election to be treated as a disregarded entity for U.S. tax purposes.



[60] If instead of spinning off a newly formed foreign corporation, USD were to spin off an existing foreign corporation, USD would recognize gain on its stock in that existing foreign corporation under section 367(e).

[61] These examples are derived, in whole or in part, from presentations at the 2022 American Bar Association Midyear Meeting (February 2022) by Scott Levine and Natan Leyva.

[62] *See* reg. section 1.7874-3 (requiring at least 25 percent of the EAG's employees, assets, *and* income to be located or earned in the foreign country in which, or under the law of which, the foreign acquiring corporation was created or organized and is a tax resident).

This transaction depicts a foreign-to-foreign reorganization under section 368(a)(1)(F) — that is, a mere change in the identify, form, or place of organization of a corporation. Under current law, this transaction would not trigger an inversion. It is treated as though Foreign OldCo transferred all its assets to Foreign NewCo in exchange for Foreign NewCo stock and then liquidated, distributing the Foreign NewCo stock to Domestic Fund in cancellation of Domestic Fund's Foreign OldCo stock.[63] By virtue of this deemed fiction (and consistent with decades of Treasury, IRS, and judicial authorities), Foreign NewCo is not considered to acquire anything from Domestic Fund. There is no domestic entity acquisition (and therefore no inversion).

But under the Senate proposal, the F reorganization would appear to be a domestic entity acquisition. The Senate proposal would expand a domestic entity acquisition to include the direct *or indirect* acquisition of substantially all the properties held directly or indirectly by a domestic partnership. Foreign NewCo acquires all the assets of Foreign OldCo, which were *indirectly* held by Domestic Fund and represent all the assets held directly or indirectly by Domestic Fund.

Moreover, this domestic entity acquisition would appear to satisfy the ownership test. This test asks how much of the stock of Foreign NewCo, the foreign acquiring corporation, is held by reason of holding an interest in Domestic Fund, the domestic entity. For this purpose, the regulations deem the investors to hold the stock of Foreign NewCo received by Domestic Fund by reason of holding interests in Domestic Fund.[64] Therefore, the investors would be deemed to own all the stock of Foreign NewCo by reason of holding interests in Domestic Fund, so the ownership percentage would be 100 percent.

This transaction would appear to be the paradigmatic case for the application of the internal group restructuring exception, which is intended to ensure that purely internal transactions in which the common parent corporation does not change are not subject to section 7874.[65] But the EAG-owned-stock rules, including the internal group restructuring exception, can apply only to disregard foreign acquiring corporation stock held, directly or indirectly, by another member of the EAG. For this purpose, a partnership is treated as an aggregate of its partners and cannot itself be a member of the EAG.[66] Therefore, the internal group restructuring exception cannot apply to stock owned by a domestic partnership that is not itself owned by one or more EAG members. As Example 1 illustrates, because of the limitations of the EAG-owned-stock rules, the proposed changes to section 7874 could trigger complete inversions even in the most benign internal restructurings.[67]

Accordingly, in Example 1, the ownership percentage would be 100 percent, and Foreign NewCo would be treated as a domestic corporation for U.S. tax purposes.

Example 2: Direct acquisition of non-trade-or-business assets of a domestic partnership. Suppose the investors would like to acquire a 5 percent interest in Foreign NewCo, a foreign corporation, for $5x. They carry out this acquisition by forming New Domestic Fund, a domestic partnership for U.S. tax purposes, and transferring a total of $5x to New Domestic Fund in exchange for equity in New Domestic Fund. New Domestic Fund transfers $5x to Foreign NewCo for 5 percent of the Foreign NewCo stock. Other investors transfer $95x to Foreign NewCo

[63] *See* reg. section 1.367(b)-2(f); *see also TBL Licensing LLC v. Commissioner*, 158 T.C. No. 1, at 25 (2022) (regarding the counterpart provision in reg. section 1.367(a)-1(f) for outbound F reorganizations, the Tax Court held that the provision "simply clarifies that the construct that necessarily applies to an F reorganization to allow for the application of the operative nonrecognition provisions of sections 354 and 361 applies without regard to whether the transaction is 'inbound, outbound, [or] foreign to foreign'").

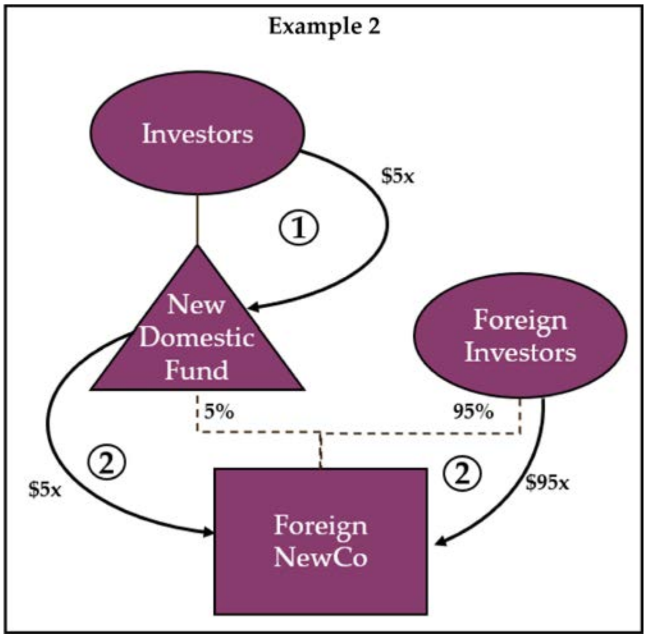
[64] *See* reg. section 1.7874-2(f)(1)(iii).

[65] *See* T.D. 9238 (in adopting the EAG-owned-stock rules, including the internal group restructuring exception, Treasury and the IRS explained that "Congress intended that the affiliate-owned stock rule could operate in specified situations to prevent the section from applying to certain transactions occurring within a group of corporations owned by the same common parent corporation before and after the transaction, such as the conversion of a wholly owned domestic subsidiary into a new wholly owned controlled foreign corporation. *Id.* In the absence of this rule, section 7874 could apply to internal group restructuring transactions involving the transfer of a wholly owned domestic corporation (or its assets) to a wholly owned foreign corporation, without a change in the parent corporation of the group.").

[66] *See* reg. section 1.7874-1(f).

[67] Note that minor changes in the legal form of a foreign entity (*e.g.*, converting from a Brazilian *sociedade anonima* to a *limitada*) could trigger the result described in this example.

in exchange for 95 percent of the Foreign NewCo stock.



This transaction, a straightforward cash investment in a foreign corporation, does not seem like it should trigger an inversion. Indeed, under current law, it does not, because Foreign NewCo does not acquire assets from New Domestic Fund constituting a trade or business; it acquires only cash.

Under the proposed changes to section 7874, this transaction would be a complete inversion. The transfer of $5x of cash by Domestic Fund to Foreign NewCo would result in a domestic entity acquisition because a domestic entity acquisition includes the direct or indirect acquisition of substantially all the properties held directly or indirectly by a domestic partnership, regardless of whether those assets constitute a trade or business. Foreign NewCo acquires 100 percent of New Domestic Fund's "properties" (that is, the $5x of cash).

The other requirement for a complete inversion, the ownership test, would also be met. The stock of Foreign NewCo held by New Domestic Fund would be treated as stock of a foreign corporation held by reason of holding an interest in a domestic partnership.[68] Further, the stock owned by New Domestic Fund would be treated as the only stock of Foreign NewCo outstanding for computing the ownership percentage, because the cash contribution of $95x by the other investors would be treated as disqualified stock (because it was issued in exchange for cash, which is disqualified property) and thus excluded from the denominator of the ownership fraction.[69]

The stock held by New Domestic Fund is not excluded from the ownership fraction, even though that stock is also attributable to disqualified property — namely, the investors' $5x cash contribution.[70] In this regard, the existing regulations do not treat cash (or other nonqualified property) contributed to a foreign acquiring corporation *by* a domestic entity like cash contributed to the foreign acquiring corporation by other persons. That is, the disqualified stock rule is a one-way street: It can reduce only the denominator of the ownership fraction; it can never reduce its numerator.[71] The proposed changes to section 7874 would exacerbate this problem.

In short, under the proposed changes to section 7874, by acquiring $5x from New Domestic Fund, Foreign NewCo would be treated as a domestic corporation.

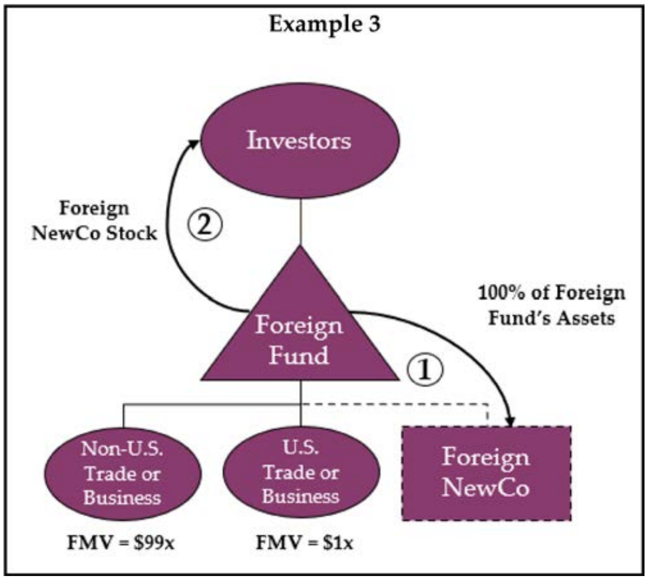
Example 3: Incorporation of a foreign partnership with a de minimis U.S. trade or business. Now suppose that the investors own all the interests in Foreign Fund, a foreign partnership for U.S. tax purposes. Foreign Fund owns assets used in both a U.S. and non-U.S. trade or business. The assets used in the non-U.S. trade or business are valued at $99x and worth much more than the U.S. trade or business assets, which are valued at only $1x. Foreign Fund decides to incorporate by contributing all its assets to Foreign NewCo, a foreign corporation, in exchange for 100 percent of the stock of Foreign NewCo, and then distributing the shares of Foreign NewCo to its partners in a liquidation.

[68] *See* reg. section 1.7874-2(f)(1)(iii).

[69] *See* reg. section 1.7874-4(c)(1)(i) and (h)(2)(i).

[70] If it were, the ownership fraction would be 0/0, which the IRS has interpreted to not be at least 60 percent for purposes of the ownership test. *See* LTR 201432002.

[71] *Cf.* reg. section 1.7874-2(h) (treating "in the money" options as equity of the domestic entity or the foreign acquiring corporation, as applicable).



The investors might not think to ask their U.S. tax advisers about this transaction because Foreign Fund, before the transaction, and Foreign NewCo, after the transaction, have such a minimal connection with the United States. Indeed, today this transaction would not trigger an inversion. Under current law, only an acquisition of or from a domestic corporation or domestic partnership can give rise to a domestic entity acquisition (and therefore could trigger an inversion). Foreign Fund, in contrast, is a *foreign* partnership, and it transfers solely non-stock assets. Current section 7874 does not apply to acquisitions of property from a foreign partnership.

The Senate proposal would expand the concept of a domestic entity acquisition to include the acquisition of substantially all the properties held directly or indirectly by a foreign partnership and constituting a U.S. trade or business. Foreign NewCo is doing that in this example: Foreign NewCo is acquiring all the assets of Foreign Fund's U.S. trade or business, even though those assets are de minimis relative to all the assets contributed to Foreign NewCo.

It would be reasonable to expect that the ownership percentage here would be low, below even the reduced thresholds in the Senate proposal, because not much of the stock of Foreign NewCo would be received by the investors by reason of their indirect interest in a U.S. trade or business. But the Senate proposal does not distinguish between stock received in exchange for U.S. trade or business assets of the partnership and stock received in exchange for other assets of the partnership.[72] Without that mechanism, all the stock received by the partners of Foreign Fund would be treated as stock received "by reason of" their interest in Foreign Fund, so the ownership percentage would be 100 percent, even though only a small component of the stock was received in exchange for the U.S. trade or business assets.[73]

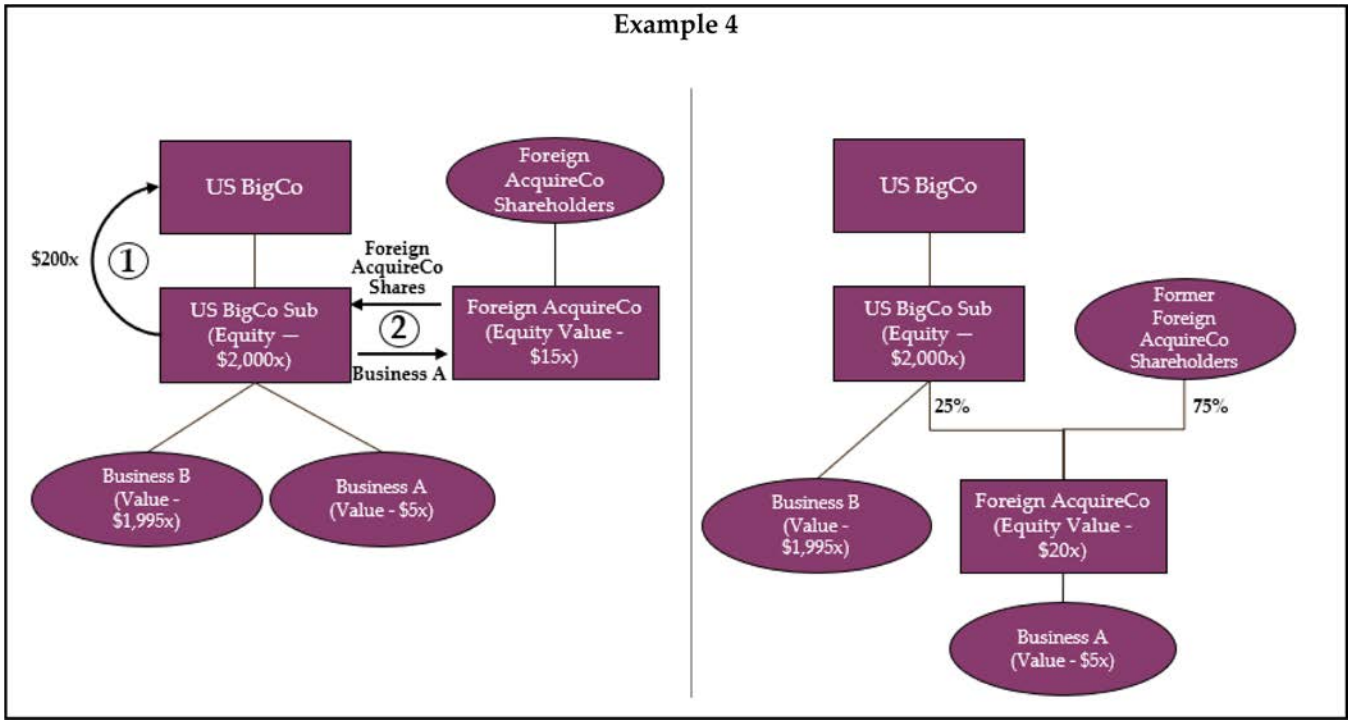
As a result, Foreign NewCo would be treated as a domestic corporation for U.S. tax purposes.

Example 4: NOCDs unrelated to the acquired trade or business. Suppose that US BigCo and Foreign AcquireCo wish to combine their two complementary business units: US BigCo's Business A (with a fair market value of $5x) and Foreign AcquireCo's larger business (with an FMV of $15x). For valid business reasons (and unrelated to any tax considerations), the managements of US BigCo and Foreign AcquireCo decide that US BigCo will receive 25 percent of the post-combination stock in Foreign AcquireCo as consideration for Business A.

Business A is owned by US BigCo Sub, which also owns another business unit (Business B, with a value of $1,995x) that is much larger than Business A and has generated substantial cash over the years. In a prior year, in a transaction unrelated to the Business A combination, US BigCo Sub paid a $200x cash dividend to US BigCo. Assume that US BigCo Sub made no other distributions before the transaction. Therefore, because of the mechanical application of the NOCD rule in reg. section 1.7874-10, the entire $200x distribution is treated as an NOCD.

[72]The proposal provides that the ownership fraction is met if after the acquisition of substantially all the properties held directly or indirectly by a foreign partnership and constituting a U.S. trade or business, "more than 50 percent of the stock (by vote or value) of the entity is held . . . by former partners of the foreign partnership by reason of holding a capital or profits interest in the foreign partnership." Prop. section 7874(a)(2)(C)(iii).

[73]Moreover, as discussed in more detail above, the EAG-owned-stock rules, including the internal group restructuring exception, do not apply to stock received by a partnership or individuals.



Under current law, Foreign AcquireCo's acquisition of Business A would not result in a domestic entity acquisition because Business A is not substantially all the properties of US BigCo Sub.

Under the proposed changes to section 7874, however, a domestic entity acquisition would include the direct or indirect acquisition of substantially all the properties held directly or indirectly by a domestic corporation *and constituting a trade or business*. Because the acquisition of Business A is the acquisition of *all* the properties constituting the Business A trade or business of US BigCo Sub, this acquisition appears to be treated as a domestic entity acquisition.

As in the prior examples, we must look at the ownership percentage to determine whether Foreign AcquireCo is completely or partially inverted. Without regard to the NOCD rule, the ownership percentage is zero. Although US BigCo Sub receives 25 percent of the equity of Foreign AcquireCo in the transaction, US BigCo Sub retains those shares, so US BigCo, the sole shareholder of US BigCo Sub, receives none of those shares "by reason of" its shares in US BigCo Sub. US BigCo Sub, however, has an NOCD of $200x. Therefore, the existing rules treat US BigCo as receiving Foreign AcquireCo stock in exchange for its US BigCo Sub stock (that is, "by reason of stock") with a value (but not vote) in an amount equal to the $200x NOCD.[74] Importantly, no existing rule would trace the NOCD to the assets acquired or otherwise limit the amount of "by reason of stock" if less than all the assets of the domestic entity are acquired. The ownership fraction, therefore, would be $200x/$220x (NOCD shares/actual shares *plus* NOCD shares), or approximately 91 percent.[75] As a result, Foreign AcquireCo would be treated as a domestic corporation for U.S. tax purposes.

Under current law, the failure of the NOCD rule to trace NOCDs to assets actually acquired already arises in the context of a domestic partnership, in which a domestic entity acquisition can occur by reason of the acquisition

[74]While there is no actual "by reason of stock" in this example regarding the NOCD rule, the example would not satisfy the de minimis exception to the NOCD rule because US BigCo, a "5 percent former equity holder" of US BigCo Sub before the transaction, owns more than 5 percent of the stock of Foreign AcquireCo after the transaction. *See* reg. section 1.7874-10(d).

[75]A technical question arises whether the existing regulations under reg. section 1.7874-10(h) would apply to the new acquisition categories introduced in the Senate proposal, in lieu of a more reasonable allocation method based on the relative size of the acquired business. For purposes of the analysis here, we have assumed that the current regulations would apply.

of substantially all of a single trade or business. The expansion of the definition of a domestic entity acquisition to include the direct or indirect acquisition of (1) substantially all the properties held directly or indirectly by a *domestic corporation* constituting a trade or business and (2) substantially all the properties held *indirectly* by a domestic partnership constituting a trade or business would significantly increase the importance of this issue, because it would increase the number of situations in which deemed "by reason of stock" created by the NOCD rule could cause an inversion even though the acquired trade or business did not (or could not from an economic perspective) directly or indirectly support the NOCDs, constituting a trade or business.

VI. Conclusion

The examples above illustrate situations in which the proposed changes to the definition of a domestic entity acquisition would pull innocuous transactions into the scope of section 7874. These examples represent a few of the much broader set of common business transactions that could be negatively affected. Moreover, we strongly believe that the policy rationale underlying some of these rules should be reassessed in light of changes to U.S. law since 2004, particularly in the partnership context, in which aggregate principles are more appropriate. After a thorough reexamination of the role of section 7874 under current law, a more tailored approach should be considered.

We believe that the Senate proposal should not be enacted into law. If, however, the Senate proposal were carried forward, we believe the following changes might address some of the overinclusiveness of the proposals:

1. Treat partnerships as members of the EAG solely for purposes of the EAG-owned-stock rules, including the internal group restructuring exception.
2. Restrict partnership inversions to acquisitions of properties owned directly by the partnership, consistent with current law.
3. Restrict partnership inversions to acquisitions of substantially all the properties constituting a U.S. trade or business of the partnership, thus conforming the treatment of domestic and foreign partnerships.
4. Provide that the acquisition of properties of a foreign corporate subsidiary does not give rise to an acquisition of the properties of a trade or business of a domestic corporation that directly or indirectly owns the foreign subsidiary.
5. Provide that property is not acquired from a domestic corporation for purposes of determining whether there is a domestic entity acquisition if (1) that property is acquired, directly or indirectly, from the domestic corporation by a foreign acquiring corporation, and (2) the domestic corporation does not directly or indirectly transfer stock of the foreign acquiring corporation to its shareholders under the same plan or series of related transactions as the acquisition.
6. Provide that for an acquisition of substantially all of a trade or business of a domestic corporation or partnership, the amount of the foreign acquiring corporation stock directly or indirectly received, or deemed received under regulations (for example, under the NOCD rule), by the owners of the domestic corporation or partnership by reason of their interest in that domestic corporation or partnership is treated as "by reason of stock" and is thus included in the numerator of the ownership fraction, only to the extent of the relative value of the properties in the relevant trade or business acquired by the foreign acquiring corporation compared with the aggregate value of all properties of that entity acquired by the foreign acquiring corporation.[76]
   a. Thus, for example, if a foreign partnership transfers all its assets to a foreign corporation, and only 1 percent of the partnership's assets are

[76]*Cf.* reg. section 1.7874-2(f)(2)(ii) (treating foreign acquiring corporation stock received in exchange for interests in a domestic entity and other property as "by reason of stock" in proportion to the value of the interests in the domestic entity compared with the value of those interests and the other property).

a. [continued] used in a U.S. trade or business, only 1 percent of the foreign corporation's stock should be treated as "by reason of stock."

b. Similarly, if a domestic corporation transfers a trade or business representing only 30 percent of its assets to a foreign corporation, only 30 percent of its NOCDs should give rise to "by reason of stock."[77]

In any case, if a proposal similar to the Senate proposal is adopted, we urge that the legislative history include a comprehensive discussion of the reasons for those changes, as well as the purpose for applying section 7874 to partnership inversions in the first place. That legislative history would be beneficial to Treasury and the IRS in administering these rules, including in drafting regulations, and to taxpayers in complying with them. As of now, both the government and taxpayers are operating in the dark.

Also, to the greatest extent possible, any changes made to expand the operation of section 7874 should be narrowly tailored, rather than broad and self-executing, to address congressional concerns, and they should address the issues raised above regarding their interaction with existing regulations. Even if Treasury and the IRS could be expected to issue regulations that would limit the application of those rules and coordinate them with existing regulations, broad, self-executing rules could have a significant negative effect on cross-border merger and acquisition activity in the interim between passage of the law and promulgation of the regulations. Given the numerous regulatory demands that would accompany the passage of the Build Back Better Act (or similar comprehensive legislation), this interim period could be long. Alternatively, any statutory changes could be made effective only upon the exercise of the Treasury secretary's authority to issue regulations.

Given the history and politics regarding section 7874, we appreciate the desire of Congress and the Biden administration to take action against inversions. And we do not pretend that the current version of section 7874 represents the Platonic ideal of an anti-inversion rule. But we caution against expanding section 7874 so that it affects benign cross-border transactions with little or no potential for U.S. base erosion. In this regard, based on our experience, the numerous changes to the tax landscape since 2004 have effectively halted inversion activity. Thus, any further expansion of these rules — Inversion 2.0 — can have only a deleterious effect on legitimate, non-tax-motivated cross-border mergers and acquisitions transactions, while presenting few net benefits to the U.S. fisc.[78] ■

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[77] If properties of more than one trade or business of a domestic corporation or partnership are acquired under a plan or series of related transactions, a rule similar to the multiple domestic entity rule in reg. section 1.7874-2(c) could apply to treat all the properties acquired as part of a single relevant trade or business for purpose of this rule.

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